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Economic growth and environmental degradation in Ethiopia: An environmental Kuznets curve analysis approach

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This study aimed to study the relationship between economic growth and environmental degradation in Ethiopia by questioning the existence of environmental Kuznets Curve. The study uses time series data from 1969/70 to 2010/2011 in a VECM analysis approach. The finding indicates existence of EKC hypothesis in Ethiopia. Like any agrarian country economic growth in Ethiopia inevitably contribute for environmental degradations at the early stage. Later on environmental degradation start to decline with increasing economic growth this might be due to an increase in share of service sector in the economic growth and application of environmental law with economic activity. To sustain the current trend the country should have to follow the existing environmental friend economic policy.

Key words: Environmental Kuznets Curve, economic growth, VECM, CO2.

INTRODUCTION

The question of sustaining the economic growth without despoiling environment, resource constraint, steady state of income and environmental quality is an issue for both social and natural science scholars. The growth in economy requires more capital and other resources which in turn generates larger quantity of wastage including emission to the environment. The accumulation of wastage and pollutant due to the extraction of resources could lead to degradation of environment, loss of human welfare, with rising in economic growth. When the accumulation of wastage and pollution due to continuous extractions of resources can run beyond the carrying capacity of the environment the whole economic activity will fall at risk.

Contrary to this view, there is an argument that states higher environmental improvement goes along with economic advancement due to the fact that at higher levels of economic growth, there could be an increase in demand for less material intensive goods and services as well as the demand for improved environment which further expect to improve the environment with increasing economic growth (Panayotou, 2003).

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The other scholars hypothesize the relationship between economic growth and environmental degradation is not fixed along with the countries path of economic growth. For instance, the environmental Kuznets Curve (EKC) has argued that there is an inverted U-shaped relationship between economic activity and environmental degradation. Kuznets explains that environmental degradation initially increases with increasing level of economic growth, and reaches a maximum point, and then it starts to decline with further increases in economic growth. In its explanation at early stage source of economic growth is mainly agriculture which costs the environment via agricultural expansion and change in land use pattern. Then when the sources of economic growth transferred to industrial bases environmental degradations reaches at maximum point. And later on the service sector dominates the economy and environmental degradation start to improve with increases in economic growth (Kuznets, 1955).

During the last 200 years the continuous increment in economic growth in the world has led to rising level of employment, income, and promotes both private and public investment in vast sectors. But Sub Saharan Africa has still been dominated by a high percentage of low income and largely rural agrarian communities. Meanwhile, increasing economic growth entails the use of physical, natural, social and human capital in economic activities. Natural capital includes raw materials extract from the earth, carbon sequestration services provided by soil and forest. Its unique elements are some have finite limits, irreversible change, its impact extends across many generations, due to critical threshold sudden and dramatic change may occurs. Environment is one of natural capital which need to be used sustainably and efficiently in order to secure growth in the long run with the fate of the coming generations (Alex et al., 2010).

According to World Bank (2013) between 2004 and 2011, Ethiopia had achieved high economic growth averaging 10.7 percent per year. As compared to the sub-Saharan African average of 5.4 percent during the same decade, the figure (10.7%) shows existence of great potential for further progress in the country. In 2012, Ethiopia was the 12th fastest growing economy in the World and the Bank forecasts that if the country can be able to continue this impressive growth performance, could potentially reach middle income status by 2025. The composition of economic growth source was through a mix of factors: including agricultural modernization, the development of new export sectors, strong global commodity demand, and government-led development investments (World Bank, 2013).

Considering this in the Ethiopian growth and transformation plan 2010/11- 2014/15 the country’s GDP per capita projected to grow from 378 USD in 2010 to 1271 USD in 2025. In addition to this the Clean Renewable Green Energy strategy projects that the contribution of agriculture in the economy will diminish from 42 to 29%, indicating migration of jobs from the agriculture sector to industry and services. This transformation plan explicitly recognizes that environment is a vital and important pillar of sustainable development, and implementation of environmental laws is part of building the green economy (MoFED, 2010).

Even if the above idea underlines economic growth and development in Ethiopia should have to care about environmental sustainability and must compromise with the fate of the coming generation, on the bases of EKC argument reliance on agriculture for economic growth inevitably costs the environment especially at the early stage. In the history of Ethiopian economy agriculture is the backbone and still remains the major sources of economic growth followed by service sector and industry.

As indicated above even during the fast economic growth (2004 onward) the source of growth is agricultural modernization, development of new export sector for agricultural output, increases in global demand for agricultural output in addition to government led infrastructure development.

To make consistency between economic growth and environment different actions are taken over time including: the 1992 Rio- Conference concern with national conservation strategy to harmonize the rate of population growth and the capacity of the country for the development and rational utilization of natural resources to the end of that the level of welfare is maximized over time. In 1994 program of action plan is adapted with the objectives of integrating poverty eradication actions with environmental sustainability and meeting current generation need must not at the cost of the coming generations. Later on formal environmental policy ratified in 1997 for sustainable development principles. Considering all the above plans different development programs of the country: agricultural development led industrialization since 1992, poverty reduction strategy papers, a plan for accelerated and sustainable development to end poverty 2005/06 – 2009/10, growth and transformation plan of 2010/11 – 2014/15, and in 2011 the climate resilient green economy strategy was developed (Environmental protection authority of Ethiopia, 2012).

Of course the relationship between economic growth and the environment is complex. This evident from the fact that economic growth entails scale and composition of the economy, particularly the share of services in gross domestic product as opposed to primary industries and manufacturing, and changes in technology that have the potential to reduce the environmental impacts of production and consumption decisions in the economic growth. So, the issue of whether the impact of economic growth on the environment increases monotonically, decreases monotonically, or first increases and then declines along a country’s economic growth has critical implications for policy. Therefore, it is also much more
important and utmost necessary to investigate whether higher economic growth lead to higher environmental damage or not (Jos et al., 2012).

According to the Intergovernmental Panel on Climate Change counties like Ethiopia are likely to suffer extremely from the adverse effect from climate change because of global warming problem which is caused from the environmental degradation. It is further predicted that Ethiopia is likely to experience a high frequency of extreme climate events, like droughts and floods (Environmental Protection Authority, 2012). Understanding the relationship between economic growth and the environment and reacting accordingly to overcome such adverse outcome such as pollution, degradation, climate changes etc. is very important.

Identifying the link between environment and economic growth will provide information to the policy makers to enable them to come up with the appropriate policies regarding the subject area is the main rationale motivated this study. In line with this, the findings of this study have significant policy implications on environmental quality and the economic growth as Ethiopia is also a signatory country in the Kyoto protocol. The study provides answers to the following questions. Is there any relationship between economic growth and environment in Ethiopia? What does the economic growth – environmental quality relationship imply for environmental quality and sustenance of Green Economic growth in the country? Does economic growth leads environmental degradation in Ethiopia?

LITERATURE REVIEW

The Hypothetical Kuznets curve was first developed by Simon Kuznets in 1950s and 1960s to show path of economic development and income inequality. It states that at the early stage when the economy depends mainly on agriculture, income inequality grow with increases in income. The curve suggests that unlike at the early stage of economic development, When a country shift to industrialization through mechanization of agriculture – the center of the nation’s economy will shift to the cities, the internal migration of labor from rural to urban by farmers looking for better-paying jobs in urban area affects a significant rural-urban inequality gap. Kuznets believes that inequality would follow an inverted “U” shape as it rises and then falls again with the increase of income per-capita (Figure 1).

Since 1991 the issues of environmental Kuznets curve have become a standard feature in technical literature of environment and economic interaction. The view is that the initial economic activity inevitably hurts the environment. The assumptions are based on static technology, tastes and environmental investments. It states that as incomes rise, the demand for improvements in environmental quality will increase, as well the resources available for investment. And concludes although economic growth usually leads to environmental degradation in the early stages of the process, the only way to attain a decent environment in most countries is to become rich (Perman and Stern, 1999).

According to the traditional argument the issues of economic growth and environmental qualities are conflicting ideas. With a state of constant technology and constant structure of the economy, pure growth in the scale of the economy would result in a proportional growth in pollution and other environmental impacts. This traditional view reflects the scale effect alone in its definitions of economic growth sources. The proponents of the EKC hypothesis argue that at higher levels of development, structural change towards information-intensive industries and services, coupled with increased environmental awareness, enforcement of environmental regulations, better technology and higher environmental expenditures, result in leveling off and gradual decline of environmental degradation (Panayotou, 1993, p 1).

A number of studies have developed theoretical models about how preferences and technology might interact to result in different time paths of environmental quality. The different studies make different simplifying assumptions about the economy. Most of these studies can generate an inverted U shape curve of pollution intensity. Selden and Song (1995) assume infinitely lived agents,
exogenous technological change and that pollution is generated by production and not by consumption. McConnell (1997) develops models based on overlapping generations where pollution is generated by consumption rather than by production activities as Stokey (1998) allows endogenous technical change. So, the result depends on the assumptions made and the value of particular parameters. And the proximate variables may in turn be driven by changes in underlying variables such as environmental regulation, awareness, and education in the course of economic development.

Ming-Feng and Daigee (2006) for Taiwan finds the inverted U – shaped relationships between NO2 and CO2 with economic growth. As income increase NO2 and CO2 increases later on start to decline with increase in income. Philip and Adeyemi (2013) find absence of ECK hypothesis in Nigeria and failed to attain reasonable turning point. Abesha (2009) studied Domestic Energy Consumption and Deforestation in Harer region Assessment of Students’ Awareness and Views in Ethiopia. And the study finds the views about environmental problems resulted from unsustainable dependence of biomass energy and Air pollution, is a serious environmental problem in developed nation is considered by more than half of students.

