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Some issues of the European Unification  
and their monetary impacts on the Egyptian  
Pound (An Overview)

By

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And Their Monetary impacts On The Egyptian Pound  
(An Overview)**

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(1) INTRODUCTION

The European community has made enormous progress on the road to European economic and monetary union during the last few years. One recalls the community's efforts in the so-called Werner Plan at the end of the sixties. A second attempt in 1988 (\*), took a different course. Two years later on July 1, 1990, stage one of the European economic and monetary union began. The institutional stage would begin with the establishment of a European system of Central Bank (Eurofed). In October 1990, the heads of state and

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\* These efforts began optimistically but soon founded in the turmoil arising from the collapse of the Bretton woods system. A second attempt was in hanover 1988 (the meeting of the heads of states and government was in 1988). Delors Report in April 1989 has added weight to the striving for monetary integration. This implies co-ordination of monetary policy instead of central banks competition which envisage the final transition to single European currency within the framework of the three stage scheme.

Also According to the decisions of the intergovernmental conference in Meastricht, it will not be determined until the end of 1996 which member states of the European community meet the requirements for entry to a European Monetary Union which relate to the permitted rate of inflation, net new government borrowing and the level of public debt. Only if at least seven countries are ready and able to set up the monetary union will a European Central bank be established in 1997. If that does not occur, the European Monetary Union will come into force by the end of 1998 at the latest.

About this historical background see, Balassa, B. and Resnick, S., Monetary Integration and the consistency of policy objectives in the European common Market, Weltwirtschaftliches Archiv, Review of World Economics, Helf 4, 1974, PP. 564-565.

Berthold, Norbert, Europe after Maastricht: Have the Monetary Questions been setted?, Intereconomics, March/April 1992, PP. 51-69.

government commissioned two intergovernmental conferences to draft the necessary changes to the treaty Rome for establishing an economic and monetary union so that they could be ratified by the respective parliaments by the end of 1992.

At the end of October 1990, the European council decided to begin the second stage of monetary unification at the beginning of 1994. The treaty would be amended. At the second stage to the final stage of Economic and Monetary Union, the practical experience of collective behaviour is gained. During this stage monetary policy guidelines would be elaborated on the basis of majority decisions in the European System of central banks, but they would not yet be binding. Currency reserves might also be jointly managed. The European system of central banks could also have to take over regulatory functions in the field of monetary policy and banking policy. At the third or final stage a transition to a single European Currency should be envisaged. The key concept in the British proposals is to introduce the hard ECU as the thirteenth currency in the European Monetary System (EMS). The precondition for fixed exchange rates namely price stability is not sufficiently met and is inadequately anchored as a community objective. Therefore the hard (ECU) <sup>(1)</sup> would be a fully fledged currency without the connotations of a unit based on a basket of currencies, it would be integrated into the (EMS) parity grid with margin of fluctuation of 2.25%. Its most important feature would

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<sup>1</sup> File, Wolfgang, A "Hard: or "Hardened" ECU for Europe? Intereconomics, July/August 1991, PP. 167-172.

be a no-devaluation guarantee, whereas the basket - based (ECU) reflects the weighted average of inflation rates in the countries concerned, the hard (ECU) would be harnessed to the strongest currency, (D-Mark). In contrast to the present (ECU) which has depreciated by 18% <sup>(1)</sup> against the Deutsche Mark since its creation, this artificial currency is not to be depreciated against the hardest of the (ECU) currencies. The determination of interest rates for the hard (ECU) should be independent and different from those in national economies. These ideas raised a lot of conflicts about some issues:

First, Acting as a worldwide alternative to the dollar, Yen and Mark, how would the fluctuations in dollar be dampened by the (ECU)? given the fact that D-Mark fluctuates more strongly against the dollar than the other currencies.

Second; In a system of fixed exchange rates countries have to face a special problem in the case of large capital movements: the burden of adjustment to capital movement lies solely on interest rates, whereas in a floating rate system exchange rate movements help to cushion the effects. In a fixed exchange rate system international disturbances have direct repercussions on domestic interest rates. The only possibility for a country trying to avoid large fluctuations in its interest rates in the absence of capital controls would be to de-and revalue repeatedly its currency which runs counter to a fixed exchange rate

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<sup>1</sup> Filc..., Ibid, P. 157.

system. Thus capital controls are used to drive a wedge between domestic and foreign asset markets and thereby prevent domestic interest rates from fluctuating too strongly. Therefore, the existence of capital controls has contributed to relative exchange rate stability in the absence of monetary and fiscal policy convergence in the EMS.

