Exchange Rate Policies in Arab Countries: Assessment and Recommendations

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Abstract

While being an important relative price in the economy, the exchange rate itself is just one technical element in a broader monetary and exchange rate operational framework. Consequently, the approach adopted in evaluating the exchange arrangements must be integrative in nature. As it follows, and in the context of Arab economies, issues related to (a) maintaining internal and external stability (in terms of demand management policies and exchange rate corrections to preserve the viability of the balance of payments), (b) introducing structural productivity-enhancing reform policies aimed at boosting growth (via a more liberalized trade system, a stimulative environment to foreign investment, timely privatization plans, or strategies aimed at diversifying the production base of the economy to reduce dependence on key commodities), (c) observing an internally consistent mix of monetary and exchange rate policies and operations in light of a globally integrated financial system, and (d) stressing the differences in factor endowments, in economic structures and financial systems, were closely scrutinized on a country-by-country basis. The central message that emerged is that sound financial policies, supportive structural

policies particularly important in securing productivity gains, as well as prudent demand management policies all work in a complementary way to achieve the optimal exchange rate regime for a country. Accompanying this message is a need for the authorities, in light of changing economic conditions, to remain vigilant and flexible in revising exchange rate arrangements on a timely basis. Despite the commonality of language and culture in Arab countries, differences on many economic and financial fronts were highlighted. It is hoped that the meticulous review of the distinctive characteristics of the region's economies, will offer the concerned policymakers helpful clues (stemming from tested experiences worldwide) as regards the need to reform exchange systems, provided the suitable technical capacity to undergo such reforms is already in place. Finally, in order to secure a successful reform process without endangering macroeconomic and financial stability, the pacing and the sequencing of steps involved need to be carefully implemented.

I. Introduction

The exchange rate matters since it is an important price in the economy. Changes can cause substantial reallocation of resources and production between the tradeable and non-tradeable sectors of the economy. But rarely is the exchange rate seen for what it is: a relative price that, like any other, responds to the laws of supply and demand. Being a price, the exchange rate according to simple economic theory is therefore determined within the economic system—its significance and behavior cannot be understood without paying attention to the factors elsewhere in that system influencing it. Accordingly, one cannot expect too much from "technical" arrangements, such as the exchange regime. There is a need for sound financial policies, a need for supportive structural policies and a need for continuity in the efforts in achieving an optimal exchange rate regime in a country. Any single exchange rate regime, on its own, cannot be considered a credible substitute for sound underlying economic policies.

In this regard, the IMF emphasizes the need for greater coordination of monetary and exchange rate policies (more so in light of increasing capital mobility) in its key macroeconomic management area. An "integrated approach" in advising on reforms of exchange systems is put in place to highlight the linkages between stable and efficient financial markets, an indirect or market-based approach to monetary control, internally consistent macroeconomic and exchange rate policies, and prudential supervision and regulations to address (systemic) risks of threat to the financial system. Coordinating a

compatible and successful mix of macroeconomic policies and supporting structural and financial policies is a formidable task ahead of policymakers.

In close relation, the merits of alternative exchange rate regimes are best debated in a *coherent monetary order*[1] framework, when it comes to the interaction of monetary and exchange policies. For instance, the exchange rate and the exchange rate regime are but particular elements in a broader set of arrangements referred to as the monetary order—policy towards them should ideally be discussed coherently in this broader context. It could be that problems with a less-than-coherent monetary order and not the exchange rate regime itself that contribute to a country's economic difficulties[2].

The economic literature[3] has identified a number of factors relating to (a) initial conditions (level of international reserves, macroeconomic conditions); (b) structural characteristics (openness of the economy, degree of capital mobility, degree of dollarization of financial system, rigidity of the labor market, fiscal flexibility and sustainability, soundness of banking system); (c) types of economic shocks facing the

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1 D. Laidler (1999) "… a coherent order requires a well-defined goal for monetary policy, one that the authorities are capable of achieving, and that anchors private sector expectations. For it to be liberal, the relevant authorities should be accountable to the electorate for their performance …"

2 The new IMF classification scheme of exchange rate arrangements acknowledges the importance of this coherent strategy by classifying, side by side, members' exchange rate regimes and members' choices of alternative nominal anchors in conducting monetary policy. This is later illustrated for the case of Arab countries.

3 A brief summary of the "factors affecting the choice of exchange rate arrangement" is given in Table A1 in appendix A.

economy (real or nominal, domestic or foreign); (d) policymakers' economic objectives and supportive policies (stabilization, full employment, competitiveness through export-oriented strategies, incentives for domestic structural reforms, financial stability, enhancing confidence[4]); and (e) non-economic criteria (such as political factors and credibility of policies), as all having an influence on the relative desirability of alternative exchange rate regimes. While many approaches and models, (reflecting either "traditional" structural criterion based on the optimal currency area view or more recent views such as the "fear of floating" or the "political economy" view) are used to investigate the importance of those factors in the selection of an exchange rate regime, the conclusions they yield are not model-free. In this respect, we review and assess certain aspects of traditional as well as newer results in the context of Arab countries.

The growing consensus emerged among policymakers and academics alike, that there may not be a single right choice for all (Arab) countries when debating the merits of fixed and floating exchange rates and their variations, rightly applies here[5]. Exchange rate arrangements, for instance, will reflect the initial conditions and the objectives of authorities, among other things. As the country's economic conditions evolve, it is required of policies to adjust on a timely and flexible basis.

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4 For example through currency boards, monetary unions, full dollarization or more pliant pegged regimes in certain cases.

5 It is also worth noting that the IMF advice to members reflects the ambiguity and diversity of their exchange systems. Consistent with the Articles of Agreement, the IMF generally respects the member's choice exchange rate regime and advises on policies needed to support that choice.

For example, despite their initial attraction, exchange rate pegs eventually have to be abandoned, a process that is often messy. On the other hand, as a country becomes more closely integrated into the global financial system, a need evolves for some flexibility in the exchange regime (provided the technical expertise in policymaking is gained and other compensating adjustment mechanisms are inactive[6]). Furthermore, the implementation of a flexible regime necessitates the presence of active spot and forward foreign exchange market along with a continuous interbank market supported by developed retail markets (such as exchange houses and foreign exchange bureaus).

The paper is organized as follows. It begins by reviewing the exchange rate arrangements currently in place in Arab countries. In *Section II*, an emphasis is placed on separating the 'words' of officials from their 'deeds' in classifying exchange rate regimes. At least three different classification schemes or indicators are reviewed and applied to the countries in question. The "openness" of Arab economies is formalized based on quantifiable economic integration indicators, and the stance of Arab financial systems is briefly evaluated. It is understood that sound financial systems and the integration of financial and economic systems with those in the rest of the world are integral elements in advising on the reforms of exchange systems. *Section III* begins with an assessment of the economic performance of Arab economies with

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[6] The compensating adjustment mechanisms in an economics system are (a) labor mobility, (b) wages flexibility, (c) fiscal transfers and, (d) the compensating role of capital markets. As long as they cannot substitute for the automatic adjustment feature of a flexible exchange rate regime, that regime will be important as a component of the monetary order.

different exchange rate regimes by analyzing key macroeconomic variables encapsulated in growth and inflation and by evaluating how Arab countries as a group have fared in terms of competitiveness—to this end, developments in real effective exchange rates, as a relevant indicator, are analyzed. The hypotheses postulated in the literature to explain the choice of exchange rate regimes are then reviewed in the context of Arab economies. While the pegged regime emerges clearly as a distinctive hallmark in Arab exchange rate regimes, an analysis of its advantages and disadvantages is conducted. Thus, the contribution of the paper lies in the analysis of "country specific" circumstances, current as well as evolving ones—here, differences in the developmental level of institutions and in the economics structures and financial systems are dynamically thought-out on a country-by-country basis. By doing so, we bring to the forefront what once was perceived to be outside the purview of monetary-exchange rate policies. Attuning the design of the institutions to the dynamics of the domestic political and economic policy-making settings, and tailoring the means or steps involved in the sequencing of exchange reforms to individual country circumstances and needs, are carefully pursued. Once the situation is assessed and subtle differentiating characteristics ranging from factor endowments to economics structures are underlined (first, among Arab regimes themselves, then between those regimes and the rest of the world), recommendations are then presented in *Section IV*. The recommendations pertaining to the relevant exchange rate arrangements and the potential reforms therein are once again drawn in light of countries' specific characteristics. A forward-looking approach is followed. While some recommendations are viewed as tentative,

others are decisively stated where clear evidence as regards the need to reform prevails. The final *Section V* concludes by summing the paper in pinpointing the more relevant policy issues and solutions /recommendations.

II. Exchange Rate Arrangements and Policies: The Current Situation

This part reviews the current status of exchange rate arrangements and policies in Arab countries[7]. A distinction is drawn between *de jure/official* and *de facto/true* classification schemes as failure to recognize the difference may lead to ignoring significant cross country variation in exchange rate regime choice and may result in an inconsistent mix of monetary and exchange rate policies.

The *official* classification of exchange rates is based on members' notification of the exchange arrangements of their choice to the IMF, which in turn summarizes them by an exchange rate classification scheme first introduced in mid-1975 and regularly published since then in the International Financial Statistics (IFS). The classification scheme distinguished between three main groups: pegged exchange rate arrangements, limited flexibility and more flexible arrangements[8]. On the other hand, *de facto* classification is based on an assessment of current policy implementation, rather than abiding by the country's official labeling of its regime.

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7 The following Middle Eastern and North African countries are members of the Arab Monetary Fund (AMF): Algeria, Bahrain, Comoros, Djibouti, the Arab Republic of Egypt, Iraq, Jordan, Kuwait, Lebanon, the Palestine Authority, the Socialist People's Libyan Arab Jamahiriya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, the Syrian Arab Republic, Tunisia, United Arab Emirates, and the Republic of Yemen.

8 International Monetary Fund (1999). World Economic and Financial Surveys. *Exchange Rate Arrangements and Currency Convertibility, Developments and Issues*. Chapter 4, Box 1.

Exchange rates of Arab currencies: the "official" classification scheme

The classification of members' exchange rate arrangements (given in Table A2 in appendix A)[9] reflects the official declaration of country authorities and does not necessarily reflect the de facto policies they may follow. Therein, the exchange rate arrangements in Arab countries are categorized in two main groups. The first group includes countries that follow pegged exchange rate regimes (where the local currency is either pegged to a single currency, or to currency composites—standardized as in the case of the SDR or other weighted composites formed from the currencies of major trading or financial partners). The second group involves countries adopting more flexible forms of exchange rate regimes (other managed or independent floating).

According to this classification, most Arab countries belong to the first group as 12 of them follow a pegged regime. Five countries (Jordan[10],

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[9] Source: Joint Arab Economic Report (2001), Appendix (10/10)—Arab Monetary Fund.

[10] Effective October 23, 1995, the Central Bank of Jordan (CBJ) amended its policy with respect to determining the Jordanian Dinar (JD) exchange rate. Under this amendment, priority was given to keeping the dinar's exchange rate stable against the U.S. dollar and allowing it to fluctuate against other foreign currencies. The JD exchange rate against the U.S. dollar was determined at an average rate of 709 fils. The CBJ took this measure in order to impart greater transparency to the stability of the JD exchange rate, and bolster the interest rate policy in its effort to enhance the attractiveness of keeping assets denominated in JD against these denominated in U.S. dollar. Monetary and in particular interest rate policy will continue to be guided primarily by the objective of maintaining the stability of the JD… *Central Bank of Jordan (2000)*.

Djibouti, Syria, Iraq and Oman) peg to the U.S. dollar, whereby the monetary authorities maintain a fixed exchange rate against the dollar for all types of transactions. While Syria[11] and Iraq maintain exchange arrangement involving more than one market, the arrangement that is categorized is the one maintained in the major market. Five other countries (United Arab Emirates, Bahrain, Saudi Arabia, Qatar and Libya) peg their currencies to the SDR. In the first four countries, exchange rates are determined on the basis of a fixed relationship to the SDR, within margins of up to ± 7.25 percent. However, because of the maintenance of a relatively stable relationship with the U.S. dollar, these margins are not always observed. On the other hand, the Libyan dinar is allowed to fluctuate against the SDR within a wide band of ± 77.5 percent. More recently, the central bank of Libya adopted new procedures allowing sharp consecutive devaluations of the official exchange rate of the dinar against the dollar in an effort to narrow the spread between the official exchange rate and the parallel market rate.

Under the pegged category, Kuwait and Morocco[12] peg to a currency composite. The currency is fixed daily based on variations in the value of the currencies of the country's principal trading partners where the

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[11] The multiple official rates in Syria are: (1) a legally designated official rate applies to the repayment of loans and interests arising from bilateral payments agreements; (2) the budget accounting rate (also known as the government free rate) applies to public sector exports of petroleum, all government imports, and repayment of loans and interest not related to bilateral payments agreements; and (3) the "rate in neighboring countries" applying to eight different transactions types. This is contrasted with two unofficial rates (1) the free market rate, and (2) the "exports proceeds" rate. An assessment of the multiple currency practices (MCPs) in the context of the Syrian economy is discussed later.

[12] The emphasis in the case of Morocco is placed on the external competitiveness of the economy, by tracking down the real effective exchange rate (REER).

weights reflect the relative importance of these currencies in the country's trade and financial relations—for instance, greater weights are attached to the U.S. dollar (in the case of Kuwait) and to the euro (in the case of Morocco, since the end of 1999).

Box 1. Exchange Rate Regimes in Arab Gulf Cooperation Council (AGCC) Countries

Saudi Arabia: Saudi riyal is officially pegged to the SDR at SRls 4.2826=SDR 1. The Saudi riyal has been *effectively pegged to the dollar* at the fixed rate of SRls 3.745=U.S.$1 since June 1, 1986.

Qatar: Qatar riyal is officially pegged to the SDR at QR 4.7619=SDR 1. The Qatar riyal has been *effectively pegged to the dollar* at the fixed rate of QR 3.6415=U.S.$1 since 1979.

Bahrain: Bahrain dinar is officially pegged to the SDR at BD 0.46190=SDR 1. The Bahrain dinar has been *effectively pegged to the dollar* at the fixed rate of BD 0.3760=U.S.$1 since December 1980[13].

U.A.E.: U.A.E. dirham is officially pegged to the SDR at Dh 4.7619=SDR 1. The U.A.E. dirham has been *effectively pegged to the dollar* at the fixed rate of Dh 3.6710=U.S.$1 since November 1980.

Oman: The Oman riyal is *officially pegged to the dollar* at the fixed rate of OR 0.3845=U.S.$1 since 1986.

Kuwait: The exchange value of the Kuwait dinar is determined on the basis of a fixed-but-adjustable relationship between the dinar and a *weighted basket of currencies*, with the weights reflecting the relative importance of these currencies in Kuwait's trade and financial relations. The Central Bank of Kuwait sets the rate for the dollar on the basis of the latest available market quotation for that currency in relation to the other currencies included in the basket. *The dollar appears to have a very large weight in the currency basket.* Between 1990 and 2000 the dinar was quite stable ranging between 0.2912 and 0.3067 KD for a U.S. dollar.

[13] The Bahrain Monetary Agency recently announced that it has formally pegged the dinar to the U.S. dollar, effective from December 25, 2001. The official exchange rate will remain $2.659 to one dinar and the dollar will be sold by the agency to all commercial banks in the archipelago at the rate of 377 fils. While making no change to the current exchange rate, the move is likely to be viewed as adding transparency to the agency's actual exchange rate arrangement.

Box 1…continue

In late 2000, the AGCC countries decided to formalize a common peg to the dollar as an initial step toward a possible common currency area in the future.

Source: Erbaş, Zubair and Sayers in I. Zubair (2001)

Regarding the second group of Arab countries adopting a floating exchange rate regime, the number of countries following a managed float has increased. In addition to Tunisia[14], Algeria[15] and Egypt[16], Lebanon[17] and Mauritania[18] more recently switched their exchange rate

14 The Tunisian authorities' emphasis on using the exchange rate instrument to maintain external competitiveness is well justified given that the exchange rate is largely insulated from market pressures under tight capital controls. Tunisia targeted a stable real effective exchange rate after 1992 (for e.g., depreciating its nominal exchange rate by 4 percent annually relative to the dollar between 1992 and 1998). The main competitiveness indicator followed by the authorities was a CPI-based real exchange rate. The recent departure from the real exchange rate targeting rule observed in 2000, in an effort to develop and rely on a broader set of indicators to guide exchange rate policy in the future, reflected the perceived limitations of the CPI-based real exchange rate. Through the currency basket underlying its exchange rate policy, Tunisia has links to EMU currencies.

15 The external value of the Algerian dinar is set on the interbank foreign exchange market, which was established in early 1996. No margin limits are imposed on buying and selling exchange rates in that market. There are rules on repatriation of foreign exchange proceeds. In recent years, Algeria has pursued a fairly flexible exchange rate policy mainly driven by reserve and economic diversification objectives.

16 During 2000, seeking to strengthen external position, Egypt departed from the de facto peg to the U.S. dollar adopted in early 1991. A devaluation (against the dollar) was permitted reaching around 14% in 2000 with a high and low for the external value of 3.42 and 3.89 respectively. Following an initial depreciation, an adjustable currency band was adopted against the U.S. dollar in January 2001. This band was subsequently further depreciated and widened in mid-2001.

17 During the last few years, Lebanon adopted a policy of fixing its exchange rate within a narrow band fluctuating between 1501 and 1514 pounds against the U.S. dollar.

classification from independent to managed float in an effort to capture more adequately their choice of the exchange rate regime. The managed floating regime aims at establishing a certain degree of flexibility in exchange rates where the central bank quotes regularly the exchange rate applied in foreign exchange interventions, according to demand and supply conditions in the interbank markets as well as to a set of indicators—more or less judgmental in nature. The central banks also intervene by setting ceilings on the buy and sell rates differential.

As for Arab countries adopting an independent float, the number has been reduced lately to just three (Sudan, Somalia, and Yemen). The rates therein are broadly market-determined. In the case of Sudan and Yemen, the central bank determines a central parity rate against a major currency (most often the U.S. dollar) and intervenes to meet the markets' needs for that currency and to influence the market—this is aimed at avoiding excessive volatility and serious misalignment of the exchange rate from an equilibrium level. Despite the monetary authorities allowing the daily exchange rates to be market determined, there is generally a need for active management to help guide the market. This is due to financial markets not being highly developed in the relevant country, often coupled with thin foreign exchange markets, which may lead to considerable volatility in an unmanaged market.

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[18] The central bank of Mauritania (BCM) is resolved to keep a maximum spread of 6% between the official exchange rate and the parallel markets rate as is targeted under the IMF program.

Exchange rates of Arab currencies: the newly revised IMF classification scheme

The existing classification scheme suffers from important drawbacks[19]. One drawback is that by lumping several inherently different regimes in few traditional categories, the wide spectrum of regimes with various degree of monetary policy independence is not always apparent and suffers from considerable ambiguity. This has become a more critical issue in an environment where consistency of monetary and exchange rate policies are a key concern in avoiding excessive short-term capital flows.

Another shortcoming of the present classification scheme is that there is no adjustment for possible discrepancies between official/de jure and true/de facto policies, such as the de facto peg of East Asian currencies to the U.S. dollar until the time the Asian crisis erupted in 1997. Among Arab countries, this is illustrated by a group of countries that are classified as following managed or independently floating regimes but use a range of different approaches to limit the flexibility of the exchange rate. Egypt (until just recently) and Lebanon are two related examples—they have a de facto peg under an announced managed or independently floating arrangement[20]. The source of these differences

[19] International Monetary Fund (1999).

could stem from either political economy considerations or from policy dilemmas in terms of the trade-offs between economic objectives facing authorities. However, classifying exchange rate arrangements based on de facto policies could bring greater transparency to members' policies in particular to the role of their exchange rate regimes in the overall policy framework. This also contributes to improving the IMF surveillance over the countries' exchange rate policies.

The newly revised IMF classification scheme, available since December 31st 1997 only and published in the IFS since April 1999, distinguishes between the more rigid forms of pegged regimes (such as currency boards); other (conventional) fixed peg arrangements against a single currency or a currency basket; exchange rate bands around a fixed peg; crawling peg arrangements; and exchange rate bands around crawling pegs. A "no separate legal tender" category is also introduced. Managed floats with a preannounced path are also distinguished from other managed and free float. This classification scheme also adjusts for possible discrepancies between de jure and de facto policies. For the case of exchange rate arrangements in Arab countries, the revised classification scheme is presented in (Table A3 in appendix A[21]). It is worth noting that "pegged" exchange rate

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[20] Although Lebanon has recently changed its official classification from an independent to a managed float it remains, de facto, considered to be a pegged regime. On the other hand, the more recent change in Egypt's exchange rate policy, evidenced through the latest rounds of serious depreciations, has moved the exchange rate arrangement more and more toward a (managed) float regime.

[21] The source of the table is the "International Financial Statistics", June 2001 (reflecting countries' regimes as of December 31, 2000). The reader may refer to

arrangements, in which the exchange rate plays the role of the nominal anchor of monetary policy, prevail as the dominant type of monetary arrangements in Arab countries (14 out of 21 countries).

A newly developed indicator of exchange rate flexibility

In complementing the newly revised IMF classification scheme, Poirson (2001) develops and uses an alternative flexibility index (FLT index) based on movements in exchange rates and international reserves. The index ranks countries on a continuous scale of exchange rate flexibility rather than lumping them in arbitrarily defined categories. The calculation of the index itself is further explained in (Table A4 in appendix A) where the scores on the FLT index in Arab countries for the 12 months to December 1998 are reported. As expected, *Sudan* for example an independent floater scored highly while *Djibouti* a currency board country scored very low (zero).

However, the FLT index confirms the existence of discrepancies between de jure and de facto exchange rate arrangements, beyond the adjustments already made in the revised IMF scheme. *Yemen*, for instance, classified as an independent floater has a relatively low (rather than an expected large) score on the FLT index. This is just to say that empirical results pertaining to the choice of exchange rate regimes must be tentative in nature, until further improvements are done to the indicators.

IMF (1999), Box 2—reproduced in the appendix—, for a detailed explanation of the various exchange rate regimes listed in the revised scheme.

Classification of Arab economies—based on level of development and de facto exchange rate regimes[22]

Out of 21 AMF member countries under consideration, (17) are classified as "developing" while four (namely, Egypt, Jordan, Morocco and Qatar) are classified as "emerging market", with no other country in the membership categorized as a "developed-market"[23]. The exchange rate classification on the other hand, is based on the IMF staff's view of the *de facto* exchange rate arrangement in place on the relevant date. As shown in Table A3, the exchange rate regimes are split into three broad categories: (1) the *"hard pegs"* group consists of economies with currency boards or those with no separate currency; (2) the *"intermediate"* group consists of economies with conventional fixed pegs, crawling pegs, horizontal bands, and crawling bands—these will sometimes be referred to as "soft pegs" as they are softer and more pliant systems than the hard pegs; and (3) the *"floating"* group consists of economies whose systems are described either as a managed float with no specified central rate, or as independently floating.

