The Global Financial Crisis and the Arab World: The Role of the Exchange Rate Regimes

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Note: the views expressed in this presentation are the author's sole responsibility and do not necessarily represent the official position of the Dubai Economic Policy & Research Institute

Outline

1. The Crisis: transmission channels and global consequences
2. Impact on Arab and other developing countries
3. Policy Responses: the role of exchange rate regimes
4. The lessons for monetary and exchange rate policy

The Crisis: transmission channels and global consequences

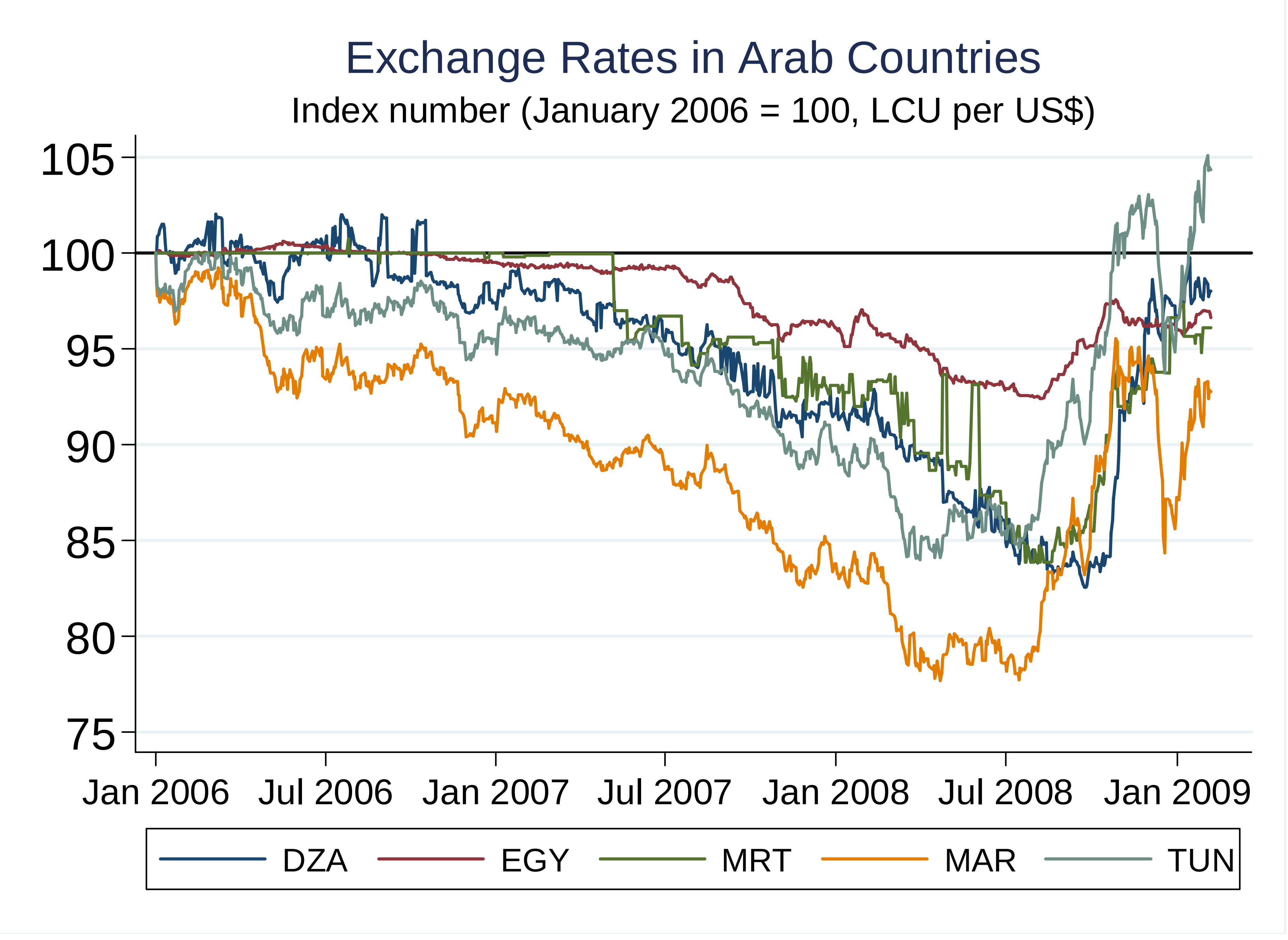
- External shocks- a perfect storm of interrelated:
  - Deepening financial crisis
  - Falling commodity prices
  - Massive world-wide economic slowdown
- Transmission Channels:
  - Financial contagion
  - Commodity prices
  - Remittances
  - External demand and foreign investment