Third: Given the D-Mark is the key and anchor currency in the EMS and the design of the hard ECU such that the ECU would never depreciate against the D-Mark as the most stable EMS currency, interest rates on the financial assets dominated in ECU would have to be the same for comparable financial assets in Germany, and in opting for an investment in ECUs, investors from countries with weak currencies would be compensated for the interest rate disadvantage by the expectation of an appreciation of the ECU and investors from countries with strong currencies would be seeking for an interest rate advantage as a premium for the risk of a future depreciation of the ECU.

The paper addresses itself to the question of whether exchange rate stability could be ensured within the European Monetary Unification EMU under recent period conditions given differences in national objectives and economic structures among the member countries. Further more in the argument about the world monetary order there is agreement that greater stability in international currency relationships would be desirable. To illustrate what are the problems before such Monetary Unification when operating fixed exchange rates, the following paper will assume that the international monetary system will comprise the US

dollar, the Japanese Yen and the Deutsche Mark, the three most important trading, financial and reserve currencies. Therefore the future of the EMS would be governed by the role of the Deutsche Mark and priority of Monetary stability and adjustment problems in Germany, and the path of both the dollar and Yen in the World Market.

In addition, there are factors underlying the relationship between Egypt and EMU which make us believe that some monetary impacts are forthcoming. The present paper intends to shade some lights on them.

As for Egypt, US\$, D. Mark, ECU, J. Yen and Sterling pound are international reserve currencies. They are affected by international portfolio shifts because they are seen by investors as alternative reserve currencies to the dollar. Moreover, the Egyptian pound is pegged to the dollar currency. At present, it is a managed floating exchange rate, i.e. determined mainly by the supply and demand forces. This means that as the dollar depreciates in the world market against the other international currencies, the Egyptian pound is consequently depreciated.

Foreign capital flows to Egypt are institutionally controlled. In addition, capital and financial asset markets have been recently developed. Transacting most of foreign trade in Egypt is in dollars. Recently, there has been a liberalization for the domestic interest rate. The present real interest rate is positive, and it is claimed that the interest rate is in harmony with the inflation rate which is estimated to be around 10%. There is a wide margin between the domestic interest rate for the Egyptian pound and the



international interest rates for dollar, Mark and Yen by more than 6 points. At present, the economic policy in Egypt is encouraging the stability of the exchange rate system and keeping the level of the domestic interest rate as high as possible in order to avoid the reverse substitution into dollars. The international reserve currencies are estimated to be around sixteen billion Dollars.

Concisely, the main enquiries of the paper would be: What is the role of the Deutsche Mark in achieving the monetary stability and what effects is this likely to have with the German re-unification?. The answers to these questions depend at least on whether the exchange rate policies they pursued previously were compatible with the other main currencies in the world: Yen and Dollar and the prospects and trends of these currencies. We shall therefore examine these aspects before considering the question of monetary areas of impact on Egypt. To assess these impacts, the stability of the pound exchange rate, the level and composition of international reserve currencies and the ECU's situation in Egypt are considered.

## (2) The Role of the Deutsche Mark and Priority of Monetary Stability:

Member states can no longer pursue autonomous monetary policies once capital movements are completely liberalized and exchange rates ultimately fixed. As long as, exchange rate fluctuations are still possible, national monetary policies retain a certain amount of latitude in principle. This will be limited to

maintain fixed exchange rates. The exchange rate variability has ebbed since the inception of the system (for real and nominal rates). The trend to stability has gathered strength in recent years. Over the short term, since the system's inception, European currencies have varied four times less than the major floating currencies. There have been eleven realignments since implementation of the EMS, the Deutsche Mark has appreciated by more than 30% of the French Franc in ten <sup>(1)</sup> years. Two main points should be born in mind:

1. The stability of the Exchange rate relationships between the parities of the system has profited from the decline in inflation rates and inflationary expectations. Excessive Exchange rate fluctuations which continually recur above all in the case of important floating currencies such as the US dollar and the sterling Pound have not happened within the EMS.
2. The EMS currencies continue to react under the influence of the US dollar rate, in different ways. This varying assessment of the currencies in the markets is an indication that, the convergence of economic and financial policies still leaves something to be desired. The consequence of this is that some of the partners have to live with high interest rates to defend their exchange rates.

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<sup>1</sup> Leon Hard Gleske, EMS Ten years on: Assessment and outlook, Monetary Integration has made progress, Intereconomics, March/April, 1980.

## IS The EMS An Engine of Inflation?

Germany's inflation rate has come down steadily from 6.3% in 1981 to 0.2% in 1986 and the behaviour of prices in the other EMS countries has a similar improvement. The average inflation rate for countries participating in the exchange rate mechanism of the EMS was only 2.6% in Sept. 1988 with a range of variance of 3.9% <sup>(1)</sup> points (from 0.9% of Netherlands to 4.8% in Italy).