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22 The tables and figures presented are based on Fischer (2001) and on the IFS (June 2001), with an emphasis on Arab economies. See also the IMF's *Annual Report 2000* (pp 141-143) for a specification of the exchange rate categories.

23 This is based on classifications by Morgan Stanley Capital International Indices and J.P. Morgan Emerging Markets Bond Index Plus (1998). The classification by other institutions may differ somewhat.

Evolution of exchange rate arrangements in general, and in Arab countries in particular

Before focusing on the Arab countries, major trends in exchange rate arrangements in IMF members' economies are first highlighted. This is done to bring out in a contrasting way the distinctive hallmark of the exchange rate regimes in Arab economies. As will be seen and later discussed in greater details, the relevant exchange rate regimes followed are predominantly of the pegged-but-adjustable nature. The reasons behind the popular use of such a regime are attributed in large to the specific characteristics of the economies under review, explained further in more details in the sections to follow.

A change in the distribution of exchange rate arrangements among all IMF members during the 1990s is summarized in the following table. The table provides clear evidence that countries are moving away from the center in support of the bi-polar or the two-corner solution view[24], a phenomenon known as the "hollow middle".

[24] Fischer (2001) …The new conventional wisdom has it that, particularly in view of the high degree of capital mobility, countries will increasingly move toward the ends of the spectrum that ranges from pure floating to hard pegs. Intermediate policy regimes (representing a variety of soft pegging exchange rate arrangements) between hard pegs and floating are not sustainable. This view states, more correctly, that for countries open to international capital flows: (i) pegs are not sustainable unless they are very hard indeed; but (ii) that a wide variety of flexible rate arrangements are possible; and (iii) that it is to be expected that policy in most countries will not be indifferent to exchange rate movements.

All IMF Member Countries	1991 (159 countries)	1999 (185 countries)	2000 (186 countries)
Hard Peg	16%	24%	25%
Intermediate	62%	34%	33%
Float	23%	42%	42%

For developed and emerging market countries, adjustable peg exchange rate systems have not proved to be viable for the long term, and should not be expected to be viable. These are exchange rate systems for countries integrated or integrating into global capital markets. Within the group of IMF emerging market countries, the following table illustrates this tendency to shift away from intermediate, soft peg, regimes, towards both greater fixity and greater flexibility.

All IMF Emerging Markets Countries	1991 (33 countries)	1999 (33 countries)
Hard Peg	6%	9%
Intermediate	64%	42%
Float	30%	48%

As for exchange rate arrangements in developing countries not open to international capital flows, the table demonstrates a change in the distribution of these arrangements over the decade of the 1990s, which is remarkably similar in appearance to that of the emerging market countries.

All IMF Developing Countries	1991 (104 countries)	1999 (130 countries)
Hard Peg	21%	24%
Intermediate	60%	37%
Float	19%	39%

The case of Arab countries

The evidence just presented above detects clearly a so-called "hollowing-out" effect in exchange rate arrangements. The "developing" Arab economies group, taken alone, or when put together with the four listed "emerging markets" Arab economies, in either case shows that the number of intermediate arrangements has declined, and the number of floaters has risen. However, this "hollowing of the middle" while present is not as pronounced (in comparison to other economies around the world), as the intermediate group remains always the dominant arrangement followed to date[25].

[25] Recently, an issue was raised as to whether the virtual stability in the *Sudanese* currency may have developed perceptions in the market that the exchange rate is effectively fixed. In *Yemen*, one-sided intervention in foreign exchange market by authorities may have undermined their efforts in allowing the exchange rate to be fully market determined. A casting doubt about the true flexibility of exchange rate regimes in Sudan and Yemen renders the "hollowing of the middle" in the distribution of exchange rate arrangements even less evident than what Figures 1 and 2 depict.

Table 1. Developing Arab Countries Grouped by Exchange Rate Arrangements

Exchange rate Regime (Number of Arab countries:(17))	Countries (as of December 1999)	Countries (as of December 2000)
NS/CBA	(1) Djibouti	(1) Djibouti
FP	(9) Bahrain, Comoros, Iraq, Kuwait, Lebanon, Oman, Saudi Arabia, Syria, United Arab Emirates	(9) Bahrain, Comoros, Iraq, Kuwait, Lebanon, Oman, Saudi Arabia, Syria, United Arab Emirates
HB	(1) Libya	(1) Libya
CP	(1) Tunisia	(0)
CB	(0)	(0)
MF	(2) Algeria, Mauritania	(4) Algeria, Mauritania, Sudan, Tunisia
IF	(3) Somalia, Sudan, Yemen	(2) Somalia, Yemen

NS = Arrangements with No Separate legal tender

CBA = Currency Board Arrangement

FP = Other conventional Fixed Pegs

HB = Pegged rate in Horizontal Band

CP = Crawling Peg

CB = Rates within Crawling Bands

MF = Managed Float with no pre-announced exchange rate path

IF = Independently Floating

Figure 1. Exchange Rate Regimes in Developing Arab Countries : 1991 (15 countries) and 1999 , 2000 (17 countries)

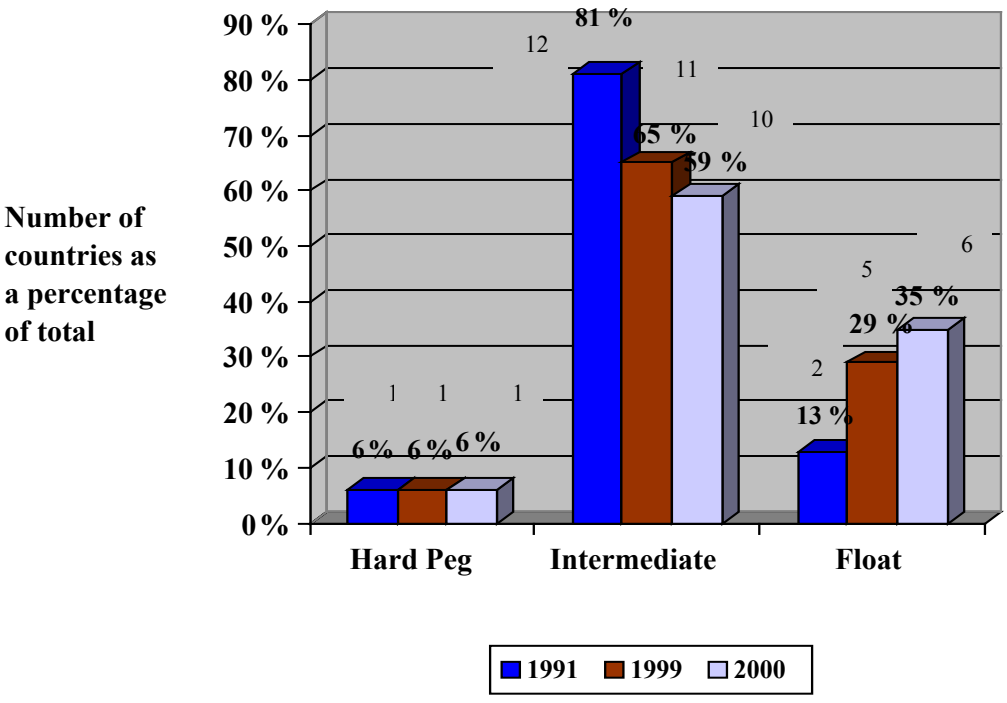
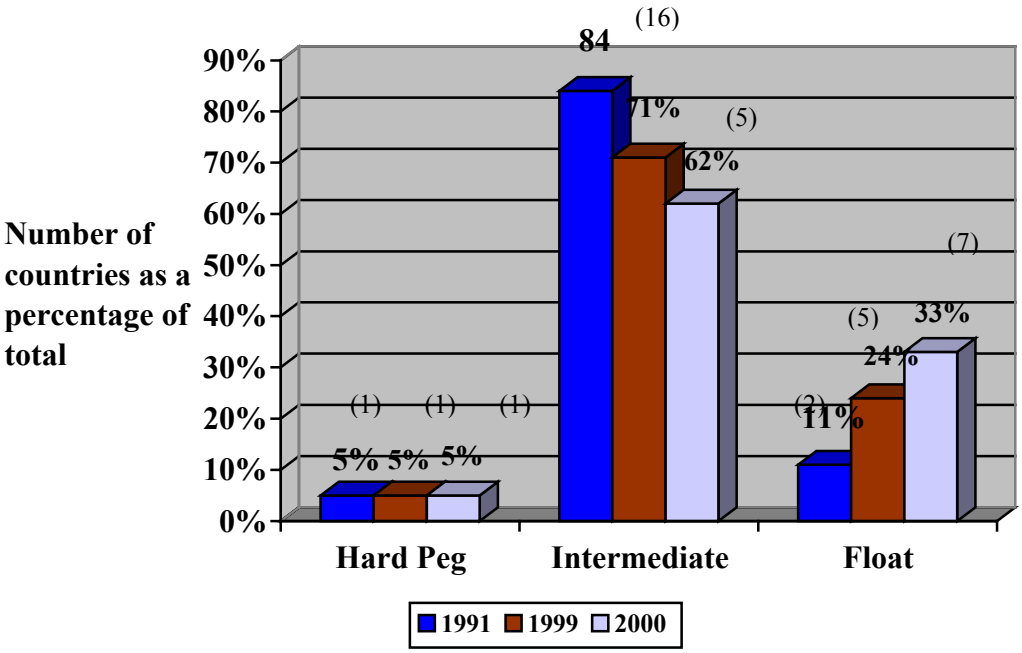


Table 2. Developing and Emerging Markets Arab Countries Grouped by Exchange Rate Arrangements

Exchange rate Regime (Number of Arab countries:(21))	Countries (as of December 1999)	Countries (as of December 2000)
NS/CBA	(1) Djibouti	(1) Djibouti
FP	(13) Bahrain, Comoros, Egypt, Jordan, Iraq, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates	13) Bahrain, Comoros, Jordan, Iraq, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates
HB	(1) Libya	(1) Libya
CP	(1) Tunisia	(0)
CB	(0)	(0)
MF	(2) Algeria, Mauritania	(5) Algeria, Egypt, Mauritania, Sudan, Tunisia
IF	(3) Somalia, Sudan, Yemen	(2) Somalia, Yemen

Figure 2. Exchange Rate Regimes in Developing and Emerging Markets Arab Countries: 1991 (19 countries)



Measures of openness in Arab countries

The IMF maintains and publishes information on members' *exchange systems* in the context of the *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*, focusing on the regulations affecting *current* international transactions and lately expanding the coverage to the *capital account* transactions. Data on the number of transaction types controlled are intended to provide an indicator of the overall degree of openness of the economy to capital movements. The formalization of the measures of openness is effected through the development of more inclusive restrictiveness indices. For this purpose, the Fund developed indices of controls on current payments and transfers denoted by *(CCI)*, indices of capital controls denoted by *(KCI)*, and indices of exchange and capital controls denoted by *(ECI)*. The latter index is an average of the two former indices and represents an overall measure of controls. These however reflect the *de jure* instead of de facto incidence of controls.

Currency convertibility and capital controls in AMF countries[26,27]

Table A2 indicate that most Arab economies (14) have accepted Article VIII. While Egypt and Libya allow for the convertibility of current payments, they haven't as of yet officially accepted Article VIII. On the other hand, both Syria and Libya still apply multiple exchange rates for various purposes, falling short of meeting Article VIII requirements.

In assessing the extent of exchange and capital controls, the AMF group of countries is split into two groups (i) high-income oil exporting countries, and (ii) other AMF countries. As illustrated in

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[26] Three articles in the IMF Articles of Agreements are relevant. *Article VIII* requires member countries to (i) avoid exchange restrictions on current payments; (ii) avoid discriminatory or multiple exchange currency practices; (iii) permit the convertibility of foreign-held balances of its currency for current account transactions, and (iv) provide information to the IMF. *Article XIV* states that for a transitional period, countries may maintain and adapt restrictions on payments and transfers for international transactions that were in place when the country became a member of the IMF (most countries have given up restrictions approved under Article XIV and have accepted the obligations of Article IV). As for restrictions on capital account, *Article VI* dealing with such matters (i) explicitly permits member countries to exercise controls over international capital movements, provided such controls do not unduly delay transfers of funds in settlement of commitments (with certain exceptions); (ii) the Fund may even request a member to impose capital controls (never used). Consideration has been given to amending the Articles of Agreement to make elimination of capital controls a purpose of the IMF and to require members to eliminate capital controls. This has not gone unchallenged in the wake of the latest East Asian financial turmoil.

[27]- Joint Arab Economic Report (2001), Appendix (10/10)—Arab Monetary Fund.
-Annual Report on Exchange Arrangements and Exchange Restrictions, AREAER, (2000)—IMF.
-World Economic Outlook, October 2001: Chapter IV "International Financial Integration and Developing Countries"—IMF.

Tables 3.1, 3.2, and 3.3 [28], we note that countries in the *first group* are well integrated into global capital markets and maintain few restrictions on international capital flows (indeed only slightly more on average than the largest industrial countries). On the other hand, the indicators for *other AMF countries* are similar, on average, to those of developing countries as a group. These countries run a substantial current account deficit, rely on attracting important inflows of foreign direct investment, have a comparable openness to trade, and maintain very similar numbers and types of restrictions on international current and capital transactions. But they are less engaged in trade and make greater use of exchange and capital controls than two of the most dynamic regions, i.e., Latin America and the newly industrialized countries of Asia. Among the second group (non-oil exporting AMF countries), it is important to note that capital account transactions are fairly liberalized in Jordan, Lebanon and Egypt. The three countries register low *(KCI)* index values similar to the ones found in highly liberalized oil-exporting countries. As capital is allowed greater mobility, the capacity of these countries to use monetary and exchange policies to achieve separate macroeconomic targets will be increasingly constrained.

A great deal of market opening remains to be done, both with respect to trade and capital flows, but to be successful and avoid endangering macroeconomic and financial stability, the liberalization of capital flows needs to be dealt with carefully. We return to this point when we

[28] Tables are provided by K. Habermeier (2000).

discuss the recommendations pertaining to the issue of liberalizing capital transactions in the group of Arab economies not yet integrated in the global financial system.

Table 3.1. Indicators of Economic Integration

	AMF Countries[1]	High Income Oil Exporting AMF Countries[1]	Other AMF Countries	Major Industrial Countries	Developing Countries	Newly Industrialized Asia	Mainland Latin American Countries
	(In percent of GDP, average 1995-99)						
Current account balance	-0.8	1.2	-2.5	-0.2	-1.4	2.9	-3.1
Foreign direct investment (net)	1.0	0.3	1.5	-0.5	2.0	0.0	2.2
Portfolio outflows	0.0	-0.1	0.0	-2.1	-0.2	-1.1	0.0
Portfolio inflows	0.1	0.0	0.1	3.1	0.9	0.7	1.4
Openness[2]	75.3	102.1	54.0	33.5	46.5	132.9	31.1
	(Indices, normalized from 0 to 1)[3]						
Exchange and capital controls	0.31	0.13	0.38	0.08	0.37	0.16	0.21
Controls on current payments and transfers	0.23	0.06	0.29	0.07	0.27	0.06	0.13
Capital controls	0.40	0.19	0.48	0.09	0.48	0.27	0.29
Capital controls, inflows	0.44	0.30	0.50	0.12	0.47	0.26	0.30
Capital controls, outflows	0.37	0.13	0.47	0.07	0.48	0.27	0.27

Source: IMF World Economic Outlook, IMF Annual Report Exchange Arrangements and Exchange Restrictions .

[1] Data not available for Iraq and Palestine .

[2] Exports plus imports of goods and services .

[3] A value of 0 indicates the complete absence of controls; a value of 1 indicats the persence of controls on every category of transaction .

Table 3.2 Measures of Exchange and Capital Controls

in Non-High Income AMF Countries

AREAER country name	***Indices of Controls***				
	ECI	***CCI***	***KCI***	***KCI-Inflows***	***KCI-Outflows***
Algeria	0.45	0.38	0.53	0.5	0.59
Comoros	0.51	0.38	0.63	0.65	0.6
Djibouti	0.17	0.18	0.15	0.17	0.16
Egypt	0.18	0.12	0.25	0.38	0.17
Iraq	0.44	0.42	0.47	0.51	0.42
Jordan	0.09	0.06	0.12	0.24	0.05
Lebanon	0.11	0.04	0.18	0.23	0.17
Libya	0.59	0.46	0.72	0.7	0.7
Mauritania	0.51	0.38	0.63	0.59	0.69
Morocco	0.42	0.28	0.57	0.51	0.66
Somalia	0.56	0.45	0.68	0.59	0.71
Sudan	0.5	0.33	0.68	0.65	0.67
Syria	0.62	0.54	0.7	0.73	0.66
Tunisia	0.53	0.26	0.8	0.87	0.81
Yemen	0.09	0.12	0.06	0.13	0.01
Group average	0.38	0.29	0.48	0.50	0.47

Table 3.3 Measures of Exchange and Capital Controls in High-Income Oil-Exporting AMF Countries

AREAER country name	*Indices of Control*				
	ECI	***CCI***	***KCI***	***KCI-Inflows***	***KCI-Outflows***
Bahrain	0.11	0.04	0.18	0.3	0.15
Kuwait	0.15	0.06	0.24	0.35	0.18
Oman	0.13	0.07	0.18	0.3	0.11
Qatar	0.08	0.06	0.09	0.17	0.04
Saudi	0.2	0.08	0.32	0.4	0.27
UAE	0.08	0.03	0.13	0.26	0.05
Group average	0.13	0.06	0.19	0.30	0.13

(CCI) denotes indices of control on current payments and transfers; (KCI) denotees indices of capital controls; (ECI) denotes indices of exchange and capital controls.

Arab financial systems: a brief evaluation

Given their often high degree of expertise and embracement of new technology, Arab financial systems are not considered strong by the international rating agencies. Eleven banking systems of AMF members rated by Moody's are not ranked in the top third in average financial strength. These assessments reflect many different concerns which vary country by country, but the most prevalent are poor credit risk management practices, excessive credit concentration (often reflecting undiversified economies), limited disclosure, inadequate

accounting, corporate governance, and limited liquidity, including in the interbank market[29].

As mentioned previously, sound financial systems form an integral part of the "integrated approach" adopted by the IMF when advising on reforms of exchange systems[30]. Adoption of international standards, improvements in disclosure and transparency, and efforts to strengthen financial systems are among the main issues discussed in fora around the world concerning the new financial architecture. Their adoption should increase both the integration of Arab financial and economic systems with those in the rest of the world and at the same time make them more resilient and stable. The details will differ substantially from country to country. In the oil exporting countries of the Gulf, greater transparency and improvements in financial sector governance may stimulate foreign and direct investment, and by diversifying the economy reduce the excessive reliance on oil exports. In many of the poorer Arab countries, the financial and policy-making infrastructure is still less developed. A consistent application of standards, be it in monetary policy-making, prudential regulation and supervision, data dissemination, or fiscal practices, will help to attract foreign

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29 M. Kara (2000) "… to provide needed momentum for reforming Arab financial systems, the AMF has responded by supplementing its traditional balance of payments financing facilities with a new facility to assist its member countries in the reform and modernization of their financial systems. The consensus is that deepening, diversifying, as well as, strengthening one's financial system is an essential prerequisite to the achievement of high and sustained growth rates…"

30 The "integrated approach" emphasizes among other things the linkages between liberalization and the need for sound financial markets and institutions, the implementation of market-based monetary control, the adoption of appropriate macroeconomic and exchange rate policies, and the development of prudential safeguards to address specific risks involved in capital flows.

investment, put domestic saving to more productive uses, and boost economic growth, while at the same time making economies and financial systems more sturdy in the face of changes in world economic conditions and market sentiment[31].

Recent developments of exchange rates and policies in Arab countries

Exchange rates in Arab countries experienced sharp fluctuations in year 2000. The external value of ten Arab currencies declined against the U.S. dollar. The extent of this effect was more prominent for currencies related to the euro in light of the recent decline of the euro against the dollar, which averaged about 14% during the year. Accordingly, the decline of the exchange rates of the *Tunisian* dinar, the *Mauritanian* ouguiya, and the *Algerian* dinar[32] against the dollar was 15.6%, 14%, and 13% respectively. In contrast, currencies of the *gulf countries*, the *Jordanian* dinar and the *Djibouti* franc (countries pegging to the U.S. dollar) appreciated against other major currencies[33].

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31 This is based on a brief assessment of the situation provided by K. Habermeier (2000).

32 During 1998 and early 1999, in the face of declining reserves, the authorities let the dinar depreciate (by 18% vis-à-vis the U.S. dollar); the dinar stabilized in the latter part of 1999 as hydrocarbon prices started recovering before depreciating again in year 2000.

33 Joint Arab Economic Report (2001), Appendix (10/11)—Arab Monetary Fund. "Exchange Rates: Domestic Currency Per U.S. Dollar (period average)". Reproduced in Table A5 in appendix A.

On the other hand, the Lebanese pound, the Egyptian pound and the Moroccan dirham were among the Arab currencies that faced more pressures than others. This has required the monetary authorities to take necessary measures in an effort to reduce the excessive volatility of the currency in the exchange market and its influence on the performance of the local economy.

During year 2000, *Lebanon* adopted a policy of fixing its exchange rate within a narrow band fluctuating between LP1501 and LP1514 against the U.S. dollar. This policy is aimed at boosting the confidence in an economy suffering from a declining growth, a huge debt buildup and recently a re-surge in dollarization of the financial economy. The central bank's intervention in the foreign exchange market helped stabilize the value of the pound albeit at the expense of drawing down the gross level of foreign currency reserves from US$7.77 billion in 1999 to US$5.94 billion in 2000 to US$5.1 in June 2001[34]. The ability of maintaining the exchange rate within a narrow corridor hinges on the success of the reforms undertaken lately which aim at spurring growth, rationing government expenditures and speeding up the privatization programs all in an effort to enhance the financial position of the government and dissipating any crowding out effect exercised by the public sector in the exchange market.

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[34] Joint Arab Economic Report (2001), Appendix (10/4)—Arab Monetary Fund. "Official International Reserves of Arab Countries". Reproduced in Table A6 in appendix A.
--More recently, the drawdown of reserves in Lebanon has been more serious. As of September 15, 2001, the gross figure stood at 3.868 billion dollars compared to 6.687 in September of 2000. The decline in net international reserves has been steeper, reflecting the trend shift from local currency to dollar deposits (only US$1.2 billion at the end of June 2001).

Similarly, the *Egyptian* pound faced significant pressures in 2000. Dating back to 1991, the objective of a (de facto) fixed exchange rate policy against the dollar was protecting those who transact on the international markets from excessive fluctuations in the foreign exchange market and bolstering international investors' confidence in the local economy. The stability of the pound up to 1997 led to a surge of financial flows and to an increase in official reserves of the central bank.