MATERIALS AND METHODS

Model specification

To determine the nature of the relationship between environmental quality and economic growth in Ethiopia, the study draw model from both the EKC and the original Kuznets curve literature. The underlying hypothesis is that the relationship between economic growth and environmental quality is not monotonic and may change direction from upward to downward when a country reaches a certain level of income. Typically, the specifications of model in the study considers standard EKC model following Omisakin (2009) which takes the following form,

\[ (E/P)_t = \alpha + \beta_1(GDP/P)_t \cdot \beta_2(GDP/P)_t^2 + B_3X_t + u_t \]

Where \( E \) is environmental degradation captured by CO2 emissions, \( P \) is population size, hence \( (E/P) \) is per capita CO2 emissions. \( (GDP/P) \) is per capita real GDP and \( X_t \) is a vector of variables that may often affect environmental quality in this regard openness considered, and \( t \) is the deterministic time trend, used as a crude proxy for technological progress. With this, the study describes the relationship that may be expected to hold between income and the environment with varying signs of \( \beta \).

If \( \beta_1 > 0 \) and \( \beta_2 > 0 \) implies linear case relationship between economic growth and environment.

If \( \beta_1 > 0 \) and \( \beta_2 < 0 \) implies U shaped relationship between environment and GDP.

Whereas when \( \beta_1 < 0 \) and \( \beta_2 < 0 \) the relationship implies monotonically decreasing among the variables.

Methods of data analysis and estimation techniques

In the econometrics model the methodology based on secondary data analysis of Johnson co-integration analysis framework: it includes lag length selection, unit root test, and co-integration, identification of long run model and diagnostic test of validity which includes the test for the serial autocorrelation in the residual. And if it finds any evidence of any serial autocorrelations the paper tries to fix it by adding or removing lags of the variables. All the analysis in the study was conducted using STATA 12 version software.

Unit root test

This is to ascertain whether the time series are stationary or not. Moreover, stationary is required so as to avoid spuriousness of the regression results. A variable is said to be stationary if it’s mean, variance and auto-covariance remains the same no matter at what point we measure them. The null hypothesis of non-stationary is tested against alternative hypothesis of stationary. A number of tests are available in the literature to check the existence of the unit root problem both in the level of the variables as well as in their first difference. The Dickey Fuller (DF) test is applicable if error terms (Ut) are uncorrelated. In case the error terms (Ut) are correlated, DF test is useless. Augmented Dickey Fuller (ADF) test takes care of this problem by “augmenting” the equation(s) of DF test by adding the lagged values of the dependent variables (Pantula, 1989). To test the unit root property of the variables, the paper employed Augmented Dickey Fuller test (ADF). The Augmented Dickey-Fuller (ADF) regression model has a form:

\[ \Delta y_t = \alpha + \beta_1 \Delta y_{t-1} + \sum_{i=2}^{p} \gamma_i \Delta y_{t-i} + \epsilon_t \]

Where \( \epsilon_t \) is the time index, \( \alpha \) is an intercept constant, \( \beta \) is the coefficient on a time trend, \( \delta \) is the coefficient present process root. \( \epsilon_t \) is an independently, identically distributed residual term, \( y_t \) is the variable of interest (\( Y, E, Y^2 \) and Openness). The aim of test is to see whether the coefficient \( \delta \) equals zero, which would imply that all possible outcomes of \( \beta_3 \) the parameter of controlled variable expect to affect environment positively over time (Agbai, 2011).
process is non-stationary, thus for the equation 2 the null hypothesis is H0: $\delta = 0$ $\beta \neq 0$, yt is non-stationary, against the alternative HA: $\delta < 0$ $\beta 
eq 0$, yt is trend stationary, represents a least restricted ADF model i.e. including trend. For equation 3 excludes trends H0: $\delta = 0$ $\alpha \neq 0$, yt is non-stationary, against the alternative HA: $\delta < 0$ $\alpha 
eq 0$, yt is level stationary and For equation 4 H0: $\delta = 0$ yt is non-stationary, against the alternative HA: $\delta < 0$, yt is stationary and excludes both trend and constant (ibid).

**Co-integration test**

The concept of co-integration can be described as a systematic cointegration among the selected time series over the long-run. If two or more series are each non-stationary, but a linear combination of them is stationary then it can be said that the series are co integrated. It is necessary to test for co-integration if we want to provide meaningful results. One of the most widely used approaches to test for co-integration is Johansen test. Divergently from other co integration tests like Engle-Granger test which permits only one co integrating relationship, Johansen test allows for more than one co-integrating relationship to be tested and thus is more applicable in this study. Johansen (1992) suggests the use of Pantula principle developed by Pantula (1989). The procedure involves the estimation of three models, starting from the most restrictive model which includes restricted constant and no trends, to the least restrictive model with unrestricted constant and no trends, where Δ is the difference operator, p is the number of lags, $\alpha$ and $\beta$ are parameters to be estimated, $\epsilon$ is serially uncorrected error term, and $\epsilon_t$ is the error correction term (ECM).

**RESULT AND DISCUSSION**

As shown in Tables 1 to 3, lag length selection criteria of Akaike Information Criterion (AIC), Hanna-Quinn Information criterion (HQIC) and Schwarz Information Criterion (SBIC) strongly advise us of inclusion of one lag in the analysis. Based on this outcome the study had included one lag for all of the variables in the model.

All the variables in the study are non-stationary at level whereas they become stationary at 5% level of significance after taking their first difference as indicated in Table 1 respectively. To proceed with Johnson co-integration analysis it needs the variables of interest must be integrated of the same order I (1), meaning they have to become stationary after taking their first differences as approved in the above result (Tables 4 and 5).

**Johnson co-integration test result Trace Statistics**

In the Johnson co-integration test both trace statistics and max-Eigen statistics indicates existence of one co-integrating equations among variables of interests. Next by normalizing the VECM on the long run relationship is in support of EKC hypothesis. At the early stage of economic growth when the economy is mainly depending on agriculture economic growth invariably contribute for environmental degradation. As shown below on Y positive sign, there is significant p-value in equation 6. Later on further economic growth starts to reduce environmental degradation with increasing economic growth as indicated with negative sign and significant p-value of Y2 in the same equation.

\[
\text{LE} = 670.89 + 0.11Y - 56.16L_2Y + 0.80L\text{Openness} \\
(0.000) \quad (0.000) \quad (0.174) \quad \text{.........6}
\]

Vector AR test $\chi^2 (23.5247) = 16 \quad (0.10041)$

According to carbon budget from 1959-2011 the main source of environmental degradation carbon dioxide emission among all human-produced carbon dioxide emissions 87 percent come from the burning of fossil fuels like coal, natural gas and oil, while from the clearing of forests and other land use changes 9% and as well as from some industrial process such as cement manufacturing 4% (IEA, 2013). In case of Ethiopia, energy consumption in the country is dominated by sort of hydro and biomass. Biomass sourcing over 80% of the country’s energy and Fossil fuel energy consumption which is a major source of CO$_2$ emission comprises coal, oil, petroleum, and natural gas products measured at 5.72 % of total energy consumption in Ethiopia for 2011 (Deriba, 2012). The composition of the economy is dominated by agriculture so the clearing of forests and other land use change pattern can initially contribute for environmental degreadations. Later on adaption of environmental policy and an increase in the service sector economic contribution can reduce environmental degradation with increasing economic growth.

In line with this argument Ethiopia have been doing enormous homework starting from: adoptions of national conservation strategy started in 1993, adaption of environmental policy in 1997, and climate resilient green economy strategy was developed in 2011 and all development plans including agricultural development led industrialization, poverty reduction strategic papers, a

**Table 1. Lag length selections criteria.**

<table>
<thead>
<tr>
<th>Lag</th>
<th>AIC</th>
<th>HQIC</th>
<th>SBIC</th>
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<tr>
<td>0</td>
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<td>13.1946</td>
<td>13.3056</td>
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<tr>
<td>1</td>
<td>6.88427*</td>
<td>7.19092*</td>
<td>7.74616*</td>
</tr>
<tr>
<td>2</td>
<td>6.96316</td>
<td>7.51514</td>
<td>8.51456</td>
</tr>
<tr>
<td>3</td>
<td>6.9296</td>
<td>7.7269</td>
<td>9.17051</td>
</tr>
<tr>
<td>4</td>
<td>7.1132</td>
<td>8.15582</td>
<td>10.0436</td>
</tr>
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</table>

Source: Stata 12 result.
Table 2. Unit root test result at level.

<table>
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<th>Intercept</th>
<th>Trend and intercept</th>
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<td>Test statistics</td>
<td>1% critical value</td>
<td>5% critical value</td>
</tr>
<tr>
<td>LE</td>
<td>-0.642</td>
<td>-3.648</td>
<td>-2.958</td>
</tr>
<tr>
<td>LY2</td>
<td>0.839</td>
<td>-3.648</td>
<td>-2.958</td>
</tr>
<tr>
<td>Lopeness</td>
<td>-1.592</td>
<td>-3.648</td>
<td>-2.958</td>
</tr>
</tbody>
</table>

Source: from stata 12 result.

Table 3. Unit root test result at first difference.

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<tr>
<td></td>
<td>Test statistics</td>
<td>1% critical value</td>
<td>5% critical value</td>
</tr>
</tbody>
</table>

Source: from stata 12 result* and ** indicates the rejection of the null hypothesis at 1% and 5% level of significance, respectively.

Table 4. Johnson co-integration test result Trace Statistics.