It will be essential to enhance the credibility of member countries monetary policy from the point of view of stability. Real interest rates between 1% and 1,5% above German rates indicates that such credibility has not yet been achieved everywhere. Germany will have to play a more prominent role as an engine of growth in Europe although this is not a task that can be performed using monetary policy instruments. This dual strategy of stability and growth should ease the conflicts that have repeatedly beset the EMS. Exchange rate realignments will continue to be necessary at least because of the realization of the internal market and the economic structural change that will entail the central banks ought to be given prominent role in this context. The time does not yet appear ripe to set permanently fixed exchange rates and to get over to a single currency.

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<sup>1</sup> Leo, ... Ibid., P.61.

## International Complication:

The EMS (\*) is widely viewed as a system of managed exchange rates in which the Deutsche Mark DM effectively plays the role of the n<sup>th</sup> currency. (\*\*) The role of German monetary policy in the system is to provide price stability for Europe but it could also be used to follow an exchange rate target vis-a-vis the dollar. Thus if there is a significant degree of currency substitution between the dollar and the DM, pressure arise in the EMS because the DM fluctuates more strongly against the dollar than the other EMS currencies. If there is a shift into the dollar and the dollar thus appreciates, the DM will tend to be weak against the other EMS currencies. Whenever, on the other hand, investors substitute DM assets for assets denominated in dollar, the DM will tend to appreciate against the other EMS currencies. As the DM tends to appreciate against the other EMS currencies any way because of the low German inflation rate, a portfolio shift away from other dollar assets puts enormous pressure on the exchange rate mechanism. Thus

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\* The European efforts to cooperate in the monetary field beginning with the snake in 1972 as a search for an appropriate response to the demise of the Bretton woods system, which was in essence a dollar standard system. The regional exchange rate union like the EMS would be to keep intra-EMS exchange rates fixed and float freely against the dollar. The fluctuation of plus or minus 2.25% leaves some space for relative movements of EMS currencies vis'a vis the dollar. A significant share of total intervention took place in dollars (manipulation of the respective currency's dollar exchange rate). On this point see, Fels, J., Kiel, The European Monetary system 1979-1987: why has it worked? Intereconomics, Sept./Oct. 1987.

\*\* It arises from the tautology that among countries in a fixed exchange rate system there are only n-1 independent exchange rate and n-1 countries employ a policy instrument i.e. monetary policy to keep their exchange rates fixed, the n<sup>th</sup> country has no influence on its exchange rate. The DM effectively plays the role of the n<sup>th</sup> currency.

periods of a weak dollar will be periods of strain for the EMS. In contrast, when the dollar appreciates, the exchange rate system can be expected to be relatively stable because there is less need for EMS countries to converge towards the restrictive German monetary policy. In a system of fixed exchange rates, countries have to face a special problem in the case of large capital movements, the burden of adjustment to capital movement lies solely on interest rates whereas in a floating exchange rate system, exchange rate movements help to cushion the effects.

Also, the EC has given priority to the liberalization of capital movements. All remaining capital restrictions would be liberalized by 1992, creating a truly common market. Given the divergent inflation performance in EMS member countries, this would enable large speculative capital movements increasing the need for more frequent realignments. Further stabilization of exchange rates in Europe can only be achieved by much closer coordination of monetary and fiscal policies between EC member states.

Moreover, in parallel with the increased inflow of savings into the EMU, the interlocked European currencies (or ECU) appreciate against the dollar, yen, etc. This in turn tends to reduce the prospects for European products in both domestic and foreign markets. The increased public sector demand is offset by a decline in world demand for European products. The product might be curbing growth.<sup>(1)</sup> The way to counter low capacity

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<sup>1</sup> Alfred, Pfaller, Economic policy within a European Monetary Union, Intereconomics, Nov./Dec. 1991, P. 267.

utilization is by means of expansionary fiscal policy as the increased inflow of capital from abroad or reduced outflow do not cause their currencies to appreciate against those of other EMU countries, their most important trading partners or lead to a deterioration in their competitive position within Europe. It would be growth mainly at the expense of the other EMU countries which would face higher interest rates and contraction of demand. Also, the capital inflow from outside the EMU into the country with expansionary policy would cause the ECU <sup>(1)</sup> as a whole to appreciate against the dollar, yen, and so forth.

A further difficulty arises if changes in external circumstances affect some EMU countries than others. A sustained decline in the dollar and the third world currencies tied to it could create such a situation as it would adversely affect primarily the cost-sensitive competitiveness of peripheral EMU countries, (and leading later on to devaluation in the countries concerned). Over the short-run, mitigating these losses could be through additional transfer payments from the community. However, over the long-run, this means adjusting the level of costs and the structure of production.

### Some Adjustment Problems with German Unification

The unification of the two Germanies offers an example of the adjustment problems that are to be expected, on the good market, it caused increased domestic demand for German products (and imports).

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<sup>1</sup> Alfred, ... Ibid., P. 268.