Impact on the Arab World

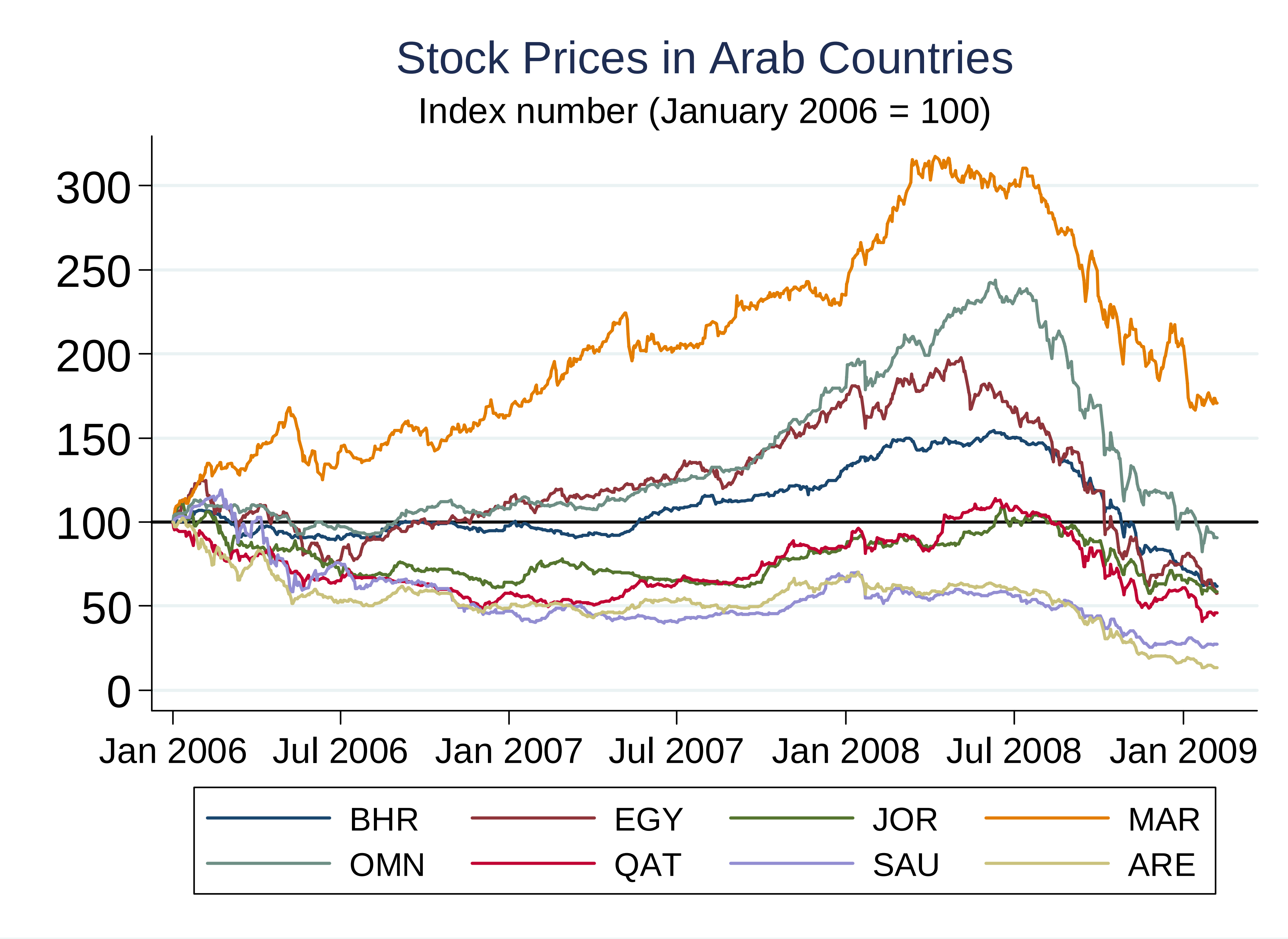
- Stages of transmission
  - 1st stage: Decoupling (August 07- May 08)
    - Appreciating currencies, soaring stock markets, expansive domestic credit but mounting inflationary pressures, especially for food
    - Expanding Exchange rate fundamentals: large capital inflows, commodity prices, remittances, build-up of official reserves and sovereign funds (GCC)

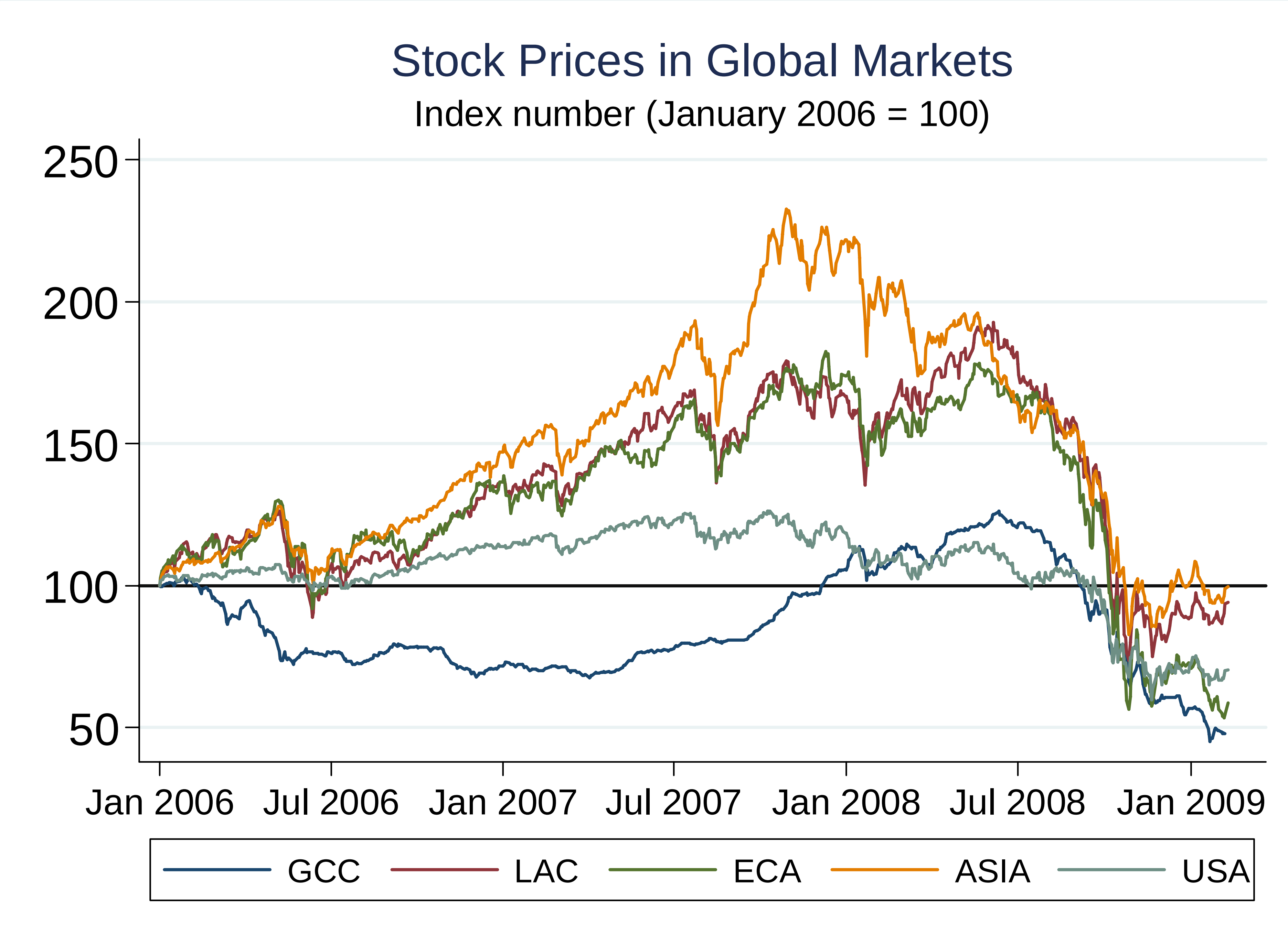
Impact on the Arab World (contd.)