<table>
<thead>
<tr>
<th>Rank_Ho</th>
<th>Ha</th>
<th>Eigen value</th>
<th>Trace statistic</th>
<th>5% critical value</th>
<th>decision</th>
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<tr>
<td>1</td>
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<td>20.3000*</td>
<td>29.68</td>
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<tr>
<td>2</td>
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<td>15.41</td>
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<td></td>
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<tr>
<td>3</td>
<td>0.16298</td>
<td>0.6641</td>
<td>3.76</td>
<td></td>
<td></td>
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<td>4</td>
<td>0.01607</td>
<td>-</td>
<td>-</td>
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Source: Stata 12 result.

Table 5. Johnson co-integration test result Max Statistics.

<table>
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<tr>
<th>Rank_Ho</th>
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<th>Eigen value</th>
<th>Max statistic</th>
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</tbody>
</table>

Source: Stata 12 result.

plan for accelerated and sustainable development to end poverty, and the growth and transformations plan underlines implementing environmental low is part of building green economy. According to climate resilient green economic strategy of Ethiopia the country aimed to achieve middle income economy as of 2020 to 2023 within this range the contribution of agriculture projected to diminish from 42 to 29%. This indicates dramati
change of factors of production mobility to industry and service sector. Even the expected industrial development doesn’t increases environmental degradation like other developed nation because in Ethiopia the current vast hydro power investment secures the source of energy for human, industrial and partly for transportation service could be from renewable source (FDRE, CRGE, 2011).

In the vector error correction model the study found the significant and correct signed error correction term. The sign of error correction term indicates convergence to the equilibrium in case of shock occurs in the model. The magnitude of the error correction term which is 13.79% indicates in case of shock occurs it adjust itself by this amount. In the process of adjustment initial level and further economic growth can play crucial rules and their significance holds the long run relationships result. The diagnostic test of serial autocorrelation to examine if data series residual have autocorrelation or linearly dependence exists? In this case it justifies there is no serial autocorrelation problem in the model (Table 6).

### Short run dynamics

**Conclusion and Policy implication**

This study aimed to assess the relationship between environmental degradation and economic growth in Ethiopia by questioning the existence of environmental Kuznets curve. It also finds existence of statistical significance relationship in support of the existence of environmental Kuznets curve hypothesis in Ethiopia: Which means, like any agriculturalist economy at the early stage economic growth inevitably contribute for environmental degradation. Later on environmental degradation starts to decrease with increasing economic growth. The argument could be justified on the bases of expected increases on the share of service sector in the economy, ratification of environmental friend development policies and currently started environmental rules and regulation can contribute for improvement in environmental degradation in the future.

On the bases of this finding when other things remain constant, the future economic growth in Ethiopia can contribute positively for environmental improvement. To realize this argument the country should have to sustain the current situation which projects increasing share of service sector in the economy, sustaining the current green economy targeted development policies, sourcing energy from climate resilient green energy and implementing environmental policies roles and regulation in the right way.

### REFERENCES


### Table 6. Short run dynamics.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficient</th>
<th>Std. error</th>
<th>Z value</th>
<th>p-value</th>
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<td>-2.55</td>
<td>0.011</td>
</tr>
</tbody>
</table>

R^2 = 0.7990; AR test Chi^2(16) = 16 (0.08837). Source: Stata 12 result.


Real exchange rate assessment in Egypt: Equilibrium and misalignments

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The underlying study focuses on assessing the real exchange rate in Egypt during the period 1999-2012. In particular, the paper estimates the Real Exchange Rate (RER) misalignments in Egypt during the period under investigation. This is implemented through carrying out two main steps: first, the observed real exchange rate is calculated. Then, the Equilibrium Real Exchange Rate (ERER) is estimated using three different techniques from the methodology spectrum of the empirical literature. These methodologies are widely used to estimate the ERER in both developing and developed countries alike; namely, the Purchasing Power Parity (PPP) approach; the Fundamental Equilibrium Exchange Rate (FEER) approach and Edwards Model (1989). Fortunately, the three techniques yield consistent results concerning the undervaluation and overvaluation episodes. Evidently, the REER appears to be misaligned during the period 2001-2009: undervalued during 2003-2007, overvalued 2001-2002 and 2008-2012. The paper concludes that the Egyptian Pound is recently overvalued; although all the applied approaches indicate different misalignment magnitudes, they all show a growing trend in the relative prices in favor of our trading partners. It is recommended to narrow down these deviations; the REER has to be devaluated by a range of 9 to 13 percent in order for the Egyptian products not to lose their competitiveness in the international markets.

Key words: Exchange rate, misalignments, Egypt.

INTRODUCTION AND MOTIVATION

One of the important issues that caught the interest of authors, economists and policy makers alike is the issue of Real Exchange Rate (RER) misalignment. Edwards (1989) provided that the rationale behind this was that maintaining a "wrong" level of real exchange rate for an extended period of time would have an adverse impact on the degree of competitiveness and the economic performance of the developing countries.

Given the importance of the real exchange rate misalignment, a vast range of theoretical and empirical literature was written on the approaches used to estimate the observed real exchange rate and the equilibrium real exchange rate to capture the magnitude of misalignment (Doroodian et al., 2002; Hallett, 2004; Nabli, 2004; Etta-
LITERATURE REVIEW

The literature review is divided into two parts. The first part sheds light on the theoretical and empirical literature, which shows the different approaches used to estimate the RER misalignments. The second part gives a brief review of the studies which attempted to identify the consequences of the real exchange rate misalignments, on both the economic growth and the trade flows.

In estimating the RER misalignments, the literature focuses on defining long-run equilibrium RER. Generally, it examines how consistent the actual real exchange rate is with the economic fundamentals of a particular country. Noteworthy, there are two approaches in the literature which constitute the theoretical basis for the RER misalignments measurement. The first approach focuses on the Purchasing Power Parity (PPP) approach, which was first introduced by Cassel (1916). The study found that the exchange rate between two countries is determined by the quotient between the general levels of prices in both of them. Meanwhile, the second approach focuses on the model based techniques first introduced as a theoretical model by Edwards (1989). The paper defined the equilibrium RER as the ratio between the relative price of tradables to non-tradables that result in the achievement of both the internal and the external equilibrium simultaneously.\(^1\) The differentiation between the justified and the unjustified changes in the country’s competitiveness was carried out. The justified changes are intrinsically an equilibrium phenomenon which needs no policy intervention, in the sense that it results from true economic changes such as the technological progress; the changes in the terms of trade (TOT); import tariffs; capital controls; the composition of government consumption, etc. As for the unjustified changes, they are the deviation of the actual RER from its equilibrium level. Worth noting, the latter necessitates a policy action to eliminate such misalignment. Subsequently, Williamson (1994) tackled the Fundamental Equilibrium Exchange Rate (FEER)\(^2\); upon which it is indicated that FEER is the exchange rate that is consistent with the ideal economic conditions.

A comparison provided by Clark and MacDonald (1998) between the FEER and the Behavioral Equilibrium Exchange Rate (BEER) indicated that they could be used as tools for assessing the exchange rates. They argued

\(^1\)Edwards (1989) defines internal equilibrium as the clearing of the non-tradable market in the current period and in the future, implying that the market will be operating at the full employment level. While the external equilibrium is defined as the attainment of the current account balance currently and in the future, this satisfies the inter-temporal budget constraint condition. It states that the discounted flow of the current account balances has to be equal zero given by:

\[
\sum_{t=0}^{\infty} \frac{C_{t+1}}{(1+r)^t} = 0
\]

\(^2\)The Fundamental Equilibrium Exchange Rate (FEER) approach defines the equilibrium real exchange rate by embedding the potential economic growth rate and the sustainable current and capital flows. The IMF (2006) defines it as the External Sustainability (ES) Approach.
that both FEER and BEER are defined to be the equilibrium real exchange rate that could be attained in case of both internal and external balances. The difference between the two approaches stems from conceptual and methodological perspectives. Conceptually, they suggest that the FEER is the RER that is accompanied with an arbitrary equilibrium capital account, while the BEER is the exchange rate determined as a function of the actual values of the economic fundamentals. Methodologically, they stated that FEER neglects the short-run cyclical conditions and transitory components, while only concentrating on the components that can persist in the medium term.

Therefore, the FEER puts the core concept of the Macroeconomic Balance (MB) approach captured from the normative identity of the balance of payment. However, in BEER, the behavioral reduced-form equation of RER is first estimated, which is a function of long-run, medium-run and transitory variables. Afterwards, the equilibrium RER is calculated after removing the transitory variables from the equation, in addition to the transitory components of the economic fundamentals using different smoothing techniques.

Although all these techniques depend on the economic fundamentals; yet, it is noticed that there is no consensus in the literature on a unique method to estimate real exchange rate misalignment. Similarly, the empirical work varies between the PPP and model-based spectrum. The model-based approaches dominate the empirical work for the developed countries. Razin and Collin (1997) applied a structural IS-LM model for 20 developed countries, to construct an indicator for the RER misalignment. Hallett (2004) employed the FEER on the US. Giannellis (2007) estimated the RER misalignment based on the BEER and the Permanent Equilibrium Exchange Rate (PEER)\(^3\) approaches for a group of four European countries; namely Malta, Poland, Hungary and Slovak Republic. Meanwhile, Quere et al. (2009) depended on the BEER approach for the G-20 countries. One interesting finding was that the terms of trade appeared to be one of the most important determinants of the equilibrium RER in those countries.

As for the empirical literature, which focused on the developing countries, although the PPP was entirely criticized, it was intensively used interchangeably with the model-based approaches. Cottani et al. (1990) applied both PPP and Edwards's model on a group of 24 less developed countries covering the period 1960-1983. In applying the model-based approach, the paper incorporated the terms of trade; an indicator for trade policy restrictions (ratio between the GDP and total trade); the net capital inflows as a ratio of GDP; the domestic credit creation in excess to devaluation; the foreign inflation; and the real GDP growth rate. The paper found that the signs of most of the estimates were consistent with the economic theory, while those with the wrong signs were statistically insignificant.