The pressure of demand on production capacity will affect price stability. On the financial market: it is the question whether German monetary policy will succeed in stifling the growing inflationary tendencies and strengthening the D-Mark or not. The Bundes Bank must counter not only rising inflation at home but also upward pressure on the D-Mark vis-a-vis the other EMS currencies. This means that the more effective is its stability policy, the more D-Mark it must offer on the foreign exchange markets, particularly as rising interest rates in Germany are reinforcing international demand for the currency. The only way out of this dilemma is European action where by other countries reduce their demand not only for DM investments but also for German products. Interest rates in the other EMS countries would have to rise in parallel with DM interest rates and overall demand would have to be curtailed. A restricted monetary and fiscal policy throughout the EC would therefore be required. EMS currencies would have to be appreciated collectively against third currencies which would again be damaging to the competitiveness of the European Countries.

Furthermore the EMS now has two major currencies, DM which is increasingly become subject to speculative capital inflows on Germany's particular exposure to Eastern Europe and the British pound which is a major international vehicle currency that is subject to the high volatility of international capital flows through London market. These speculative attacks on the DM and new fears of higher inflation and rising interest rates could lead to a new increase in exchange rate volatility.<sup>(1)</sup>

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<sup>1</sup> Paul. J., Welfens, International Effects of German Unification, Intereconomics, Jan./Feb. 1991, PP. 15-16.

### (3) Will there be a Further Depreciation of the Dollar?

The dollar's important role in the international network of relationships is also clear from its functions in the world economy. The dollar is a transaction currency. The bulk of world trade in goods and services is invoiced in dollar and the dollar is often used as a vehicle currency in the foreign exchange markets. It is also a reserve currency, held by the central banks of the world. Moreover, it serves as a key currency, where numerous countries have tied the parity of their currencies to the dollar. Finally, it is the premier currency for borrowing and lending in the international financial markets, even if the share of Euro currency transactions in non-dollar currencies has risen to around 50% <sup>(1)</sup> recently on account of the weakness of the dollar. Therefore, expecting the path of the Dollar exchange rate finds a difficulty. The empirical evidence <sup>(2)</sup> so far shows that real interest rates in the united states have a pronounced influence on

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<sup>1</sup> Buschgen, H.E., "The US Dollar-Scenario of a world currency, Intereconomics, March/April 1987, P.59.

<sup>2</sup> Rolf Schneider, Is the Performance of the Dollar a random process, Intereconomics, July/August, 1989, PP.159-160.

In his article Buschgen indicated that the theoretical basis for his model (explaining the exchange rate movement of the dollar of 1984-85 and 1987-88) is the new approaches of the eighties: purchasing power parities and the interest rate parities. Purchasing power parities help determine the long-term exchange rate trend. Interest rate parities interpret the exchange rate as the relative price of interest bearing financial assets in the domestic economy. The various portfolio approaches do have at least one merit in that they have again introduced trade imbalances and economic growth into exchange rate models, Busschgen has included them by the two variables in his model.



the exchange rate between the dollar and the Deutsche Mark. Undoubtedly, the attempt to find empirical evidence that real interest rates in Germany influence the exchange rates is made more difficult by the fact that US and German real interest rates sometimes move in the same direction. It is possible that a single world capital market still does not exist despite the internationalization of capital flows. Even today, the dollar area is still the capital market international investors prefer. Even moderate changes in the behaviour of fundamental (\*) economic variables can lead to pronounced differences in the trend of the dollar.

There is also the question whether the reallocation of resources necessary to reduce the US trade deficit can be achieved quickly in the context of an inflation-free economic process. A sharp fall in the dollar would also cause interest rates to rise by inducing reactions in the capital account. Expectations of dollar exchange rate changes and high negative swap rates in the forward exchange market could make dollar investments appear even less attractive <sup>(1)</sup>. The government would then have difficulty financing its budget deficit by means of capital imports, the only remedy would seem to lie in a restrictive fiscal policy and a higher saving ratio (OR Solving America's dilemma by forcing its trading partners to adopt an expansionary economic policy).

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\* The fundamentals of the US economy are large current account deficit, the country's heavy foreign indebtedness and the substantial budget deficit.

<sup>1</sup> Buschgen, H.E. Op. Cit., PP. 65-66.

It is wrong to equate Japan and Germany as regards their current economic situation, their interests, and their importance for the US balance of payments. Japan supplies 20% of US imports, Germany only 6%, the United States trade deficit with Japan came to 43\$ billion in 1985, that with Germany to 10US\$ billion. Therefore according to calculations made by the IMF, <sup>(1)</sup> an acceleration in growth in Japan and Germany would produce an improvement of 10\$ billion at best in the USA current account. If the dollar depreciates further as a result of monetary measures (reductions in interest rates), the current account deficit could be eliminated only by a sound budget policy and a monetary policy pay heed to the need of stability, otherwise, there would be a danger of rising protectionism and accelerating inflation.

