Why the Dollar Dances With the Egyptian Pound

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THE DOLLAR has surged upward to approximately E£3.10 on the black market, but the government is not giving the general public any explanation for this sudden leap. Perhaps it is because no one in the government understands the causes. But let no one believe that the public will swallow the excuse that the Gulf crisis is to blame.

If it is not the Gulf crisis that is behind the sudden appreciation of the dollar how can we explain this outcome? The answer is simply found in any introductory economics text. Keynes identified the demand for money to be linked to three motives: speculative, precautionary, and transactive.

Let us look at the speculative motive for the demand of money. In Egypt's case everyone, and I mean everyone, knows that the government has a very clear intention to devalue the pound by a considerable percentage. Devaluation has been so widely debated that everyone knows it that is not simply a possible outcome, but is expected to definitely occur.

The publicity accompanying the prolonged negotiations with the International monetary Fund (IMF) have brought a sense of realism to devaluation which is expected to be both considerable and quick. Thus, the majority of Egyptians holding large amounts of pounds perceive large windfall losses in purchasing power from devaluation.

For example, let us assume that our typical Egyptian household holds E£30,000 at the existing black market value of E£3.10 to the dollar giving them $9,677. Suppose they anticipate the dollar rising to E£3.25 over one year, or $9,230 in dollar terms. A loss of E£1,400 is predicted.

How many households out there are interested in relinquishing any savings just because they wanted Egyptian pounds? Can it really be a surprise to anyone that the majority of Egyptians holding large amounts of cash in pounds are exchanging their currency for dollars?

In many other developing countries that have unstable rates of exchange this phenomenon is called dollarization. And, of course, dollarization is fueled by expectations of households.

'It should be clear by now that the expectations of household is what got us as high as E£3.10 to the dollar, and it is likely that speculation may push the black market exchange rate up even further.

But as no one can be certain how far the government will devalue the pound, or how quickly, isn't it safer to just hold one's savings in U.S. dollars to prevent oneself from windfall losses? It is obvious that a considerable amount of Egyptians have chosen this option and are dumping their pounds as a precautionary action. Precautionary behavior towards money is documented well in Keynes' General Theory.

Additionally, the Gulf crisis may be giving the public a signal that a dollar shortage will eventually result from decreased worker's remittances and tourist revenues. This can lead to some taking the attitude of converting their pounds now into hard currency before its all gone. Consequently, if the Ministry of Economy is finding it difficult to explain why the dollar to pound exchange rate is becoming very unpredictable the blame should not be laid at the doorstep of the Egyptian households: their actions are simply based on plain common sense.

A quick review of Keynesian economics should bring back some clarity to those in government who may be confused by this phenomenon.

A phenomenon that will continue as long as household expectations support the belief that the pound is going nowhere but down.

The public is just trying to interpret the signals.