Doroodian et al. (2002) employed the model proposed by Edwards (1989) to estimate the real exchange rate misalignment in Turkey during the period from January 1987 to June 1996. The paper applied the model using the terms of trade; the ratio of investment to GDP; an indicator for trade restrictions (custom duties as a percentage of total imports); a proxy for the technological progress (GDP growth rate); a proxy for the capital control (lagged ratio of net capital inflow); and the government consumption as a ratio of GDP. The time series were smoothed using the moving average technique to capture the persistent components in the fundamentals. The paper argued that although the capital and trade control variables were not statistically significant, yet they should be included to conform to the economic theory.

Similarly, Joyce and Kamas (2003) applied Edward's model on three Latin American countries; namely, Argentina, Colombia and Mexico; for which quarterly data was utilized covering the period 1971-1995. The paper concluded that the RER was consistent with the following determinants: the terms of trade; the capital flows; productivity; and the government share of GDP. Moreover, the variance decomposition showed that both the TOT and the productivity were the most responsible variables for the variations taking place in the RER.

Nabi (2004) employed a dynamic model on 53 developing countries, 10 of which from the MENA countries, including Egypt, which adopt a unique nominal exchange rate. The results indicated that the Real Exchange Rate (RER) was over-valued during the 1970s and 1980s in the MENA countries.

Yajie et al. (2007) employed the BEER on China using Johansen co-integration technique covering the period 1980-2004. The model included long-term and short-term variables. The long-term variables determine the long-run path of the real exchange rate, while the short-run variables belong to the monetary and fiscal policies and measures that led to the temporary deviation of the observed real exchange rate from its equilibrium level. Long-term variables were the terms of trade; relative prices of non-tradable to tradable goods; and per-capita output. Whereas for the short-term variables, the foreign exchange reserves and the money supply were included as a proxy for the fiscal and monetary policies, respectively. The paper concluded that all variables had a strong effect on the Equilibrium RER except the terms of trade indicator.

Finally, the IMF Consultative Group of Exchange Rate Assessments applied model-based approaches on a group of advanced and emerging countries (IMF, 2006) in addition to Egypt using time series analysis as well as panel data analysis (IMF, 2007). The paper applied the BEER approach whereas the data sample spans from 1975 to 2006. The included variables were a proxy for the

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3Permanent Equilibrium Exchange Rate (PEER) is a special case of the BEER. According to the BEER approach, the exchange rate is a function of transitory and permanent factors. The PEER approach differs in that the equilibrium exchange rate is a function of variables that only have persistent effect on it.
relative productivity (per capita GDP relative to the main trading partners); a proxy for openness (total trade to GDP); the current account inflows; the price of oil; the terms of trade; and the government expenditure. The paper found that most of the estimates were with the right signs and statistically significant except for the terms of trade, the oil price, the government expenditure and the net foreign assets measures. The paper concluded that the real exchange rate for Egypt appeared to be overvalued during the period 1998-2001. Moreover, due to the announcement of the Egyptian pound floatation, the observed real exchange rate under-shot its equilibrium level in mid-2003. Since then, the Egyptian Pound started to nominally appreciate vis-à-vis the US Dollar, which partially resulted in the real appreciation of the Egyptian pound.

Turning to the consequences of the RER misalignments, both the theoretical and empirical studies concentrate on two main economic indicators: the economic growth and the trade performance. It is argued that RER misalignments affect economic performance and the economy’s growth through two possible channels: either domestic (foreign) investment, thus influencing the capital accumulation process, or through the tradable sector and competitiveness.

Cottani et al. (1990) examined whether the RER behavior and the economic performance were correlated. The empirical analysis of RER determinants was conducted as a combination of time series and cross sectional data of LDCs over the 1960-83 period. The results show a strong negative correlation between the growth performance and the two indicators of RER behavior, instability and misalignment.

Similarly, Ghura (1993) confirmed the negative relationship between the real exchange rate (RER) misalignment and the economic performance in Sub-Saharan Africa (SSA). The paper used different measures of misalignment (the Model- based using official nominal exchange rates and the PPP). The results show that the macroeconomic instability slowed growth in the sense that higher levels of misalignment were accompanied by higher levels of macroeconomic instability. Razin (1997) analyzed the relationship between RER misalignment and growth. The paper constructed yearly measures of both RER misalignment and per capita GDP growth, in addition to other variables that were relevant for its explanation on 93 countries, over 16-18 years. The results show that high (but not very high) average under-valuations were associated positively with growth. Moreover, overvaluations (especially very high) were associated positively with growth. Furthermore, very high and extreme standard deviations of the misalignment were associated negatively with growth.

In an attempt to explain the sources of economic growth in the developing countries, Toulaboe (2006) analyzed how exchange rate misalignment affects economic growth. The paper constructed a model of economic growth that incorporated a measure of exchange rate misalignment and a set of explanatory variables to determine the contribution of RER misalignment to economic growth. The variables were constructed for 33 developing countries for the period 1985-99. The results indicated that average real exchange rate misalignments were negatively correlated with economic growth. The results also indicated that it was RER misalignment rather than its instability that hampers economic growth.

Theoretically, Bouoiyour and Rey (2005) argued that the volatility in the exchange rates might have mixed effects on FDI. A depreciation of the host currency reduces FDI into the host country, because a lower level of the exchange rate is associated with lower expectations of future profitability. On the contrary, a depreciation of the host currency increases the relative wealth of foreign entrepreneurs and may increase the attractiveness of the host country for FDI. Empirically, the paper concluded that the volatility in the Moroccan currency proved to have insignificant effect on the FDI.

Moreover, addressing the relationship between the real exchange rate and the trade performance was relatively a recent issue. The literature in that regard is divided into two main categories. The first category concentrates on testing the relationship between the volatility of real exchange rate and the trade flows. The first intuition for this relationship is the presence of a negative relationship between the uncertainty of the exchange rate and the trade flows; causing misallocation of resources (Chowdhury, 1993; Arize, 1995; Eckwert, 1999; Nabli, 2004; Ozkan, 2004). As the second category, it focuses on the relationship between the exchange rate misalignments and trade. The hypothesis states that overvaluation adversely affects the degree of competitiveness of a particular economy. A real exchange rate appreciation reflects an increase in the domestic cost of producing tradable goods (relative to the rest of the world), that implies less efficiency in production. This idea was widely presented by Pick and Vollrath (1994), Al-shawarby (1999), Nilsson and Nilsson (2000), Rajan and Sen (2004), Bouoiyour (2005) and Etta-Nkwelle (2007).

**METHODOLOGY**

The proposed study estimates the equilibrium RER and misalignments in Egypt covering the period 1999:Q1-2009:Q4. The main reason behind the sample choice owes to the fact that misalignment results from nominal shocks that were not clearly demonstrated before 1999 because the nominal exchange rate remained fixed for an extended period of time and the relative prices did not change dramatically till 1999. In this context, some statistical investigations were conducted on the period 1981-2009; and it was found that the relative prices experienced two distinct patterns during that period. The standard deviation was calculated to be five during the sub period 1981-1998, while it increased tremendously to around 20 during the sub period 1999-2009, implying a higher degree of instability.\(^4\) This was particularly

\(^4\) For further clarification of that point, refer to the relative prices index graphs in the annex.
because starting from April 1999; the CBE carried out a series of devaluations in the Egyptian Pound, which resulted in the dramatic increases in the relative prices due to the pass-through effect.

This section is divided into two main parts. The first part tackles the observed Real Effective Exchange Rate (REER) calculations. While the second part, the Equilibrium RER and the misalignments are estimated.

**Observed real effective exchange rate (REER)**

The paper starts by getting the weights for Egypt's main trading partners. For simplicity reasons, authors included the partners whose average trade share with Egypt covers about 70% of its total trade with the world in 2007-2008 and 2008-2009 (CBE, 2010). The formula that the paper relied upon for calculating the REER is given by equation (1). In the context of calculating the REER, the summation of the trade share should add up to one, so it is suggested to adopt a standardization technique to adjust the shares as illustrated in Table 1.

\[
REER_i = \prod \left[ \frac{e_i}{e_o} \right] * \left[ \frac{P_{dt}}{P_{dt}} \right] * 100
\]

Where
- \(e_i\) = foreign exchange rate of country \(i\) in terms of the domestic currency in the period \(t\);
- \(e_o\) = foreign exchange rate of country \(i\) in terms of the domestic currency in the period \(0\);
- \(P_{dt}\) = domestic inflation rate in the period \(t\);
- \(P_{dt}\) = trade partner country \(i\)'s inflation rate in the period \(t\);
- \(W_i\) = the trade share of the partner country \(i\) in the total trade of a particular country \(j\).

Moreover, to calculate the REER, CPI (1999=100) and nominal domestic exchange rates of all the trading partners versus the US dollar were gathered for the period Q1:1999 to Q2:2009. Worth mentioning, the exchange rate for the trade partners in terms of the US dollar represents the period average. However, the exchange rate used for Egypt's case is the end of period. For further information about the price indices and the calculated observed REER, refer to Figure A in the annex.

**Equilibrium Real Exchange Rate (ERER) and Misalignments**

The current section presents three different methodological approaches in estimating the equilibrium RER by applying the PPP approach, Edwards' model and the FEER approach (known as the External Sustainability Approach), in the framework of the model-based approach.