In the late 1990s, macroeconomic performance weakened as a result of a combination of policy and external factors. Among the external factors, the pound continued to appreciate as a result of the strengthening of the U.S. dollar to which it remained pegged. This along with a temporary tourism slowdown and a tightening of global financing after the Asian crisis resulted in sizable official reserve losses. In 1997, the series of shocks hitting the economy led the central bank to intervene in meeting the markets' needs of foreign exchange in support of its fixed exchange rate policy. The loss of reserves was estimated at about US$5.6 billion between 1997 and 2000 (from a peak of US$18.7 billion in 1997 down to US$13.1 billion in 2000—albeit, still a comfortable position by all means). The monetary tightening in 1999-2000 has reduced pressures on the exchange rate and helped stabilize official reserves toward end-2000. At end-June 2001, net official reserves amounted to US$14.2 billion.

During 2000, seeking to strengthen external position, the authorities departed from the de facto peg to the U.S. dollar adopted in early 1991. The shortage of liquidity of foreign exchange in the markets reached

its peak in 2000, leading to substantial deterioration in its current account deficit. In light of these developments, the monetary authorities allowed a devaluation (against the dollar) by the foreign exchange dealers reaching around 14% in 2000 with a high and low for the external value of 3.42 and 3.89 respectively. The devaluation along with other positive factors (oil prices increases and tourism sector pickup) ameliorated the current account situation in 2000. Following an initial depreciation, an adjustable currency band was adopted against the U.S. dollar in January 2001. This band was subsequently further depreciated and widened in mid-2001, resulting in a cumulative depreciation of about 25% relative to the U.S. dollar.

As for *Morocco*, the source of pressures that faced the Moroccan dirham in the foreign exchange market in year 2000 came primarily from textile, clothes and agriculture products' exporters and from tourist companies. Despite the strong external position, the external competitiveness of these sectors has been likely affected during the 1990s by an appreciation of the real effective exchange rate (REER). This, along with other important factors, may have contributed to some losses in export market shares when compared to more export-oriented developing countries. The substantial rise in capital formation over the last couple of years should reinforce export capacity, and tourism receipts and related activities have already rebounded over the last two years. Even though the REER appreciation has slowed down considerably with declining inflation, tariff dismantling under the Association Agreement with the European Union (AAEUs), combined with the phasing out of textile quotas under the WTO, will put added competitive pressures on the economy.

To date the monetary authorities have not succumbed to the demands of these export sectors to devalue the currency, which proclaims such a move would boost the competitiveness of their products and services in the international markets. The authorities fear the negative repercussions of a weaker currency on the economy stemming from a further increase of the oil import bill, an increase in the servicing costs of the external debt and importing of external inflation. The potential role of a more flexible exchange rate policy in strengthening competitiveness is assessed later.

For *Sudan*, the feeling at the IMF is that no major pressure on the exchange rate is evident, despite the virtual stability in the rate in 2000.

III. Assessment

Economic performance of Arab countries under alternative exchange rate regimes

Inflation and growth

We briefly review the extent to which a country's economic performance and the way in which monetary and fiscal policies affect *inflation* and *growth* depend on the exchange rate regime.

Before the case of Arab countries is dealt with, we note in general that for countries around the world, inflation has been lower and less volatile in the past in countries with pegged exchange rates in comparison to countries with more flexible exchange rate arrangements. Though such a difference has narrowed substantially in the 1990s[35]. On the other hand, there does not appear to be a clear relationship between exchange rate regime and output growth.

In confirmation of the general view that alternative exchange rate regimes on their own do not necessarily lead to better or worse

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[35] Over the past several years, inflation in the developing world has come down sharply, even as the number of countries adopting more flexible exchange rate arrangements has steadily increased. There is almost a convergence in median inflation rates in countries of different exchange rate regimes. This is probably a reflection of the fact that the same factor that has underlined the need for greater exchange rate flexibility, namely, the increased international integration of financial markets, has also served to discipline countries' macroeconomic policies.

inflation rates[36], the performance (in terms of inflation) of a group of Latin American countries selected arbitrarily is summarized in the following table.

Year 2000	Regime	Inflation
Argentina	Peg (CBA)	-0.7
Bolivia	Peg (crawling)	3.4
Brazil	Float	5.3
Chile	Float	4.5
Ecuador	Peg (dollarization)	91
Peru	Float	3.7
Uruguay	Peg (with band)	5

In this respect, we postulate right from the beginning that economic growth can be satisfactorily high, and inflation desirably low, under either exchange rate arrangement provided that appropriate policies and other conditions for good economic performance are in place.

As for Arab economies, most of them experienced a general deceleration in inflation as a result of prudent monetary and fiscal policies. Generally tightened demand management policies, and in some countries exchange rate corrections, helped to reduce external current account deficits. Despite this deceleration in inflation, it seems that the group of Arab countries adopting floating exchange rates registered higher inflation rates than the pegged group. In year 2000,

[36] There are cases in which exchange rate stabilization policies resulted in lowering inflation, but unless accompanied by timely "exit" strategies, such policies may have adverse consequences on the economy.

Sudan and Yemen registered the highest inflation rates in the region (10% and 9%, respectively), while Tunisia, Algeria, Egypt, Mauritania, all belonging to the managed float (MF) group, recorded higher inflation on average than the fixed and pegged regimes group—the average inflation for the (MF) group is 2.6% compared to an average of 0.4% inflation rate in AGCC countries belonging to the peg group. In this regard, it is interesting to note a correlation between the high level of international integration of financial markets (low index value of exchange and capital controls) and low inflation, which applies for most of the countries just mentioned. It would appear that increasing the international integration of financial markets (say in Algeria, Tunisia, Mauritania, and Sudan) could add a further disciplining element to the countries' macroeconomic policies.

Despite the general positive picture of successful demand management policies, low inflation and fiscal retrenchment, growth of real GDP remained generally weak while population continued to grow briskly in the region. The slow pace of improvements in production efficiency may have contributed to the modest inflow of foreign direct investment and kept growth largely import substituting rather than outward oriented. While this paper is not about the causes of the slow growth in the region, it is obvious that a structural reform strategy to improve resource allocation and create institutional conditions suitable for accelerated growth while maintaining internal and external stability is desperately needed. As will be seen later, exchange rate flexibility is advocated as part of this strategy in a number of cases.

Table 4. Annual Rates of Change in the Consumer Price Index
Arab Countries (1989-2000)

(in percent)

COUNTRY	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Jordan	25.7	16.1	8.2	4.0	4.7	3.6	2.3	6.5	3.0	3.1	0.6	0.7
United Arab Emirates	3.3	0.6	5.5	6.8	5.1	4.2	4.8	2.6	2.0	3.5	2.0	1.3
Bahrain	1.5	0.9	0.8	-0.2	2.5	0.9	2.7	-0.2	1.0	-0.4	1.3	2.0
Tunisia	7.8	6.5	8.2	5.8	3.9	4.8	6.3	3.7	3.7	3.0	2.7	4.1
Algeria	9.3	16.7	25.9	31.7	20.5	29.0	29.8	18.7	5.7	5.0	2.6	0.3
Saudi Arabia	1.0	2.0	4.9	0.2	0.8	0.6	4.9	0.9	-0.4	-0.2	-1.3	-0.7
Sudan	70.0	64.7	125.0	117.5	101.5	115.2	68.4	132.8	46.6	17.1	16.0	10.0
Syria	11.4	19.3	9.0	11.0	13.2	15.3	7.6	8.8	2.2	-0.5	-2.1	-0.6
Somalia	101.8	200.3	...	...	...	...	...	...	...	...	...	...
Iraq	6.2	10.9	328.6	68.1	...	...	...	...	...	...	...	...
Oman	1.4	-0.4	4.6	1.0	1.2	-0.7	-1.3	0.3	0.6	-0.6	0.4	-0.8
Qatar	3.3	3.0	4.4	3.1	-0.8	1.3	3.0	2.5	4.9	2.9	2.2	-1.0
Kuwait	3.3	9.9	9.1	-0.5	0.4	2.5	2.7	3.6	0.7	0.2	3.0	1.7
Lebanon	69.9	70.1	60.0	105.0	8.8	10.0	10.3	8.9	7.8	4.0	1.0	0.0
Libya	...	...	...	...	...	...	...	...	...	...	...	...
Egypt	21.2	16.8	19.8	13.6	11.1	9.0	9.3	7.2	4.6	3.8	3.1	2.1
Morocco	3.1	7.0	8.0	5.7	5.2	5.2	6.1	3.0	1.0	2.7	0.7	0.6
Mauritania	12.9	6.6	5.6	10.1	9.4	4.2	6.6	4.7	4.6	8.0	4.1	3.2
Yemen	20.3	34.0	36.0	29.4	38.1	49.4	54.5	30.8	-3.6	5.5	-1.2	9.0

Source : Economic Indicators, Table 5. Arab Monetary Fund (2001)

Table 5. Annual Growth Rates of Gross Domestic Product (%)
Arab Countries (1995-2000)

(national data in local currency)**

COUNTRY	1995-2000 *	1995	1996	1997	1998	1999	2000
Jordan	3.0	6.4	2.1	3.1	2.9	3.1	3.9
United Arab Emirates	5.2	6.7	6.1	6.7	4.1	3.8	5.2
Bahrain	4.0	3.9	4.1	3.1	4.8	2.9	5.2
Tunisia	5.7	2.4	7.1	5.4	4.8	6.2	5.0
Algeria	3.4	3.8	3.8	1.1	5.1	3.3	3.8
Djibouti	0.1	-3.6	-3.7	0.7	0.8	1.3	1.5
Saudi Arabia	1.7	0.5	1.4	2.0	1.7	-0.8	4.1
Sudan	5.7	4.4	4.0	6.7	5.0	6.0	6.7
Syria	3.6	5.8	7.3	2.5	7.6	-1.8	2.5
Iraq	…	…	…	…	…	…	…
Oman	3.1	4.8	2.9	6.2	2.7	-1.0	4.6
Qatar	10.4	2.9	4.8	24.0	12.3	7.6	4.3
Kuwait	1.4	1.2	1.2	2.3	2.0	-2.4	4.1
Lebanon	2.0	6.5	4.0	4.0	3.0	-1.0	0.0
Libya	1.6	-1.6	1.2	1.3	-3.0	2.0	6.5
Egypt	5.7	4.7	5.0	5.3	5.7	6.1	6.5
Morocco	3.1	-6.6	12.2	-2.2	6.8	-0.7	0.3
Mauritania	4.4	4.5	4.7	4.8	3.5	4.1	5.0
Yemen	5.5	10.9	5.9	8.1	4.9	3.7	5.1
Arab Countries	**3.5**	**…**	**4.0**	**3.4**	**3.7**	**1.8**	**4.4**

* Average annual growth rate over the period .

** National data provided by officials in Arab Countries .

Source :Joint Arab Economic Report (2001), Appendix (7/2).

Measure of competitiveness[37]

There has been an increased recognition in Arab countries of the role played by external policies, particularly exchange rate policies, in achieving and maintaining competitiveness, and thus balance of payments viability, which is critical for sustained growth.

The real exchange rate (RER) is deemed to be a good proxy for a country's degree of competitiveness in international markets. According to Edwards (1988), it is defined as the relative price of tradable goods with respect to the price of nontradable goods. A decline in the RER represents a real exchange appreciation or a rise in the domestic cost of producing tradable goods. An increase, conversely, reflects real exchange depreciation or an improvement in the country's international competitiveness[38].

Few papers on the effects of real exchange rate misalignment (RERM)[39] on the collective economic growth of Arab countries have been written. RERM describes a situation in which a country's actual (RER) deviates from its long run, sustainable, equilibrium-level. Misalignment could refer to either an undervalued or overvalued

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37 Reference: (1) Domaç and Shabsigh and (2) Nashashibi, Brown and Fedelino: Chapters 8 and 10, respectively, in I. Zubair, editor (2001).

38 Below, we use the IMF methodology in defining a real effective exchange rate based on an indirect quote for the exchange rate. See Aghevli, Khan and Montiel (1991).

39 There is generally a lack of consensus on what constitutes an appropriate indicator of misalignment and the methodology for producing it.

exchange rate—in the latter case the exchange rate is more appreciated than its equilibrium level. Correction of misalignment generally entails both demand management policies as well as real exchange rate adjustments. In summary, misalignment can lead to a reduction in economic efficiency, a misallocation of resources, and capital flight[40].

Evidence from Latin America, Asian, and African countries supports the view that the link between the RER behavior and economic performance is strong. It is argued that, although unstable RERs undermined export growth in Latin America, their stability was central in promoting East Asian expansion. Conversely, many African countries experienced sustained RERM, which in turn obstructed the development of agriculture and reduced the domestic food supply.

Among the rare studies of Arab countries' exchange rate policies and their effects on economic performance, Domaç and Shabsigh study the

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[40] Misalignments adversely affect economic growth in three different ways. *First*, they could undermine external competitiveness by overpricing exports. This would result in deterioration in the external balance and a depletion of foreign exchange reserves. This in turn may ultimately lead to a sharp devaluation in the wake of an external balance of payments crisis, with the associated adverse effects on domestic prices and production. *Second*, they could cause a misallocation of resources by distorting the prices of domestic goods relative to each other and to international prices. This would adversely affect domestic investment, causing losses in domestic production through reduced efficiency. Third, they could adversely affect domestic financial markets, by increasing uncertainty in these markets and by encouraging speculation against the domestic currency. If the overvaluation is sustained, many industries and banks may fail due to speculation. In the latter case, the government may have to bear heavy costs to bail out the financial system … Domaç and Shabsingh (2001).
--See also Cottani, Cavallo and Khan (1990) on the links between RER and economic growth.

effects of exchange rate policies on growth in four Arab countries (Egypt, Jordan, Morocco and Tunisia) for the period 1970-1996. The empirical results confirm that misalignments stemming from exchange rate policies in these countries had adverse effects on their economic growth during the period 1970-1990. The authors note that the liberalization and economic reform policies initiated by these countries in the late 1980s and 1990s have resulted in major realignments of their real exchange rates, which—if pursued in a sustained fashion—could enhance their growth prospects.

Nashashibi, Brown and Fedelino (2001) on the other hand assessed, among other things, how Arab countries as a group has fared in competitiveness[41]. To this end, they analyzed development in real effective exchange rates (REER) as an indicator of competitiveness. To isolate the effect of oil on export and output, Arab countries were divided in two groups, oil-exporting countries (comprising Algeria, Libya and GCC countries) and non-oil-exporting countries (Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Mauritania, Morocco, Sudan, the Syrian Arab Republic, Tunisia, and the Republic of Yemen).

For oil-producing countries, whose first and foremost export is oil, the real exchange rate is not necessarily an indication of competitiveness,

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[41] Nashashibi, Brown and Fedelino (2001) provided the relevant REER series. The following paragraphs draw heavily from the thorough analysis of the series' behavior in their paper.

because oil prices are determined in the world market and costs of production are not a determinant of export performance. Nevertheless, for these countries the real exchange rate is still a relevant indicator of the competitiveness for non-oil exports as well as of the tradable sector as a whole; this is important for the oil-exporting countries with relatively large populations (e.g., Algeria and Saudi Arabia) where there is a need to create employment opportunities for the rapidly growing labor force, or for those oil-exporting countries where there is substantial potential for non-oil activities (Bahrain, Oman, Qatar, and the UAE particularly in the service sector).

REER is defined according to the standard IMF methodology as follows[42]:

$$REER = \sum_{i=1}^{n} w_i \frac{e_{it}}{e_{io}} \frac{P_d}{P_{fi}}$$

e_{it} : units of foreign currency per unit of domestic currency

w_i : bilateral (trade) weights, where the subscript (i) denotes the ith partner

n : (trading) partners

P_{fi} : the level of foreign prices in the trading partner country i

[42] Under the assumption that all traded goods are homogeneous and that international trade equalizes their prices across countries, the REER provides a measure of the evolution of nontradable prices in various countries. With an indirect quote definition of the exchange rate, an increase (numerical) in the REER indicates appreciation and, other things equal, a loss of competitiveness.

$^{(0)}$: base year

P_d : level of consumer prices in the home country

In analyzing the recent REER trends, the authors noted that the REER depreciation of the 1980s reversed into appreciation in the 1990s for the region as a whole. REER averages for the three main country groupings in the region (GCC, Mashreq, and Maghreb[43]) showed depreciation in the latter half of the 1980s reversing into appreciation in the early 1990s (Figures 3 and 4). Regression analysis also supports the evidence of a turnaround in the trend around 1992 toward appreciation.

What factors contributed to the reversal of this trend? For the *GCC countries*, whose currencies are pegged to the U.S. dollar (or to baskets in which the dollar is a significant component), the main factor was the appreciation of the dollar in the 1990s. A similar factor may have been at play for several of the *Mashreq economies*, and for Morocco, all of which adopted fixed exchange rate regimes in the early 1990s. Moreover, although these countries have generally succeeded in implementing tight demand management policies and have achieved substantial fiscal retrenchment to contain the rise in nontradable prices, during the period 1992-1998 some inflation differentials remained relative to trading partners, resulting in further real appreciation. In

[43] GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; the Mashreq economies include Egypt, Jordan, Lebanon and Syria; and the Maghreb economies include Algeria, Morocco and Tunisia.

contrast to the fixed exchange rate regimes adopted by the countries mentioned above, Algeria, Tunisia, and Yemen adopted more flexible exchange rate policies. Tunisia targeted a stable real effective exchange rate after 1992, depreciating its nominal exchange rate by 4 percent annually relative to the dollar between 1992 and 1998. Algeria also adjusted its rate of exchange to ensure that the REER would not appreciate on a sustained basis. Consequently, the post-1992 REER appreciation for both countries was much less pronounced than for the first group of countries.

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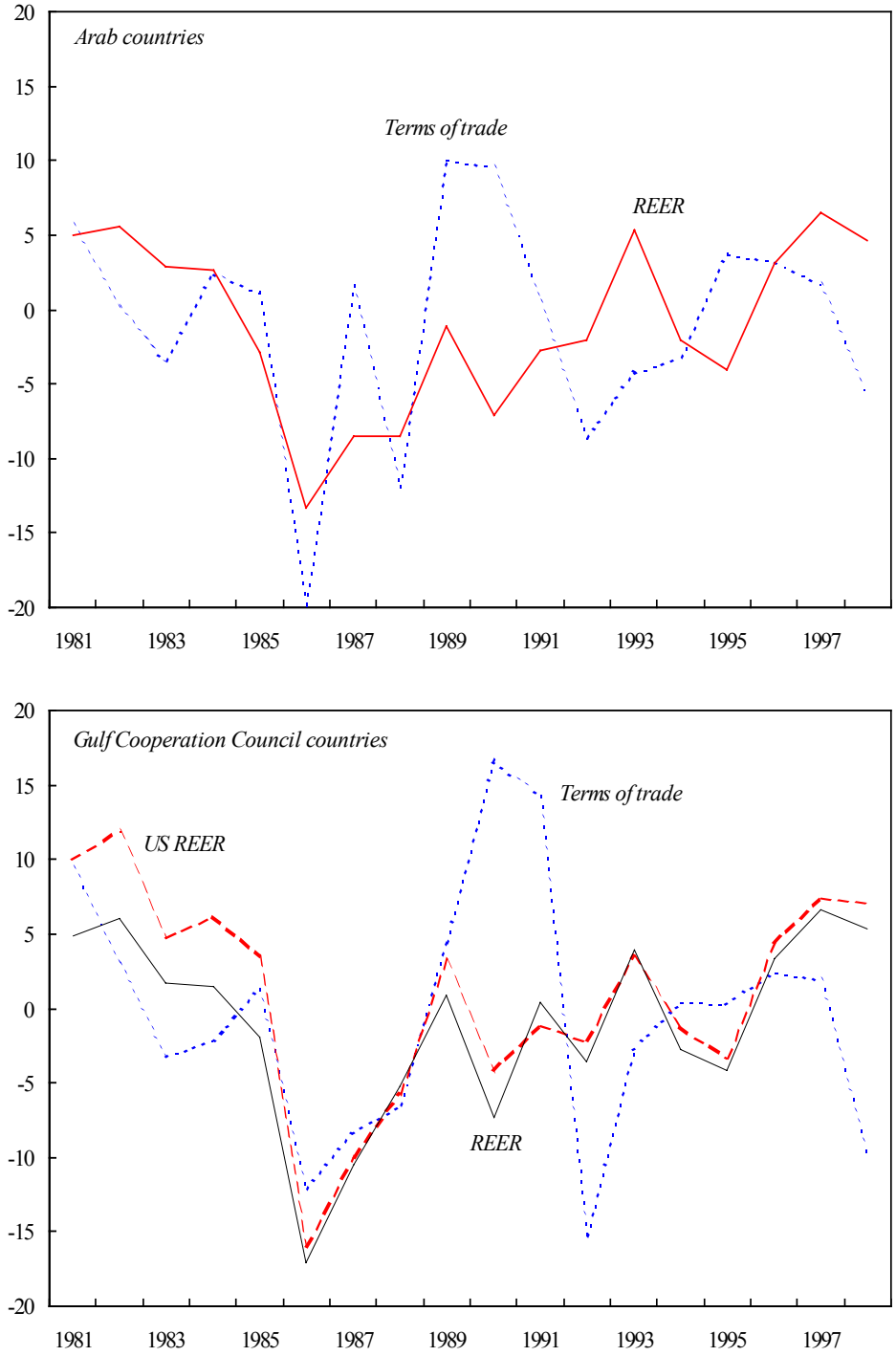
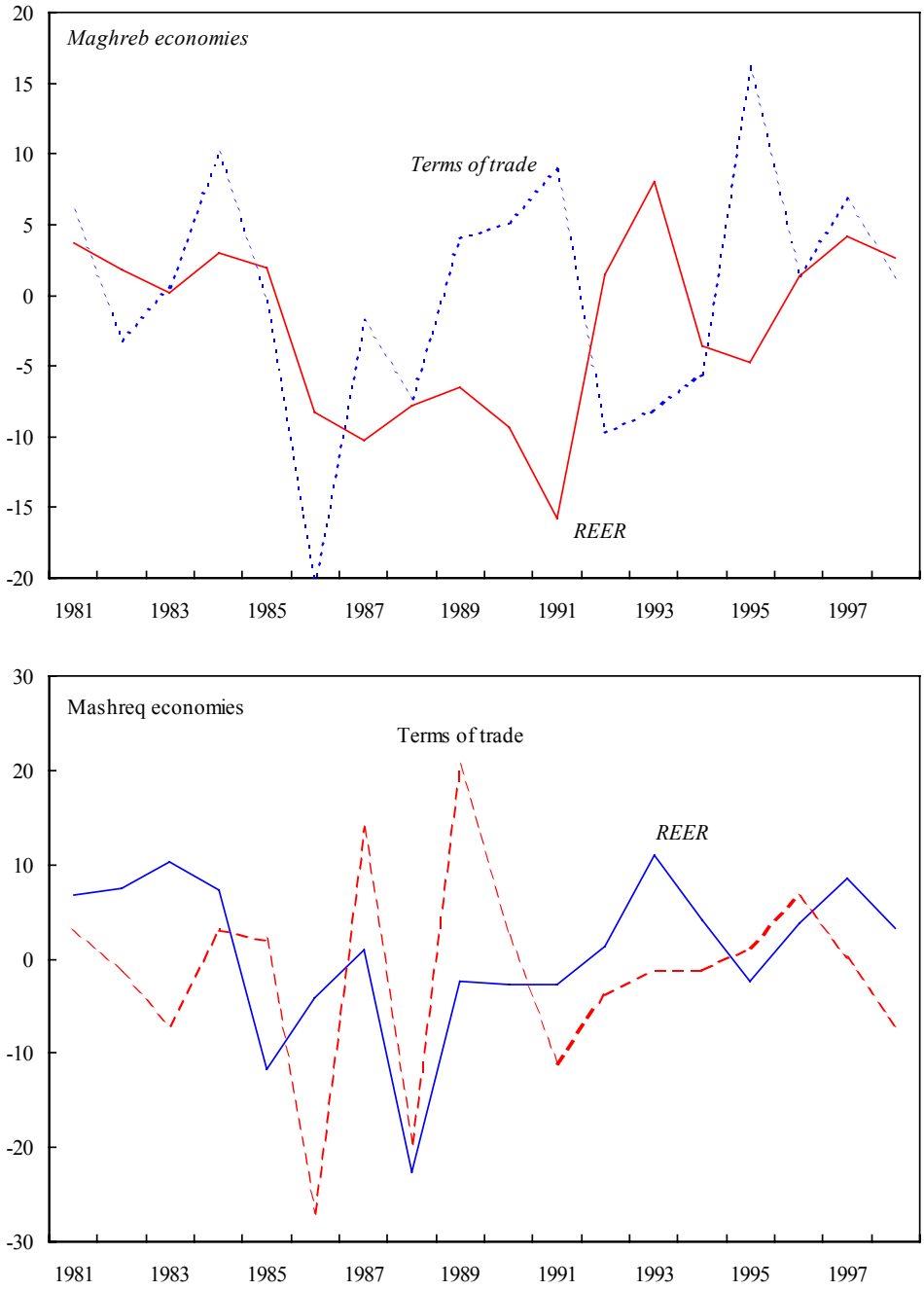
Figure 3. Annual Changes in Real Effective Exchange Rates and Terms of Trade in Arab Countries
(in percent)



Source: IMF, Information Notice System and World Economic Outlook. Note: Annual changes in country's REER are weighted by the country's share of total export volume for the whole sample in the same year.