Moreover, the growth in the Euro-Dollar Market, <sup>(2)</sup> would be significant. This market has many operations with the different parts of the World Economy, it quickly adjusts with the unexpected financial inflows. Also, these flows are multinationals. They might not be under the control of the central banks and this situation leads to monetary instability and threatens they by the

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<sup>1</sup> Buschgin, H.E., Ibid., P. 67.

the author expected that an expansionary policy in Germany and Japan to make a decisive difference in the current account of the USA because the Japanese consumers had strong preferences for Japanese products and in Germany, a slackening in exports would be offset by acceleration in the growth rate of domestic demand to achieve a stable growth path.

<sup>2</sup> Einzig, Paul-The EORO-Dollar system, practice and theory of International Interest Rates, Macmillan 2, London, 1973, Chapter 16, PP. 138-151.

strength of the Dollar in the world markets. In fact it reveals a weakness in the present international monetary system. This role might have been widened with the evolution of Multinational corporations.

### Concerning the battle between the Yen and the Dollar

few remarks should be added:

1. The increase in the Yen value is not expected to affect only the Japanese economy but also the world economy. This is because Japan is a big exporter in the world and its claim stocks are estimated to be around 513.6 billion dollars in 1992. The current appreciation of the Yen against the dollar is thought to create a difficult situation for the Japanese economy, since the empirical statistics <sup>(1)</sup> so far reveal huge losses for many corporations, deflationary trends.. unemployment and bankruptcies (especially in small and medium corporations). The intention of the American government to bring down the dollar to 100 yen may aim at decreasing the Japanese current account surpluses. A last resort out of this situation is searching for new areas of investment outside USA after 50 years of settlement there in China and Russia.

### 2. Will there be a further appreciation for the Yen?

The answer will depend on the ability of the Japanese economy to sustain large surpluses in the current accounts during the next years i.e. savings exceed private sector investment and public deficit. Undoubtedly, the savings ratio in GDP will tend to decrease for two reasons:

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<sup>1</sup> Al-Ahram, The Yen battle between Japan and USA, 6<sup>th</sup>, June 1993, (Published in Arabic).

- a) The current propensity to consume for the generations (Youth) is much higher than before, therefore the saving ratio is expected to decrease from about 16% (in disposable income) to 8% <sup>(1)</sup> at the middle of the nineties.
- b) Most of the Japanese exports are valued in dollars. Moreover, the financial market there especially, the capital market is still immature in spite of the reform undertaken so far, (some taxes were reduced, and restrictions on transferring liabilities were too lax).

**(4) Expected impacts on some monetary variables in Egypt:**

Table (1) presents data on the shares of national currencies in official holdings of foreign exchange between 1985 and 1991. The share of dollar holdings for all countries declined from 65.0% to 56.2% while that of the Deutsche mark rose from 15.2% to 17.3%. It is also interesting to note that the fall of US dollar was slightly compensated by the rise in mark while a stable level of sterling pound could be distinguished. However, there is a steady rising importance of the Yen as a reserve currency. Since March

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<sup>1</sup> Abd El-Fatah Elgebali, Dollar, Yen and Mark, and the future of the international currency; the future of the international monetary system, AL-ALAMA-YOUM, (a newspaper, in Arabic), Monday 30/12/1991.

The author of the present study is skeptic about the drastic decline of the ratio from 16% to 8% since there is no clear justification for this. However it is still correct to believe that some changes in the behavior of the Japanese are in favor of stimulating consumption such as encouraging the tourism outside Japan by the government itself which is coincident with the current account surplus in the balance of payments.

1973, the adequacy dimension of the liquidity (1) problem has become entirely meaningless. Any country wishes to increase its reserve can simply purchase foreign exchange and let its currency depreciate. The share of ECU in official holdings declined from 15.4% 1981 (2) to 7.0% for all countries 1991. The main gainers of shares are Dollar, Mark and Yen. On the contrary, the present table does not introduce any clarification for the possibility of replacing the ECU currency for the US\$ as an international reserve currency for the developing countries. The indicators (Table 1) refer to a slight decline in US dollar in total holdings of foreign exchanges for the developing countries (from 64.8% 1985 to 63.8% 1991). The trend for the sterling position reveals improvement from 4.3% to 6.6% in total holdings. It seems to us that the trend in Yen share is nearly stable at the level of 7.0% over 1985-1990. The participation of both D. Mark and Yen as being reserve currencies has not exceeded 14% over 1985 and 1990. Thus the total vision for the developing countries does not support the impression that US dollar has lost importance.

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1 Smith, S., John and Bouter, C., Arie, The Treatment of Reserves and of Reserve Creation in the Balance of payments Accounts, IMF staff working papers, July 1969, PP. 203-220.