- 2nd stage: Re-coupling (May 08- present)
  - Steep corrections in foreign exchange and stock markets, clogging credit channels and decelerating inflation, if not deflation in some
  - Collapsing Exchange rate fundamentals
- Evidence (Figures)

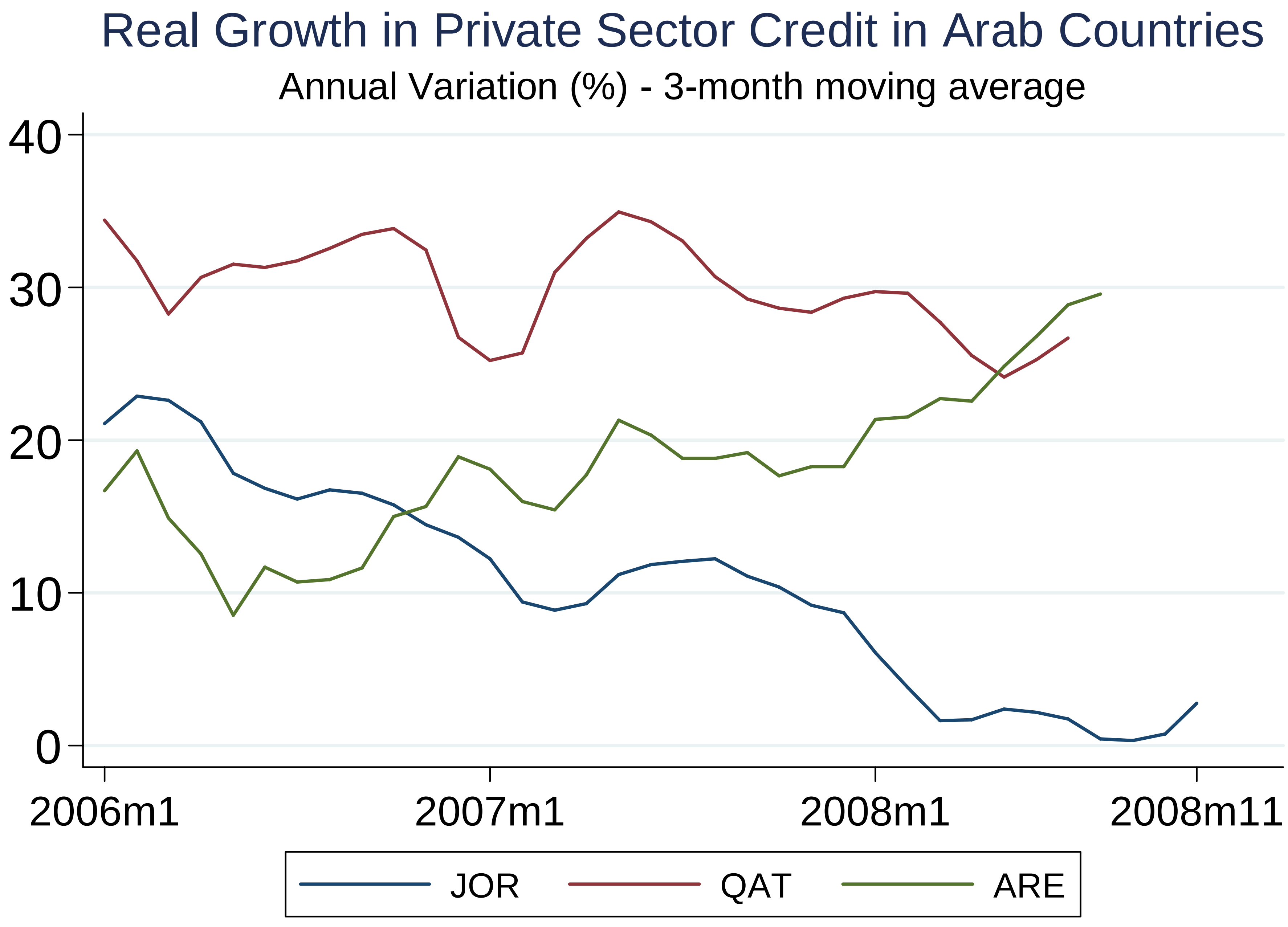


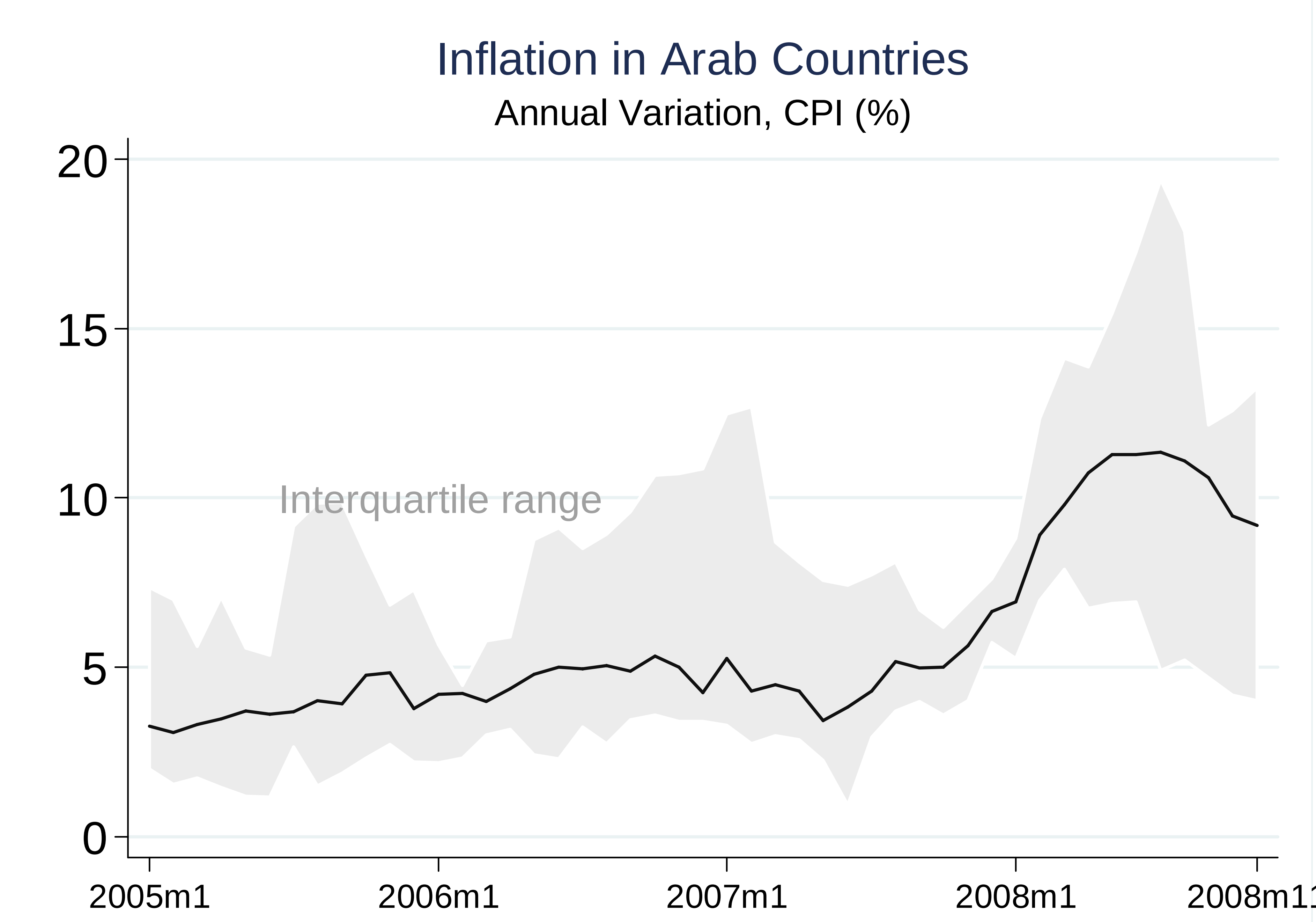
Exchange Rates in Arab Countries
