POLICY PAPER

ONWARDS AND UPWARDS?

THE LIRA'S TREACHEROUS ROUTE AHEAD

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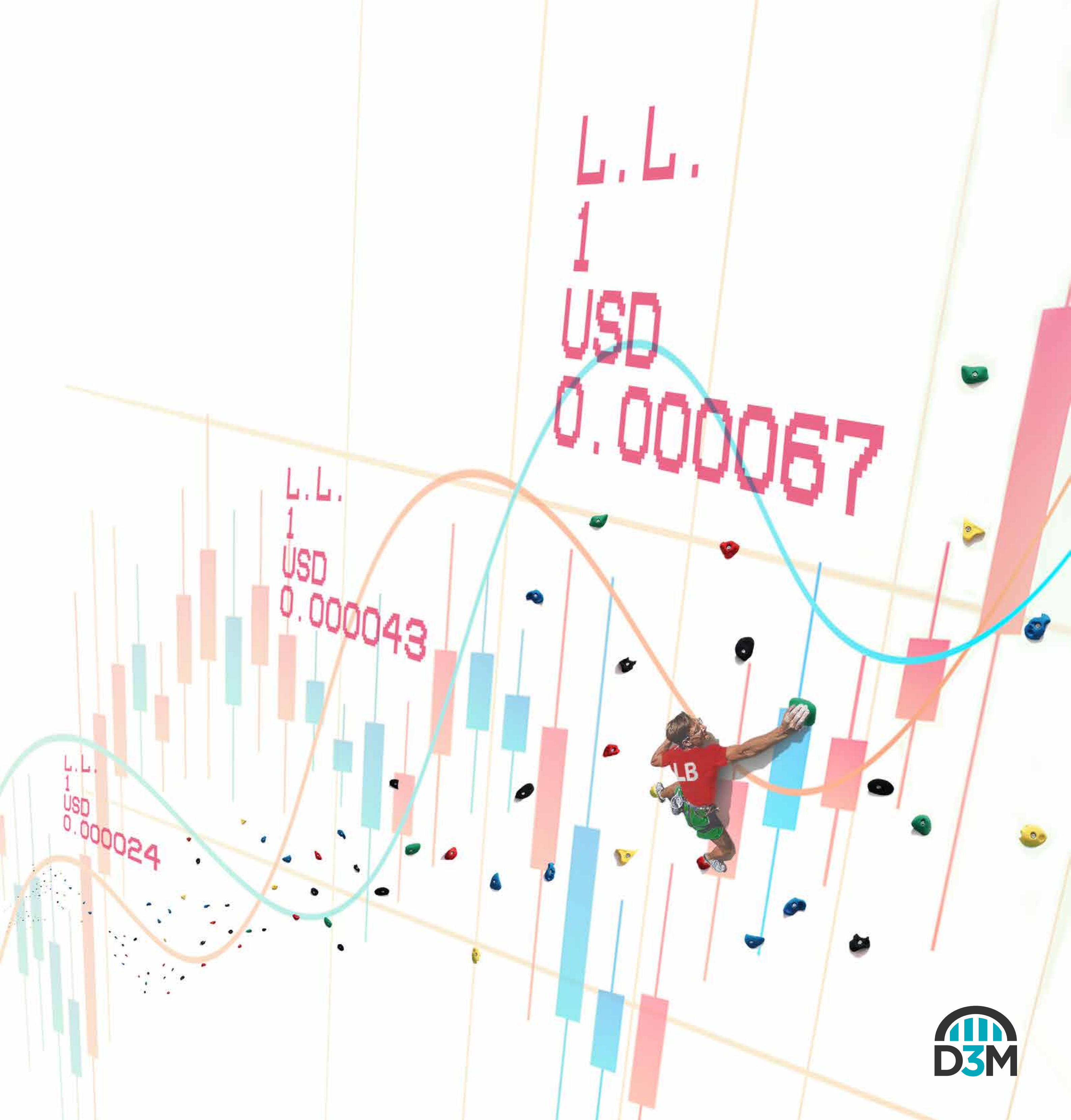
WILL MANSOURI SUCCEED WHERE SALAMEH DELIBERATELY FAILED?