Under the Bretton woods system, the countries failed to promote adjustment to balance of payments disequilibria and had generated the international liquidity problem. Countries were reluctant to sacrifice their domestic economic objectives for the sake of maintaining balance of payments equilibrium. Deficit countries demanded an ever increasing volume of reserves so as to avoid the introduction of corrective measures. Surplus countries attempted to sterilize the increments to their reserve holdings in the hope of preventing their respective rates of inflation from accelerating. In addition, growth of the international liquidity followed US-monetary policy.

2 I.M.F., Annual Report, 1987.

**Table (1)**  
**Share of National Currencies in total**  
**identified official holdings of foreign**  
**exchange, some selected years.**

	1985	1987	1989	1991
<b><u>All Countries</u></b>				
U.S. Dollar	65.0	67.8	60.2	56.2
Sterling Pound	3.0	2.4	2.7	3.8
Deutsche mark	15.2	14.4	19.0	17.3
French Franc	0.9	0.8	1.4	3.6
Swiss Franc	2.3	2.0	1.5	1.4
Netherlands Guilder	1.0	1.2	1.1	1.2
Japanese Yen	8.0	7.5	7.7	9.9
<b>Industrial Countries</b>				
U.S. Dollar	65.2	71.4	59.6	51.6
Sterling Pound	1.8	1.1	1.4	2
Deutsche mark	19.5	15.9	22.5	21.2
French Franc	0.1	0.4	1.2	4.6
Swiss Franc	2.0	1.6	1.1	0.9
Netherlands Guilder	1.0	1.3	1.2	1.4
Japanese yen	8.9	7.1	8.1	11.3

<b>Development Countries</b>				
U.S. Dollar	64.8	60.0	61.6	63.8
Pound Sterling	4.3	5.2	5.6	6.6
Deutsche mark	10.1	11.1	11.3	10.7
French Franc	1.9	1.8	1.9	1.9
Swiss Franc	2.7	2.7	2.3	2.3
Netherlands Guilder	0.5	1.1	0.8	0.8
Japaness Yen	7.0	8.5	6.9	7.6

Source: I.M.F. Annual report, 1992, P. 92.

Remark: The share of ECUs in total foreign exchange holdings was 12.1% for industrial countries and 7.1% for all countries.

**Reserve assets and their composition in Egypt:**

Table (2) presents data on the Egyptian official holding of reserve assets at the end of selected years over the period 1985-1991. The most striking feature of these figures is the sharp increase in foreign exchange reserves which implies that between 1985 and 1991, this component of international liquidity did not

cease to grow after the move along the liberalization of the exchange rate of the Egyptian pound since May 1987 (which is pegged to the Dollar). The managed floating exchange system now is accompanied with the increase in international liquidity (which is estimated recently to be around 16 billion dollars). Furthermore, as the different components increased at different rates, the composition of developing countries has undergone slight changes. Equally important have been the changes in the composition (\*) of the foreign exchange component of international reserves (for which no data is available for Egypt) about the shares of national currencies in official holdings of foreign exchange in a way similar to the developing countries (Table 1).

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\* There is some consensus on the academic level that the dollar predominates the composition of foreign exchange reserves in Egypt. This phenomenon was a reflection of currency substitution in favor of the pound with the increase of both real and nominal domestic interest rate. Also the foreign exchange reserves are functioned in dollar deposits at the domestic and foreign banks. Moreover the dollar interest rate is less than 4%. This reserves management policy may not be considered an optimal one because its role is confined to absorbing the excesses of supply without putting certain limits (price or quantitative) for intervention. Moreover, the predominance of dollar in the composition of reserves exposes the Egyptian economy to losses with the fluctuations of the dollar exchange rate. These losses might be discounted because the evaluation of the foreign exchange holdings runs in dollars. Therefore, it ought to be evaluated in SDR.



**Table (2)**  
**Egyptian official holding of reserve assets/**

(million US\$) some selected years

	1985	1987	1989	1990
- Total reserves minu Gold	792	1378	1520	2684
- SDR	-	-	-	1
- Reserve position in the fund.	-	-	-	-
- Foreign exchange	792	1378	1520	2689
- Gold (National valuation)	578	814	679	641

Source: I.M.F., International Financial Statistics, Yearbook,  
 No. 1, Nov., 1991.

Can an ECU be a real reserve currency?