**Purchasing power parity approach**

In estimating the equilibrium RER in the context of the PPP approach, the paper assumes that the ERER is the average of the observed REER over a 10-years period. That average acts as a benchmark through which the misalignments could be detected. This implies that whenever the observed REER overshoots the average, the Egyptian Pound experiences overvaluation. However, when the observed REER moves beneath the benchmark, the Egyptian Pound is undervalued. Although this technique is widely criticized because it lacks the dynamics taking place in the productivity in the tradable sector compared to the non-tradable sector, the paper insisted on its calculation to get preliminary insights about the real exchange rate misalignments before digging deeply by applying the model-based approaches.

**Fundamental equilibrium exchange rate (FEER) approach or external sustainability**

The FEER concept is based on the notion of macroeconomic balance, which has both internal and external dimensions. The core idea of the macroeconomic balance approach is the Balance of Payments (BOP) identity, which equates the current account to the negative capital account. As such, the exchange rate that is consistent with the macroeconomic balance (the FEER) is the real effective exchange rate that will bring the current account into equality with the sustainable current account where the determinants of the current account have been set at their full employment values (Clark and Macdonald, 1998).

On the other hand, the IMF consultative group of exchange rate assessment defined the FEER as the External Sustainability approach, which involves estimating the adjustment in the REER needed to stabilize the NFA to the GDP ratio at a certain benchmark level. This approach focuses on the relation between the sustainability of a country’s external stock position and its flow current account position and the real exchange rate. It relies on an inter-temporal budget constraint, which requires that the present value of future trade surpluses is sufficient to pay for the country’s outstanding external liabilities. One of the simple ways to satisfy a country’s inter-temporal budget constraint is to ensure that the size of the net foreign assets is stabilized relative to the size of the economy (a stable NFA/GDP ratio), thus preventing assets or liabilities from growing without bound.

Applying this approach consists of three steps:

1. Determining the current account balance to GDP ratio that would stabilize the NFA position at a given “benchmark” value.
2. Comparing this NFA-stabilizing current account balance with the level of a country’s current account balance expected to prevail over the medium term.
3. Assessing the adjustment in the real effective exchange rate over the medium term that would bring the current account balance in line with its NFA-stabilizing level.

Worth mentioning, the ES approach requires only a few assumptions about the economy, including: the potential real GDP growth rate that will prevail in the medium term; an average inflation profile; and setting a level at which external indebtedness should be satisfied (external indebtedness is defined as the NFA position, and the benchmark level is its latest observed value). This approach implies that economies that grow faster can afford to run larger current account deficits and smaller trade balances without increasing their ratio of external liabilities to GDP.

To determine the level of the current account balance that stabilizes NFA at a given level, we use the BOP accounting identity that holds at all times, which is:

\[
\begin{align*}
CA & + Kapital Account + Trade \text{ Assets (financial account)} + Net Errors & & \text{& Omissions} = 0
\end{align*}
\]

The paper then derives the equation, which states that the changes in net foreign assets are due to either the net financial flows (net purchases of foreign assets minus net foreign purchases of domestic assets) or the changes in the valuation of outstanding foreign assets and liabilities:
where $B_t - B_{t-1} = \frac{CA_t}{K_{it}} + K_{G_t} + Z_{it}$

(3)

Where $B_t$ is the net foreign assets, $CA_t$ is the current account balance, $K_{it}$ are capital transfers, $K_{G_t}$ are capital gains arising from valuation changes, and $Z_{it}$ are errors and omissions that can drive a wedge between the current account balance and the net financial flows.

Assuming that $K_{it}$, $K_{G_t}$, and $Z_{it}$ are zero, dividing equation (2) by nominal GDP growth rate $\eta_t$, and then denoting the ratios to GDP by lower case letters, the equation will be:

$$b_t - b_{t-1} + b_{t-1} \left( \frac{\eta_t}{\eta_{t-1}} \right) = c a_t$$

(4)

Then the current account level (denoted by $ca^s$) that stabilizes the net foreign assets at a benchmark level (denoted by $b^s$) is:

$$ca^s = \left( \frac{g + \pi}{(1+g)(1+\pi)} \right) b^s$$

(5)

Where $g$ is the real GDP growth rate and $\pi$ is the inflation rate. Equation (4) implies the following links between the current account, the economic growth, inflation, and the net external position:

1. The current account balance consistent with stabilizing the ratio of net foreign assets to GDP at level $b^s$ is proportional to $b^s$ (moving in the same direction). For example, for a country with a nominal growth rate of 7 percent, the current account balance necessary to stabilize the net foreign assets at -50 percent of GDP is about -3.5 percent. However, for the same level of nominal growth, the current account balance will be -2.8 percent that would able to stabilize the net foreign assets at -40 percent of GDP.

2. The absolute size of the current account balance consistent with stabilizing net foreign assets at any given level $b^s$ is proportional to the rate of growth. So the current account balance consistent with stabilizing the net foreign assets at -50 percent of GDP becomes -2.5 percent of GDP if the nominal growth rate is 5 percent, compared to the value of -3.5 percent when growth rate was assumed to be 7 percent, in the previous example.

Equilibrium real exchange rate based on Edward’s Model (1989)

An important motivation for estimating the ERER is to quantify the magnitude of RER misalignments during the study period spanning from 2001: Q3 to 2009: Q4.6 In this context, the paper follows Edwards’ model (1989) based on a Vector Error Correction Model (VECM) to estimate the long-term path of the RER as a function of a group of economic fundamentals. Accordingly, stationarity test based on augmented Dickey Fuller (ADF) test is carried out to examine the degree of integration among the incorporated variables.

$$\Delta Y_t = \Pi Y_{t-1} + \sum_{i=1}^{p-1} \tau_i \Delta Y_{t-i} + \lambda X_t + \epsilon_t$$

(6)

Where:

$\Delta Y_t$: vector of non-stationary (I(1)) variables

$\Pi$: refers to a reduced form matrix equals ($\alpha$ $\beta'$), where ($\alpha$) is the adjustment parameter in the vector error correction model and ($\beta$) is the co-integrating vector

$X_t$: is the vector of the deterministic (exogenous) variables

$\epsilon_t$: is the vector of innovations

$\tau_t$: Short-run dynamics estimates

It is noteworthy that the theme of the analysis stems mainly from the relationship between the tradable and non-tradable sectors. In addition, the expected signs of most of the estimated coefficients are settled upon in the empirical literature (refer to equation (7)).
prices and consequently real appreciation. Intrinsically, the impact of \( \beta_3 \) is known as Balassa-Samuelson effect, because the improvement in the productivity of the tradable sector will cause the increase in the wages of those employed in that sector; inducing higher wages in the non-tradable sector. If this is not accompanied with a higher productivity in the non-tradable sector, then an increase in the overall price level will result and consequently real appreciation. Similarly, the impact of \( \beta_4 \) is very intuitive, in the sense that any increase in the current account inflows would increase the country's disposable income, consequently higher price level and real appreciation. This mechanism is called the Dutch Disease effect (IMF, 2007). On the contrary, coefficient \( \beta_5 \) is expected to have a negative sign, implying that the higher the degree of openness, the higher the degree of real depreciation because spending will be diverted to the tradable goods.

\[
\Delta (\text{LREER}) = \alpha [\beta_1 \text{LREER}_{t-1} + \beta_2 \text{OPEN}_{t-1} + \beta_3 \Delta \text{LTOT}_{t-1} + \beta_4 \text{EXOG}_{t-1} + \beta_5 \text{GOVCS}_{t-1} + \beta_6 \text{GDPD}_{t-1} + \beta_7] + [\tau_1 \Delta (\text{LREER}) + \tau_2 \Delta (\text{OPEN})] + \tau_3 \Delta (\text{LTOT})_{t-1} + \tau_4 \Delta (\text{EXOG})_{t-1} + \tau_5 \Delta (\text{GOVCS})_{t-1} + \tau_6 \Delta (\text{LGDPD})_{t-1}] + \lambda_1 \text{DUMEX} + \lambda_2 \text{DUMCRIS} + C
\]  

(7)

Where:

- LREER: logarithm of the observed real effective exchange rate
- OPEN: refers to the degree of openness, sum of total trade relative to GDP
- LTOT: logarithm of the terms of trade
- EXOG: exogenous current account inflows of the Suez Canal receipts and tourism receipts
- GOVCS: government expenditure to GDP ratio
- GDPD: logarithm of the Egypt's GDP per capita relative to that of the main trading partners
- DUMEX: dummy variable for the shift of exchange rate regime from fixed to float in 2003
- DUMCRIS: dummy variable for the incidence of the global financial crisis in 2008

Nevertheless, the signs of \( \beta_3 \) and \( \beta_4 \) are undecided because they might have positive or negative signs. As for the sign of the government coefficient \( \beta_5 \), the issue depends on whether the increase in the government consumption is directed to the tradable (equivalent to real depreciation) or to the non-tradable goods (equivalent to real appreciation). Turning to the expected sign of the terms of trade \( \beta_6 \), it has been argued that the idea depends on which effect is stronger, whether the income or the substitution effect. Implicitly, if the terms of trade improve (Price exports > Price imports), then the disposable income rises, thus the two effects are demonstrated. The substitution effect will induce the producers to direct the available resources to produce the tradable products leading to higher supply of tradables relative to non-tradables, thus higher non-tradable prices and real appreciation. On the contrary, the income effect will induce the producers to maintain the same level of income even if they reduce the supply of tradables, thus higher prices of tradables that leads to real depreciation. The opposite will happen if the terms of trade deteriorated.

Once the equilibrium RER is calculated, the RER misalignment could be easily obtained as the difference between the observed RER and the equilibrium RER. According to the model structure used, any positive (negative) values mean overvaluation (undervaluation) in the Egyptian Pound.