EXECUTIVE SUMMARY

The government and central bank have deliberately failed to implement a coherent exchange rate regime in the wake of the financial crisis, instead opting to create endless, confusing exchange rates for different transactions. With the disgraced Riad Salameh leaving office at the end of July, his deputy Wassim Mansouri acceded to acting Governor. He and his colleagues presented a plan to float the lira by September along with a package of sorely needed reforms.

The plan, if implemented responsibly, will be a sharp departure from the government and central bank's handling of the crisis thus far. Charged with resolving the implosion of the banking sector and cultivating a stable monetary environment, Salameh and the finance ministry instead created increasingly numerous exchange rates as the parallel market value of the lira has collapsed, creating arbitrage opportunities and market inefficiencies at every turn.

Meanwhile, the central bank printed ever more lira to finance the state which is unable to collect taxes or borrow money. As lira plunged further into the abyss, the difference in value between the lollar rate and market value of a dollar grew ever wider, forcing depositors to take larger and larger haircuts on their deposits imposed by illegal central bank circulars while writing down the dollar-denominated liabilities of the banking sector.

Mansouri, now acting central bank governor, and the vice governors announced that they intended to move to a floating exchange rate regime. For the lira to float without bringing more financial pain to those who have already suffered the most due to Salameh's haphazard and harmful policies, the government and central bank must cease to print fresh lira to fund the government's budget deficit, legislate a capital control law, and resolve the banking crisis – easier said than done.

Rebuilding the confidence of the markets by reforming the role and governance of the central bank and tightening fiscal policy is critical. To that end, both the 2023 and 2024 budgets need to be passed urgently, something that has proven to be difficult in Lebanon's challenging governance environment. The Code of Money and Credit should be updated in line with international standards so that the abuses perpetrated by Riad Salameh will not happen again, were another central banker of dubious character be put at the helm of the Banque du Liban in future.

The decision to do away with the Sayrafa platform should be welcomed as, like most components of Lebanese state, the platform quickly became another tool of state capture and daylight robbery, as the central bank subsidised favoured groups' foreign exchange costs, generating $2.5 billion in arbitrage profits in the process. The creation of a transparent and efficient foreign exchange platform is key to floating the lira responsibly.

In the darkest hour in the lira's history, Mansouri faces a momentous task. To clear up the mess left by his predecessor, Mansouri will need the cooperation of Lebanon's rivalling political factions in passing reforms - something that recent years suggest will be a challenge.

SALAMEH'S OUT, MANSOURI'S IN

Riad Salameh, notorious central bank boss and darling of the political elite, ended his term at the end of July 2023. A period of uncertainty preceded his departure as the four central bank deputy governors threatening to resign if Salameh's responsibilities were foisted upon them, giving life to speculation that he might be kept on.[1]

Despite an initial unwillingness to step up to the plate,[2] the first vice governor Wassim Mansouri has become acting central bank governor.[3] Mansouri and his fellow vice governors have signalled their intentions to move to a flexible exchange, a departure from Salameh's anti-reform stance, rate by September to help resolve Lebanon's present economic quagmire.[4]

The mess Mansouri has inherited is formidable. The Lebanese of financial crisis, caused by years of fiscal indiscipline, a skewed economic model dependent on inflows of foreign currency, illegal BDL circulars, and lack of confidence in the Lira have all lead in one way or another to a long and acute divergence between the official exchange rate and that of the parallel market. Rather than reacting to the financial meltdown quickly, Salameh's use of a fragmented exchange rate policy, characterised by different rates for different transactions, since 2019 created market distortions, spurred dollarization, and the decline of formal financial cycles. Central bank circulars forced an unfair distribution of losses from the collapse of the banking sector onto depositors that contributed to widespread poverty and skyrocketing inequality.[5]

The plan presented by Mansouri and his fellow vice governors in late July 2023 proposed a managed float of the lira so that the exchange rate would reflect the "real" value of the currency.[6] Over a six-month period, the deputies a series of reforms including major fiscal reforms, the issuance of laws to rebuild confidence in the currency, and the creation of a new foreign exchange platform.[7]