Index number (January 2006 = 100, LCU per US$)
105
100
95
90
85
80
75
Jan 2006
Jul 2006
Jan 2007
Jul 2007
Jan 2008
Jul 2008
Jan 2009
DZA
EGY
MRT
MAR
TUN

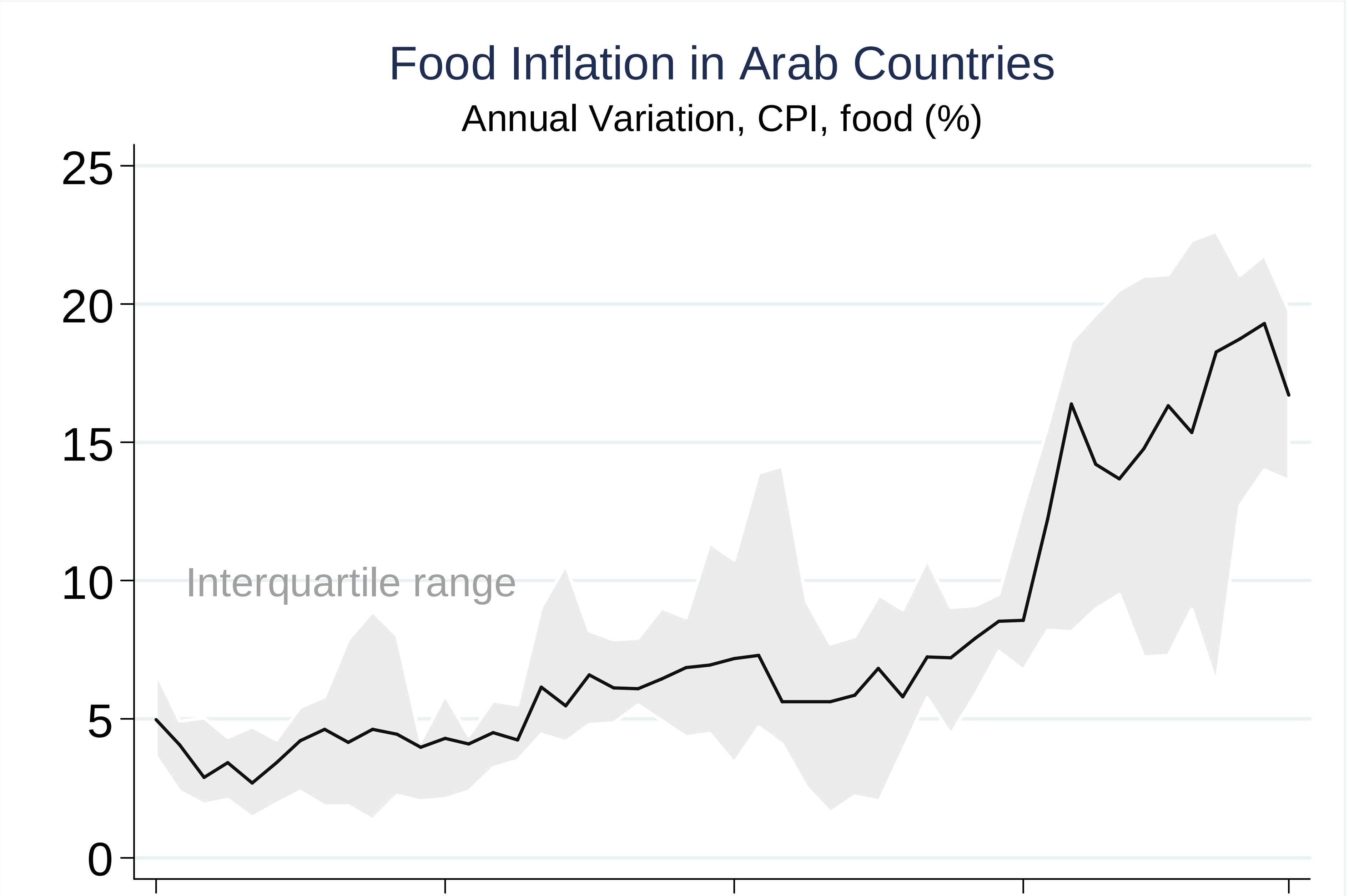

Stock Prices in Arab Countries
Index number (January 2006 = 100)
300
250
200
150
100
50
0
Jan 2006
Jul 2006
Jan 2007
Jul 2007
Jan 2008
Jul 2008
Jan 2009
BHR
EGY
JOR
MAR
OMN
QAT
SAU
ARE

