

REAL EXCHANGE RATE DETERMINANTS IN EGYPT: A VAR COINTEGRATION APPROACH

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“To float or not to float” is no longer the question for developing countries. The recent banking and exchange rate crises in Latin America, East Asia, Eastern Europe and Turkey have proven that the fixed exchange rate is unsustainable in the growing financial globalisation context. The other corner solution advocated by the IMF, the free float, makes economies subject to high fluctuations. Moreover, there are no central banks in the world that completely abstain from intervention in the currency markets. Therefore, the main question for most emerging market economies, and particularly for Egypt since January 2003, is what kind of managed float to have. We suggest that the most viable solution is the “managed bands” regime around a crawling effective equilibrium central parity, with no pre-announced management parameters.

We use the Johansen multivariate VAR cointegration approach to define the variables that determined the real exchange rate behavior in Egypt as an indicator of the government’s real exchange rate policy. We apply this time series methodology on a data set from 1960 to 1999.

Our empirical findings confirm that the Egyptian economic policy mix has almost always been inside the Trilemma triangle, and not on one of its sides. We believe that explicit or even implicit choice of a “managed bands” exchange rate regime has allowed and will continue to allow the Egyptian policymakers to steer the economy out of the numerous regional and international political and economic shocks.

We conclude that the success of such a regime is conditioned by the availability of substantial international currency reserves, and that Egypt needs to participate in a regional monetary cooperation, similar to the East Asian Chiang Mai Initiative, with its Arab trade partners using the Gulf Cooperation Council monetary cooperation impetus, but also with its partners in the Euro-Mediterranean initiative.

Keywords: economic trilemma, exchange rate policies, VAR cointegration, “managed bands”, monetary regional cooperation

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