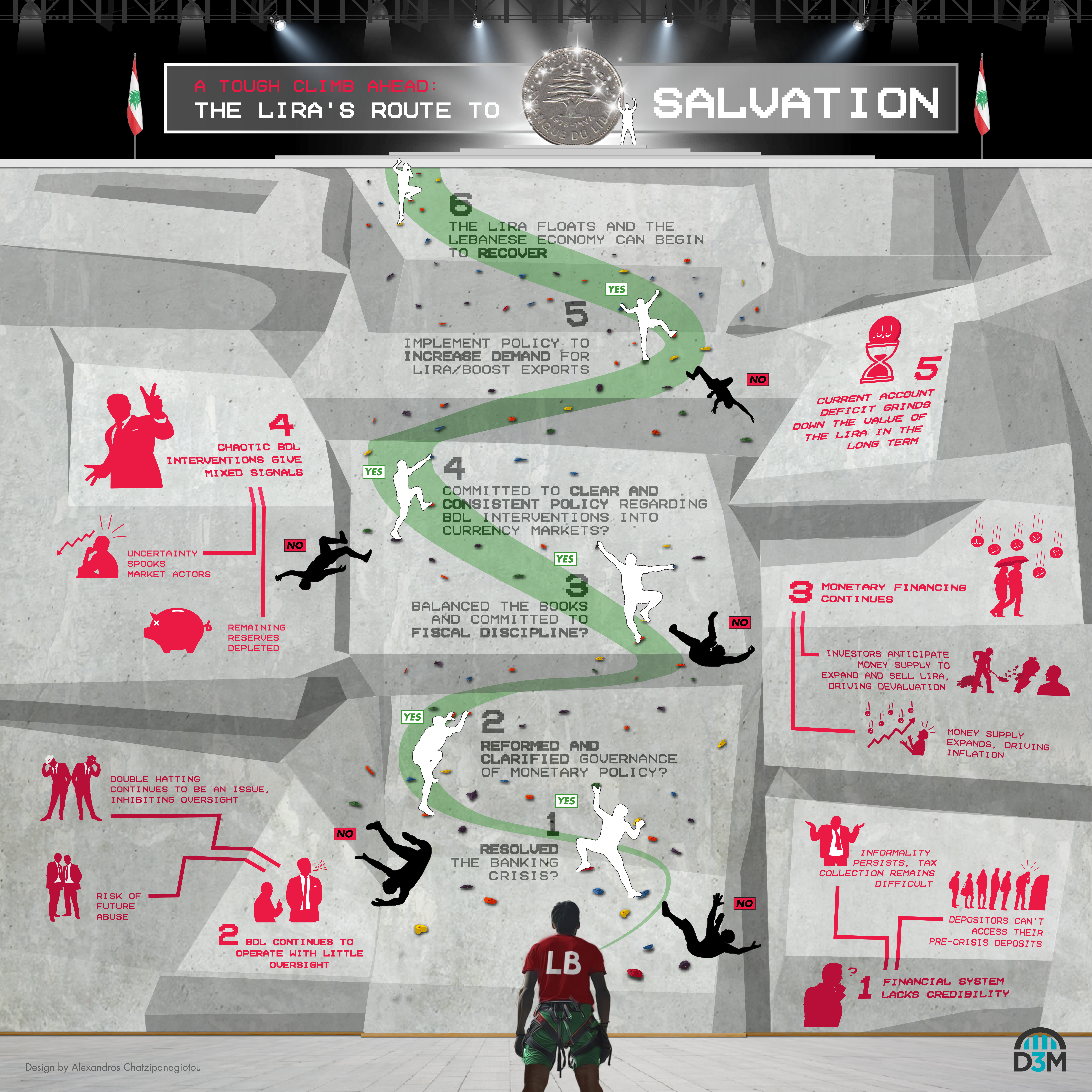
The deputy governors stressed that the time is opportune to float the lira due to two factors: the country is awash with dollars thanks to tourist arrivals and a decrease in cash lira in circulation.