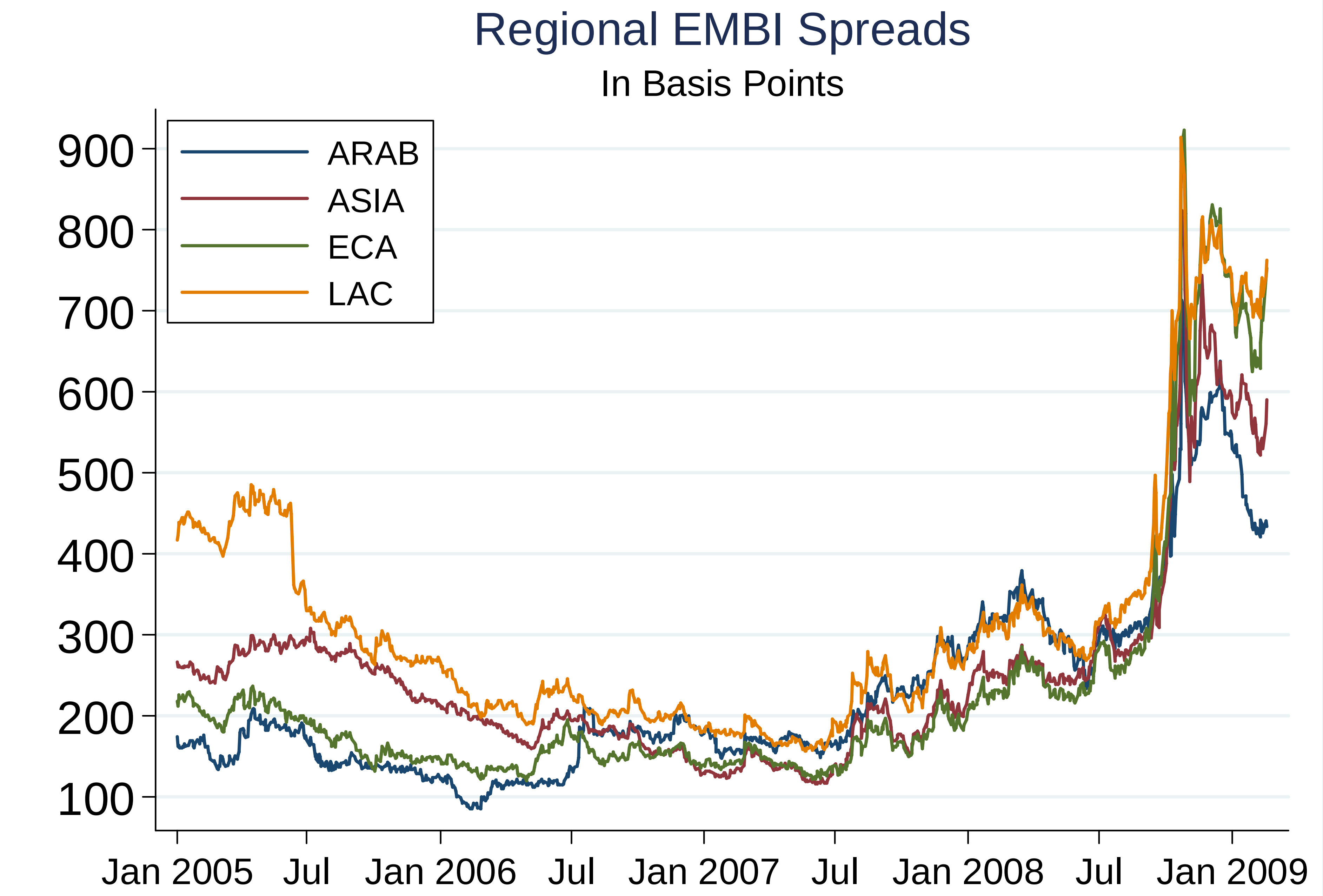


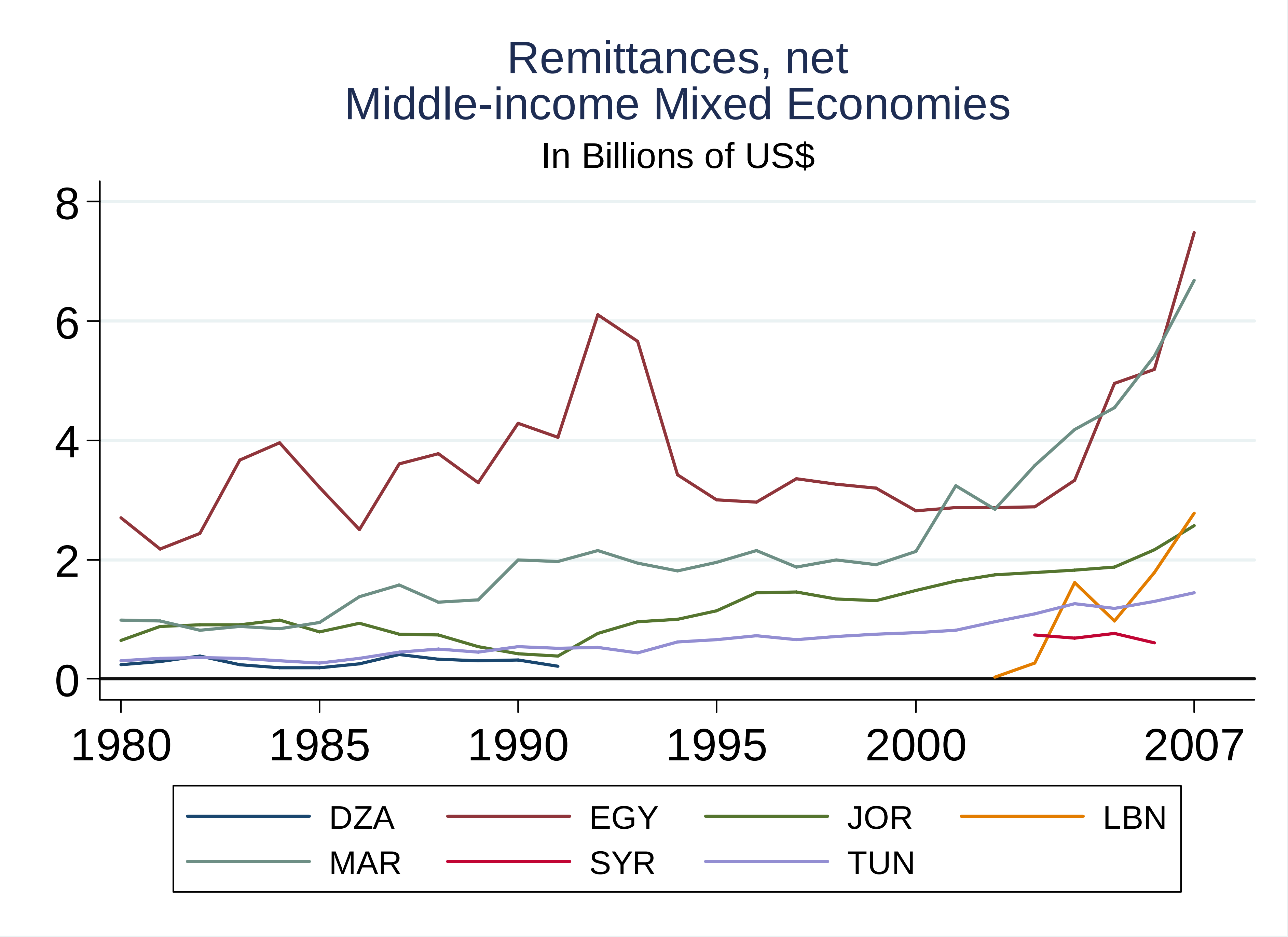
Stock Prices in Global Markets
Index number (January 2006 = 100)
250
200
150
100
50
Jan 2006
Jul 2006
Jan 2007
Jul 2007
Jan 2008
Jul 2008
Jan 2009
GCC
LAC
ECA
ASIA
USA


