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The New Flexible Exchange Rate Regime in Morocco: A Tool to Improve National Economic Growth or a Further Burden on Exportations Dependency?

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Abstract: ***The exchange rate is a very important factor to take into consideration when it comes to any transactions or trades with foreign countries, especially a country like Morocco that relies hugely on importations to provide its supply in necessary staple goods such as petroleum, wheat and others goods that the country simply cannot afford the luxury of cutting out from the list of its imports. To carry such transactions, Morocco has to pay in foreign currencies such as euro and U.S. dollar due to the fact that most of Morocco's trades are done with European countries and that the U.S. dollar is a widely used currency on an international scale. Before adopting this new reform, the Moroccan currency (Dirham) was pegged to a basket of currencies and the exchange rate was fixed by the central bank of Morocco (Bank Al-maghrib) on a daily basis following the trends of the currencies in the said basket. This regime allowed the government to have control over the exchange rate, therefore having a tool to assess the risks of any agitated fluctuations on the market. Such stable rates were fitting pretty well with the monetary policies in the country, as well as the productive sectors relying on imported raw materials and mostly the supply of subsidized staple goods at more or less stable prices. The new reform will considerably affect the national economy in many ways, as the following analysis will show.***

Keywords: exchange rate, foreign trade, currency, monetary policy, inflation, payment balance, central bank

1. Introduction

How did the exchange rate regime evolve in Morocco over the years?

The exchange rate regime in Morocco was introduced to gradual changes throughout the years, as it evolved from a fixed peg regime to a flexible exchange rate regime. The old regime consisted essentially in pegging the Moroccan dirham to a basket of foreign currencies composed mainly by euro and U.S. dollar with the respective rates of 60% and 40%. As it is mentioned previously, the selection of these two currencies was meticulously calculated based on the importance of the volume of trades made with the said currencies and also considering their wide usage internationally. The exchange rate was determined on a daily basis by the central bank according to the fluctuations of these currencies on international markets, in other words, when the euro appreciates against the US dollar, the dirham appreciates against the U.S. dollar and depreciates against the euro and vice versa. This regime granted stability and resilience to the country's economy which depends considerably on imports. An exchange rate fixed by the financial authorities in charge, mainly the central bank and the Ministry of Finances, enabled the maneuver of appropriate measures according to what the governments saw fit for the situation, especially when it comes to regulating price levels and encouraging the import/export of goods and services. The transition to a flexible exchange rate will allow the forces of supply and demand to determine the value of the national currency on the foreign exchange market, hence limiting the financial authorities' ability to make any needed adjustments. The central bank is still in charge of fixing the maximum selling price and the minimum buying prices of foreign currencies traded on the domestic market and it's also keeping the variation of the dirham inside a limited fluctuations band, it initially was a range of -0.3% to +0.3%, as for now, the said fluctuation band expanded to a range of -2.5% to +2.5% since January 18th 2018. The range will gradually grow wider until the achievement of a complete liberalization of the Moroccan dirham.

Why does the country need foreign exchange reserves?

A country that does not produce its needs of energy, staple goods, technology and others indispensable substances/services that are indispensable to its normal functioning, is doomed to a chronic dependency on importing these products from other countries that use foreign currencies such as euro and U.S. dollar. As a result, the country needs to build a healthy supply of foreign exchange reserves in order to proceed to such purchases on international markets.

As for Morocco, it has been registering a negative trade balance over the past years as the following table details:

Table1: Evolution of the trade balance over the period of 2010-2017

External accounts \ Year	2010	2011	2012	2013	2014	2015	2016	2017*
Importations	297 963	357 770	386 949	383 720	391 296	372 225	410 584	437 277
Exportations	149 583	174 995	184 885	185 387	200 808	218 040	225 651	248 493
Trade Balance	-148 380	-182 775	-202 064	-198 333	-190 488	-154 185	-184 933	-188 784

***Estimated**
Source: Ministry of Economy and Finance

Such dependency on import makes building foreign exchange reserves a very top priority for the government and the rest of the financial authorities involved in holding, managing and investing in it.

