Egypt's Exchange Rates Dilemma And Need for Fiscal Reform

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THE International Monetary Fund (IMF) has been asking the Egyptian government to unify its exchange rates over the last two and a half years, and even though there has been some considerable movement in this regard, unification has not been completed to date. The reason for this is probably that the government is concerned about the possible effects on the fiscal balance of any move to close the gap between the official and parallel exchange rates.

Egypt has a very large fiscal deficit estimated to be as high as 20 percent of gross domestic product (GDP), which has been financed by strict foreign exchange rationing and printing money. This has led to inflationary pressures in the economy from which every segment of society suffers in varying degrees.

Today, the black market exchange rate is a more accurate measure of the true value of the Egyptian pound than the official rate. Currently, the purchase and allocation of foreign exchange at the official rate levies an implicit tax on exports and grants an implicit subsidy on imports.

For example, a $1 million import transaction taking place at the official rate of exchange implies that importers will receive foreign exchange at approximately E#2.75 instead of the black market's current level of E#2.85, implying a 10-piaster subsidy by the state on every pound worth of imports financed through the government- controlled parallel market.

On the other extreme, according to state law, a $1 million export transaction taking place at the official rate of exchange implies that exporters will have to convert 75 percent of their foreign exchange at around E#2.75 in local commercial banks instead of the black market's current level of E#2.80, implying a 5-piaster tax imposed by the state on every pound worth of exports sold through the government-controlled parallel market.

Is it right for the state to burden exporters with implicit taxes and to implicitly subsidize imports? The answer, of course, is no, and the need to unify exchange rates reflects the importance of doing away with this kind of implicit taxation and subsidy on exports and imports, respectively. There is, thus, a need to proceed with further devaluation, which should be accompanied by fiscal reform with the objective of eliminating the implied export tax that exists as a result of the difference between the official and black market exchange rates.

Why is there a need to address the fiscal deficit with further devaluation? Probably, the best example of the link between these two forces is demonstrated by recent events in Sierra Leone. Sierra Leone is a country that witnessed tremendous difficulties in the process of unifying its exchange rate system. The government decided to float its currency at a time when the black market rate of exchange was roughly five times that of the official exchange rate. Inflation, as a result, jumped from 57 percent before the float to 259 percent in the period after devaluation. This disastrous outcome was blamed by many on an underlying fiscal imbalance.

Sierra Leone's deficit amounted to as much as 14 percent of GDP during the time of the float, and it was primarily being financed by the printing of money and an implicit tax on exports that existed because of a difference between the official and black market exchange rates identical to that in Egypt. The effective elimination of the export tax that accompanied unification led to a decrease in export tax proceeds, forcing the rate of money creation to rise.

Since Sierra Leone had large subsidies on items like staple foods and petroleum that it wanted to maintain, inflation increased the deficit even further.

The experience of a country such as Sierra Leone shows that devaluation and a float policy by themselves cannot adjust a macroeconomic imbalance (e.g., a large budget deficit), but can, in fact, make them even worse. Thus, it is safe to say that fiscal reform is a prerequisite for unifying exchange rates and that both kinds of reform must go hand in hand.

This, of course, raises some serious concerns for a country such as Egypt, which needs to unify its exchange rate system and at the same time has large fiscal imbalances reflected in a substantial budget deficit inflated by high levels of subsidies on staple foods, petroleum and electricity. Is the Egyptian government prepared to take a risk at unifying exchange rates without accompanying reforms on the fiscal deficit front and have inflation increase by as much as 500 percent in one year, as was the case in Sierra Leone?

Undoubtedly, an implicit subsidy on imports and an implicit tax on exports cannot be maintained if the government is serious about getting its balance of trade picture in order, and thus there is a serious case for exchange rate unification. Yet, on the other hand, without accompanying fiscal deficit reforms we may have overcome these forms of implicit taxes and subsidies only to create another monstrous effect — much higher rates of inflation.

The experience of a country such as Sierra Leone must be worrying the Egyptian government to a major degree since it, too, faces considerable political pressures to keep the level of subsidies high and the inflation rate low at a time when the government faces serious balance of payments disorders that come from large balance of trade deficits.

I am confident that the government is against implicitly taxing exports and subsidizing imports, a practice that harms any efforts to restore a trade balance. Yet, on the other hand, the government must be extremely worried about inflationary pressures that may accompany exchange rate unification and their obvious political implications.

Thus, if the government has been slow to unify the rates, I believe the above discussion and the example of Sierra Leone illustrate why. This reluctance, of course, has affected negotiations with the IMF, which have now reached a dead end.

In my opinion, the dead end will only be passed when the government presents a formula to the IMF that not only supports exchange rate unification but at the same time provides for directionality in dealing with the fiscal deficit, or accepts an IMF prescription in this regard. The way things seem to be going with the IMF and Egypt implies that we have apparently been unable to see eye to eye in this crucial reform area. I wish the government luck in negotiating this one — they need all the luck they can get!