Real Growth in Private Sector Credit in Arab Countries
Annual Variation (%) - 3-month moving average
40
30
20
10
0
2006m1
2007m1
2008m1
2008m11
JOR
QAT
ARE

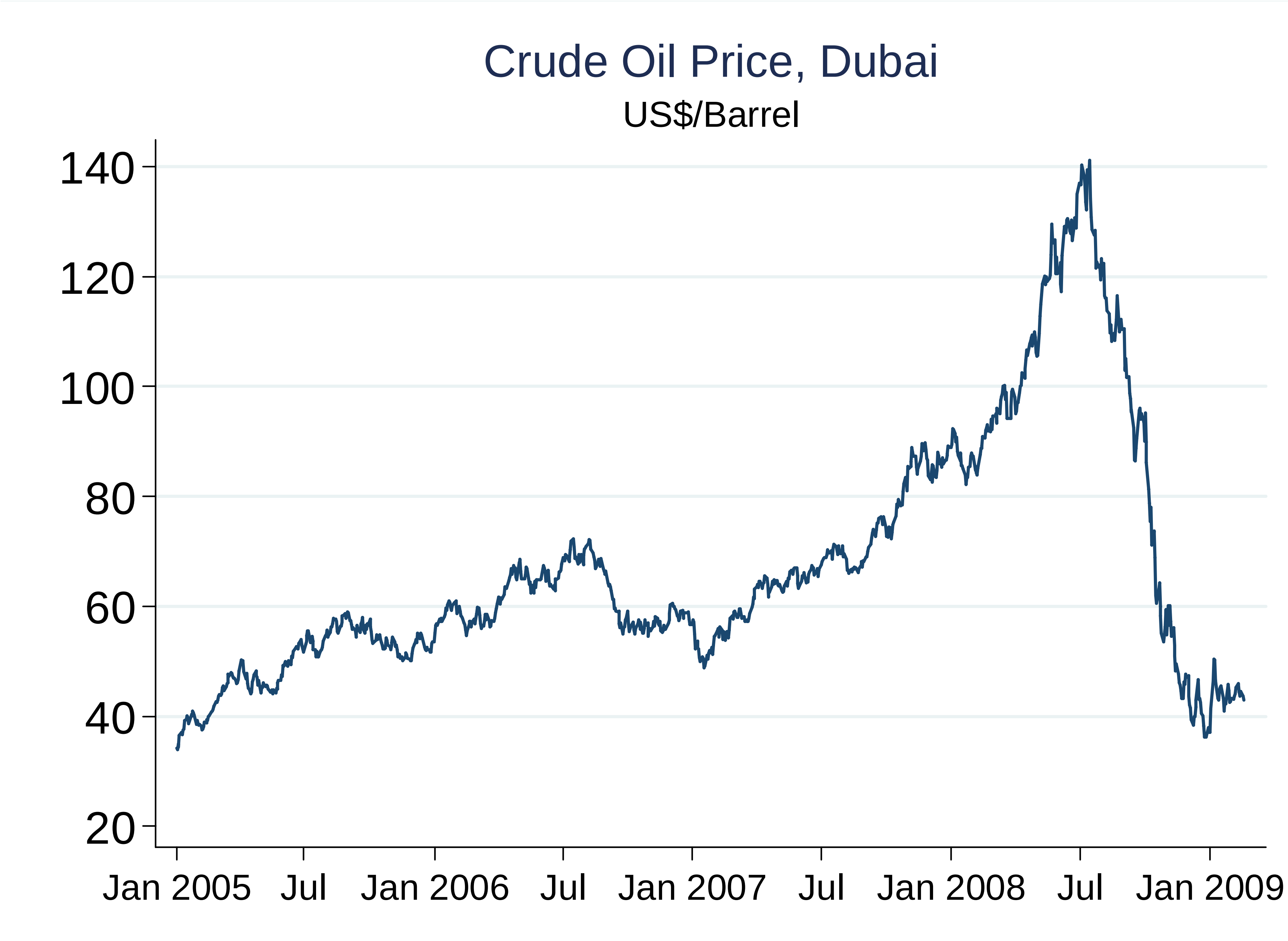

Inflation in Arab Countries
Annual Variation, CPI (%)
20
15
10
5
0
Interquartile range
2005m1
2006m1
2007m1
2008m1
2008m11


