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# A DIFFERENT APPROACH TO ECONOMIC POLICY

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Op-ed

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## A DIFFERENT APPROACH TO ECONOMIC POLICY

Lebanon has been going through one of the worse economic crises in modern history. Banking, currency, and sovereign debt crises are not uncommon, but very few countries experience all three at once. What also makes Lebanon's crisis unprecedented is its severity, given the collapse in the value of its currency, the extent of banking system insolvency, and the inadequacy of public resources to deal with it. A proper response to the crisis has been relatively non-existent, undermined by the continued political vacuum and the country's dysfunctional state institutions, including the judiciary.

There are no easy solutions to Lebanon's crisis. Crisis mitigation policies usually seek tradeoffs between potentially conflicting objectives, namely the protection of depositors, ensuring the health of the banking system, and minimizing the recourse to public resources. In Lebanon, most (if not all) banks are insolvent if they were to value their assets at market prices, which makes it impossible to cover all deposits without public support or massive increases in bank equity. Public support to banks is not a viable option, given the collapse in government revenues and concerns about the use of state assets to bail out depositors. Meanwhile, there may be few incentives for banks to raise capital without credible macroeconomic reform and significant improvements in governance.

## DEALING WITH THE CRISIS

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There have been several initiatives to formulate a comprehensive plan to deal with the crisis. The most recent initiative is the draft plan prepared by the Prime Minister's Office in September 2022, which is a slight modification of the plan that was the basis for the agreement with IMF staff in April 2022. Since the beginning of the crisis, several measures have been implemented to deal with it. Among these measures is the subsidization of essential commodities, the introduction of multiple exchange rates, and not adjusting the exchange rate for tax and fee assessments to the market rate. While these measures were meant to be temporary — pending the implementation of a comprehensive reform program — the resulting monetary expansion led to high inflation and a collapse of the currency, and the depletion of central bank foreign exchange reserves.

## MONETARY AND EXCHANGE RATE POLICIES

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The loss of the exchange peg as an anchor for monetary policy, and the lack of a replacement anchor, has led to a very rapid monetary expansion during the last three years. Between 2019 and 2022, currency in circulation increased 7½ times even as the economy contracted. So, it is not a surprise that inflation was so high. During this three-

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year period, the price level increased 12 times, while the value of the lira in the parallel market that emerged fell to a small fraction -less than 2 percent - of its pre-crisis value. Central bank foreign exchange reserves (excluding gold) fell from about USD 35 billion to USD 10 billion.

This rapid monetary expansion and the decline in foreign exchange reserves seem to have been largely the result of policies geared towards lessening the impact of the crisis on the population. Price stability may have been a secondary objective, which became more difficult with the depletion of official foreign exchange reserves. Central bank support was provided through two main channels: the financing of imports at the official exchange rate which was significantly appreciated relative to the parallel market rate; and the provision of foreign currencies through the Sayrafa platform.<sup>1</sup>

The central bank subsidized imports of items that were deemed necessities through providing foreign exchange at the official rate of LBP1,500/USD for about 1½ years, which led to a significant reduction in its foreign exchange reserves. In an assessment for the Lebanese government, the World Bank found these subsidies to be distortionary, expensive, and regressive.<sup>2</sup> They also encouraged the smuggling of subsidized commodities to Syria, especially gasoline. The fuel shortages that emerged during the period disappeared following the suspension of this policy in September 2021 despite a decline in fuel imports.

The central bank operations related to the Sayrafa platform also led to a decline in official foreign exchange reserves, in addition to rapidly expanding the monetary base. Sayrafa subsidized imports and provided a supplement to the salaries of public sector employees, as well as to others who could purchase foreign exchange through the platform, to the extent that the Sayrafa rate was depreciated relative to the market rate. The central bank provided USD to the Sayrafa market from its foreign exchange holdings, while also purchasing USD in the parallel market to limit the reduction in official foreign exchange reserves. This led to an expansion of currency in circulation, which doubled between mid-2021 and end-2022.<sup>3</sup> Recognizing the effect of Sayrafa transactions on the money supply, the central bank did not increase the monthly LBP withdrawal limit from pre-October 2019 USD deposits following the devaluation of the official exchange rate in February 2023. It also adjusted the Sayrafa rate (from LBP45,500 to 70,000 per USD) at the beginning of March 2023, which was accompanied by an appreciation of the parallel rate. The significant narrowing of the margin between the two rates will help to reduce pressures on the exchange rate and inflation.