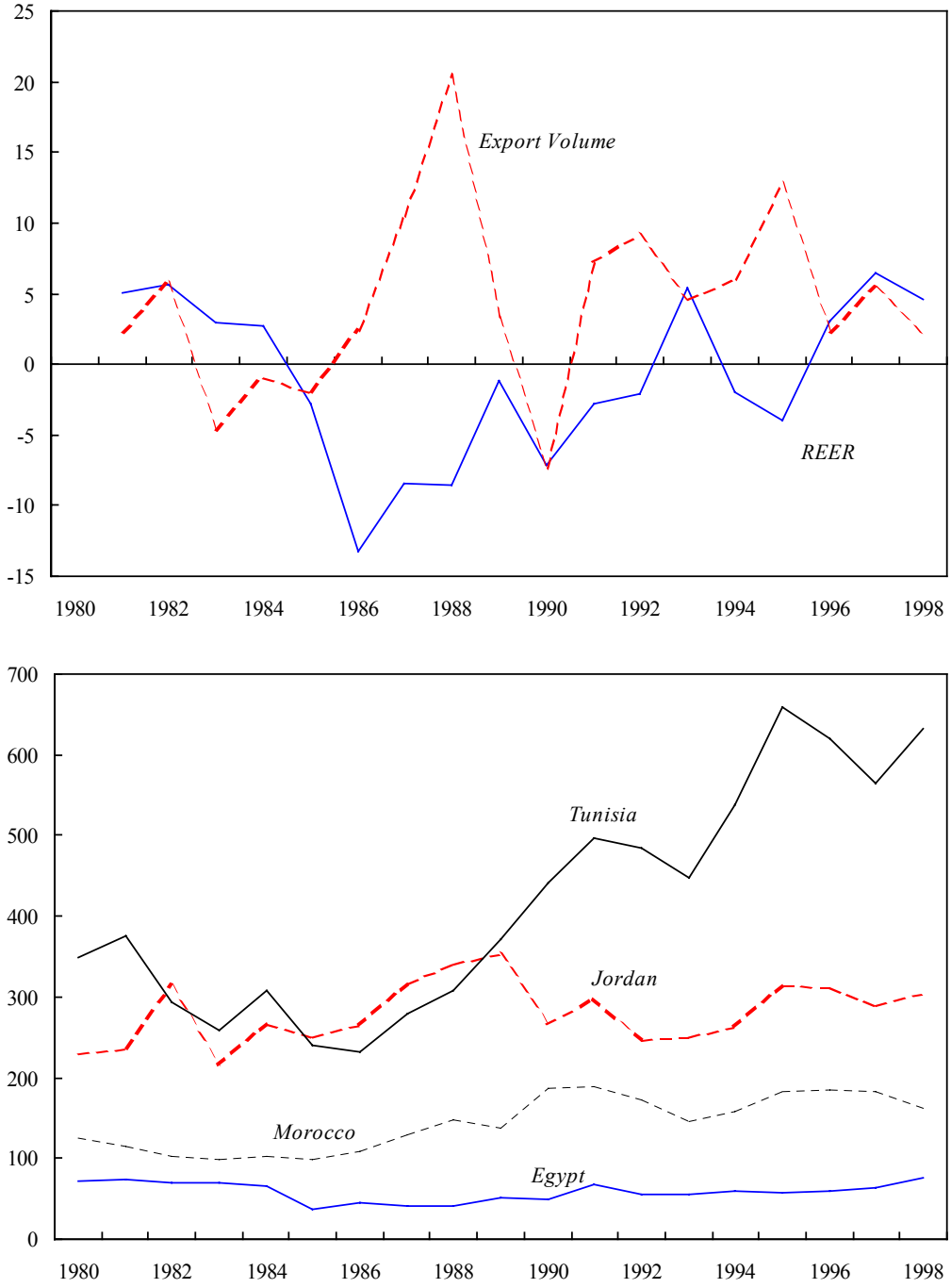
This appreciation appears to have contributed to the slowing of export volume growth in the 1990s, particularly in the last three years of the sample. Figure 5 provides some preliminary evidence on the negative relationship between the changes in REERs and *export volumes* (excluding oil, since oil exports are unlikely to be affected by movements in a country's REER) for the sample period. Episodes of real appreciation in REERs dampened the growth of non-oil exports and the potential for diversification. Tunisia's managed exchange rate may have helped to promote its export performance, which improved in the 1990s, in contrast to the declines experienced by Morocco, Egypt and Jordan. For some non-oil exporting countries with fixed exchange rates, such as Egypt and Jordan, the decline in export volume growth in the last three years was quite sharp.

Figure 4. Annual Changes in Real Effective Exchange Rates and Terms of Trade in Arab Countries
(in percent)



Sources: IMF, information Notice System and World Economic Outlook. Note: Annual changes in a country's REER are weighted by the country's share of total export volume for the whole sample in the same year.

Figure 5. Export Indicators for Arab Countries



Sources: IMF, Information Notice System and World Economic Outlook.
1 For Algeria and the Gulf Cooperation Council countries, includes only non-oil exports. For other countries, includes total exports.

Although it is perhaps too early to see strong signs of the potential effects of such developments on real GDP growth, some countries nevertheless experienced a noticeable decline in real GDP growth in the last three years of the sample period.

Some theoretical hypotheses explaining the choice of exchange rate regimes

Are two sizes only fit for all Arab economies?

The evidence presented in section II predicates that countries around the world are moving away from the center of the distribution of exchange rate arrangements. Hence, it is useful to ask whether the two sizes deemed to be the only viable choices according to the bi-polar view is fit for Arab countries (taking into consideration the importance of the exchange rate for mid-size and smaller open economies). For various reasons, such economies have opted not to choose a hard peg regime (with the exception of Djibouti[44]). On the other hand, in light of the absence of well developed monetary, financial and policy-making institutions in the region, a smoothly functioning pure floating regime cannot be realistically supported. For the moment, intermediate regimes continue to be in favor—mathematically, the solution to the tradeoff between internal monetary stability and constancy of the exchange rate is likely to be an interior one.

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[44] The desirability of creating a currency board in the Palestine Authority—among other alternative monetary regimes—is reviewed later.

As classified elsewhere, most Arab economies[45] are *non-emerging market developing economies*. In this section, a distinction is drawn between (1) oil-exporting economies characterized as being well integrated into global capital markets (the group of GCC members), (2) non-oil exporting, highly-integrated countries (Egypt, Jordan, Lebanon) and, (3) non-oil exporting countries, with high exchange and capital controls.

When assessed against the *bi-polar hypothesis* (built on the premises of increased capital mobility), the conclusion is that because of the limited involvement of non-emerging market developing countries with modern global financial markets, some form of exchange rate peg or band or highly managed float is generally more viable and more appropriate for them than for most of the emerging market countries[46]. While this conclusion may well be true in general, it is contrasted using an example drawn from the globally integrated AGCC countries. The viability of their (pegged) regimes is more so attributed to the fact that the currencies are backed by hefty foreign exchange reserves and a war chest of billions in U.S. dollars of liquid securities invested overseas. With the loss of the monetary independence as a stabilization tool (dictated by the "impossible trinity" argument) readily accepted by the monetary authorities, an alternative compensating adjustment mechanism, based on the stabilization role of the fiscal policy (mainly

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45 Recall that Egypt, Jordan, Morocco and Qatar are regarded as "emerging markets" economies.

46 Mussa *et al* (2000).

through a fiscal transfer system not afforded elsewhere in the region) is put in place.

What about the validity of the arguments proposed by the *fear of floating hypothesis*[47] in explaining the pegged exchange rate regimes in the region? High dollarization in financial systems on the asset side (foreign denominated assets held) and/or high unhedged foreign currency liabilities can both increase the likelihood of fixing the exchange rate[48]. A fixed arrangement as such is likely to protect the economy from the effects of potentially excessive exchange rate and money market volatility. This *fear of floating hypothesis* argument rightly applies in the case of numerous Arab countries who officially allow their exchange rate to float but don't in actual practice, rendering in this case the demise of the fixed exchange rates a fallacy.

The general trend dictates that as the ability in hedging exchange rate risk exposure is enhanced, and as countries not yet integrated in the global financial system increasingly become so[49], it is more likely that

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47 Calvo and Reinhart (2000).

48 Lebanon, Yemen, Jordan and Egypt are among the more highly dollarized systems in the Arab region. This is illustrated in Table B1 in Appendix B.

49 Countries would want to open up their capital account as a natural step in their development progress. The evidence that the more developed economies in fact all have open capital accounts backs this claim. On the positive side, less restrictive capital controls and higher international capital flows can increase investment possibilities, create technology spillovers, and deepen domestic capital markets. The possibility of sudden capital flows reversals can create instability in the economy. However, strong and internally consistent domestic macroeconomic and financial policies, and sufficiently developed financial systems to cope with large capital flows, together work to reduce the magnitude of that risk.

we will observe greater exchange rate flexibility. In the meantime, until such features evolve and become well established, the order of the day for most Arab economies following a pegged system is to continue with their policies. The say “if it ain’t broke, don’t fix it” rightly applies here. Undoubtedly, there are important qualifying caveats that need to be respected on a country-by-country basis in order to take into account the wide differences in the levels of economic and financial development among Arab countries.

Prior to assessing the use of nominal anchors in conducting monetary policies in Arab countries, Box 3 highlights concepts in explaining the optimal choice of exchange rate regimes. Among the more important ones, the impossible trinity argument, the internal consistency of monetary and exchange rate policy and operations, the effective ways to liberalize the capital account and intervention in the foreign exchange markets are discussed in details.

Box 3. Monetary and Exchange Rate Policy and Operations, and Issues in Capital Account Liberalization and Foreign Exchange Intervention

The impossible trinity

Secular movements in the scope for international lending and borrowing is understood in terms of a fundamental macroeconomic policy trilemma that all national policymakers face: the chosen macroeconomic policy regime can include at most two elements of the *"impossible trinity"* of (i) full freedom of cross-border capital movements, (ii) a fixed exchange rate, and (iii) an independent monetary policy oriented toward domestic objectives.

If capital movements are prohibited (element (i) is ruled out), a country on a fixed exchange rate can break ranks with foreign interest rates and thereby run an independent monetary policy. Similarly, a floating exchange rate (element (ii) is ruled out) reconciles freedom of international capital movements with monetary-policy effectiveness (at least when some nominal domestic prices are sticky). But monetary policy is powerless to achieve domestic goals when the exchange rate is fixed and capital movements free (element (iii) is ruled out), since intervention in support of the exchange parity then entails capital flows that exactly offset any monetary-policy action threatening to alter domestic interest rates.

Countries' attempt simultaneously to hit exchange-rate targets and domestic policy goals has, almost as a logical consequence, entailed exchange controls or other harsh constraints on international transactions, not to mention the related problems of policy credibility and international noncooperation similarly inimical to foreign investment.

Reference: Obstfeld and Taylor (1996)

Box 3…continue

Internal consistency of monetary and exchange rate policy and operations

Internal consistency of the elements of monetary and exchange rate policies is crucial in ensuring the achievement of the authorities' ultimate objectives of economic policy. The exact manner in which this consistency is manifested in turn depends on the nature of the chosen arrangement and the accompanying operating monetary framework.

The integration of financial markets globally has underscored the need for consistency between exchange and monetary policies, as countries deregulated their financial systems and liberalized their capital account[50]. In such an environment, less than consistent policies complicates, and places significant strains on, the implementation of monetary policy. Against this backdrop, an underlying condition based on the principal of arbitrage suggests that the ex-ante risk adjusted rates of return will be equalized across all assets. The *uncovered interest rate parity condition* states that in a fixed (pegged) or targeted (crawling) exchange rate regime, the central bank must set the interest rate consistent with the foreign interest rate adjusted for expected exchange rate depreciation. If it does not, capital flows will tend to undermine monetary policy. As long as the exchange rate (or the targeted rate) is credible, it represents an implicit guarantee for capital flows. The *covered interest rate parity condition* (in the presence of a formal forward exchange market) states that provided that domestic and foreign assets are perfect substitutes, international mobility of capital will ensure equality of rates of return across countries. Because the foreign interest rate and forward exchange rate are determined externally, a country can only determine the domestic interest rate or the spot exchange rate, but not both. With greater freedom of capital movements, any attempt to set both interest rates and exchange rates could give rise to incentives for significant short-term capital

[50] The principal forces driving the growth of international trade and investment are (1) the liberalization of financial transactions, including the deregulation of financial markets, (2) the removal of controls on capital movements, (3) and the liberalization of trade and exchange controls (technological and financial innovation has also shaped the evolution of the international exchange and payments systems).

Box 3…continue

flows. In the presence of capital controls, however, some temporary independence of monetary policy could be achieved[51].

Liberalizing the capital account … the effective way

As a country develops it would want to open up its capital account[52]. This is best done gradually, at a time when the exchange rate is not under pressure, and, as the necessary infrastructure—in the form of strong and efficient domestic financial institutions and markets, a market-based monetary policy, an effective foreign exchange market, and the information base necessary for the markets to operate efficiently—is put in place. Unless the country intends to move to a hard peg, it would be desirable to begin allowing some flexibility

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51 Ariyoshi *et al* (2000) provide a detailed discussion of experiences with capital controls. Based on internally consistent macroeconomic and structural policies, *China* successfully maintained its pegged exchange rate through the Asian crisis with the assistance of capital controls. In *Malaysia* (a relatively more open economy than China) the idea behind the controls was that, insulated from speculative pressure, interest rates can be cut without sending the currency through the floor, while the government gives the economy a big fiscal stimulus. However, the slow progress achieved to date in tackling the non-performing loans' problem, as part of reforming Malaysia's banking system, remains a major obstacle in the economy. As for the capital inflows controls, as in a *Chilean* encage markets-based style, the typical instance occurs when a country is trying to reduce inflation using an exchange rate anchor, and for anti-inflationary purposes needs interest rates higher than those implied by the sum of the foreign interest rate and the expected rate of currency depreciation. A tax on capital inflows can in principle help maintain a wedge between the two interest rates. The effectiveness of such measures wears off if applied over a long period of time.

52 The following is probably more appropriately directed to *Arab countries* liberalizing their capital accounts at the same time holding modest reserves for defending credibly a pegged regime. Those countries are also assumed to lack a substitutable adjustment compensating mechanism to the stabilization role a flexible regime offers.

Box 3… continue

of exchange rates as the controls are gradually eased. Prudential controls that have a similar effect to some capital controls would also be put in place as direct controls are removed.

In most general cases, the policy response to capital inflows has involved allowing more flexibility in exchange arrangements. Nevertheless, some countries have subordinated monetary policies to the maintenance of exchange rate pegs as part of their programs of stabilization and structural reform, or in the context of regional integration initiatives. On the other hand, there are countries that have adopted a strong nominal exchange rate anchor, subordinating monetary policy to the maintenance of the anchor, and allowed interest rates to adjust in response to capital movements. This has enabled them to avoid capital flow reversals that would have been provoked by uncertainty about the exchange rate. Because they cannot use exchange rate policy to reduce short-term capital inflows, they have paid greater attention to *prudential standards*[53] to reduce the risks associated with potential reversals in capital flows. Other countries have targeted the exchange rate (hence, monetary policy) to maintain competitiveness and relied on *fiscal consolidation* to achieve domestic stabilization and offset the effects of large capital inflows. However, because fiscal policy is fairly inflexible in the short term, the authorities have had to resort to other measures—*capital controls*, in particular—to deal with volatile flows. Generally, such controls are effective primarily as temporary measures … *Fischer (2001)*.

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[53] Prudential regulations can, for example, limit the open foreign exchange positions of banks, but it is harder to control corporate sector financing through such regulations, and it is in any case probably unwise to rely to too great an extent on supervision to prevent transactions that would otherwise be highly profitable … (Fischer 2001). I must add that the heavy weight on regulation and supervision must give way to greater emphasis on *market discipline*, where the rules are monitored and enforced by the action of the financial markets. Financial engineering and cheap information technology increase the ability of banks to escape regulation. Moreover, regulatory sources cannot match those available to private sector.

Box 3…continue

It is also worth noting that high capital mobility alters the effectiveness of different monetary instruments in achieving the objectives of monetary policy. For example, instruments that impose a high cost or administrative constraints on the banks may be circumvented more easily by disintermediation through the capital account, and therefore become less effective[54].

Intervention in foreign exchange

Intervention strategy is outgrowth of broader policy choices. In light of the importance of exchange rates, some countries intervene directly from time to time in the foreign exchange markets to try to stabilize them[55] over and above the interest rate policies that also work to affect the exchange rate.

Decisions as to which two to choose from the impossible trinity have an impact on the intervention regime of a country. Under a currency board arrangement in Hong Kong, capital flows freely and interest rates are linked to the U.S. monetary policy. The intervention is quite frequent—the willingness to tolerate very high interest rates when HK$ is under pressure is plausible given the strong banking systems in HK. New Zealand follows a free float (no intervention has been conducted in the last 16 years), allows capital flows and retains control over monetary policy. Another example, Malaysia, followed a fixed rate supported by intervention and system of capital controls (capital controls applied in 1998) while retaining control over monetary policy.

While intervention is passive (can become more active at times when currency is under pressure) under fixed or pegged regimes, it is rather active (policymakers must make affirmative decision) under a floating rate regime.

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54 The process of sequencing financial sector reforms is summarized in the book by Johnston and Sundararajan (1999)—Chapter 2 deals specifically with the issue of monetary control reform and the use of indirect monetary instruments.

55 The Fed in the U.S. intervenes to "counter disorderly market decisions". Canada practices "leaning against the wind" policy.

Box 3…continue

Intervention is used periodically when market is at extremes. So long as they are not perceived as trying to defend a particular rate, such interventions can be useful. Admittedly, this is one area in which central bankers follow more or less a judgmental approach about market conditions when intervening.

A distinction is drawn between (1) unsterilized intervention (the norm in fixed rate regimes) where the foreign exchange intervention is not offset by other domestic open market actions[56] and, (2) sterilized intervention (the normal situation in floating rate regimes) where the foreign exchange intervention is offset by activity in domestic reserves market[57]. Here foreign exchange intervention is not allowed to dictate monetary policy stance; it affects composition of central bank balance sheet—but not the size (example: reduced foreign securities and increased domestic securities).

As far as *Arab economies* are concerned, it is important that large (one-sided) interventions in the foreign exchange markets do not result in large real appreciation in their currency, which may hamper the development of diversified and competitive export sectors. Efforts to further develop the interbank foreign exchange markets should be stepped up while reducing the exchange transactions undertaken by central banks to encourage greater participation by banks.

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[56] Example: The central bank buys domestic currency and reduces liquidity. This leads to a rise in interest rates inducing investors to buy currency. This is the only kind of intervention that can be systematically effective under fixed exchange rates.

[57] Example: The central bank buys domestic currency and reduces liquidity; ceteris paribus, interest rates rise. To offset drain from intervention, it buys domestic government securities and pays with cash.

Monetary regimes and corresponding operating frameworks

In recent years a growing consensus has emerged for price stability as the overriding, long-run goal of monetary policy. However, despite this consensus, the following question still remains: how should monetary policy be conducted to achieve the price stability goal?[58] The monetary policy frameworks in Arab countries (as shown in Table A3) are revisited. While monetary arrangements employed to achieve the objective of price stability differ, we discern from the Arab experience a prevalent use of *exchange rate anchors*.

Different types of monetary and exchange operating frameworks may address differently certain policy conflicts that may arise from a significant exogenous shock or preexisting macroeconomic disequilibrium. The ultimate choice among alternative operating frameworks depends on the preferences of the monetary authority regarding which type of trade-off they wish to accommodate, the specific features of the economy (openness, nature of the shocks affecting the economy), the stage of development of the financial markets, the technical capacity of the central bank[59], the fragility of the banking sector, the magnitude of fiscal deficit and public debt and the nature of the transmission mechanism through which the effects of the central bank's actions are transmitted—a tall order of things to consider.

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[58] To shed light on this question, Mishkin (1999) examines the experience with different monetary policy regimes currently in use.

[59] Where such capacity lacks, more rule-based frameworks such exchange rate pegs or mechanical money growth targets are favored.

Exchange rate anchors in Arab economies: advantages and words of caution

With open capital markets, an *exchange-rate target* results in the loss of monetary policy independence since the targeting country loses the ability to use monetary policy to respond to domestic shocks that are independent of those hitting the anchor country. An exchange-rate target means that shocks to the anchor country are directly transmitted to the targeting country because changes in interest rates in the anchor country lead to a corresponding change in interest rates in the targeting country (irrespective of the conditions in the targeting country in terms of growth and unemployment)—this is generally true for a large number of Arab countries pegging to the U.S. anchor country.