**RESULTS**

This section presents the outcomes of the three aforementioned techniques used to estimate the RER misalignments in the Egyptian Pound. The rest of the

**Purchasing Power Parity Approach**

As per this approach the ERER is calculated as the 10-years average rate for the period 1999-2009 that is found to be 79.7. This is calculated to get a preliminary insight about the real misalignment before the paper digs deeply by applying the ES approach and Edwards’s model. It is noticed that the Egyptian Pound was over-valued during the period (1999:Q1 to 2002:Q4) since the actual REER exceeded the Average Equilibrium REER of 10 years (Figure 1). This reached an end by the steps of devaluation that the CBE had taken over the mentioned period; then the Egyptian pound registered the trough rate after announcing the official floatation of the Egyptian Pound.

Nevertheless, during the above-mentioned period, the actual REER had a downward trend; implying real depreciation that was supported by the steps of the devaluation on one hand, and the inflation differential in favor of the Egyptian economy on the other hand.

The second period extends from 2003:Q1 to 2008:Q2, wherein the Egyptian pound was under-valued. During this period, the REER experienced two different patterns; the first was real depreciation that was due to the nominal depreciation resulting from the floatation announcement at 2003 till 2004:Q4. Since then, the Pound started to appreciate due to the nominal appreciation of the Pound and the deterioration of inflation differentials in favor of the main trading partners over the following three years till 2008:Q2 (refer to Figure A in the annex).

Over the third period (2008:Q2 to 2009:Q4), the Pound started to be over-valued once again, a situation that can be attributed to the increasing levels of the domestic price level that exceeded the international prices; due to the economic slowdown that our partners faced during the second half of 2008 because of the Global Financial Crisis. This was reflected as well in a real appreciation that would adversely affect the Egyptian economy’s competitiveness in the international markets.

**Fundamental Equilibrium Exchange Rate (FEER) Approach**

For the sake of calculating the ERER in Egypt by relying on the external sustainability approach, the study had to go through three main steps as follows: first, choosing the benchmark level for NFA (as a ratio of GDP), using the CBE International Investment position (IIP) data in 2009 that was found to be -14.0%. Second, calculating the Current Account (CA) balance (as a ratio of GDP) that
would stabilize the NFA at the benchmark level for four consecutive years (2011-2014) using equation (5) displayed in the previous section. In this context, the study utilizes the World Economic Outlook (WEO) medium-term projections of the inflation rate and the potential Real GDP growth rate that would prevail in each of these years. Against this background, CA balances that would stabilize NFA/GDP ratio at the benchmark level are computed (these balances represent equilibrium CA and implicitly indicate the equilibrium REER level).

Finally, the authors compare the gap between the projected current account that would prevail in the projected years, and the current account stabilizing NFA; it has been found that Egypt's REER will be over-valued during the four years as shown in Table 2. It is noteworthy that in order to quantify the percentage change in REER needed to fill the gap between the projected current account balance and the current account level at the NFA-stabilizing benchmark level; the paper employed a simple regression between the REER and the current account balance (as a ratio of GDP) for the period 1999-2009. The elasticity computed from this regression states that 1 percent depreciation (appreciation) in the REER, leads to 0.03 percent improvement (deterioration) in the CA balance (as a ratio of GDP).

To sum up the main findings of the ES approach, it is concluded that in order to correct REER misalignments, some policy actions should be taken to restore the equilibrium level by stabilizing the Egyptian economy's NFA (as a ratio of GDP) at its benchmark level in a selected year from 2011 to 2014. Practically, the issue depends on the policy maker's preferences. Evidently, it

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Table 1. Egypt's main trading partners (average 2007/2008 and 2008/2009).

<table>
<thead>
<tr>
<th>Trade share</th>
<th>Standardized share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro Area (16)</td>
<td>26</td>
</tr>
<tr>
<td>USA</td>
<td>21</td>
</tr>
<tr>
<td>UK</td>
<td>7</td>
</tr>
<tr>
<td>Switzerland</td>
<td>5</td>
</tr>
<tr>
<td>China</td>
<td>4</td>
</tr>
<tr>
<td>India</td>
<td>3.4</td>
</tr>
<tr>
<td>Japan</td>
<td>2.6</td>
</tr>
<tr>
<td>Total</td>
<td>69</td>
</tr>
</tbody>
</table>


Table 2. Equilibrium Real Effective Exchange Rate (EREER) applying External Sustainability (ES) approach.

<table>
<thead>
<tr>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>NFA Benchmark 2009 (% of GDP)</td>
<td>-14.01</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CA-Balance Stabilizes NFA (% of GDP)</td>
<td>-1.83</td>
<td>-1.74</td>
<td>-1.65</td>
</tr>
<tr>
<td>Projected CA Balance (% of GDP)</td>
<td>-2.10</td>
<td>-2.02</td>
<td>-1.71</td>
</tr>
<tr>
<td><strong>Misalignment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(+) Overvaluation</td>
<td>9.13</td>
<td>9.15</td>
<td>1.91</td>
</tr>
<tr>
<td>(-) Undervaluation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

7WEO projections for percent change in prices (Π) are 9.5%, 8.5%, 7.8%, and 7.0%; and real GDP growth rate (g) are 5.5%, 5.7%, 5.9%, and 6.2% for 2011 till 2014, respectively.
is suggested that the magnitude of real depreciation is determined based on one of two scenarios: either the policy maker chooses to reach equilibrium in 2011 or 2012; in this case, the REER has to be depreciated by 9.1 or 9.2%, respectively from 2009 level. Or, the policy maker decides to reach equilibrium in 2013 or 2014, which showed a different pattern; in this case, the REER has to be depreciated by 1.9 or 0.2%, which is an insignificant rate of depreciation, for example: maintain 2009 REER level.

**Equilibrium Real Exchange Rate based on Edwards Model (1989)**

The application starts by testing the order of integration of each variable based on Augmented Dickey Fuller (ADF) unit root test. The result shows that all the incorporated variables are integrated of the first order (i.e., I(1) (Table 3). This suggests that it is more likely to find a co-integrating relationship among these variables.

Moreover, the Johansen co-integration test is employed wherein both the Trace Statistics and the Maximum Eigen Value indicate the existence of three co-integrating equations at 95% and 99% confidence levels among the selected variables; implying the stability of the equilibrium relationship. Since the restrictions on the estimated parameters (β) should be captured from the economic theory yet, the theory did not tackle that issue. In addition, estimating more than one co-integrating vector will complicate the economic interpretation of the long-run relationship between the REER and the economic fundamentals. Therefore, the paper relied on the long run estimates of one co-integrating equation without imposing any restrictions to estimate the three co-integrating equations. The long run estimated coefficients appear to be consistent with the economic theory concerning their signs, except the productivity differential estimate that is statistically insignificant and carries a wrong sign. This is so intuitive and implies that Balassa-Samuelson mechanism is not suitable for the Egyptian case. In fact, the whole issue deals with the relative wages and productivity between the tradable and the non-tradable sectors, whereas these relationships suffer significant distortions in Egypt due to labor market rigidities.

The estimated long run equilibrium and short run dynamics estimates are given by equation (8). The error correction term (α) appears negative and significant implying that equilibrium is restored back when there exists a misalignment between the observed REER and the ERER. The adjustment term is equal to 9.2% per quarter. This indicates that it takes from 2.5 to 3 years for the real exchange rate to restore back its equilibrium level.

$$\Delta (\text{LREER}) = -0.092 \times \text{LREER}_{t-1} + 0.010 \times \text{OPEN}_{t-1} - 5.358 \times \text{LTOT}_{t-1} - 0.360 \times \text{EXOG}_{t-1} - 1.210 \times \text{GOVCS}_{t-1} - 1.675 \times \text{LGDPD}_{t-1} + 21.175 + [0.224 \times \Delta (\text{LREER}_{t-1}) + 0.002 \Delta (\text{LREER}) - 0.017 \Delta (\text{LTOT}_{t-1}) - 0.013 \Delta (\text{EXOG}_{t-1}) - 0.043 \Delta (\text{GOVCS}_{t-1}) + 0.150 \Delta (\text{LGDPD}_{t-1}) - 0.103 \Delta \text{DUMEX} + 0.0521 \Delta \text{DUMCRIS} + 0.063$$  

Additionally, to estimate the EREER and then get a measure for the RER misalignment, the literature suggests a smoothing technique to exclude the transitory effects embedded in the economic fundamentals as long as the ERER is a long-run phenomenon. In this context, HP filter is utilized to capture the persistent component in each variable (see Figure (B) in annex). Subsequently, the estimated long run coefficients are applied to the new time series. The results, as illustrated in Figure 2, show that the Egyptian RER experienced two overvaluation episodes: the first was spanning from 2001 till the announcement of the exchange rate fluctation in 2003; whereas the second episode of overvaluation was experienced in 2008 and 2009. On the other hand, during the period between 2003 and 2008, the RER witnessed substantial undervaluation that was fortunately accompanied by favorable current account balances. Interestingly, these findings came in line with previous conclusions obtained by Riad (2008).

An interesting finding is that these results are in line with the early findings presented in the PPP approach. The two methods coincide in the periods of undervaluation and overvaluation despite the fact that each of them reveals different misalignment magnitude. For example, in 2009, the estimations based on Edwards' model suggest that the RER is misaligned on average by 6.6% from its equilibrium level. However, although the PPP approach indicates overvaluation as well, yet with different magnitude equals to 13% from its equilibrium level.