Food Inflation in Arab Countries
Annual Variation, CPI, food (%)
25
20
15
10
5
0
Interquartile range
2005m1
2006m1
2007m1
2008m1
2008m12

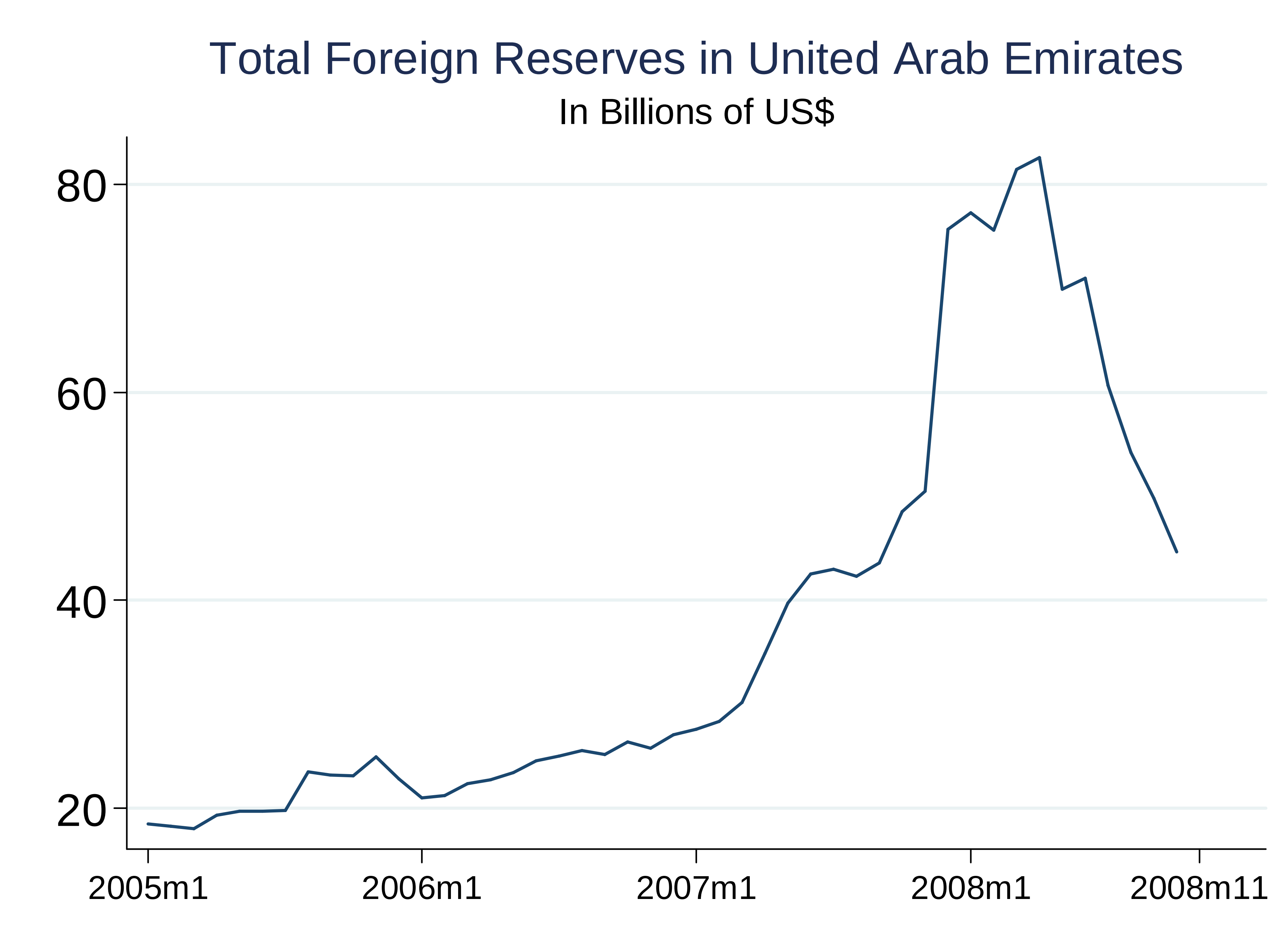

Regional EMBI Spreads
In Basis Points
ARAB
ASIA
ECA
LAC
900
800
700
600
500
400
300
200
100
Jan 2005
Jul
Jan 2006
Jul
Jan 2007
Jul
Jan 2008
Jul
Jan 2009