Under an exchange-rate target regime, it is often argued that central banks are more susceptible to pursue overly expansionary policies that are not discovered until too late, when successful speculative attacks has undermined the economy. By also providing a more stable value of the currency, exchange rate targeting might lower the true/perceived risk for foreign investors. Lack of accountability of the central bank under an exchange-rate target regime can make it harder to ascertain its policy actions[60]. In contrast, exchange rate depreciation when the exchange rate is not pegged can provide an early warning signal that monetary policy is overly expansionary, and fear of depreciation can

[60] Thailand, before the July 1997 currency crisis, serves as an illustrative case.

make overly expansionary, time-inconsistent monetary policy less likely.

The general conclusions drawn with respect to this regime are that (1) an exchange-rate target does not guarantee that the commitment to the exchange-rate based, monetary policy rule is sufficiently strong to maintain the target[61], and (2) the cost to economic growth from an exchange-rate regime with its loss of independent monetary policy can be high.

By in large and as far as Arab economies are concerned, an important reason for adopting exchange-rate targets is the underdeveloped nature of the political, monetary and policy-making institutions. This has undoubtedly undermined the ability of the relevant authorities to use discretionary monetary policy successfully. One can argue that under these circumstances, the loss of monetary policy independence can be less costly—even advantageous, since a less-than-coherent monetary order can have serious economic costs. Accordingly, many countries in the region have recognized the benefits by effectively adopting the monetary policy of a country like the U.S. rather than pursuing their own independent policy.

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[61] Pre-EMU Netherlands' guilder peg to the Deutsche Mark and GCC countries peg to the U.S. dollar are two obvious exceptions.

There is also an important disadvantage of exchange-rate targets[62] worth noting. Experience shows that such a regime in emerging market countries managed to promote financial instability. Because of uncertainty of the future value of the domestic currency, many nonfinancial firms, banks and governments find it much easier to issue debt if the debt is denominated in foreign currencies. This tendency can be further encouraged by an exchange rate targeting regime that may encourage domestic firms and financial institutions to issue foreign denominated debt[63]. In this case, a devaluation of the domestic currency increases the debt burden of domestic firms and with assets denominated in domestic currency, the devaluation leads to a substantial deterioration in balance sheets and a decline in net worth, both for nonfinancial firms and financial firms which now are unable to collect on their loans to nonfinancial firms. The deterioration of balance sheets, by reducing effective collateral, makes lending less

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62 Mishkin (1998).

63 Hausman, Panizza, and Stein (2000) argue that a country's ability to borrow abroad in its own currency can be used as a proxy for its ability to hedge its exchange rate risk exposure. Measures of the ratio of foreign borrowing in own currency relative to total foreign borrowing are used as proxies. The ratio of total foreign securities issued in the country's currency to total foreign securities issued by the country, can also be used as an alternative. Higher values of these measures mean more flexibility in the exchange rate is plausible (in accordance with the fear of floating view). Knowing the extent to which foreign denominated debt is a prominent feature of the institutional structure in Arab financial markets, and knowing how much foreign denominated assets are readily available for matching purposes according to sound asset/liability management techniques, would enable us to assess the vulnerability of the financial system. Sound asset/liability management is a safeguard for a stable financial system, if and when devaluation occurs, by protecting the net worth value of nonfinancial and financial institutions from deteriorating. Table B2 in Appendix B shows the ratio of Arab commercial banks' foreign liabilities as a percentage of total liabilities (in a number of Arab countries who made available the relevant data).

attractive and also increases moral hazard incentive for firms, which leads to a decline in investment and economic activity. Under a weak banking system, monetary authorities are in a weak position to defend the exchange parity since increases in interest rates may further deteriorate banks' net worth, making a speculative attack on the currency the more likely.

However, there are times when an exchange rate targeting makes sense. Exchange rate targeting might be the only way to break entrenched inflation expectations and stabilize the economy, in double or triple-digit inflation economies. As far as Arab economies are concerned, it is apparent that inflation is to a large extent under control, with the exception of Sudan and Yemen experiencing higher than average inflation. Over the last decade, Jordan, Algeria, Syria, Lebanon and Egypt were quite successful in bringing inflation to manageable levels[64]. In short, the argument that the potential use of exchange rate targeting serves as a stabilization policy of last resort cannot be accepted as the main reason behind its adoption in many Arab countries. The popularity of the regime in the region has more to do with circumstances all too specific to individual or group of countries—features we now turn to highlight in more details.

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64 In light of the large levels of underutilized capacity, more of a deflation problem looms as a threat in countries like Jordan, Syria, and Lebanon (as was illustrated in Table 4).

Nominal exchange rate anchors in AGCC countries[65]

All member countries of the AGCC officially, or effectively, peg their currencies to the U.S. dollar. This policy has been guided by the broad objectives of minimizing exchange risks for the private sector and ensuring stable exchange rates among AGCC member countries. Among other well known reasons behind such a peg we mention: (1) the U.S. dollar is the unit of account used in pricing petroleum[66]; (2) with countries highly dependent on oil revenues, a stable relationship help fiscal authorities better plan; (3) AGCC countries' imports from the U.S. are large; and (4) dollar-denominated instruments constitute a large portion of those countries' external investments[67]. Based on this, the relevant authorities in the Council have continued to favor a peg to

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65 Abdel-Aziz Aldakhil (2000), "The euro and its impact on GCC economies" and commentary by I. Dabdoub; in *The Impact of the Euro on Arab Economies*, Arab Monetary Fund, F. Bin Jarada, editor.

66 The idea of switching the pricing of oil from dollar to euro on international markets has been discussed recently. The main arguments for such a move is to avoid the risk of excessive exchange rates fluctuations. A weaker dollar (a stronger euro) will impact negatively on AGCC economies as a result of weaker real value for oil exports. Also, paying the import bill for Europe in euros requisite an equivalent amount of euros from oil exports. A counter argument is that, as in the case for any international commodity, the currency with which a commodity is priced plays an accounting role only; it simply transfers income from one currency to another but does not determine the price of the commodity. The later is determined by demand and supply forces. The process that determines the value of a currency and not its pricing is the one that has an impact on exchange rate risk management.

67 Large AGCC governments' investments play an important source for non-oil income, especially in times of budget deficits. A fixing of AGCC currencies to an alternative currency may expose the countries' investment income to the risk of exchange rate fluctuations.

the dollar[68]. They remain always vigilant and flexible in revising the exchange rate arrangements on a timely basis in response to changing economic conditions.

Note that AGCC countries might find it useful to target exchange rates for reasons that have little to do with the conduct of monetary policy, such as encouraging integration of the domestic economy with its neighbors. Clearly this is the rationale for long-standing pre-EMU pegging of the exchange rate to the mark (by countries such as Austria and the Netherlands), and the exchange rate pegs that have taken place in the run-up period to the EMU. However, if economic integration is the goal, it is more likely to be accomplished by 'currency union' rather than an exchange-rate peg. This requires further exploration and empirical scrutiny before AGCC members can seriously consider carrying out the second part of the slogan "one market (with the prospective customs union scheduled for 2003), one money"[69].

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[68] The use of discretionary fiscal measures as effective stabilization tools (as a substitute to monetary policy) in AGCC countries is assessed when drawing final recommendations.

[69] On October 13, 2001, finance ministers of the six-nation alliance of the Gulf Arab states (AGCC) set 2010 as a target date for monetary union and a single currency (with the US dollar to serve as a yardstick for the single currency, effective by 2010, and with Kuwait given a "margin of movement against he dollar"). The ministers also approved a five percent common customs duty on imports and decided to bring forward the complete implementation of a customs union to 2003 from 2005.

Exchange rate anchors in other Arab countries

Jordan is adamant about preserving the stability of the Jordanian dinar, subordinating the monetary policy and in particular interest rate policy to this objective. Official interest rates have and continue to move in reaction to changes in U.S. interest rates in preserving the stability of international reserves. Prudent monetary policy during 1999 contributed importantly to the recovery of confidence and the rebound in the demand for the dinar after the uncertainties of late 1998 and early 1999. Official foreign exchange reserves registered large increases during 1999 and 2000 (close to 2.7 billion U.S. dollars). It seems that the central bank policymakers' preoccupation with preserving confidence in the local economy, through stable demand for the dinar and through comfortable levels of reserves, is an uppermost concern.

However, this shouldn't stop authorities from paying attention to important developing trends in the economy. Although, the current account as a percent of GDP, with the inclusion of grants, had shown a surplus since 1997, the current account situation is reversed into deficits when grants are excluded—for the period from 1995 to 2000 (with one exception of being balanced exactly in 1999)[70].

[70] A similar feature characterizes Jordan's fiscal balances. Overall fiscal balances before grants register deficits in percent of GDP almost twice the size of the fiscal deficits after grants. It appears that grants have come to play a crucial role in depicting a somewhat rosier picture of the financial health of the economy. Because grants are not predictable or sustainable, expenditures planned and incurred on the

On the other hand, Jordan is currently going through a low output growth period and creating demand is attracting the attention of concerned policymakers. In this regard, we ask whether a weak exchange rate can make it possible to grow income through exports. Export strength must be achieved either from healthy global demand[71], or from more competitive currencies. In the case where comfortable levels of foreign exchange reserves have existed, the exchange rate policy would remain credible and won't lead to wrong expectations of the central bank's intentions if and when the authorities decide on allowing more flexibility in the exchange rate[72]. Fiscal stimulus, on the other hand, is a substitute for a weak currency in terms of creating demand. But in light of the fiscal deficits and debt burden of Jordan, there isn't much fiscal power to fret about. It is also important to keep

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assumption that grants will continue at current rates can seriously distort fiscal planning and force a severe adjustment in the future if the assumption turns out to be optimistic.

71 However, the outlook for global demand for Jordan's primary traditional exports (phosphates, potassium, cement) is bleak.

72 Whichever indicator of foreign exchange adequacy is used (more recent indicators have focused on financial vulnerability, such as the stock of short-term liabilities—a practice recently adopted by Tunisia), the nature of the exchange rate regime plays a part in determining the adequacy of the reserve level. Traditionally, the presumption has been that a country with a fixed rate needs larger reserves than a country with a floating rate regime since, with a fixed rate, reserves are the only cushion for absorbing shocks. However, if confidence in the authorities' ability to maintain supporting policies is high, a country with a fixed exchange rate may not require large reserves to defend its currency. At a fundamental level, the *credibility* of the authorities' economic policies and the *confidence* that market participants place in them are the more important factors in assessing the adequacy of reserves. Indeed, it is credible policies that allow the authorities to augment reserves by borrowing abroad at favorable terms; borrowed reserves can provide a major supplement to the country's own reserves for countries with access to international financial markets.

in mind that demand stimulus alone, brought about either through a weak currency or through fiscal spending, will be ineffective unless structural problems are addressed (Taiwan and Japan are two cases that come to mind).

More recently, *Egypt* rightly recognized an overvaluation problem in its real effective exchange rate and consequently allowed the pound to depreciate to fetch its equilibrium market value. In the last few years, the foreign exchange market in Egypt faced consecutive disturbances reflecting on one hand the gap between resources and uses, and on the other the expectations effect about the future of the Egyptian pound that was nurtured by speculative activity. As a result, an initiative for multiple exchange rates initially surfaced and was followed by multiple activities in the foreign exchange market accompanied by destabilizing forces to the economy.

In order to bring these negative effects under control, efforts aimed at strengthening the role of market forces in determining the exchange rate were undertaken, commencing January 31, 2001. A central rate determined according to market forces was put in place and later considered as a basis to establish a transaction rate among all participants in the market, banks and exchange bureaus alike. A central rate of 385 piasters to the dollar (with a margin of ± 1%) was used to determine the US dollar price, with other foreign currencies' prices determined on the basis of the latter relationship with the dollar in foreign markets. The banks here announce their wishes to buy or sell

foreign exchange through the "central chamber" of the free foreign exchange market. It was perceived that this announcement effect has instituted the required transparency for the exchange rate regime and the mechanics through which it operates.

In August 2001, the current arrangements were amended by increasing the central rate to 415 piasters to the dollar and widening the margin to ± 3% from 1% and since then, the average transaction rate has been computed based on a simple averaging method rather than a weighted one. Early assessment of the changes points to their impact in stemming off the multiplicity in exchange rates. Furthermore, the more flexible and transparent initiatives also helped narrow the difference in prices between banks and exchange bureaus while bringing more stability to the foreign exchange market and enhancing the role of the interbank market.

In *Lebanon*, many experts are calling for allowing the exchange rate to depreciate in light of its misalignment from its equilibrium market value[73]. Estimates of the overvaluation of the Lebanese exchange rate

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[73] A. Kubursi (2000) calls for resisting temptation of a flexible regime on the premises that it provides a shelter behind which unproductive manufacturers hide rather than take measures to improve productivity. However, I must add that it is hard to reconcile that a single macroeconomic factor, such as the behavior of the exchange rate, plays a crucial role in undermining productivity growth. If anything, the bulk of the available research suggests that the causal link between productivity and currency goes in the other direction. Exchange rate depreciation could be a symptom and not necessarily the cause of a country's declining economic welfare. An alternative argument proposed by advocates of a pegged system in Lebanon is (1) to preserve the hard-won fight against inflation—recall Lebanon is heavily dependent on imports to

range between 18% and 40% and this magnitude is growing over time. Continuing with maintaining a firm grip on the exchange rate may have gained the authorities the reputation as being staunch defenders of the peg and consequently reinforced the authorities' much sought-after credibility. But this doesn't necessarily mean that the costs of such actions do not exist. I explain further. Fixing a relative price like the exchange rate doesn't make the problem go away. It simply transfers the burden of adjustment elsewhere. If an economy is subject to serious and frequent macroeconomic disturbances, and the nominal exchange rate is not allowed to adjust to help offset them[74], the resulting economic pressures are typically shifted onto other variables, while the economy is trying to re-equilibrate after the shock. Under relatively (downwardly) sticky prices and wages and less than perfect mobility in factors of production—features observed in most real-world economies—the result is often greater variability in output and employment than would have been the case if the exchange rate had

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meet its domestic demand; and (2) the fear of floating in Lebanon which de facto peg to the dollar is based on the country's large accumulated foreign debt that has to be paid. Recent 2001 estimates of Lebanon's debt to GDP range between 160-170%, up from 153% in 2000.

[74] To resist a downward pressure on the currency when it originates in some shock to fundamentals that lowers the economy's equilibrium real exchange rate would, (assuming that price inflation in the anchor country remains negligible), require the domestic price level to move downward, and perhaps the money-wage level too. These adjustments might be exacerbated by higher interest rates needed to attract an extra capital inflow sufficient to offset the trade account deterioration that would persist until the real exchange rate was back in equilibrium. As well, in the presence of nominal stickiness higher unemployment and lower output would be integral components of this adjustment. Regardless of its source, downward pressure on the currency would always produce extra difficulties stemming from the fact that foreign exchange reserves are necessarily finite.

been allowed to move. The exchange rate uncertainty and destabilizing economic forces that one had hoped to eliminate by fixing the currency may simply manifest themselves elsewhere—in a less obvious but potentially more damaging form. It is high time for policymakers in the country to justify the incurrence of such costs and to speed up its corrective reforms in order to ease up the pressure on the pound.

I suspect that once the debate intensifies—as it almost certainly will in the months or years ahead—it will become apparent that there is no miracle solution to the pound's plight being under pressure. Just choices, all of which are difficult. Instead of contemplating solutions to the pound, it would be more productive to focus on policies to promote stronger economic growth which may, who knows, even help to ease the pressure on the Lebanese exchange rate. Hopefully and ultimately it will be economics that will carry the day and not politics that will decide the issue.

In wrapping up, we put it simply, the kind of change in fundamentals that produces a depreciation under a flexible exchange rate can, under a pegged rate, lead to a foreign exchange crisis. Such crises produce downward pressure on the domestic economy, in addition to that needed to adjust the real exchange rate to fundamentals, and are all too often resolved by devaluation or the re-establishment of a floating rate.

Other monetary policy frameworks in Arab economies

According to Table A3, Tunisia and Yemen are classified as following a *monetary aggregate targeting* (an M4 growth objective in the case of Tunisia). In light of structural and institutional changes and technological innovations in financial systems, the tenet that guarantees the success of such a regime, namely stable empirical money demand relationship is subject to a breakdown. Such a regime in which monetary aggregate becomes the intermediate target of monetary policy has lost its popularity[75].

As of yet no single Arab country applies the *direct inflation-targeting*[76] regime. Such a regime gained popularity particularly in countries where exchange rates became harder to defend and money more difficult to target. The unhappy experience with pegged exchange rate regimes led emerging-market countries to consider inflation targets as

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[75] Even Germany's success with such a regime is attributed to a pragmatic application of it, looking more like an inflation targeting regime than anything else that resembles a Friedman-rule approach.

[76] The 1990s have seen the adoption of this new approach to the conduct of monetary policy, by a growing list of countries. Inflation targeting has so far been very successful in the countries that have adopted it. Inflation-control targets are by no means a miracle solution for monetary policy but experience shows however that they provide a framework that leads to better policy decisions, better economic performance over time, and a more accountable, and therefore more sustainable, position for autonomous central banks. Also, explicit inflation targets are not by all means the only way to achieve good macroeconomic results. Indeed, the worldwide reduction of inflation in the 1990s across countries (*Arab countries included*) with different frameworks for monetary policy clearly indicates that there are a number of ways to achieve low inflation.

an increasingly attractive alternative[77]. The bottom line is that, although inflation targeting is not a panacea and may not be appropriate for many Arab countries (not in the foreseeable immediate future), it can be a highly useful monetary policy in a number of them provided two crucial prerequisites namely, sounder banking systems and more fiscal discipline are put in place[78].

The remaining monetary policy regime is the *Fund-supported or other monetary program*, as it appears in (Table A3). This involves implementation of monetary and exchange rate policy within a

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[77] It has been adopted by a number of emerging-market countries—Chile, Brazil, the Czech Republic, Mexico, Peru, Poland and South Africa. Turkey is considering adopting inflation targeting.

[78] A high degree of (partial) dollarization may create a potentially serious problem for inflation targeting. This problem is likely to materialize in countries where the balance sheets of firms, households, and banks are substantially dollarized, on both sides, and the bulk of long-term debt is denominated in dollars. Because inflation targeting necessarily requires nominal exchange rate flexibility, exchange rate fluctuations are unavoidable. However, large and abrupt depreciations may increase the burden of dollar-denominated debt, produce a massive deterioration of balance sheets, and increase the risks of a financial crisis. This suggests that those countries cannot afford to ignore the exchange rate when conducting monetary policy under inflation targeting, but the role they ascribe to it should be clearly subordinated to the inflation objective. It also suggests that inflation targeting in partially dollarized economies may not be viable unless there are stringent prudential regulations on (and strict supervision of) financial institutions that ensure that the system is capable of withstanding exchange rate shocks. On the other hand, absence of outright fiscal dominance and a sound financial system (when financial systems blow up, there is typically a surge in inflation) are essential prerequisites for successful inflation targeting. Mishkin and Savastano (2000) point out that the two prerequisites are also crucial to the sustainability and success of any other monetary policy strategy, including a CBA or full dollarization. To the extent that government is involved in setting the inflation target, an advantage of inflation targeting here is that it may help constrain fiscal policy.

framework that establishes floors for net international reserves (NIR) and ceilings for net domestic assets (NDA) of the central bank. The (NIR) floor establishes a ceiling on foreign exchange market intervention in the presence of an exchange rate target; when the ceiling is hit monetary policy is tightened to defend the exchange rate or the exchange rate is allowed to adjust. Ceilings on (NDA) limit base money increase through central bank operations. Indicative targets for bank reserves may be appended to this system, rendering it a multiple anchor framework. Djibouti, Jordan, Mauritania, Sudan and Yemen are classified as being under an IMF supported program. Egypt's monetary authorities, on the other hand, intend to guide monetary policy using a range of indicators, given uncertainties in money demand.

The role of the exchange rate under alternative monetary frameworks

The exchange rate always has an important role to play. There is no one central bank in the world that does not care, implicitly or explicitly, about its country's exchange rate. Changes in the exchange rate can have a major impact on inflation, particularly in small, open economies. For example, a depreciation of the currency can lead to a rise in inflation because of the pass through from higher import prices and greater demand for the country's exports. An appreciation of the currency on the other hand can make businesses uncompetitive[79].

[79] Mishkin (2000) … In emerging market countries, concerns about exchange rate movements are even greater. Real appreciation makes domestic industries less

The avoidance of a target for the exchange rate does not imply an indifferent central bank toward exchange rates. As just mentioned in *footnote 76*, this issue is particularly relevant for countries with a lot of foreign denominated debt. Central banks in these countries may thus have to smooth "excessive" exchange rate fluctuations, but must make it clear to the public that they will not preclude the exchange rate from reaching its market-determined level over longer horizons (Lebanon and Egypt are two cases in mind).

The fact that exchange rate fluctuations are a major concern in so many countries raises the danger that monetary policy may put too much focus on limiting exchange rate movements. This can induce the wrong policy response when a country is faced with real shocks (such as a terms of trade shock). The idea behind the Monetary Conditions Index[80] is that both interest rates and exchange rates on average have offsetting impacts on inflation. When the exchange rate falls, this usually leads to higher inflation in the future, and so interest rates need

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competitive, but it can lead to large current account deficits, which might make the country more vulnerable to currency crises if capital inflows turn to outflows. As seen, depreciations are particularly dangerous because they can trigger a financial crisis in light of their debt denominated in foreign currency.

80 MCI is a weighted average of the exchange rate and a short-term interest rate. In Canada for example, to carry out monetary policy, the central bank tracks monetary conditions with the MCI. The information provided by the MCI helps to guide the monetary policy decisions. New Zealand's abandoned the use of the MCI in 1999, placing far less emphasis on the exchange rate in its monetary policy decisions. New Zealand may be the only country in the world that can truly qualify to be classified as a pure floating exchange rate regime.

to rise to offset the upward pressure on inflation. However, the offsetting effects of interest rates and exchange rates on inflation depend on the nature of the shocks to the exchange rates. Exchange rate depreciation as a result of a negative terms of trade shock, which decreases the demand for a country's exports, is thus likely to be deflationary. The correct interest rate response is then a decline in interest rates, not a rise as the MCI suggests.

This all works to show that interpreting exchange rate movements and responding with appropriate policies is a delicate matter and requires a high degree of technical capacity at the central banks' level, regardless of the country's development stage and of the operating monetary framework in place.

IV. Recommendations for Future Directions

We are guided by the key policy implications of Mundell's pioneering analysis that there does not exist one universally preferable exchange rate arrangement at all times and in all countries as a great deal of changes affect economies over time. The importance of debating the merits of alternative exchange rate regimes in a framework of a "coherent monetary order" is also very crucial[81].