The plan, not yet approved by the government, marks a promising departure from Salameh's ad hoc and centralized decision-making, however the appropriate reforms need to prevent the transition having disastrous consequences on the economy. If this were to occur, it would be the same social classes that have suffered from the government's intentional mismanagement of the crisis that would suffer the most, especially in context of eroded social safety nets.

IMBALANCED BOOKS

Mansouri made it clear upon assuming his new responsibilities that the central bank must cease financing the government outside of legal frameworks. He warned that if the government continued to dip into the BdL's coffers, that its hard currency reserves would eventually deplete,[8] an unacceptable outcome given the need to resolve the banking crisis.[9]

Although the proposed plan would allow the government to borrow up to $1.2 billion over 6 months, Mansouri stressed that the long-awaited 2023 state budget needed to legislate. Meant to have been passed in January, it needs to include adjustments to


A TOUGH CLIMB AHEAD:
THE LIRA'S ROUTE TO
SALVATION
6
THE LIRA FLOATS AND THE LEBANESE ECONOMY CAN BEGIN TO RECOVER
YES
5
IMPLEMENT POLICY TO INCREASE DEMAND FOR LIRA/BOOST EXPORTS
NO
5
CURRENT ACCOUNT DEFICIT GRINDS DOWN THE VALUE OF THE LIRA IN THE LONG TERM
4
CHAOTIC BDL INTERVENTIONS GIVE MIXED SIGNALS
YES
4
COMMITTED TO CLEAR AND CONSISTENT POLICY REGARDING BDL INTERVENTIONS INTO CURRENCY MARKETS?
UNCERTAINTY SPOOKS MARKET ACTORS
NO
YES
3
BALANCED THE BOOKS AND COMMITTED TO FISCAL DISCIPLINE?
NO
3
MONETARY FINANCING CONTINUES
REMAINING RESERVES DEPLETED
INVESTORS ANTICIPATE MONEY SUPPLY TO EXPAND AND SELL LIRA, DRIVING DEVALUATION
YES
2
REFORMED AND CLARIFIED GOVERNANCE OF MONETARY POLICY?
MONEY SUPPLY EXPANDS, DRIVING INFLATION
DOUBLE HATTING CONTINUES TO BE AN ISSUE, INHIBITING OVERSIGHT
YES
1
RESOLVED THE BANKING CRISIS?
NO
INFORMALITY PERSISTS, TAX COLLECTION REMAINS DIFFICULT
RISK OF FUTURE ABUSE
NO
DEPOSITORS CAN'T ACCESS THEIR PRE-CRISIS DEPOSITS
2
BDL CONTINUES TO OPERATE WITH LITTLE OVERSIGHT
1
FINANCIAL SYSTEM LACKS CREDIBILITY
LB
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D3M

strengthen the fiscal regime, include progressive reform laws, such as a capital control law,[10] according to the new bank boss. This, however, requires the support of the political class, who have long used the state as a patronage vehicle.[11]

The government's imbalanced books have been a major driving factor behind the collapse of the lira's value. Unable to issue new bonds, the Treasury has relied on the central bank printing new lira to fund its budget deficit. The M1 money supply rose from LL12.7 trillion in Oct 2019 to LL135 trillion in July 2023, an increase of 650%.[12]

The inflated money supply has led to a long and severe decline in the lira's value on the parallel market. This has eviscerated the public's lira-denominated savings and salaries and further widened the gap between the cost of goods and the rate at which depositors can withdraw their trapped funds. This has served the elite by writing down commercial bank's liabilities to depositors.

SAYRAFA AND ITS SUCCESSOR

The plan laid out by the deputy bank governors includes abandoning the much-maligned Sayrafa platform, which, as a parting gift by Salameh, expended $600 million of central bank foreign currency reserves in his last two weeks in office.

The Electronic Exchange Platform, known domestically as Sayrafa, is the central bank's primary instrument to intervene in currency markets. During interventions, the BDL injects foreign currency into the economy by selling dollars on the platform at a discounted rate (known as the Sayrafa rate). Econometric analysis by the World Bank suggests that Sayrafa is overall an ineffective monetary policy tool, with a low correlation between the Sayrafa rate, Sayrafa volumes and parallel market rates.