As a means of exchange: it is advantageous for an individual or entity to bear these transactions and information costs (\*) only if the holding of ECU payment instruments promises a high investment utility than the holding of payment instrument denominated in the national currency. In the case of interest-bearing ECU payment instruments it should be assumed that they can offer no systematic advantage over interest bearing payment instruments in national currency as far as investment utility is concerned, as efficient foreign exchange markets always ensure expectations of changes in exchange rates are offset by corresponding interest rate differences. As it can be noted in the case of investment by a strong currency like Mark it gives low interest rate 9.5% but if investment will be in lira or peseta the interest rates must be higher (11.6% and 11.0% respectively) than that of the ECU (10.06%): and Mark 9.5% (Table 3). However, it is expected that the differences in interest rates between national currencies are offset by the Risk involved in the differences

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\* Even currency substitution among the EMS currencies and the ECU would entail additional transaction costs if there is no assurance that the recipient of the payment would be willing to accept ECUs in place of national currency. Further conversion costs would then arise or if another seller would have to be sought who was prepared to accept payment in ECUs. And as to the information costs, it would always be incurred as the day's ECU rate for the national currency in question would have to be determined, at least as long as the present margins of fluctuation within the EMS are maintained.

Bofinger, P., Stuttgart, Is an ECU parallel currency the way to achieve - European Monetary Integration? Intereconomics, Sept./Oct., 1985, P. 225.

between the exchange rates of the weak currencies and the strong ones (realignments). For a German exporter and an Egyptian importer, it is attractive to invoice in ECUs owing to Egyptian restrictions on capital movements. However, if money and capital movement were completely free, they would no longer have any incentive to use the ECU instead of Dollar except if transactions costs in such exchange intermediation systems were less. The question may not be the convertibility of ECU and dollar and the risks involved so far as it is the compatibility of payment systems (spot or forward payments). Using an ECU in such case (spot payments) <sup>(1)</sup> may reduce any risks underlying the exchange rate of US dollar particularly for the members of the community. As a store of value (and as a unit of account), if one concentrates on the function of money as a store of value, it is obvious that there will be little demand for non-interest bearing ECU notes and coin for that purpose as long as interest-bearing securities in national currency are available, i.e. in Egyptian pounds. It is sometimes

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<sup>1</sup> In the recent literature it shows that flexible exchange rates follow a random walk which means that the best as an individual could do is to take today's exchange rate as a predictor for the future spot rate. However in a more recent study forward rates have been found to be poor and biased predictors of the future spot rate under a flexible exchange rate system. These results might not hold for fixed but adjustable exchange rates as in the case of the European Monetary system because the variability of the spot rate is reduced see.

Jung, C., Alexander and Wieland Volker, Forward Rates and spot Rates in the European Monetary system, *weltwirtschaftliches Archiv, Review of World Economics*, Band 126, Heft 4, 1990, PP. 615-629.

**Table (3)**  
**The Interest Rates of ECU and the European**  
**Currencies for one month till 27.4 1992**

<u>Interest rate</u>	<u>Currency</u>
10.06%	ECU
9.5 %	D-Mark
9.37%	Belgian Franc
9.75%	French Franc
10%	Danish Krone
9.38%	Netherlands Guilder
10.43%	Sterling Pound
20.50%	Greace Drachma
11.62%	Italian Lira
11.87%	Spanish Peseta
13%	Portuguese Escudo
10.25%	Irish Punt

Source: Fawzya Ebraheem, The European Monetary Unit, ECU, Al-Ahram El-Iktisadi Economic Weekly, No. 1218, 18<sup>th</sup>, May 1992, PP. 26-28.

expected for the ECUs to replace US dollars in deposits and credit. However, with a view to the current situation in Egypt in connection with liberalization of interest rate policy and the other elements of the monetary policy, replacing pounds by ECUs will be somewhat difficult. Our conviction is that it will be less effected by ECUs due the wide margin between the interest rates (\*) on the national currency, both for deposits and credits and on the ECU currency - for the certificates of deposits and credit they are in the range between 13% to 22% compared with 10.1% for the ECU.

Being a basket of currencies, the ECU offers the advantage of diversification, therefore fluctuations in the exchange rate of an EMS currency contained in the exchange rate mechanism must be smaller vis-a-vis the ECU than vis-a-vis a currency such as the US dollar or J.Yen. However, it continues to be much safer to invest the store of value in securities denominated in national

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\* The published data on the interest latest rates are the following; Budget Bonds, 14.9% the interest rates according to the time period of the deposit certificates: less than one year 13.5%, from 2-7 years, 13.5%, above 7 years 13%. Moreover, the credit and discount rate is 17%. The average interest rates on credit according to the activities: commerce 22%, for the rest of activities 19.5%, and for the export activities 19.5%.

Also the report of the advisory council indicated that the domestic nominal interest rate on the deposits in L.E. pounds was 16.7% against an interest rate of the deposits in US\$ dollars of 3.2% in June 1992 and given that the inflation rate in Egypt and USA was 9.7% and 3.1% respectively, the real interest rate for the pound and US\$ was 6.4% and 0.1% respectively on the same date. That reflected the currency substitution in favor of the L.E. pound and against the US\$ dollar in June 1992 while the liberalization of the domestic interest rate of the pound started in Jan. 1991.