**Equilibrium Real Exchange Rate based on Edwards Model (1989): An extension**

In this section, the paper presents the re-estimation of Edwards’s model using annual data set, which portrays the relationship between equilibrium real exchange rate...
and a set of five economic fundamentals expressed as a vector of the following variables:

$$X_t = (\text{LREER, LGDPC, OPENGDP, INVESTGDP, LGOVCONS})$$  \hspace{1cm} (9)

It is worth to mention that although the previous section presented the same methodology while using higher frequency data, the sample was too small to draw conclusions about the exchange rate misalignment or to provide adequate policy implications. Given such data limitations and statistical implications, it was found more convenient to update the estimations through re-running the model while covering a larger time span that ranges between 1974 and 2012.

A necessary condition of the co-integration and VECM analysis is that each of the variables should be stationary and integrated of same order. Hence, the first step of our empirical work is to check the degree of integration of each variable by using unit root test (ADF and PP) for the levels and first differences of each variable. The estimated results of this part are reported in Table 4.

It was found that each of the series is non-stationary when the variables are defined in levels. But first-differencing the series removes the non-stationary components in all cases and therefore, the null hypothesis of non-stationarity is clearly rejected at the 5 percent significance levels. Both the ADF and PP stationarity tests suggest that all the variables are integrated of order one (I (1)) in their levels and found stationary in their first differences (I (0)).

Since the variables are stationary and integrated of order one, this paved the way to applying a co-integration technique to test whether there exist a long-run relationship among the variables. In this context, Johansen (1988) provided a unified framework for estimation and testing of co-integrating relations in the context of a VAR error correction model. The co-integration rank ($r$) of the time series was tested using our two test statistics; $\lambda_{trace}$ and $\lambda_{max}$. Denoting the number of co-integrating vectors by $r_0$, the maximum eigenvalue ($\lambda_{max}$) test is calculated under the null hypothesis $H_0: r_0 = r$ against an alternative hypothesis $H_1: r_0 = (r + 1)$. The trace test ($\lambda_{trace}$) is calculated under the null hypothesis that $H_0: r_0 = r$ against $H_1: r_0 > r$. The results of both statistics are reported in Table 5.

The results of the co-integration show that both the trace and the maximum eigenvalue test statistics suggest the existence of only one co-integrating relationship among our variables at both the 1 percent significance level. This gives an evidence for a long-run equilibrium relationship between the real effective exchange rate in Egypt, GDP per capita denoting the productivity differential between Egypt and its main trading partners, investment as a share of GDP, openness of the Egyptian economy, and government consumption.

To determine the sign and magnitude of the long run relationship, the co-integrating vectors were normalized so that the co-integrating regression of the REER in

---

8The study makes use of annual data as early mentioned. Data availability constrains the sample period to 1974 to 2012. Definitions of the five endogenous variables and two exogenous variables along with their sources are as follows: LREER: logarithm of REER, constructed by the authors using data from the IMF, IFS and IMF, DOTS databases. LGDPC: logarithm of per capita GDP as a proxy for relative productivity differential between Egypt and its trading partners, obtained from the World Bank (WB), WDI database. OPENGDP: Exports and Imports as a ratio of GDP, data obtained from the IMF, DOTS and WB, WDI database. INVESTGDP: Investment ratio to GDP, data obtained from the WB, WDI database. LGOVCONS: logarithm of government consumption, obtained from the WB, WDI database. FLOATDUM: a dummy for the float of the Egyptian pound that takes a value of one starting from 2003. CRISDUM: a dummy for the global financial crisis that takes a value of one starting from 2008.
Table 4. Unit root tests results

<table>
<thead>
<tr>
<th>Levels Variables</th>
<th>Augmented Dickey-Fuller (ADF) Test</th>
<th>Phillips-Perron (PP) Test</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Model Form: Intercept</td>
<td>Model Form: Intercept</td>
</tr>
<tr>
<td>LREER</td>
<td>-3.49</td>
<td>-2.45</td>
</tr>
<tr>
<td>LGDP</td>
<td>-0.81</td>
<td>-0.77</td>
</tr>
<tr>
<td>OPENGDP</td>
<td>-0.64</td>
<td>-0.72</td>
</tr>
<tr>
<td>INVESTGDP</td>
<td>-1.70</td>
<td>-2.27</td>
</tr>
<tr>
<td>LGOVCONS</td>
<td>-2.44</td>
<td>-1.65</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>First Differences Variables</th>
<th>Model Form: Intercept</th>
<th>Model Form: Intercept</th>
</tr>
</thead>
<tbody>
<tr>
<td>LREER</td>
<td>-4.24*</td>
<td>-3.79*</td>
</tr>
<tr>
<td>LGDP</td>
<td>-3.59*</td>
<td>-4.89*</td>
</tr>
<tr>
<td>OPENGDP</td>
<td>-4.48*</td>
<td>-6.43*</td>
</tr>
<tr>
<td>INVESTGDP</td>
<td>-5.26*</td>
<td>-10.18*</td>
</tr>
<tr>
<td>LGOVCONS</td>
<td>-4.63*</td>
<td>-6.67*</td>
</tr>
</tbody>
</table>

*Denotes significance at the 5 percent level and the rejection of the null hypothesis of non-stationarity. Mackinnon (1991) critical values for rejection of hypothesis of unit root are applied. The critical values at 5 percent significance level are -3.5348 and -3.5312 for ADF and PP tests, respectively.

Source: Authors’ estimations using EViews software.

Table 5. Johansen’s co-integration likelihood ratio test for multiple co-integrating vectors.

<table>
<thead>
<tr>
<th>Trace Statistic</th>
<th>Maximum Eigenvalue Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ho</td>
</tr>
<tr>
<td>r0 = 0</td>
<td>r1 &gt; 0</td>
</tr>
<tr>
<td>r0 ≤ 1</td>
<td>r1 &gt; 1</td>
</tr>
<tr>
<td>r0 ≤ 2</td>
<td>r1 &gt; 2</td>
</tr>
<tr>
<td>r0 ≤ 3</td>
<td>r1 &gt; 3</td>
</tr>
<tr>
<td>r0 ≤ 4</td>
<td>r1 &gt; 4</td>
</tr>
</tbody>
</table>

N.B: i. (r) refers to number of co-integrating equations. ii. CV1% refers to the critical value at the 1 percent significance level. * Denotes rejection of the hypothesis at the 1 percent level.

Source: Authors’ estimations using EViews software.

Egypt can be given as shown in Table 6.

The long run estimated coefficients appear to be consistent with the economic theory concerning their expected signs. It appears that the productivity differential cause an appreciation of the real effective exchange rate in Egypt. The effect of the openness of the economy is dominated by substitution effects since it leads to a depreciation of the real effective exchange rate as well. Regarding the investment ratio, it has a depreciating effect on the real effective exchange rate in Egypt. This can be explained by the import intensive investment projects and thus; an increase in the ratio of investment to GDP is expected to increase absorption, worsen the current account and lead to depreciation of the REER. Government consumption causes an appreciation of the REER, since this gives a clue about the structure of the government expenditure that gives higher weight to the non-tradables compared to the tradables. As such, higher government expenditure would be mirrored in higher demand on non-tradable goods and services, which in turn would raise the prices of non-tradables (Table 6).

The results suggest the following magnitude of effects:

- A 1 percentage point increase in the differential between the rate of growth of the real per capita GDP in Egypt and its main trading partners is associated with a 0.85 percentage point appreciation of the REER in the long run.
- A 1 percentage point increase in the relative openness of the Egyptian economy is associated with a 0.60 percentage point depreciation of the REER in the long run.
- A 1 percentage point increase in the relative investment...

9 Substitution effect stems from the fact that trade liberalization reduces the domestic prices of tradables causing a demand shift away from non-traded goods. It is argued that given reasonable cross-price elasticities, non-traded prices should go down leading to a real depreciation.
Table 6. Normalized Co-integrating Coefficients: 1 Co-integrating Equation (Reduced-form Estimates).

<table>
<thead>
<tr>
<th></th>
<th>LREER</th>
<th>LGDPC</th>
<th>OPENGDP</th>
<th>INVESTGDP</th>
<th>LGOVCONS</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coefficient</td>
<td>1.00</td>
<td>-0.85</td>
<td>0.60</td>
<td>0.53</td>
<td>-0.61</td>
<td>1.01</td>
</tr>
<tr>
<td>[t-statistic]</td>
<td>[-7.92]</td>
<td>[7.08]</td>
<td>[2.26]**</td>
<td>[-4.22]</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s estimations using EViews software. N.B: Figures in parentheses are the t-statistics.* (**) Denotes significance at the 1 percent (5 percent) level.

Table 7. Results of VECM for short-run dynamics.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>[t-statistic]</th>
<th>Estimates</th>
<th>[t-statistic]</th>
</tr>
</thead>
<tbody>
<tr>
<td>D(LREER(-1))</td>
<td>-0.53</td>
<td>[-4.44]**</td>
<td>0.62</td>
<td>[3.55]</td>
</tr>
<tr>
<td>D(LGDPC(-1))</td>
<td>0.38</td>
<td>[2.25]**</td>
<td>0.42</td>
<td>[1.64]</td>
</tr>
<tr>
<td>D(OPENGDP(-1))</td>
<td>0.71</td>
<td>[2.15]**</td>
<td>0.19</td>
<td>[1.85]</td>
</tr>
<tr>
<td>D(INVESTGDP(-1))</td>
<td>-0.24</td>
<td></td>
<td>0.18</td>
<td></td>
</tr>
<tr>
<td>D(LGOVCONS(-1))</td>
<td>0.80</td>
<td>[3.07]**</td>
<td>0.02</td>
<td>[0.48]</td>
</tr>
<tr>
<td>C</td>
<td>-0.24</td>
<td></td>
<td>0.10</td>
<td>[-2.09]</td>
</tr>
<tr>
<td>CRISDUM</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FLOATDUM</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s estimations using EViews software.* indicates significance at 5 percent level.