The dollars which the BdL sells on Sayrafa are either sourced from central bank reserves or from the market. Over the course of the crisis, the central bank's reserves

BOX I: No Taxes? No Problem

The Lebanese government budget has for decades been characterized by overspending with little to show for it, which has led Lebanon to have the third worst debt-to-GDP ratio in the world at 171%. Unsurprisingly, debt servicing in recent years has been amongst the largest budget items, representing 32% in 2018, along with government salaries and subsidies for the public power producer – with the latter two woefully underperforming in spite of their cost.[13,14]

Government tax revenues were equivalent to $7.81 billion before the crisis, or roughly 15-16% of GDP — a much lower proportion of tax revenue relative to economic activity than either Morocco or Tunisia, which are only marginally poorer. Following the crisis, tax revenue in Lebanon collapsed by 86%, equivalent to $1.13 billion.[15]

At the same time, Lebanon's tax policy continues to be characterised by a reliance on indirect taxes, weak revenues from progressive tax streams, and abundant loopholes for the rich to avoid taxation, placing the burden of taxation disproportionately on the middle and lower classes.[16]

Collecting tax has only been made more difficult by the collapse of the banking sector. Its Byzantine rules and regulations drive an increasing proportion of transactions into cash, making tax evasion easier and more likely.

have fallen by approximately two thirds to $9 billion,[17,18] making a flexible exchange regime under which its remaining reserves are used parsimoniously attractive.

The quartet of vice governors have approached international finance institutions Bloomberg and Refinitiv to create a more transparent platform closer resembling a central bank clearing house to float the lira, a move which should be welcomed.[19]

Under a flexible exchange rate regime, the central bank must foster a deep and liquid foreign exchange market. This requires that the bid-offer spread be low with low transaction costs and efficient clearing and settlement mechanisms, and enough volume so that individual transactions do not impact prices.[20] A deep and liquid market also helps "price discovery"" or finding the "true value" of a currency to occur and reduces the severity and shorten periods of volatility.[21]

At present, the foreign exchange market for the lira is relatively underdeveloped due to the central bank's role as a market maker. There is therefore a need to stimulate foreign exchange activity. This can be achieved by initially allowing for some exchange rate flexibility and fostering a sense of two-way risk – the possibility that the exchange might rise or fall.[22] This encourages market actors to take both long and short positions.

Mansouri has signalled that the BdL will intervene in response to speculative attacks to "ensure a smooth transition".[23] The central bank might choose to occasionally intervene in foreign exchange markets in line with policies, for instance to calm volatility, however this should be kept to minimum in order to allow for a healthy foreign exchange market.

BOX II: Trade Deficit Troubles

Lebanon has historically run a deep trade deficit, with exports accounting for only a fraction of imports. On balance, this creates a large outflow of foreign currency, mainly US dollars, and puts downward pressure on the value of the Lebanese lira. A negative consequence of this is that the price of imports, purchased from abroad in dollars, rise for those in Lebanon who earn and spend in lira, leading to a decline in general living standards. There is upside opportunity, however, for the Lebanese manufacturing sector — a weaker lira would tend to lower real production costs in Lebanon, allowing Lebanese exports to be more competitive internationally. The increased costs of goods coming into Lebanon would also spur demand for cheaper, domestic alternatives.

RECOMMENDATIONS

Floating the lira can only happen after certain preconditions are met, including rebuilding confidence in key areas, such as monetary policy governance and the finance sector. Thereafter the government and parliament must gradually unify the exchange rates and pursue an orderly monetary policy transition to a managed float for the lira. Doing so will rely on three inter-related pillars: restructuring the banking system, regaining confidence of the markets, and introducing the management protocol for the lira float.

A. RESTRUCTURE THE BANKING SYSTEM

A prerequisite for exchange unification is the implementation of just deposit recovery plan and a radical restructuring of the banking system, which the proposed plan does not address. The primary issue at present is the de facto differentiation between "fresh" and "old" money in the Lebanese economy with lollars subject to severe haircuts and withdrawal limits. With the implementation of a successful and just deposit recovery plan, this illegal value-differentiation between the two will be resolved. This is critical to restore the financial system's viability, credibility, and support economic recovery, as stressed in the Staff Level Agreement made with the IMF.