It was observed that Arab economies differed substantially from one to another in many respects despite the commonality in culture and language. Differences in economic structures and financial systems, in the degree of capital account liberalization as well as differences with respect to the developmental level of institutions were closely scrutinized in assessing the exchange systems and policies in the region. While certain exchange rate regimes in Arab countries are currently deemed viable in light of their current economic and financial conditions, others are under pressure to undergo key reforms in policies in light of the exigencies of the new domestic and global challenges facing them. Key world developments such as

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[81] One should keep in mind that such a framework takes time to be well established and should be put in place piecemeal. Less-than-coherent monetary orders can have adverse consequences on the real economy. In this regard, any one regime could be compatible with many monetary orders, including the badly configured ones. It could be that problems with the monetary order and not the exchange rate regime itself that contribute to a country's economic difficulties …Laidler (1999).

globalization, liberalization in exchange controls, innovation, the introduction of the euro and the impact of regional trade liberalization as in the case of the Association Agreements with the European Union (AAEUs), among many other things, are likely to exert an important influence on the exchange rate arrangements of those countries. At a country level, a large number of Arab countries have implemented wide-reaching stabilization and structural reforms. On the macro track, demand management policies successfully brought inflation and fiscal deficits under control and large external imbalances were reduced. On the other hand, it is taking time for the productivity-enhancing reforms ranging from liberalized trade regimes, to privatization plans and friendlier environment for foreign direct investment, to become effective—reasons that are behind the low growth rates in the region.

This section endeavors to pinpoint weaknesses in the economies of the region while focusing on the role that the exchange rate came to play in this regard. While a loss of competitiveness was evident in all three groups of economies highlighted in section III, the overvaluation in the exchange rate seems to be a lesser problem for the handful of countries that permitted flexibility in the exchange rate. Issues ranging from diversifying the production base, reducing dependence on oil exports, enhancing the authorities' credibility and securing financial stability are examined on a country-by-country basis.

As previously mentioned, the exchange rate arrangement is merely a technical arrangement, and on its own cannot substitute for sound

underlying economic policies. Sound financial policies, supportive structural policies particularly important in securing productivity gains, as well as prudent demand management policies all work in a complementary way to achieve the optimal exchange rate regime for a country. It is also in light of the region willingness to become integrated into the global economy through exchange and trade liberalization that recommendations concerning the relevant exchange rate arrangements and potential reforms are presented. We begin by assessing the impact of the euro and the (AAEUs) on the exchange rate management in the region, before recommendations are drawn on a country-by-country basis.

The euro and Association Agreements with the European Union (AAEUs)[82]

For most Arab countries, there was no mentioning of an immediate change in exchange rate policies in response to the introduction of the euro. Understandingly, the euro may however trigger possible changes in policies: (1) if it does prove to be more or less stable vis-à-vis the leading currencies, in particular the U.S. dollar; (2) if it becomes a competitor to the U.S. dollar in its role as a unit of account; and (3) if

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82 Allum and Nashashibi (2000), " The macroeconomic impact of the euro on Arab economies" in F. Bin Jarada, editor. Allum, Enders and Nashashibi (1998), "European Monetary Union: Impact on the MENA region", IMF Occasional Paper 174, section III. See also, Al- Mannai (2000) for a brief summary of the euro on the GCC economy and finance.
- See H. Ghesquiere (2001) for a discussion of the impact of the AAEUs on Mediterranean countries.

the euro speeds up the process of economic and financial integration between Europe and the Arab world—each of which may by itself has an impact on the conduct of Arab exchange rate policies.

One consequence in changes in the value of the euro pertains to trade competitiveness. A depreciation of the euro relative to other international currencies could result in a loss of competitiveness in European markets for those countries with strong currency links to the U.S. dollar[83]. On the other hand, EMU will also give some Arab countries a degree of additional exchange rate assurance, to the extent that the introduction of a single currency would eliminate the risk of large devaluations of individual currencies within the EU group. Changes in the valuation of the euro can also have implications for the terms of trade of Arab countries dependent on EMU markets for exports—but non-EMU markets for imports—if export prices are determined by the currency of the export market and import prices by the currency of the country of the origin.

In the MENA region[84], countries currently maintain a variety exchange arrangements and pursue widely different exchange rate policies. Morocco and Tunisia already have links to EMU currencies, through

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83 With respect to exports, euro fluctuations would be primarily important for Syria and Egypt as the EU markets account for 55 and 44 percent of the total exports of those countries, respectively. For the oil-exporting countries pegged to the dollar, export prices are determined in world markets, and competitiveness is relatively unaffected by exchange rate movements.

84 Included here are the countries of Algeria, Egypt, Jordan, Kuwait, Lebanon, Libya, Morocco, Saudi Arabia, Syria and Tunisia.

the currency baskets underlying their exchange rate policy. For them, the implementation of exchange rate policy to manage external competitiveness need not be changed in view of potential changes in the value of the euro. The exchange rate policy in other MENA countries—whether in the context of announced pegs or not—is aimed at maintaining nominal stability vis-à-vis the U.S. dollar. For the non-oil countries with currencies linked to the dollar and large trade shares with the EU countries, there may be merit in considering linking to a broader basket or switching to a more flexible exchange rate policy that might better preserve relative price stability against European markets. This decision depends on a variety of factors including the effectiveness of exchange rate adjustment in achieving relative price movements; the type of shocks affecting the MENA region; and the currency composition of merchandise and services trade flows, migrant workers' remittances and debt-service obligations[85]. In order to avoid the effects of exchange rate movements, it may be desirable in this regard for countries to adjust their exchange rate regimes to better reflect the composition of their trade and financial links or change their debt management policies.

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[85] As far as debt-service obligations, exchange rate movements could have important effects on countries with substantial external debt, over and above the impact of EMU on trade and investment flows. In selected MENA countries, a large proportion of debt is denominated in EU currencies—Syria with the highest proportion at close to 80%. In the event of a mismatch between the currency denomination of the debt and the anchor of the exchange rate regime or the currency mix of trade partners, an appreciation of the euro would benefit countries that peg to the euro and export primarily to euro-area countries but service a substantial debt denominated in dollars.

In light of the increased capital mobility in the particular group of MENA economies that have a nominal exchange rate anchor (with the exceptions of Syria and Libya), there may be advantages in promoting increased exchange rate flexibility quite independent of the introduction of the euro. In addition to facilitating adjustments in relative prices as external reforms lead to changes in MENA countries' equilibrium real exchange rates, greater exchange rate flexibility would also allow MENA countries to respond in a flexible manner to shifts in the value of the euro relative to other currencies in the short-term and to shifts in competitiveness or foreign direct investment following the onset of EMU[86].

For many Arab countries of the MENA region, the evolution of trading relations with the EU will be affected over the coming years not only by EMU but also as a result of the implementation of *Association Agreements with the European Union (AAEUs)* which fall under the framework of the broader *Euro-Mediterranean Partnership Initiative*[87].

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86 Of course the advantages of greater flexibility need to be balanced against other traditional OCA arguments in favor of close links to the currency of a major trading partner such as the EMU area. In all, we remind the reader of the essential role of the supporting macroeconomic and financial structural policies in reaching an optimal exchange rate regime.

87 Tunisia, Morocco, and Jordan, among other countries in their region, have concluded such agreements. Negotiations are advanced with Egypt and Lebanon, and are under way with Algeria and Syria.

It is perceived that the agreements provide a major impetus toward an open trade regime over the next decade or so and constitute a catalyst for overall economic reform. In a rapidly changing world of globalization, the signatories' small open economies are establishing free trade for industrial products with the success of the agreements hinging on the Mediterranean's countries ability to generate a critical mass of foreign investment in labor-intensive, export-oriented sectors rather than inward-looking, low profitable labor intensive activities.

In light of the added competitive pressures that will result from trade liberalization, and to prevent a deterioration of domestic and external balances, the macroeconomic policy response is that, in conjunction with structural reforms and fiscal consolidation, a *more flexible exchange rate policy* in response to market forces could play an important role in strengthening competitiveness and spurring faster growth. The benefits of a flexible exchange rate in improving competitiveness are advocated, in the early stages, to complement the role that he expected productivity gains (realized as structural reforms take hold—albeit, with a considerable time to become effective) will come to play in improving competitiveness. Allowing real exchange rate depreciation, if and when needed, will work to preserve the strength of the external accounts without jeopardizing financial stability.

The Arab countries: case-by-case

AGCC countries: These countries have followed a pegging to the U.S. dollar regime since the early eighties[88]. The viability of such a peg has a lot to do with the huge financial armory in place to defend it against any attack. Two quick recommendations are made as far as the single currency and the use of fiscal policy as a substitutable stabilization tool are concerned.

On the adoption of a common currency recently declared in a meeting of the AGCC ministers of finance, and in order to properly assess the viability of the arrangement, it is advisable that the institutional and structural characteristics of the alliance members and the way they respond to external shocks be further studied. Although not tested empirically, it seems little would be lost, in terms of insulation or policy effectiveness if AGCC currencies were linked under a monetary union. It is argued, countries that are so inexorably bound, and growing ever more integrated, should be natural candidates for a common currency[89]. Very briefly, some of the things favoring a move as such

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[88] The say that any devaluation in the currency is an enticing factor as it makes exports cheaper on the international markets does not apply here. GCC export, among other products, oil, petrochemicals, liquefied natural gas, and steel. The prices of these products are in dollar and are determined in the world markets through forces of supply and demand; they do not benefit from depreciation in the local currency. A strong dollar in most likelihood will not affect markets negatively, as on the contrary it has helped reduce inflationary pressures and has increased the purchasing power of the consumer in the Council.

[89] The following is a check list serving as criteria for assessing the viability of such an arrangement: (a) the stability of monetary orders between members; (b) the size of

are the following: the economies are highly integrated and share many important characteristics; they are in close geographic proximity; their citizens travel extensively between the two countries; and they share similar values, culture, and history; gains in terms of reduced transactions costs and the elimination of currency risk can be important; savings in terms of transactions costs incurred in the AGCC foreign exchange markets can be realized.

On the other hand, it is perceived that a flexible exchange rate is somewhat redundant under a system of fiscal transfers. Such a system can be activated through subsidies or special social assistance, whenever the region or an industry therein is hit by an external shock,

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trade between members and geographic proximity; (c) flow of capital between countries; (d) transactions costs' savings and the elimination of currency risk; (e) costs (to firms and households) of adapting to new domestic unit of account; (f) existing legal barriers to inter-country labor mobility; (g) composition of countries' output—common important characteristics; (h) degree of wage–price flexibility; (i) the role of fiscal policy; (j) problems of fundamental political importance; (k) degree of integration of the banking systems; (l) the coverage of the payments system (union-wide?), and (m) degree of commonness in the regulatory framework.

-This first concrete step in adopting a single currency brings to the forefront a much debated issue—that of adopting a single currency in the entire AMF membership. A monetary system exists to facilitate trade in goods, services, and capital. Just as the growing integration of their real economies as a result of a common-market arrangement has led European countries towards monetary integration, so do other free trade agreements (the Greater Arab Free Trade Agreement launched in 1997, in the context of the Arab region) offer the starting point for a similar process of integration—or so it is argued. Despite the Arab countries' call for a monetary union well before the Europeans, more concerted efforts and preparation need to be seriously undertaken before such an idea comes to fruition since it is ill-advised to disregard wide discrepancies that currently exist on many economic fronts. The criteria for assessing the viability of such an arrangement include a long list of conditions of differing economic and political weights—it goes well beyond the rhetoric of "one nation, one money".

until conditions improved. Accordingly, AGCC countries have afforded dropping the monetary policy as a stabilization tool in light of the compensating role of its fiscal policy. A word of caution on the use of discretionary fiscal policy for stabilization purposes is in order here. In the last few years, periodical oil price shocks have imposed serious constraints on the countries' financial resources, which led many of them to ration government expenditures and re-define expenditures priorities[90]. Discretionary fiscal measures often lack the necessary speed and focus to serve as effective stabilization tools and are difficult to reverse once the shock has passed. Additional problems arise if the shock is permanent and the fiscal expenditures inhibit necessary long-run economic adjustments. There is also a risk that trading partners might complain about the subsidies offered to certain industries under these schemes and retaliate with countervailing duties and other anti-dumping measures. In short, discretionary fiscal measures and other

[90] In its first ever published annual review of the Saudi economy, the IMF warned that the Saudi economy remains vulnerable to downside oil price risks, which could put extra strain on fiscal and external balances (where export earnings are heavily dependent on oil). Recent developments show that the risk premium being charged to lock in the riyal's exchange rate one-year forward (SARF) rose to around 4.4 percent in November 2001—there is empirically a strong correlation between the oil price and the one year SARF. Recall that during the Asian crisis, in November 1998, risk premiums hit 1,000 basis points intra-day at one point. Repeatedly and particularly during periods of sharp price changes in crude, mounting political pressure on the riyal peg is becoming more and more a recurrent theme. In light of the strength of the economy and the hefty reserves under lock, it is believed that the peg remains sustainable in the short-term. While a pegging system is here to stay, it is perceived that a more diversified economy is better equipped to lessen arising pressures on the external balances in the region.

government actions are unlikely to be a perfect substitute for flexible exchange rates[91].

Egypt: Over the recent past, the Egyptian authorities have allowed significant depreciation to the exchange rate. By the end of 1999, we mentioned that the Egyptian pound was under pressure and that the authorities at that time didn't adopt a clear and acceptable policy to regain equilibrium in the foreign exchange market (the LE was trading at 3.45 per U.S. dollar within narrow bands). The resulting shortage in foreign currencies and the increase in the interbank interest rate on the LE prompted the authorities to adopt a crawling peg regime against the dollar, where the exchange rate was fixed at LE 3.85 per U.S. dollar while allowing the currency to fluctuate within a currency band width of plus or minus 1%.

The last changes introduced in August 2001 to the exchange rate system allowed a 6.5% depreciation of the central rate (from LE3.90 to LE4.15 per U.S. dollar) on top of the significant depreciation over the past year[92]. It is apparent that the crawling peg strategy first instituted

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91 Experience with them has not been very encouraging. Obstfeld and Peri (1998) provide a skeptical view on the usefulness of fiscal transfers as an adjustment mechanism.
-See Karam (2001) for a review of fiscal frameworks, targets and government accounts.
-See also Chalk. N (2001) for a discussion of the fiscal sustainability in oil-producing countries, in I. Zubair.

92 Egypt devalued its currency to a core rate of 4.50 pounds to dollar on December 13, 2001, while allowing the pound to trade within the same currency band width of plus

as a reform to the exchange rate regime is following in its transition path towards greater flexibility. Box 4 highlights some essential elements in the transition path to a flexible exchange rate and the exit strategies involved in such a migration toward greater flexibility.

It is believed that the latest rounds of depreciations are working toward further strengthening competitiveness, helping to boost exports and economic growth. The doubling of the currency band width to plus or minus 3% is expected to provide greater room for the exchange rate to respond to changes in economic conditions. Such a commitment to continuing exchange rate flexibility seems to be adequate in light of Egypt's further integration into global markets. A flexible regime would allow Egypt to ride out periods of market turbulence and weather any external shocks while avoiding further significant declines in official reserves from the currently relatively strong position. External competitiveness is more likely to be maintained in an environment of a liquid foreign currency market and a currency band that is allowed to be adjusted in response to market conditions.

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or minus 3%. Anecdotal evidence point to the sale of dollars outside the legally allowed limit (the weakest being 4.635) by Egypt's exchange bureaus.

Box 4. Transition Path and Exit Strategies Towards Exchange Rate Flexibility

Transition path to a flexible exchange rate regime

It was mentioned that as countries' ability to hedge their exchange rate risk exposure is gained, and as those countries not yet integrated in the global financial system increasingly become so, flexible exchange rate regimes become more viable as an alternative to a pegged system. Increased exchange rate flexibility may take a variety of forms: (1) allowing appreciation/depreciation of the currency within a relatively flexible regime (Malaysia, Peru, Philippines, South Africa, Turkey); (2) allowing greater flexibility within pegged or tightly managed systems; (3) introducing bands around a fixed parity and successively widening the band (Czech and Slovak Republic, Korea); (4) moving to a crawling band from a crawling peg or a horizontal band, successively widening the band, and adjusting the rate of crawl (Hungary, Israel, Russia); (5) floating the exchange rate (Malaysia before 1997). Figure A illustrates diagrammatically a particular transition path from a fixed pegged regime to free float. One Arab country at least (Egypt) can be described as being on a transition path toward greater flexibility in its exchange rate regime.

Exit strategies towards exchange rate flexibility

Exchange-rate-based stabilization programs were successful in reducing inflation and imposing policy discipline for a period of time[93]. More often

[93] Typically, an initial and often large devaluation was followed by a predetermined path of depreciation for the exchange rate, aimed at boosting the external position, reining in monetary growth, and imposing fiscal discipline by limiting financing from the central bank.
In light of the entailed real exchange rate appreciation, current account deteriorated leading to the programs being short-lived. As the real exchange rate rises, especially if inflation is not reduced sufficiently fast, the conflict between the authorities' objectives of reducing inflation and maintaining competitiveness becomes increasingly apparent, raising the probability of a speculative attack.

Box 4…continue

than not, the end of a peg under such programs came about with disruptions to the economy. A well thought "exit" strategy could prevent disruptions of this kind[94].

For Arab countries considering a changeover from pegged to more flexible regimes, the following is presented as tested guidelines for ensuring success along the transition path. It is best to allow a regime shift during a period of calm or upward pressure on exchange rate while timing the shift before strong real appreciation and exhaustion of net international reserves. The exchange rate anchor must be replaced by clear commitment to low inflation (a credible new anchor for monetary policy) while retaining the exchange rate as part of an overall policy package. Central bank operational independence, institutional and technical capacity to conduct monetary policy (underlying all that a clear mandate for monetary policy to pursue price-stability objective), disciplined, transparent and more flexible fiscal policy, as well as strong, deep and well-developed and supervised financial sector, strengthened prudential regulations, are all essential conditions that facilitate an orderly exit. Creating effective foreign exchange market[95] is also desired when exiting.

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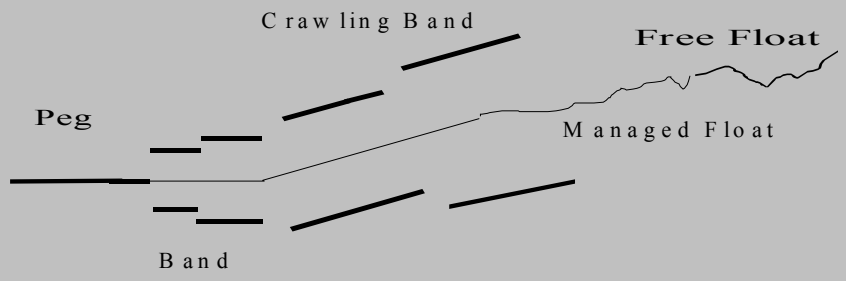
94 The need to move away from a soft peg is one of the reasons an exit mechanism was built into the Turkish stabilization and reform program that began in December 1999. The intention is that a band around the crawling peg will begin broadening in the middle of this year, and continue broadening through the end of 2002. The recent difficulties in Turkey relate more to banking sector problems, and the failure to undertake corrective fiscal actions when the current account widened, than to the design of the exchange rate arrangement. Corrective measures in both these regards have been agreed and are being implemented.

95 In moving towards flexible regimes, the role played by retail foreign exchange markets (i.e., exchange houses and foreign exchange bureaus) becomes more important since they are in closer contact with market forces and detect more promptly official exchange rates that are off equilibrium. The level of development of these markets in Arab countries is worth exploring.
In order to promote a continuous interbank foreign exchange market, it is essential to enlarge the size of the market, tackle insolvency problems of banks, allow participants to play an active role in allocating and pricing the foreign exchange and allow authorized dealers to assume the leading role in setting buy-sell quotations

Box 4… continue

In a normal period, a gradualist pre-announced strategy is followed, whereas in crisis situation the exit is toward more flexible regime provided inflation pressures are under control.

Figure A. Fixed pegged rates to free float



Jordan: The fixed exchange rate to the U.S. dollar allowed Jordan to follow an exchange rate regime similar to that followed in AGCC countries—economies with which it has strong economic and trade relations. Accordingly, the fixing of the exchange rate against the dollar has encouraged the flow of Jordanians savings working in Gulf countries. In addition, it has helped to attract foreign direct investment

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rather than the central bank, enforce prudential regulations, remove restrictive foreign exchange control laws (eliminate taxes and surcharges on foreign exchange transactions and liberalize surrender and repatriation requirements as in the case of Algeria), build trust between dealers and, finally, eradicate inefficiencies in payments and communication systems.

and it supported tourism and other services sectors which exports to AGCC countries[96]. Moreover, the fixed exchange rate policy has helped reduce the risks of a weaker Jordanian dinar (an uppermost concern with the savers and investors in Jordan), and has undoubtedly stabilized the foreign exchange market. Given the circumstances and local exigencies of the local economy over the last few years, a pegged system may have well been the suitable choice.

On the other hand, fluctuations in oil prices and declining proceeds from oil trade have can also negatively affect, in an indirect way, the Jordanian economy through lower transfers and remittances from oil-exporting countries and lower import demand in the region. Consequently, efforts to diversify its production base to reduce dependence on oil developments and to penetrate new markets outside the region (recall Jordan having concluded the AAEUs) may be a good reason to allow more flexibility in the exchange rate. Looking forward, and in light of surfacing fiscal and current account imbalances (once grants are excluded), the monetary authorities in Jordan should be flexible in their view on preserving the exchange rate constancy over prolonged periods of time, particularly under a regime where capital flows freely.

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[96] The primary exports in Jordan (phosphate, potassium and cement) are all priced in U.S. dollar. It is argued that similarly to the AGCC case, any depreciation in the currency is unlikely to add to its market value in the world exports markets.

Lebanon: The loss of competitiveness, which has an impending negative effect on growth, is largely due to the substantial appreciation of the country's real effective exchange rate under a pegged currency to the U.S. dollar. The financing of the government sizeable fiscal deficits from banks resulted in a financial crowding out of private spending by the public sector (as banks are forced to reduce credit to the private sector). More recently, the central bank has increasingly played a more important role in meeting government's financing needs. Under a fixed exchange rate regime and unchanged interest rates, the expansion in central bank financing has led to a serious deterioration in its external reserve position. While the authorities' commitment to revive economic growth and consolidating the public finances over the medium term are encouraging, more convincing debt reduction strategies are needed. In relation to this point, allowing an exchange rate adjustment in conjunction with prudent fiscal and monetary policies and speedy structural reforms is crucial to the country's success in facing the mounting economic challenges. While flexibility in the exchange rate is deemed beneficial, the specific circumstances of the country may requisite something akin to a crawling peg to mitigate the risks involved in exiting a pegged regime. For those advocating a continuation of the peg regime, the ability of maintaining such a regime hinges on the success in correcting very large and persistent macroeconomic imbalances and on removing structural and administrative impediments.

Mauritania: Given a comfortable level of reserves (in relative terms to the size of its economy, as reserves are second lowest to Djibouti only standing at 284 million U.S. dollars in 2000), the central bank should be soon in a position to intervene more often on the exchange market, both as seller and buyer, to prevent sharp short-term fluctuations in the exchange rate. However, the central bank will aim at maintaining the real effective exchange rate at a competitive level in the hope of diversifying the export base. In addition, the BCM undertakes not to carry out any longer exchange transactions outside the sessions of the expanded foreign exchange market, which should encourage greater participation on the part of banks.