Furthermore, there are many other expenses that need to be paid with foreign currencies such as: payment for external loans and debt interests, investments of Moroccan companies in foreign countries, expenses of Moroccans leaving the country for tourism purposes and the transfers to Moroccans studying abroad.

How does the country provide its foreign exchange reserves?
There are many sources on which the government relies to provide its supplies of foreign currencies. The most important ones in the case of Morocco are:

- Exports;
- Tourism receipts;
- Transfers from Moroccan expatriates;
- Foreign investments on national soil;
- External debts;
- Grants from foreign countries.

To adequately assess the eventual repercussions of this new foreign exchange reform, we must analyze the different aspects of the economy that will be affected directly by it.

2. Results and Discussion

A country with a growing negative trade balance may see their currency weaken as a result. It is no secret that the Moroccan economy is not strong enough to compete with European countries; therefore, the national currency would easily sink when confronted with currencies such as euro or U.S. dollar. Such factors were reason enough for many opposing voices to rise against the process of the exchange rate regime reform.

How was the country's performance in building up its foreign exchange reserves with the fixed regime?
One of the most important perks of the previous fixed exchange rate regime was stability and excellent control of inflation levels, as inflation rates were low and stable for many years. It also was a very helpful regime when it comes to forecasting the country's needs in foreign exchange reserves and assessing how long the current provisions would last. It is safe to say that with the fixed regime there wasn't much margin for speculations to agitate the market, as the fluctuation band was very narrow and thoroughly regulated. The table below showcases the evolution of foreign exchange reserves in the past few years:

Table 2: The evolution of foreign exchange reserves for the period of 2010-2017

External accounts \ Year	2010	2011	2012	2013	2014	2015	2016	2017*
Importations	**297 963**	**357 770**	**386 949**	**383 720**	**391 296**	**372 225**	**410 584**	**437 277**
Foreign Exchange Reserves	**194 605**	**173 843**	**141 400**	**146 528**	**179 575**	**222 060**	**249 243**	**240 901**

***Estimated**
Source: Ministry of Economy and Finance

As we can see, there was a steady growth of the foreign exchange reserves but the gap between reserves and imports has been significantly widening over the years.

What was the purpose behind this reform?
The flexible exchange rate regime might be a challenge for the national economy if we take into consideration the factors stated previously, but we ought to mention the potential benefits of this reform if the financial authorities succeed in adjusting the monetary policies, anticipating the challenges that may occur and adapting the whole economy dynamics to its new context. Although it is easier said than done, a successful transition to a flexible exchange reform implies mainly:

- Decreasing the levels of external loans destined to cover foreign exchange reserves deficiency, therefore strengthening public finances;
- Decreasing importations dependency as a result of an eventual depreciation of the national currency;
- Increasing exportations as foreign importers would be encouraged by an eventual depreciation of the Moroccan dirham;
- Decreasing the balance payment's deficit;
- Improving the national economy's competitiveness since Moroccan products would be more accessible to consumers;
- Improving the performance of the productive system and enhance the quality of national products as result of an eventual expand in production;
- Stimulating investment, thus boosting economic growth;

- Creating new jobs;
- Enhancing business climate thus attracting more foreign investments;
- Increasing foreign exchange reserves from an eventual increase in exports, foreign investment and tourism receipts;
- Enhancing tourism as Morocco would be a much cheaper destination with the flexible exchange regime;
- Increasing the country's ability to achieve a more open and resilient economy.

How the new flexible exchange rate regime may impact the sectors that are more open to foreign markets?

Although the new exchange regime is promising and is justified by many advantages as mentioned above, it is also undeniable that switching to a complete liberalization of the Moroccan dirham may cause a very sharp depreciation in its value thus provoking serious repercussions on sectors that are directly exposed to foreign trade. As imported goods and raw materials will be quite more expensive, production costs would skyrocket, causing inevitable price inflation. These sectors would lose competitiveness and the companies' market shares would shrink significantly.