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<sup>1</sup> The central bank established the Sayrafa platform in May 2021. It is an electronic platform for the LBP trading of foreign currencies with commercial banks and with exchange dealers licensed to trade on the platform.

<sup>2</sup> World Bank, *Subsidy Reform Note*, December 2020.

<sup>3</sup> Trading on Sayrafa amounted to USD 11.8 billion in 2022. Had the central bank not used any of its reserves, it is estimated that currency in circulation would have increased 1½ times in 2022.

### FISCAL POLICY

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Public finances collapsed after the beginning of the crisis, which severely curtailed government services. Government revenues and spending are now a small fraction of their precrisis levels. Revenues (including grants) fell from 20.7% of GDP in 2019 to 6.6% of GDP in 2021 and were projected to decline to 6% in 2022 by the World Bank.<sup>4</sup> The decline in revenues — together with the unavailability of funds to finance the deficit — led to a sharper contraction in spending. At the same time, expenditures fell from 29.9% of GDP in 2019 to 5.8% in 2021 and were expected to decline further to 5.4% of GDP in 2022. This decline led to severe cuts in public services including social services. Public sector wages and pensions also fell sharply relative to inflation.

The collapse in revenues during 2020-2022 is partly attributable to the policy of not adjusting the exchange rate used for customs and excises in line with market rates. This policy effectively reduced the effective rate of taxation, and it is estimated that it cost the government 5.6% of GDP in 2022.<sup>5</sup> The adjustment in the exchange rate used for customs valuation to LBP45,000/USD in March will accordingly be important for restoring fiscal revenues. The forgone revenues in 2022 were equivalent to the current level of government receipts including grants.<sup>6</sup> An alternative approach — assuming that it was feasible — would have been not to reduce the effective tax rates, and to use government revenues for social services and for targeted support to the most vulnerable.

### RECOMMENDATIONS

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There are measures that the authorities should take to halt the deterioration of the currency and to lower inflation, as well as to strengthen public finances and the social safety net. These measures can be adopted irrespective of prospects for implementing their plan to deal with the crisis or for IMF support of that plan.

First, there is a need for a monetary policy anchor to replace the exchange rate peg. The only viable option at present is a monetary growth target given current prospects for an exchange rate peg or for inflation targeting in Lebanon. Monetary growth targets would be set in line with inflation objectives, taking into account the needs of the economy. This target would be supported by limits on lending to the government, and by limits on the amount that could be withdrawn from bank deposits in LBP, should that scheme be continued.

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<sup>4</sup> World Bank, *Lebanon Economic Monitor*, Fall 2022.

<sup>5</sup> See IMF Technical Assistance Report: *Lebanon, Putting Tax Policy Back on Track*, November 2022.

<sup>6</sup> Tax receipts declined from 15.5% of GDP in 2019 to 5.4% of GDP in 2021, and were projected to further decline to 5.2% in 2022, per World Bank estimates.

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Second, it is important to unify the exchange rate as early as possible and to have all transactions at a single free-floating rate. The central bank has already moved towards that objective with the devaluation of the official rate in February and by the adjustment of the Sayrafa rate at the beginning of March. Multiple exchange rates provide opportunities for the misuse of public resources, they are distortionary, besides having been an important source for monetary expansion. In the immediate future, until exchange rates are unified, keeping the margin between the Sayrafa and parallel market rate — and Sayrafa volumes — to a minimum would help to contain monetary growth.

Third, tax and fee assessments should be based on the market exchange rate. As an immediate and interim step, the Sayrafa rate could be used for taxes and excises pending the unification of exchange rates. This move would help to further restore tax rates and fiscal revenues, providing an opportunity to strengthen the social safety net. The adjustment in the exchange rate for customs valuations in March was an important step in this regard. A targeted subsidy system should also be put in place as a matter of priority, taking advantage of the experiences in other countries. The increased tax revenues could finance an increase in public sector wages, preferably as part of overall civil service reform. Such a policy would be an important step in the rehabilitation of state institutions, which have suffered badly since the beginning of the crisis.



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