The ratio of the Egyptian economy is associated with a 0.53 percentage point depreciation of the REER in the long run.

- A 1 percentage point increase in the relative government consumption of the Egyptian economy is associated with a 0.61 percentage point appreciation of the REER in the long run.

Since long run association has been observed among these variables, it is possible to explore the possibility of a short run relationship by using an Error Correction Model (ECM) framework, which permits the introduction of past disequilibrium as explanatory variables in the dynamic behavior of existing variables and thus, facilitates in capturing both the short run dynamics and long run relationships among variables. 10

Table 7 gives the speed of adjustment from disequilibrium along with the short run coefficients of the VECM. In the latter specifications, it is shown that the coefficient of the Error Correction Term (ECTt-1) of the REER is significant and does have the correct sign (negative). The error correction term is the short-run forward looking self-correcting mechanism. If for instance, there is a real undervaluation in the REER, then there will be a real appreciation in the next period, self-correcting the undervaluation. The term indicates the speed of adjustment and in this case, 53 percent adjustment is observed. In other words, about 53 percent of disequilibrium (the gap between the equilibrium REER and its actual value) is corrected each year caused by the REER itself. This implies a stable long-run co-integrating relationship.

Another point to observe is that both the per capita GDP and government consumption do not help in bringing the real effective exchange rate to its equilibrium level. The two variables have a destabilizing effect on the system. A positive sign of the adjustment coefficient of the government consumption – as a determinant of the equilibrium exchange rate – means that; an undervalued exchange rate (caused by a decline of the equilibrium exchange rate), for instance, will lead to an increase in the government consumption (which in turn leads to an appreciation of the equilibrium REER) causing an increasingly undervalued REER. The same applies for the productivity differential variable.

Results of variance decomposition process are shown in Table 8. Variance decomposition process shows that the main source of variance in the real effective exchange rate arises from its own shocks during all periods. In the first period, the change of the exchange rate can be explained by its own shock at 100 percent. In the medium to long term, two variables represent important

---

10 As a robustness check for the results, a residual test was conducted on the estimation output. This is shown in figure (c) in the annex.
Table 8. Results of variance decomposition analysis.

<table>
<thead>
<tr>
<th>Period</th>
<th>S.E.</th>
<th>LREER</th>
<th>LGDPC</th>
<th>OPENGDP</th>
<th>INVESTGDP</th>
<th>LGOVCONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.15</td>
<td>100.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>2</td>
<td>0.24</td>
<td>97.00</td>
<td>0.10</td>
<td>1.07</td>
<td>0.59</td>
<td>1.24</td>
</tr>
<tr>
<td>3</td>
<td>0.29</td>
<td>90.02</td>
<td>0.73</td>
<td>6.86</td>
<td>1.52</td>
<td>0.87</td>
</tr>
<tr>
<td>4</td>
<td>0.33</td>
<td>74.13</td>
<td>0.75</td>
<td>15.68</td>
<td>7.34</td>
<td>2.10</td>
</tr>
<tr>
<td>5</td>
<td>0.38</td>
<td>58.04</td>
<td>0.57</td>
<td>22.55</td>
<td>13.78</td>
<td>5.06</td>
</tr>
<tr>
<td>6</td>
<td>0.43</td>
<td>46.74</td>
<td>0.46</td>
<td>26.95</td>
<td>18.15</td>
<td>7.69</td>
</tr>
<tr>
<td>7</td>
<td>0.47</td>
<td>39.06</td>
<td>0.39</td>
<td>30.00</td>
<td>21.03</td>
<td>9.52</td>
</tr>
<tr>
<td>8</td>
<td>0.52</td>
<td>33.42</td>
<td>0.34</td>
<td>32.25</td>
<td>24.84</td>
<td>11.90</td>
</tr>
<tr>
<td>9</td>
<td>0.56</td>
<td>29.03</td>
<td>0.30</td>
<td>33.94</td>
<td>23.15</td>
<td>7.69</td>
</tr>
<tr>
<td>10</td>
<td>0.60</td>
<td>25.57</td>
<td>0.27</td>
<td>35.21</td>
<td>26.18</td>
<td>12.77</td>
</tr>
</tbody>
</table>

Source: Author’s estimations using EViews software.

The sources of variation in the exchange rate. These are the openness and investment ratios. For example and starting from the third period, it is seen that economic openness explains the variation in real effective exchange rate at a rate that ranges between nearly 7 percent and 35 percent. Between 1.5 and 26 percent of the variation in the exchange rate can be explained by the investment ratio. Government consumption plays a more significant role in the variations of the real effective exchange rate from the fourth period onwards while productivity differential do not exceed the rate of 0.8 percent variation of exchange rate during all periods.

An important feature of Edwards’ approach is the recognition that the equilibrium exchange rate change over time with the changes in its main fundamentals. The long-run relationship estimated above allows for the calculation of the equilibrium rate by imposing the long-run coefficients of the economic fundamentals employed to the permanent values of the latter. The HP filter with a smoothing factor of 100 was used to smooth the variables. Figures 3 and 4 show the actual and equilibrium real effective exchange rate and the extent of currency misalignments during the period (1974-2012) (Table 8).

When the actual real effective exchange rate is above the equilibrium, it is undervalued, and when it is below the equilibrium, it overvalued. Through 1974 up till 1990, before the implementation of the ERSAP, the Egyptian trade-weighted exchange rate was always overvalued with the exception of the period (1979-1982). Starting from 1991, Egypt witnessed an undervaluation of the exchange rate that continued till 1998. This means that the unification of the multiple exchange rates that existed before the ERSAP brought a temporary end to the currency overvaluation.

Thus, despite the real appreciation of the Egyptian pound during that period, it was not as much as is

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11This smoothing factor is what Hodrick and Prescott suggested for annual data (EViews User’s Guide).
needed to keep the value of the pound in line with the calculated average equilibrium rate in real terms, a conclusion that can be reasonably thought of under the improved economic conditions that accompanied the beginning of the economic reform in Egypt. In addition, this is suggestive of the active and periodical foreign exchange market intervention that was practiced during that period to maintain the pegged exchange rate – mainly through the international reserves – and thus, preventing the free market determination of the pound’s value. Mohieldin and Kouchouk (2003) describe the first half of the 1990s decade by an undervalued currency based on the latter’s own calculations as well.

A short overvaluation period during the three years between 1999 and 2001 was followed by an undervaluation period that lasted between 2002 and 2008. The latter period marked the consequences of the series of devaluations adopted in 2000 and 2001 and the floatation of the Egyptian pound in 2003. Overvaluation of the Egyptian real effective exchange rate was resumed in 2009 and lasted till the end of the sample employed in the present study. This came just in line with the early misalignment findings in the previous section. Importantly, it also conforms to the judgment of the IMF’s 2010 Article IV consultation report on the Egyptian economy.

CONCLUSION AND POLICY RECOMMENDATIONS

The paper acquires its importance from the fact that the exchange rate misalignment or the permanent deviation of the actual exchange rate from its equilibrium level could have adverse impact on the macroeconomic stability. Thus, the exchange rate misalignment would be of a great interest to the policy makers in general and to the monetary authority and Central Banks in particular. Since the exchange rate is considered an important monetary transmission mechanism channel that could affect both the economic activity and the economy-wide price level. Therefore, real effective exchange rate movements can directly affect consumption and production choices between domestic and international goods. Tracing those movements would help the policy makers in avoiding economic instability created from the distortions resulted in the relative prices between the tradable and non-tradable goods due to keeping the exchange rate away from its equilibrium level for a long time.

Against this background, the paper tries to adequately assess the real exchange rate in Egypt during the period 1999-2009, based on three different methodologies that both theoretical and empirical literature has focused upon. The carried out techniques are the PPP approach, the FEER approach and Edwards’s model that was introduced in 1989. Fortunately, the three techniques give out consistent results concerning the undervaluation and overvaluation episodes. Evidently, The REER appears to be misaligned during the period 2001-2009: undervalued during 2003-2007, overvalued 2001-2002 and 2008-2009. Although all the applied approaches indicate different misalignment magnitudes, nevertheless, they all showed that the REER was overvalued during 2009. More interestingly, the results are in line with those presented by the IMF in 2010 concerning the three techniques: a 10 years average is calculated to be 13% compared to the IMF estimates of 14%. Turning to the ES Approach, the paper determined the misalignment by 1.9% that would prevail in 2013 while the IMF stated that it would be 3.5%. Finally, the econometric results show that the RER was misaligned in 2009 by 6.6% compared to 9% by the IMF consultative staff.

To sum up, as long as all the conducted methods show that the Egyptian Pound is recently overvalued and there is a growing trend in the relative prices in favor of our trading partners, it is recommended to narrow down these deviations, the REER has to be devaluated by a range of 9% to 13% in order that the Egyptian products do not lose their competitiveness in the international market. In addition to safeguarding the economy from resources misallocation between the tradable and non-tradable sector, thus maintaining the macroeconomic stability.

Conflict of Interests

The authors have not declared any conflict of interest.

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Annex

Figure A. Calculated Relative Prices Indices, NEER and REER. Source: Calculated using the data obtained from the IMF, IFS, Online Database, 2010.

Figure B. Equilibrium Real Exchange Rate (ERER) – Actual and Filtered Variables Using HP Filter. Source: Calculated using Eviews, the data obtained from the IMF, CBE and Ministry of Planning.
Figure C. Correlogram of the Estimated Residuals of Edwards' Model.
Table 9. Johansen co-integration test.

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1 Co-integrating Equation

Normalized co-integrating coefficients (reduced form estimates)

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Adjastment coefficients

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Table 10. Vector error correction estimates.

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<td>EXOG(-1)</td>
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Short Run Dynamics

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