How will this reform affect foreign trade and the price levels of subsidized staple goods?

Such a large scale reform will eventually have very important repercussions, especially in later stages once fluctuation ranges are amplified and the dirham is completely submitted to the forces of supply and demand on the exchange market. The most important one is the impact on the imported goods' prices, especially petroleum, wheat, sugar and butane gas (Liquid petroleum products were completely unsubsidized by 2015, but the other remaining three products are benefiting still from the government's subsidy). An eventual depreciation of the national currency would directly affect the price levels of imported goods and services.

The government is clearly counting on national economy to prevail and Moroccan companies to expand their production to overcome any supply shortages. However, we cannot expect to produce fossil fuel and Morocco is importing the totality of its needs from foreign countries, the same goes for other staple goods that are being currently subsidized by 'the compensation fund' which is the public institution in charge of stabilizing the domestic prices of staple goods.

The Dirham's depreciation would weigh heavily on public finances and cost millions of dirhams to cover eventual arrears in terms of subsidies.

a) The gas butane supply is a 100% imported.
b) Soft wheat represents 50% of the cereals imported.
c) National production of sugar is also far from satisfying the country's demand, as importations covered:
    - 80% of the demand in 2012;
    - 71% of the demand in 2013;
    - 59% of the demand in 2014;
    - 58% of the demand in 2015;
    - 51% of the demand in 2016.

Importing these goods at a high cost (due to exchange rates) would have a devastating impact on the purchasing power of low income households, putting at risk the social welfare of large amounts of people, especially if we take into consideration the fact that no accompanying measures have been implemented to mitigate any negative repercussions on vulnerable social classes.

This begs the question of what if Morocco is not ready to undergo such a large scale reform that currently does not make part of a bigger plan to change the economy's dynamic but rather an isolated action with no solid arguments behind it.

Similar experiences: a case study on Egypt

Months before Morocco proceeded to announce a new exchange rate reform, Egypt engaged in a similar reform on November 3rd, 2016, switching to a floating exchange rate regime for the Egyptian pound. However, it should be noted that Morocco opted for a gradual liberalization of its currency, as previously detailed.

According to the Central Bank of Egypt: *"This move would allow market demand and supply dynamics to work effectively in creating an environment of reliable and sustainable provision of foreign currencies. Moreover, it would improve the deepening of foreign currency liquidity, while streamlining activity into the formal channels".*

The central bank and the government of Egypt are reporting wonderful results of the exchange rate policy and an impeccable performance of its first year after the reform, backing their claims with improved key indicators that show substantial progress in terms of economic growth and public finances' recovery from many tough years of instable conjuncture and serious geopolitical tensions, that weakened the country in many ways. The media seems to disagree. In fact, many alarms are being rung as levels of inflation have begun to rise, reaching dangerous levels, and subsidies are being cut for basic goods.

The following key indicators published by the Central Bank of Egypt, show Egypt's economy performance during the period of **July 2016 - March 2017**:

The tendency of the Egyptian pound after adopting a floating exchange rate regime: According to the central bank of Egypt, the Egyptian pound (EGP) depreciated by 104.2% during the period of July 2016 to March 2017 against the U.S. dollar, as the Egyptian pound reached EGP 18.14 per 1 USD at the end of march 2017, instead of EGP 8.8 per 1 USD at the end of June 2016.

In the same period, the EGP market value went through a sharp drop against many other currencies such as:

- Saudi riyal increased by 104.2%;
- UAE dirham increased by 104.1%;
- Kuwaiti dinar increased by 102.2%;
- Swiss franc increased by 100.6%;
- Euro increased by 97.7%;
- Chinese Yuan increased by 96.8%;
- Sterling pound increased by 89.3%.

The trade balance: the trade deficit decreased of about USD 2.8 billion, dropping from USD 29.8 billion to USD 27 billion. This was mainly due to:

- An Increase in **exports** of about 19.3%;
- A decrease in **imports** of about 0.5%.