Morocco: Over the 1990s, Morocco witnessed a decline in competitiveness. It was deemed that in conjunction with structural reforms and fiscal consolidation, a more flexible exchange rate policy could play an important role in strengthening competitiveness and spurring faster growth. The added competitive pressures that will result from trade liberalization were highlighted in this regard. An alternative belief is that, in light of the relative success of the current fixed exchange rate arrangement in Morocco, the latter arrangement remains appropriate when viewed against the strength of external accounts and the need for preserving financial stability. Furthermore, productivity gains realized as structural reforms take hold would improve competitiveness (albeit it at a rate of change that is relatively slow). To date, the monetary authorities haven't succumbed to the pressure of certain export sectors calling for devaluation of the dirham.

Palestine Authority[97]: Palestine is currently using three foreign currencies. Should it continue to do so or launch a money of its own? What are the economic implications of the choice? What conceivable environment is likely to provide the basis for a self-sustaining economy and a viable currency?

In the absence of a local currency, it is difficult, but not impossible, to influence domestic monetary conditions. The instruments are largely fiscal and regulatory. While there are many advantages, which a country can exploit from having a national currency and being able to determine its own monetary policies, certain benefits may accrue from not having a national currency or domestic monetary policy options if local situations and exigencies are not cooperative.

What is important in this regard is that a national currency should never be introduced for symbolic, cosmetic or purely political reasons. A national currency does confer on the national leadership considerable power to influence a number of important economic policy variables, such as exchange and interest rates, which in turn affect levels of domestic liquidity, inflation rates, savings propensities, the health of the financial sector, the balance of trade and levels of investment. These are important determinants of national economic

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97 The following assessment is based on the broad themes and recommendations presented in a conference "On the Features of the Palestinian Monetary System", Cairo, Egypt. November 1999. Another good source for a discussion of the potential monetary regime in Gaza and the West Bank is O. Dabbagh (1999).

development. Unfortunately, like all other policy instruments, ill-conceived monetary policy can also create huge economic distortions and greatly damage the health and welfare of a nation if it is not predicated on methodical research, prudent fiscal policies and, above all, a strong independent central bank.

Also the timing of the introduction of a national currency is another very important consideration. If having a national currency is a prerequisite to the formulation of independent monetary policies, its introduction should only be considered under circumstances of political stability, good governance, and reasonable expectations of economic growth. Public confidence in the capacity of the government and central bank to manage the currency responsibly, and in the soundness of the domestic banking system is essential. A cushion of foreign assets also helps the cause.

The present state of the economy of Gaza and the West Bank does not appear propitious for a new currency[98]. If the political problems impeding development were to be solved while infrastructure improvements continued, one might expect that domestic and foreign investment would raise output and begin to generate export revenue to reduce and ultimately eliminate aid dependence (which finances the

[98] Because of transportation and security problems and the deteriorated state of the infrastructure, Palestine is producing at less than the potential of its existing resources. Despite relatively low wages coupled with relatively high level of education for the region, uncertainty over the future political and economic conditions has continued to discourage domestic and foreign investment.

bulk of current imports). In that environment, a new independent currency could be viable. To make that potential a reality however, a great deal needs to be done not only to build a new infrastructure but also to develop an institutional framework to assure adherence to budgetary discipline, by building an effective barrier against the use of central bank credit to finance the government state enterprises, or directed credit programs—as a best defense against inflations fueled by government deficits, and to maintain a responsible monetary policy. Establishing central banks and finance ministries that are committed to price stability and economic reforms, along with a public willing to support the commitments and to accept the new currency (by exchanging their holdings of shekels, dollars and dinars for Palestinian pounds) for the bulk of transactions and as a major store of value are also critical in avoiding costs to the economy.

In this regard, the framework for macroeconomic policy should also include sound, well-supervised banks, a monetary authority with a well-trained staff for policy analysis as well as for supervision. Arrangements of that kind should be in place and tested in operation before a new currency is launched. Assurances that policy will maintain price stability and sustainable growth are needed to stimulate local investment, attract foreign capital and to induce Palestinians to use the new currency as their primary monetary asset.

But before a currency is launched it is necessary to choose a currency regime. The potential regimes (varying from dollarization to currency

boards to floating rates) are assessed in Box 5 in light of the exigencies of the local economy and the implications of the choice for fiscal and monetary policies are closely scrutinized. In summary, (1) it is difficult, often painful, to maintain a fixed rate. The economic pain is the same under an ordinary fixed rate regime or a currency board, but the automatic decision rules of a currency board reduce the political pain making a currency board more durable; (2) the real problem with a fixed rate is that it may be maintained when it is no longer viable without controls and that can prove very costly; (3) it is difficult to manage a floating rate in a way which avoids costly instability but the floating rate avoids the danger of being locked into the wrong rate.

Where do we go from here? It seems that maintaining the present arrangements until the institutional framework is strengthened and the competitive position of the economy established may be the best option. The general piece of advice to Palestine Monetary Authority is to proceed slowly, keep expectations low, and to prepare the ground well before introducing a national currency. In the end, it is not the currency that matters but rather it is the freedom which the currency creates to implement policies which can, at best, help to fine-tune the economy but, at worst, can lead to calamity.

Box 5. Potential Exchange Rate Regimes in the Palestine Authority

A currency board[99] can build confidence in a new currency more readily than a central bank. The currency board system appears to provide for a fixed exchange rate without the need for the painful political choices required under ordinary fixed rate regimes. In effect it builds the difficult choices into the system. Its provisions provide assurance against the kind of government sponsored inflation, which has caused so many currency disasters. While the power of the fixed exchange rate guarantee is a great advantage in establishing a new currency it is likely, in time, to cause difficulty. There are after all times when the exchange rate ought to change: devaluation of the currency of a major trading partner or persisting changes in terms of trade can cause continuing balance of payments deficits. Given the uncertainty of Palestine's competitive position that is not an unlikely contingency. The stronger the guarantee of a fixed rate the more difficult it will be to break the contract. But to maintain it Palestine would have to undergo a painful fiscal contraction and might nonetheless devalue.

A floating rate regime does not involve such dangerous commitments but it not only permits but also requires some management of money supply and interest rates. Even with very modest and cautious domestic management objectives a central bank needs to be able to control money supply growth and to respond to shocks affecting the exchange rate. Even when the Palestinian authorities are ready to undertake those tasks it will be difficult to achieve widespread acceptance for new currency whose value can change from day to day. It is obviously difficult to launch a new currency without some expectation that the currency will retain its value in the immediate future. That is especially true when wealth holders have a viable alternative. In establishing new currencies, many have advocated a preference for a currency board, at least in the initial stages, over a floating rate regime. But the dilemma here is that while a currency board regime makes a new currency more acceptable than a floating rate regime, the fixed rate may prove very costly. With the two proposed regimes being imperfect at best, one wonders whether the present *mixed up version of dollarization* remains the better alternative?

[99] More general features of the Currency Board Arrangements are discussed further in Box 6.

Box 5…continue

Dollarization like a currency board provides no way for monetary authorities to exert much influence on the economy for good or ill. It protects against government-sponsored inflation but does not provide for any influence on money supply or interest rates. And, of course, there is no way for the Palestinian authorities to change nominal exchange rate. If a change in real exchange rate is needed it has to come about through changes in nominal wages and prices brought about by supply and demand pressures and those pressures will be exerted through Palestine's competition in tradable goods markets. That would also be true with a currency board but not with a floating rate.

The difference between dollarization and currency board regimes arises from the existence of a local currency and a monetary authority with reserves which back the paper currency one for one but which do not back bank deposits one for one. Trade developments or financial concerns which result in a negative overall payments balance threaten the exhaustion of foreign currency reserves. When actual dollars or other foreign currency are in use outflows of that currency may bankrupt individual businesses or banks but pose only an indirect threat to the whole system. Dollarization is therefore much safer than currency board but is also expensive since it requires a large investment in foreign currency or the payment of interest on borrowed foreign currency.

Box 6. Currency Boards: General Features

A currency board can allow a developing country to establish its domestic currency relatively promptly and efficiently by fixing the value of its currency to that of another country and guaranteeing that its currency is backed by sufficient foreign exchange reserves. Currency boards not only provide a foundation that encourages traders and investors to accept new currencies, they also do not require sophisticated money markets and central banking operations in order to be effective.

Although, by design, they circumscribe the powers of their monetary authorities, thereby shifting the responsibility for macroeconomic policy to their fiscal authorities, these boards also promote a greater degree of fiscal rectitude by denying their governments a ready supply of credit from their central banks. The supply of base money grows only as rapidly as net foreign trade and capital flows allow, thereby reducing the banking system's capacity to create money and credit in order to finance spending that exceeds its economy's resources.

Despite their merits, currency boards alone cannot ensure success. Although they guarantee that their base money is backed by appropriate foreign exchange reserves, confidence in the value of deposits, loans, assets, and resources that are denominated in their currencies is limited by confidence in the performance of their economies. A sound and healthy financial system and an acceptable balance between government receipts and expenditures through a responsible fiscal authority, support both the economy and the currency. Captive capital markets (rather than reasonably efficient capital markets that allow resources to flow to the most promising applications), poor investments, or substantial government deficits can diminish an economy's prospects, foster capital outflows, and ultimately undermine the value of its assets and currency.

A currency board requires a sound financial system because its ability to conduct open market operations or to act as lender of last resort is, at best, limited. The banking system, therefore, should be able to manage the

Box 6…continue

volatility of interest rates, assets' values, and financing that can result from the monetary authority maintaining a fixed exchange rate.

In highlighting the role of monetary policy under a currency board, the operations of a currency board are confined to the exchange of its currency for foreign currencies at the prescribed rate of exchange. As a result, a currency board cannot assume the role of a full-service central bank. It has limited capacity to serve as lender of last resort or to conduct open market operations, deposit auctions, or other actions that alter the supply of base money, except through the acquisition of its reserve currency. By design it cannot influence employment, prices, and interest rates in its economy or the volume of money, credit and capital flows.

Although currency boards can give currencies a quick start, they do not necessarily provide a lasting foundation. To benefit most from a currency board, an economy should use the temporary shield of this regime to prepare for its potential departure. Although a currency board relieves its monetary authority from the responsibility of executing its own policy, it also obligates its monetary authority to prepare for its potential departure from the board. To fulfill this obligation, its authority could install the data base, analytical staff, and senior officials that it requires to study, debate, and adopt a monetary policy. It also should develop its money markets and its financial institutions' ability to manage currency risks.

The two most important decisions for a currency board are its choice of "reserve" currency, and its exchange rate. Setting the appropriate exchange rate for an emerging economy's currency is difficult because estimates of its equilibrium value often are especially uncertain.

Source: Kopcke, R.W. (1999), "Currency board, once and future monetary regimes?"

Sudan: Despite the virtual stability in the rate in 2000, there is no evidence of a major pressure on the exchange rate. However, in view of the many challenges and risks facing Sudan's economy and the still low level of international reserves (higher only to Djibouti), the

authorities are encouraged to allow the exchange rate to move flexibly in response to market forces and not to allow any perception to develop in the market that the rate was effectively fixed. In this regard, efforts should be stepped up to further develop the interbank foreign exchange market. The authorities are also encouraged to closely monitor developments in external competitiveness, and, in particular, to avert any threat of oil-induced strength in the exchange rate undermining the competitiveness of the non-oil sector.

Syria[100]: As discussed previously, the official conventional pegged rate in Syria applies only to a few debt payments relating to bilateral payment arrangements[101]. In total, three official rates and two unofficial rates exist in Syria. Without any doubt, unification of the multiple exchange rate systems[102] should be seen as a first essential step toward reforming the exchange system. A clear plan needs to be designed to bring about unification over a specific and appropriately

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100 Restrictions maintained by Syria (and Libya) under Article VIII are not of the type approved under the IMF jurisdiction. To be approved, the restrictions have to be temporary, maintained for balance of payments reasons, and non-discriminatory. While restrictions can be approved only if they are imposed for balance of payments reasons, multiple currencies practices can be approved when they have been introduced for non-balance of payments reasons "provided that such practices do not materially impede the member's balance of payments adjustment, do not harm the interests of others, and do not discriminate among members."

101 To be clear on the usage of terms of multiple exchange rate (MER) arrangements and multiple currency practices (MCPs) in direct management of foreign exchange transactions. The cost management approach (sometimes refered to as MCPs) in the allocation of foreign exchange resources among different uses involves the introduction of a variety of taxes, subsidies, and regulations, which can produce effects on international transactions similar to those of the MER system.

102 Unification of exchange rate systems in Mauritania and Yemen was associated with a move to floating exchange rate regimes.

brief period of time accompanied by a firm commitment to the eradication of the multiple regimes.

Whether used for balance of payments purposes, or to raise tax revenue through the exchange system, or to promote or discourage certain types of transactions or sectors, or as a temporary measure before liberalizing transactions, multiple exchange rate regimes have more drawbacks than advantages. Experience with them shows that they can distort economic incentives and impose costs on the economy by misallocating resources for production and consumption. Moreover, the maintenance of such systems generally requires a complex and costly system of controls administered by using public sector resources, and when administrative and institutional systems are weak and scare resources are employed toward sustaining such systems, foreign exchange pressures may reemerge, manifesting themselves either directly through reserve losses or indirectly through a growing informal sector—side effects that are all too familiar to the state of economic affairs in Syria.

Tunisia: In as much as capital controls were likely to remain in place[103] and therefore, the exchange rate would continue to be largely insulated from market pressures, the authorities' emphasis on using the exchange rate instrument to maintain external competitiveness is well justified. As pointed out by the by IMF staff, the equilibrium real exchange rate would be more difficult to predict in a situation where trade liberalization (putting pressure on competitiveness) and

[103] Tunisia registers the highest *(KCI)* index value (0.8) among all AMF members.

productivity gains (enhancing competitiveness) might proceed at different paces. In this context, the CPI-based real exchange rate—the main competitiveness indicator followed by the authorities in recent years—was likely to become a less reliable measure of competitiveness. The latest IMF mission urged the authorities to develop and rely on a broader set of indicators to guide exchange rate policy in the future, including export performance and unit labor cost developments. The authorities indicated that already they had begun following developments in relative market shares, and that the departure from the real exchange rate targeting rule observed in 2000 reflected the perceived limitations of the CPI-based real exchange rate. As for their foreign reserve objective, the general feeling is that a sufficient cushion is in place against unforeseen events[104]. A last word of caution on allowing a flexible exchange rate to benefit the export performance in Tunisia. The central bank in 2001 has allowed the dinar to depreciate more than required to maintain the real exchange rate in order to compensate for the impact of the reduction in external tariffs (under the Association Agreement with the European Union). This should produce a favorable impact on the external balance. However, to support this policy, the authorities must continue to adopt prudent monetary and fiscal policies. Action on the exchange rate front is not a substitute for the fiscal adjustment needed to redress external imbalances.

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[104] A broader approach to reserve adequacy is sought in monitoring closely the reserve coverage of short-term financial liabilities. Under the current reserve target for end-2000, 90% of short-term liabilities (including debt coming due within one year) would be covered. In view of the limited scope for portfolio outflows and the generally stable nature of the deposits of non-residents, the mission deemed that this ratio provided a sufficient safety margin.

Republic of Yemen: The improved external position helped stabilize the exchange rate at about YRls 160 per US$ from mid-1999 through late-2000, following a 13% depreciation in the first half of 1999. It is observed that during 2000 one-sided intervention in the foreign exchange market, by contributing to real appreciation of the rial, has weakened incentives for tradeable goods production and diversification away from oil. The authorities are advised to allow the exchange rate to be fully market determined and limit intervention in the foreign exchange market.

V. Conclusion

In tackling the question of an ideal exchange regime, we noted that an optimal regime depended on policy makers' economic objectives, source of shocks and a tall order of other factors. The adoption of a specific exchange regime was regarded as neither necessary nor sufficient by itself to achieve the desired outcomes. Regardless of the exchange rate arrangement, macroeconomic policies need to support the arrangement to ensure its success. For instance, in a country lacking financial discipline, macroeconomic problems will emerge regardless of the exchange regime. Whatever exchange rate is in place, it will only contribute to stabilization if macroeconomic policies are sound and if structural reforms support macroeconomic policies.

For most Arab economies, we assumed throughout that the choice of exchange rate regime is not simply one between a perfectly fixed and a freely floating exchange rate. Rather, there is a range of regimes of varying degrees of exchange rate flexibility reflecting different intensities of official intervention in the foreign exchange market, and different degrees of monetary policy independence. Consequently, in debating a country's monetary order, we emphasized a need to deal with the configuration of the monetary order as a whole, and not merely its exchange rate component. A central issue that usually emerge in the topic of optimal exchange rates was how to best deal with the tradeoff between the maintenance of internal monetary stability and the constancy of the exchange rate in conducting monetary policy, at different stages of the institutional development of a country. In advising on desirable exchange rate regimes,

recommendations that were drawn have also embedded a dynamic and a forward-looking view in light of changing considerations and conditions overtime.

An important measure of competitiveness configured in the "real effective exchange rate" was reviewed in the context of Arab economies. A real appreciation trend was noteworthy in the recent past. To the extent that this trend continues in the future, pressures on the competitiveness of economies in the region will persist. For GCC countries, although not totally shielded from competitiveness pressures, the threat of appreciation on non-oil exports growth (the only type of exports affected by cost competitiveness) is weak in light of the competitiveness-enhancing productivity gains emanating from low exchange and capital controls and from flexible labor markets prevalent in the Council. As for the non-oil exporting economies, in the absence of productivity gains, real appreciation may eventually result in tighter profit margins in some export activities and disinvestment in favor of domestic activities, further curtailing export growth and possibly economic growth. Minimizing the effects of decreased competitiveness on export growth will depend crucially on the ability of these countries to continue to liberalize their economies and their trade regimes, so that downward pressure on profits may be alleviated by favorable movements in domestic prices, notably those of imported inputs and labor. On the other hand, accelerating privatization and creating a friendlier environment for foreign direct investment would provide the technology and best managerial practices necessary for productivity growth. The conclusion reached is that an appropriate level of the REER and its medium-term path

depends upon the mix of monetary, fiscal and structural policies that underpin the evolution of inflation, balance of payments, and productivity growth.

In cases where floating exchange rate were contemplated, they were advanced as the only way of preserving monetary policy autonomy in a world where capital is completely mobile. Floating exchange rates are also believed to relieve domestic prices and incomes from the full burden of adjusting to changing conditions in world markets—although not complete, a floating regime can at least partially assist its economy's adjustment to these outside pressures. Lebanon and Egypt were two cases in mind where a shifting of the burden of adjustment has shown elsewhere in the economy in less visible but damaging forms as a result of policies that didn't allow due adjustments in the nominal exchange rate.

It was mentioned that productivity gains could mitigate real appreciation in the currencies resulting in the loss of competitiveness. On one hand, liberalizing the economies, pushing ahead with privatization plans, and attracting foreign direct investment are all policies that can increase productivity growth. However, implementing such reforms take considerable time. On a parallel track, compensating demand management policies such as contractionary monetary policies and fiscal retrenchment, via lower domestic prices, can work to restore some of the competitiveness lost to the overvalued currency. However, good overall results achieved to date in the Arab region in curbing inflation and fiscal responsibility limit the effectiveness of the related demand policies. The deflationary trends appearing in a number of

Arab countries along with their associated negative effects on growth make the adoption of flexible exchange rate regimes an attractive alternative in improving competitiveness[105].

In assessing the desirability of floating regimes in Arab economies, we generally observed that the lack of monetary policy independence associated with a fixed exchange rate system might be viewed as an advantage, in light of the development stage of the monetary institutions therein. Many Arab economies adopting a pegged exchange rate to the U.S. dollar have rightfully acknowledged the superior policy performance of the anchor country and the irrelevance of their own independent policies, at least for the time being[106]. For the AGCC group, it was noted that a flexible exchange rate is somewhat redundant under a system of fiscal transfers, but at the same time we expressed caution in the use of discretionary fiscal policy as effective stabilization tools. Large fiscal deficits at times of low oil prices have resulted in increased interest spreads, which have usually dampened diversification efforts by curbing investment in non-oil sectors.

What about the state of affairs of the 'traditional' pegged systems in Arab countries? For the case of the exchange rate systems in AGCC countries, the effective or official pegging to the U.S. dollar has resulted in stable currencies since the adoption of such regimes (as

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105 For the signatories of AAEUs, an appropriate macroeconomic policy response is to combine firm fiscal discipline, thus allowing room for exchange rate flexibility while maintaining financial stability.

106 If domestic prices and wages were relatively flexible, a flexible exchange rate would offer no advantage in terms of facilitating the adjustment process. A similar situation would arise if factors of production, were perfectly mobile within (or across) countries which reduce the need for domestic or external price adjustment.

early as 1979 in Qatar). In general such regimes have brought with them strong guarantees of exchange rate constancy, despite few episodes where large oil price fluctuations added pressures on the currency peg (at least for one country in the Council). Lately, attention has focused increasingly on making their economies more resilient to terms of trade shocks[107] by diversifying output and export composition. In this vein of thinking, it is worth mentioning that the 1997-1998 oil price downturn has triggered an adjustment strategy that sought to fundamentally address structural weaknesses in the AGCC economies. In mobilizing non-oil revenues as a central plan of the reform strategy, facilitating sustained growth of the non-oil sector may require vigilance in not allowing disequilibria in exchange rates to develop which would likely undermine the competitiveness of would-be products in world markets. On another front, regarding the viability of a common currency, it was advised that the institutional and structural characteristics and the way those countries respond to external shocks be studied further.

As for the other (non-oil producing) Arab countries that have either effectively or officially adopted a pegged system, the virtual stability of the exchange rate has not managed to institute, at all times, a high level of confidence in the constancy of the exchange rate. It is true that

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[107] The variability of the terms of trade of oil-producing countries has been the highest among various groups of producers with a standard deviation close to 42 percent between 1980 and 1998; for producers of non-oil products, primary products, and manufactures, it was at most 6% in the same period.
Diversifying efforts in oil downstream activities and non-oil output growth will undoubtedly be supported by an efficient infrastructure system in oil recovery techniques and a network of comprehensive and modern services.

the constancy of such exchange rates have been observed, but the pressing question here is at what costs has this been achieved. In Jordan, Lebanon and Egypt (until just recently), the monetary policy emphasis on the stability of the local currency has been right in light of the specific circumstances. Nonetheless, although fixing the exchange rates may have contributed to financial stability, the perceived overvaluation of the real exchange rates came at the cost of high and volatile real interest rates where sizable interest spreads shifted investable resources from real (including exports) into financial investments. We acknowledge that misalignments in equilibrium exchange rates carry with them serious negative impact on the GDP growth (in terms of reduction in economic efficiency, misallocation of resources, and capital flight), disturbances to the economy that call for early and necessary corrective realignments measures.