Advisory council "An Elementary Assessment of the Economic Reform program" The Elementary Report of the financial and Economical Affairs committee, The First Stage Results, U.R.A., 1993., Table (1/2), P. 18. (In Arabic).

currency. For companies operating in international markets, it maybe safer to place their resources not in ECUs but in say sterling pounds or yen if they export their goods to the United Kingdom or Japan. Hence, a possible process of displacement can not be deduced in respect of this function of money either. In this area, the ECU proves at best to be a valuable addition to the range of investment possibilities.

### Is the stability of the Egyptian exchange rate sustainable?

The present situation of the international monetary system raises two problems for the developing countries and Egypt. **First**, uncertainty concerning their import expenditure and export revenues of commodities and services. **Second**, the floating exchange rate policy followed so far on the part of the advanced countries has led to more appeal to the national monetary policy tools which in effect adversely affected the developing countries and among, them Egypt. Due to these external factors i.e. fluctuations in terms of trade, and in exchange rates, more borrowing was evident. Indeed, there were tendencies either to peg to one currency (like Egypt) or to a basket of main currencies. May be for Egypt the best solution is to peg to a weighted basket of currencies or ECU. Their weights should be the shares of foreign trade with the other countries. This should help keeping the stability of the effective exchange rate of the national currency. Given the relative weights of foreign trade movements with the European community (with the ECUs)

Table (4), the Major weight ought to be for ECUs which lessens the effect of any bilateral price movement on the import indicator (expressed in national prices). But the problems may lie deeply in the disability of this alternative to intervene directly i.e. it is only a unit of account without being worked as an intervention asset regardless of the technical problems underlying implementing such an operation. Moreover the exchange risk for a large proportion of Egypt's foreign trade and payments may be reduced with the Common European Economic Area if the importance of the EC for the foreign trade of Egypt can be expected to increase further since linking the Egyptian pound with ECU is synonymous with linking them to practically all the EC currencies. Moreover, by pegging the Egyptian pound to the ECU, the aim should mean subjecting the Economic policies in Egypt for a long time to stronger stabilization pressure (particulary, inflation expectations).

Here table (4) shows up that Egypt's foreign trade with the developed countries constitutes about 50% of total exports and 68% of total imports in 1990. At the same time, the share of the community EEC represents about 40% on the export side and 50% on the import side in 1990. The data supported our apriori impression about considering EEC as a big partner. Despite the fact that neither united states nor Japan are major partners in foreign trade with Egypt (their shares are less than 10% on export and less than 20% on imports), one could not underestimate the role of Dollar in the context of putting the exchange rate policy of the Egyptian pound. Generally the path of dollar determines the direction of pound. However, our contention is that the stability of the exchange rate of pound lies in domestic factors more than in

**Table (4)**  
**Exports and Imports According to some economic**  
**groups (Million Pounds)**

	Advanced Countries (1)				E E C Countries (2)			
	Export		% of total		Export		% of total	
1980	1284	60.2%	2485.6	73.1%	1070.0	50.2%	1670.0	49.1%
1985	1224.7	47.1%	4894.6	70.2%	1121.4	43.1%	3629.4	52.1%
1990	3470.2	49.9%	16885.1	68.0%	2684.5	38.6%	12458.7	50.2%

Source: National Bank of Egypt, Economic Bulletin, Vol.42, No. 1 and 2, 1992, Appendix.

1. It includes Western European countries in addition to North America, Austria and Japan.
2. It excludes United States and Japan.

external factors. The experience of today's tends to support this. The dollar has been depreciating in world markets for a long time after 1985. However, after reforming the Egyptian pound since 1987, the last year witnessed a stability of the pound (at the level \$1=330 piastres). That was achieved mainly by government measures, like limiting imports, reducing central government public expenditure in connection with granting subsidies, liberalizing pricing, ... and so on.



In addition to the above mentioned impacts, the economic interdependence between Egypt and the EMU raises other questions concerning the European monetary policy and its impacts on the capital flows to Egypt i.e facilities, loans, aid, and direct investments. In line with the capital flows mobility ACT inside, the European community and in parallel with the procedures made so far toward unifying the taxes (value added tax rates) and the other financial legislative items, the competitiveness between the European banks could be expected to increase and thereby the prices of the banking services facilities would decrease. Besides with the application of the Basle agreement, all the Arab Countries except Saudi Arabi should be considered dangerous regions. As a result of this the Arab banks whether they are inside the countries concerned or outside them (international or offshore banks) have to apply a capital sufficiency ratio of 8%. The cost of financial resources in this case could be high and the results of the banks processes would be moving, toward a decline in profits. In general, this introduces a potential of increasing the credit costs from the international financial markets which add some pressure on the foreign debt services and shrinks the capital flows to the developing countries and among them Egypt.

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