Balance of payment: Egypt's transactions unfolded an overall BOP surplus of USD 11 billion, against a deficit of USD 3.6 billion in the same period a year earlier.

Net International Reserves: it increased by a total of USD 11 billion, reaching USD 28.5 billion, and allowing 6 months coverage of goods' imports at the end of March 2017.

Foreign currency deposits: bank deposits of foreign currency increased by 1.9% from July 2016 to March 2017, reaching a total of USD 37.3 billion.

International investment position: it registered, at the end of March 2017, an increase in net external liabilities of about 12.3% compared to its rate at the end of June 2016.

The impact of the floating exchange rate regime on basic goods' subsidies:
In order to reduce public finances' deficits and restore a healthy macroeconomic equilibrium, Egypt engaged in new reforms for the subsidy system by cutting considerable budgets that were allocated to subsidize staple goods; especially fuel, since it's the product that drains the most important share of these budgets. As a result, fuel prices increased significantly and the same goes for electricity bills.

Egypt implemented these major reforms with the International Monetary Fund's green light to do so, as they stated: *"The Egyptian authorities' economic reform program has already shown promising results. The authorities have allowed the exchange rate to be determined by market forces, and reduced inefficient fuel and electricity subsidies". They also added: "Some of the savings from the latest subsidy reform (around 0.3 percent of GDP) will be used in 2018/19 to mitigate the impact of the energy price reform on the most vulnerable".*

Accompanying measures of social welfare to attenuate the reform's impact on low income citizens:
To prevent any social agitations due to the cuts in subsidies to basic goods like petroleum and electricity, the Egyptian authorities have established a number of social measures to implement, such as:

- Doubling the value of cash transfer allowances offered through food smart cards – from 21 to 50 Egyptian pounds per person
- Expanding the social solidarity pensions to include medical coverage, as well as expanding the coverage of the Takaful and Karama programs to 2.2 million households;
- Raising pension benefits, especially for the lower pension categories;
- Starting a new program "forsa" in partnership with the private sector, to provide employment opportunities for job seekers;
- Paying a one-time allowance to public employees to compensate for high inflation;
- Providing free school meals and new gas connections in poor districts;
- Increasing the exemption threshold for taxes on domestic salaries.

Although the outcome of these reforms may differ from one country to another, taking into consideration the economic contexts, political conjunctures, monetary policies and many other factors that play a very important role in defining the success or failure of implementing these large scale measures, the Egyptian experience offers key indicators to evaluate and assess future impacts in Morocco. Adopting a floating exchange regime led to a sharp depreciation of the Egyptian currency, and caused important fuel and electricity subsidy cuts, but it also helped the trade balance to score better results by boosting exports, and increased international reserves as well as improving international investment position. It is an important and risky step for any country to undergo such transition but it is safe to say that with the adoption of the right strategies for a gradual implementation accompanied with proper social measures to guarantee fairness and stability, these reforms can only bring growth and prosperity to the economy.

3. Conclusion

There's no doubt that the transition to a flexible foreign exchange rate regime will inflate the budgets allocated to subsidize butane gas, sugar and soft wheat flour in Morocco. After so many years of consecutive reforms of the subsidy system to reduce deficits and arrears accumulated throughout the years, it seems that these efforts might be jeopardized by the liberalization of the Moroccan dirham. This might be a sign that the government is getting closer to suppress all subsidies for good.

Taking in consideration that the subsidy policy benefits the wealthy more than the vulnerable social classes (as the current subsidy system in Morocco is non targeted, allowing wealthy social classes that consume the most to benefit from these subsidized goods), cutting subsidies would be a wise measure. The issue here is that the Moroccan government did not establish any social programs to mitigate any negative impacts of the eventual rising prices of these goods.

This reform should be part of much bigger and structural reforms to set the economy on the path of growth and prosperity and mostly to preserve the people's purchasing power to insure the economy's capacity to grow.

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