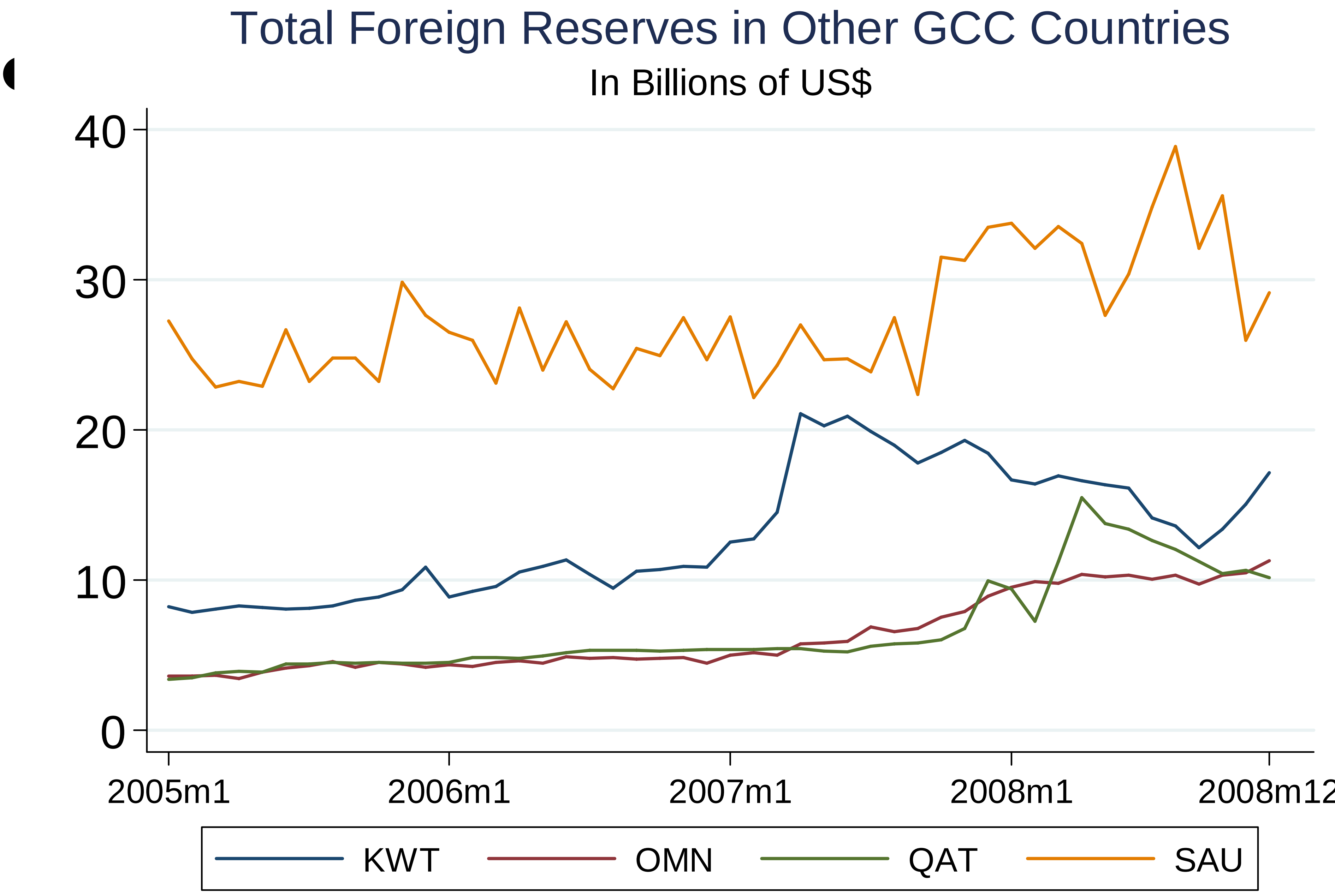
Remittances, net
Middle-income Mixed Economies
In Billions of US$
0
2
4
6
8
1980
1985
1990
1995
2000
2007
DZA
EGY
JOR
LBN
MAR
SYR
TUN



Crude Oil Price, Dubai
US$/Barrel
140
120
100
80
60
40
20
Jan 2005
Jul
Jan 2006
Jul
Jan 2007
Jul
Jan 2008
Jul
Jan 2009



Total Foreign Reserves in United Arab Emirates
In Billions of US$
80
60
40
20
2005m1
2006m1
2007m1
2008m1
2008m11


Total Foreign Reserves in Other GCC Countries
In Billions of US$
40
30
20
10
0
2005m1
2006m1
2007m1
2008m1
2008m12
KWT
OMN
QAT
SAU

Policy Responses: the role of exchange rate regimes

- In general the impact and the consequent policy response is contingent upon:
  - The extent of vulnerability
    - Dependence on commodity exports- oil
    - Integration into the global financial markets – high private capital inflows (Dubai /UAE vs Syria & Sudan)
    - How leveraged have domestic banking and other financial institutions been - high credit to the private sector, including in "toxic" debt

Policy Responses: the role of exchange rate regimes (contd.)

- However, the prevailing exchange rate regime also matters:
  - Flexible exchange rate regimes will:
    - Facilitate smooth adjustments to external shocks
    - Reduce speculative pressures
    - Avoid deflationary high interest rates- no need to defend a fixed nominal exchange rate
    - Conserve valuable foreign exchange reserves
    - Most importantly, accelerate equilibrium RER depreciation:
      - Restore export dynamism and overall economic growth (recent evidence- Dani Rodrik, Elbadawi et al)

Policy Responses: the role of exchange rate regimes (contd.)

- Instead, some countries may still prefer fixed (or heavily managed) regimes (GCC, Jordan, Sudan):
  - Stability relative to a global currency
  - Large foreign currency-denominated debts by banks, corporations or households
- However, monetary/exchange rate policy in these countries is very constrained:
  - Policy response mostly driven by fiscal policy- strong fiscal position or massive official assistance is required
  - Drawing, may be heavily, on reserves and/or sovereign funds (UAE, Sudan)

The lessons for monetary and exchange rate policy

- For most countries pegged exchange rate regimes tend to be fragile:
  - Difficult or costly to maintain in a world of high and volatile capital mobility
- Move towards “Flexible” rather than “strict” inflation targeting:
  - Central banks should target the RER, the most important real asset price, together with inflation- an extended “Taylor Rule”

The lessons for monetary and exchange rate policy (contd.)

- Moreover, the monetary policy response to the financial crisis might also consider other measures (controversial: Demirguc-Kunt and Serven, 2009):
  - Use monetary policy to “prick” the bubble:
    - Target asset prices (those with feedback loops to credit expansion)
    - However, there are some issues: not easy to spot, not all asset prices are synchronized, timing of the effect is uncertain
    - Moreover, monetary policy alone may not be adequate:
      - One instrument for two objectives (price as well as financial stability)

The lessons for monetary and exchange rate policy (contd.)

- Instead, couple monetary policy with macro-prudential regulation
  - Unlike micro risk management regulations, the macro ones focus on the risk management of the financial system as a whole
  - Deals with systemic vulnerabilities due to:
    - Periodic business downturns that affect all financial institutions
    - Increases in the number of financial institutions that have become too large, too interlinked and, therefore, too difficult to fail or unwind

The lessons for monetary and exchange rate policy (contd.)

- And, yes, consider “temporary” capital controls:
  - On capital outflows as a crisis containment tool:
    - Protect the stock of reserve of the central bank
    - Relieve pressure on the exchange rate
    - Provide some room for independent monetary policy
  - On Capital inflows as a prudential measure to prevent future crisis:
    - Enhance economy-wide competitiveness - depreciated RER
    - Avoid asset price bubbles and excessive risk taking
    - Protect monetary policy autonomy- monetary tightening
    - Influence composition of private capital inflows toward FDI and other long term portfolio flows

The lessons for monetary and exchange rate policy (contd.)

- However, evidence on effectiveness is mixed and some caveats should be made explicit:
  - Controls should be temporary because it tends to lose effectiveness over time
  - And, should be complementary to, not a substitute for, strong macro fundamentals

Thank You