Final words regarding a pegged regime allude to the fact that a pegged rate will only remain credibly constant if those administering will exercise self-discipline in doing some things and abstaining from doing others. In light of policy-makers' continuous discretion in making choices under a pegged regime, a lot is riding on the authorities' ability to reliably maintain an exchange system that is compatible with stable markets expectations and confidence and hence with a viable overall monetary order. Moreover, under a pegged system, intervention in the foreign exchange market by the central bank would be as frequent as it is necessary to keep the exchange rate in line—monetary authorities are committed to stabilize the exchange rate. In contrast to a flexible regime, under a pegged regime, priority ought to be given to the constancy of the exchange rate (ahead of the maintenance of internal

monetary stability). But what must be observed, particularly in three Mashreq economies (Jordan, Lebanon and Egypt), is a rationale calling for exchange rate smoothing as a policy that is not aimed at resisting market-determined movements in an asset price, but at mitigating potentially destabilizing effects of abrupt changes in that price. Otherwise, disadvantages of the fixed and pegged regimes in terms of selling free insurance, discouraging risk assessment and hedging, shifting burden of adjustment elsewhere and distorted asset allocation process (Asia 1997) will eventually destabilize any economy in the world.

Appendix A

Table A1. Factors Affecting the Choice of Exchange Rate Arrangements

Economic Structure and Objectives	**Desirable / Feasible**
Very high inflation	Pegged or Flexible
Large external imbalances	Flexible
Low level of reserves	Flexible
Small size	Pegged
Openness	Pegged
Low flexibility of labor market	Flexible
Fiscal inflexibility	Flexible
Internationalization own currency	Flexible
Degree of dollarization	Pegged
Degree of financial development	Flexible
High mobility of capital	Flexible
Foreign nominal shocks	Flexible
Domestic nominal shocks	Pegged
Financial runs	Flexible
Real external or domestic shocks	Flexible
Policymakers' objectives	
Inflation reduction	Pegged
Correcting external imbalances	Flexible

Table A2: Exchange Rate Systems in Arab Countries-Year 2000

	Jordan	UAE	Bahrain	Tunisia	Algeria	Djibouti	Saudi Arabia	Sudan	Syria	Somalia	Iraq	Oman	Qatar	Kuwait	Lebanon	Lybia	Egypt	Morocco	Mauritania	Yemen
A. Exchange rate arrangements																				
1. Pegged exchange rate																				
- U.S. dollar	*	-	-	-	-	*	-	-	*	-	*	*	-	-	-	-	-	-	-	-
- SDR basket	-	*	*	-	-	-	*	-	-	-	-	-	*	-	-	*	-	-	-	-
- Special basket of currencies (not delared)	-	-	-	-	-	-	-	-	-	-	-	-	-	*	-	-	-	*	-	-
2. Floating exchange rate																				
- Managed float	-	-	-	*	*	-	-	-	-	-	-	-	-	-	*	-	*	-	*	-
- Independent float	-	-	-	-	-	-	-	*	-	*	-	-	-	-	-	-	-	-	-	*
3. Exchange rate structure																				
- Unitary for imports and exports	*	*	*	*	*	*	*	*	-	*	*	*	*	*	*	-	*	*	*	*
- Unitary for invisible transactions and captial transactions	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	-	*	*	*	*
B. Forward exchange market	*	*	*	*	*	*	*	*	-	*	-	*	*	*	*	-	*	*	*	*
C. Forward rates (on a commercial basis)	*	*	*	*	-	-	*	-	-	-	-	-	*	*	-	-	*	*	-	*
D. Acceptance of the obligations of IMF Articles of Agreement																				
- Article VIII: freedom of payments and transfers for current international transactions. [1]	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	Yes	Yes	Yes	Yes	No	No	Yes	Yes	Yes
- Article XIV: maintain restrictions on current payments. [2]	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	No	No	No	No	Yes	Yes	No	No	No

* Indicates that the mentioned practice is a feature of the exchange system.

\- Indicates that the mentioned practice is not a feature of the exchange system.

1 Article VIII, Section 2- requires member countries to avoid exchange restrictions on current payments; Section 3- requires members to avoid discriminatory or multiple exchange currency practices; Section 4- permit the covertibility of foreign- held balances of its currency for current

2 Article XIV states that for a transitional period countries may maintain and adapt restrictions on payments and transfer for international transactions that were in place when the country became a member of the IMF.

3 In fact, the country allows for the covertibility of current payments and transfers in part or in whole. However, the country has not officially accepted Article VIII

Source: Data provided to the Joint Arab Economic Report for the year 2001; Annual Report on Exchange Arrangements and Exchange Restrictions (2000), IMF.

Table A3: Exchange Rate Arrangements and Anchors of Monetary Policy in Arab Countries
(as of December 31, 2000)

	Exchange Rate Regime (Number of Arab Countries) (XI Regimes)	Monetary Policy Framework[1]					
		Exchange rate anchor (14)		Monetary aggregate target (2)	Inflation-targeting framework (0)	IMF supported or other monetary program (5)	Other (3)
Hard peg	Exchange arrangements with no separate legal tender (0)	*Another currency as legal tender (I)*	*Monetary union (II)*				
	(III) Currency board arrangement (1)	Djibouti*				Djibouti*	
Intermediate or	Other conventional fixed peg arrangements (including de facto peg arrangements under managed floating)	*Against a single currency(10) (IV)* Bahrain[4,5] Comoros[6] Iraq Jordan*[4] Lebanon[4] Oman Qatar[4,5] Saudi Arabia[4,5] Syrian Arab Republic[3] United Arab Emirates[4,5]	*Against a composite (2) (V)* Kuwait Morocco			Jordan*	
	Pegged exchange rates within horizontal bands (1)[7]	*Within a cooperative arrangement ERM-II (VI)*	*Other band arrangements (1) (VII)* Libya				
	(VIIII) Crawling pegs (0)[4]						
	(IX) Exchange rates within crawling bands[4]						
Float	(X) Managed floating with no pre-announced path for exchange rate (5)			Tunisia		Mauritania Sudan	Algeria[2] Egypt[3]
	(XI) Independently floating (2)			Yemen, Rep. of*		Yemen, Rep. of*	Somalia[3,8]

Source: IMF staff reports.
(21) Arab Countries are classified. The (number between parantheses) refers to the number of countries in that category. Roman numbers identify 11 separate categories.
1 A country with an asterisk, *, indicates that the country adopts more than one nominal anchor in conducting monetary policy. It should be noted, however, that it would not be possible, for practical reasons to infer from this table which nominal anchor plays the principal role in conducting monetary policy.
2 The country has no explicitly stated nominal anchor but rather monitors various indicators in conducting monetary policy.
3 Member maintained exchange arrangements involving more than one market. The arrangement shown is that maintained in the major market.
4 The indicated country has a de facto arrangement under a formally announced policy of managed or independent floating. In the case of Jordan, it indicates that the country has a de jure peg to the SDR but a de facto peg to the U.S. dollar.
5 Exchange rates are determined on the basis of a fixed relationship to the SDR, within margins of up to ±7.25 percent. However, because of the maintenance of a relatively stabe relationship with the U.S. dollar, these margins are not always observed.
6 Comoros has the same arrangement with the French treasury as do the CFA franc zone countries.
7 The band width for Libya is (±77.5 percent),.
8 No relevant information is available for the country.

Box 2. New IMF Exchange Rate classification System

The new classification system is based on the members' actual, de facto, regimes that may differ from their officially announced arrangement. The system ranks exchange rate regimes on the basis of the degree of flexibility of the arrangement. It distinguishes among the more rigid forms of pegged regimes (such as currency board arrangements); other conventional fixed peg regimes against a single currency or a basket of currencies; exchange rate bands around a fixed peg; crawling peg arrangements; and exchange rate bands around crawling pegs, in order to help assess the implications of the choice of exchange rate regime for the degree of independence of monetary policy. This includes a category to distinguish the exchange arrangements of those countries that have no separate legal tender. The new system presents members' exchange rate regimes against alternative monetary policy frameworks with the intention of using both criteria as a way of providing greater transparency in the classification scheme and to illustrate that different forms of exchange rate regimes could be consistent with similar monetary frameworks. The following explains the categories.

Exchange Rate Regime

Exchange Arrangements with No Separate Legal Tender

The currency of another country circulates as the sole legal tender or the member belongs to a monetary or currency union in which the same legal tender is shared by the members of the union. Adopting such regimes is a form of ultimate sacrifice for surrendering monetary control where no scope is left for national monetary authorities to conduct independent monetary policy.

Currency Board Arrangements

A monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuing authority to ensure the fulfillment of its legal obligation. This implies that domestic currency be issued only against foreign exchange and that it remain fully backed by foreign assets, eliminating traditional central bank functions such as monetary control and the lender of last resort and leaving little scope for discretionary monetary policy; some flexibility may still be afforded depending on how strict the rules of the boards are established.

Other Conventional Fixed Peg Arrangements

The country pegs (formally or de facto) its currency at a fixed rate to a major currency or a basket of currencies, where the exchange rate fluctuates within a narrow margin of at most ±1 percent around a central rate. A weighted composite is formed from the currencies of major trading or financial partners and currency weights reflect the geo-graphical distribution of trade, services, or capital flows. The currency composites can also be standardized, such as those of the SDR and the ecu. The monetary authority stands ready to maintain the fixed parity through intervention, limiting the degree of monetary policy discretion; the degree of flexibility of monetary policy, however, is greater relative to currency board arrangements or currency unions, in that traditional central banking functions are, although limited, still possible, and the monetary authority can adjust the level of the exchange rate, though infrequently.

Box 2…….continue

Pegged Exchange Rates Within Horizontal Bands

The value of the currency is maintained within margins of fluctuation around a formal or de facto fixed peg that are wider than ±1 percent around a central rate. It also includes the arrangements of the countries in the exchange rate mechanism (ERM) of the European Monetary System (EMS)—replaced with ERM-II on January 1, 1999. There is some limited degree of monetary policy discretion, with the degree of discretion depending on the band width.

Crawling Pegs

The currency is adjusted periodically in small amounts at a fixed, pre-announced rate or in response to changes in selective quantitative indicators (past inflation differentials vis-à-vis major trading partners, differentials between the target inflation and expected inflation in major trading partners, etc.). The rate of crawl can be set to generate inflation adjusted changes in the currency's value ("backward looking"), or at a preannounced fixed rate below the projected inflation differentials ("forward looking"). Maintaining a credible crawling peg imposes constraints on monetary policy in a similar manner as a fixed peg system.

Exchange Rates Within Crawling Bands

The currency is maintained within certain fluctuation margins around a central rate that is adjusted periodically at a fixed preannounced rate or in response to changes in selective quantitative indicators. The degree of flexibility of the exchange rate is a function of the width of the band, with bands chosen to be either symmetric around a crawling central parity or to widen gradually with an asymmetric choice of the crawl of upper and lower bands (in the latter case, there is no pre-announcement of a central rate). The commitment to maintain the exchange rate within the band continues to impose constraints on monetary policy, with the degree of policy independence being a function of the band width.

Managed Floating with No Preannounced Path for the Exchange Rate

The monetary authority influences the movements of the exchange rate through active intervention in the foreign exchange market without specifying, or precommitting to, a preannounced path for the exchange rate. Indicators for managing the rate are broadly judgmental, including, for example, the balance of payments position, international reserves, and parallel market developments, and the adjustments may not be automatic.

Independent Floating

The exchange rate is market determined, with any foreign exchange intervention aimed at moderating the rate of change and preventing undue fluctuations in the exchange rate, rather than at establishing a level for it. In these regimes, monetary policy is in principle independent of exchange rate policy

Box 2 ….continue

Monetary Policy Framework

Members' exchange rate regimes are presented against alternative monetary policy frameworks in order to present the role of the exchange rate in broad economic policy and help identify potential sources of inconsistency in the monetary-exchange rate policy mix.

Exchange Rate Anchor

The monetary authority stands ready to buy and sell foreign exchange at given quoted rates to maintain the exchange rate at its preannounced level or range (the exchange rate serves as the nominal anchor or intermediate target of monetary policy). These regimes cover exchange rate regimes with no separate legal tender, currency board arrangements, fixed pegs with and without bands, and crawling pegs with and without bands, where the rate of crawl is set in a forward looking manner.

Monetary Aggregate Anchor

The monetary authority uses its instruments to achieve a target growth rate for a monetary aggregate (reserve money, M1, M2, etc.) and the targeted aggregate becomes the nominal anchor or intermediate target of monetary policy.

Inflation-Targeting Framework

A framework that targets inflation involves the public announcement of medium-term numerical targets for inflation with an institutional commitment by the monetary authority to achieve these targets. Additional key features include increased communication with the public and the markets about the plans and objectives of monetary policy-makers and increased accountability of the central bank for obtaining its inflation objectives. Monetary policy decisions are guided by the deviation of forecasts of future inflation from the announced inflation target, with the inflation forecast acting (implicitly or explicitly) as the intermediate target of monetary policy.

IMF-Supported or Other Monetary Program

An IMF-supported or other monetary program involves implementation of monetary and exchange rate policy within the confines of a framework that establishes floors for international reserves and ceilings for net domestic assets of the central bank. As the ceiling on net domestic assets limits increases in reserve money through central bank operations, indicative targets for reserve money may be appended to this system.

Other

The country has no explicitly stated nominal anchor but rather monitors various indicators in conducting monetary policy, or there is no relevant information available for the country.

Table A4: Country Scores on the FLT index, 1998 (19 Arab Countries)

Country	ME	MR	FLT
Bahrain	0	0.102	0
Comoros	0	0.078	0
Djibouti	0	0.037	0
Egypt	0	0.005	0
Iraq	0		0
Jordan	0	0.021	0
Oman	0	0.094	0
Qatar	0		0
Saudi Arabia	0	0.038	0
Syria	0		0
UAE	0	0.031	0
Lebanon	0.001	0.038	0.027
Kuwait	0.003	0.098	0.034
Libya	0.001	0.016	0.093
Tunisia	0.006	0.069	0.093
Yemen	0.008	0.036	0.226
Algeria	0.011	0.051	0.227
Morocco	0.009	0.014	0.655
Sudan	0.027	0.011	2.446

Source: H. Poirson (2001)

The degree of de facto exchange rate flexibility of country i (FLT) is measured by the ratio of the average absolute value of monthly nominal exchange rate depreciation (ME) to the average absolute value of the monthly change in reserves normalized by the monetary base in the previous month (MR), in order to proxy for the monetary impact of these changes. FLT assumes values ranging from zero to infinity, with the limits being defined by a perfectly pegged policy at the one end (ME=0) and a completely intervention-free policy at the other

For country i:

$$FLT = \frac{ME}{MR} = \frac{\sum_{k=0}^{11} E_{t-k} - E_{t-k-1} / E_{t-k-1}}{\sum_{k=0}^{11} R_{t-k} - R_{t-k-1} / H_{t-k-1}}$$

wher E_t = nominal exchange rate in month t, R_t = net international reserves, minus gold, in mo and H_t = monetary base in month t.

Table A5: Exchange Rates: Domestic Currency per U.S. Dollar (period average) (1992-2000)

	Currency of Arab Countries	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average rate of change in the currency value during 1999-2000 (%) [2]	Average annual change rate in the currency value for the period 1995-2000 (%) [2]
Jordan	Dinar	0.6797	0.6929	0.6988	0.7008	0.7090	0.7090	0.7090	0.7090	0.7090	0.00	-0.23
UAE	Dirham	3.6710	3.6710	3.6710	3.6710	3.6710	3.6711	3.6725	3.6725	3.6725	0.00	-0.01
Bahrain	Dinar	0.3760	0.3760	0.3760	0.3760	0.3760	0.3760	0.3760	0.3760	0.3760	0.00	0.00
Tunisia	Dinar	0.8844	1.0037	1.0116	0.9458	0.9734	1.1059	1.1387	1.1862	1.3707	-15.55	-7.15
Algeria	Dinar	21.8360	23.3450	35.0590	47.6630	54.7490	57.7070	58.7390	66.5740	75.2600	-13.05	-8.73
Djibouti	Franc	177.7210	177.7210	177.7210	177.7210	177.7210	177.7210	177.7210	177.7210	177.7210	0.00	0.00
Suadi Arabia	Riyal	3.7450	3.7450	3.7450	3.7450	3.7450	3.7450	3.7450	3.7450	3.7450	0.00	0.00
Sudan	Dinar	6.9444	15.3846	28.9610	58.0870	125.0790	157.5740	200.8020	252.5500	257.1200	-1.81	-25.73
Syria [1]	Pound	28.2600	30.0600	33.0000	34.3600	39.2689	44.8792	49.2700	48.8304	49.0500	-0.45	-6.87
Somalia	Shilling	...	...	...	...	...	...	...	...	...	...	...
Iraq	Dinar	0.3109	0.3109	0.3109	0.3109	0.3109	0.3109	0.3109	0.3109	0.3109	0.00	0.00
Oman	Riyal	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.3845	0.00	0.00
Qatar	Riyal	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	3.6400	0.00	0.00
Kuwait	Dinar	0.2933	0.3013	0.2976	0.2985	0.2994	0.3033	0.3047	0.3044	0.3067	-0.77	-0.55
Lebanon	Pound	1,713.0748	1,741.4000	1,680.1000	1,621.4000	1,571.4000	1,539.5000	1,516.1000	1,507.8000	1,507.50	0.02	1.47
Libya	Dinar	0.2985	0.3224	0.3596	0.3532	0.3651	0.3891	0.3785	0.4616	0.5081	-10.07	-7.02
Egypt	Pound	3.3303	3.3534	3.3868	3.3910	3.3900	3.3880	3.3880	3.4050	3.6900	-8.37	-1.68
Morocco	Dirham	8.5380	9.2990	9.2030	8.5400	8.7160	9.5270	9.6040	9.8040	10.6260	-8.38	-4.28
Mauritania	Ouguia	87.0270	120.8060	123.5750	129.7680	137.2220	151.8530	188.4760	209.5140	238.9230	-14.04	-11.49
Yemen	Riyal	28.5000	39.5400	55.2400	100.0000	128.0000	128.0000	135.8820	155.7180	161.7180	-3.85	-9.17

[1] The exchange rate of the U.S dollar in "neighboring country".

[2] The average rate of change is calculated on the basic of U.S. dollar units per one local currency unit; The sign (-) refers to a depreciation in the local currency value.

Source: Data provided by Arab authorities to the Joint Arab Economic Report (2001), and the International Monetary Fund.

Table A6: Official International Reserves of Arab Countries *
(1995-2000)

(in million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total Arab Countries	**35757.9**	**44163.7**	**45611.9**	**46586.8**	**51666.86**	**59099.16**	**73082.97**	**81563.97**	**79833.52**	**85984.51**
Jordan	221	825	769	595.2	431.2	428.3	698	1693.3	1170.3	1991.1
United Arab Emirates	4583.9	5365.4	5711.8	6103.7	6658.8	7470.9	8055.5	8372.3	9077.07	10675.1
Bahrain	1234.9	1514.6	1258.7	1149.1	1103.5	1273.7	1264.7	1362.2	1349.2	1371
Tunisia	794.8	789.9	852	853.8	1461.5	1624.6	1965.8	1978.1	1850.1	2261.5
Algeria	725	1486	1457	1475	2674	2005	4235	8047	6846	4543
Djibouti					73.76	72.16	76.97	66.57	66.45	70.61
Saudi Arabia	11668	11673	5935	7428	7378	8622	14321	14876	14220	16997
Sudan	11.4	7.6	27.5	37.4	78.2	163.4	106.8	81.6	90.6	174.2
Syria	163	623	581	627	1087	1343	1709	1624	1860	2110
Somalia	...	...	...	...	...	...	...	...	...	...
Iraq	...	...	...	...	...	...	...	...	...	...
Oman	1672.4	1663.3	1983.5	908.1	979.4	1137	1389.2	1548.7	1064.3	2767.5
Qatar	631.1	667.7	683.3	693.7	694.4	727.6	667.7	845.5	1445.6	1277.5
Kuwait	2419	3409	5146.9	4214.1	3500.7	3560.8	3515.1	3451.7	3947.1	4823.7
Lebanon	659.9	1275.5	1496.4	2260.3	3884.2	4533.2	5931.9	5976.3	6556.3	7775.6
Libya	5745.4	5694	4809	3357	3440	5640	6794	7572	6574	7280
Egypt	2684	5325	10935.5	13039.8	13476	16192	17400	18667	18113.5	14480.5
Morocco	2066	3100	3584	3655	4352	3601	3794	3993	4435	5689
Mauritania	54.1	67.6	61.2	44.6	39.7	85.5	141.2	200.8	202.9	224.3
Yemen	424	677.1	320.1	145	354.5	619	1017.1	1207.9	965.1	1472.9

*Excluding gold

Note: The total does not include Iraq and Somalia.

Source: - Data provided by Arab central banks to the Joint Arab Economic Report for year 2001.

- International Monetary Fund, Balance of Payments Statistics, Government Finance Statistics, Direction of Trade Statistics.

Appendix B

Table B1: Dollarization Rates
(Foreign denominated deposits as a ratio of domestic liquidity)
end of December 1996 -2000

	1996	1997	1998	1999	2000
UAE	19.9	19.6	20.0	21.2	22.4
Jordan	16.2	15.1	18.8	19.0	21.3
Saudi Arabia	17.0	16.4	17.9	16.4	15.6
Oman	11.9	11.9	12.3	9.0	9.2
Qatar	25.1	26.6	24.8	26.4	22.3
Kuwait	17.1	15.2	13.7	11.5	11.0
Lebanon	51.0	57.4	58.2	54.6	60.3
Egypt	20.4	18.0	17.3	17.7	20.1
Yemen	23.7	25.6	28.8	30.8	30.8

Source : Monetary and financial statistics bulletin (2001) and Arab Monetary agencies and Central Bank Surveys .
*According to available data from countries to date .

Table B2: Foreign Liabilities* in Arab Commercial Banks
(as a percentage of total liabilities)
end of period, 1996 -2000

	1996	1997	1998	1999	2000
Jordan	24.8	22.6	20.9	20.2	21.0
UAE	20.0	22.5	23.7	22.5	19.6
Bahrain	14.6	19.0	17.4	23.1	16.1
Tunisia	7.6	7.6	7.3	8.6	8.0
Saudi Arabia	10.8	16.3	10.7	12.3	14.2
Syria	1.1	0.5	0.6	0.8	0.6
Oman	10.7	15.2	16.4	16.7	16.0
Qatar	11.0	12.1	12.8		4.4
Kuwait	6.6	9.6	8.4	9.4	8.8
Lebanon	12.5	14.0	16.2	15.8	16.0
Egypt	2.1	3.4	4.3	3.7	3.8
Morocco	1.1	1.4	1.6	1.6	1.3
Yemen	12.1	18.7	23.4	24.0	17.4

Source : Monetary and financial statistics bulletin (2001) and Arab Monetary agencis and Central Bank Surveys .Foreign Libalities = Borrowing from foreign banks + nonresidents deposits + other foreign liabilities .
*(Foreign denominated deposits of residents are not included)

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