- First and foremost, the hole in central bank finances and the government's outstanding debt must be dealt with separately from commercial bank obligations to repay depositors.
- The primary responsibility of commercial banks to pay back their liabilities to their depositors must be acknowledged, regardless of the vast losses commercial banks incurred during the crisis, given that their irresponsible engagement in financial engineering was a catalyst for the country's current predicament.
- Insolvent banks should be declared bankrupt and exit the market.
- Commercial bank restructuring needs to secure minimum cash payments to depositors, aiming for a minimum of $250,000 per account in line with US Federal Deposit Insurance Corporation (FDIC) standards. An audit of the banks would determine the maximum possibly guarantee. Minimum yearly re-payments need to be guaranteed for syndicates to cover the cost of hospitalisations and pensions.
- These recovery costs can be funded by the sale of both foreign and domestic bank assets, recapitalisation, and clawback provisions.
- It's important to note that banks profited $5 billion from the disastrous financial engineering scheme and paid out politically connected shareholders hundreds of millions of dollars in dividends over the period from 2015 to 2019. And thus, clawback provisions can yield significant asset recovery levels if combined with international sanctions and cooperation.

Any plan must under no circumstance involve forced haircuts of depositors' funds or involve the sale of state assets, such as BDL foreign exchange reserves and gold.

B. REGAIN THE CONFIDENCE OF THE MARKETS

i. Reform and Clarify Monetary Policy Governance

Monetary policy governance both in general and in terms of central bank operations are in dire need of reform. The Code of Money and Credit (1963), the 2022 budget, and the multiple central bank circulars that at present govern interest rates have created a lack of clarity as who has the prerogative to make the required changes to the exchange rate regime. This needs to be clarified by the government and parliament with the necessary checks and balances, especially given the departure of current BDL Governor Riad Salameh and the entrance of a new central bank leadership for the first time in 30 years.

The central bank must adopt best practices; its involvement in financing budget deficits of the government and the EDL should cease. Enhancing central bank oversight is critical given the current state of operations in which decisions are made in a highly centralised and opaque manner. The Central Council of the BDL should be reformed to strengthen government oversight. The seats currently occupied by the director generals of the ministries of finance and economy should be reallocated to independent, non-executive directors.

At present, the central bank is lacking adequate checks and balances. For example, the Higher Banking Commission (HBC), the judicial body at the central bank, is compromised by conflict of interest. It is chaired by the governor of the central bank, at present Riad Salameh, who has veto power over the commission's decisions. The central bank governor heads two other banking oversight bodies: the Special Investigations Commission, the Capital Markets Authority, and the Higher Banking Commission.

This is a case of systemic double hatting, where the chair of a board also serves as an institution's chief executive. Double hatting is prohibited by the Basel Committee on Banking Supervision (BCBS) and seen to have contributed to the 2008 financial crisis. The Lebanese government should commit to the BCBS' principles to ensure that future governance of the central bank is devoid of political influence and conflicts of interest.[24]

Furthermore, the budget and salaries for the supervisory bodies that oversee the central bank are currently set by the central bank itself. This must also be set by an independent body and fall in line with wider civil service reform.[25]

ii. Adopt Fiscal Discipline and Boost Tax Revenues

Controlling the volume of money in circulation is critical to manage inflation expectations, reduce exchange rate volatility, and increase confidence in the lira. The central bank must end its policy of financing government spending through monetary. This will require passing fiscally responsible budgets, namely those for 2023 and 2024, in a timely manner and fiscal reforms to raise tax revenues.

One of the last remaining sources of potential revenue for the government is progressive taxation and improving tax collection systems. Progressive reforms such as increasing the top-tier personal income tax and reforming banking secrecy (estimated to have cost the government $5 billion in 2015 due to domestic tax evasion) will likely be opposed by entrenched interests and will require widespread political support. This must be undertaken in tandem with restructuring the financial system to reduce the proportion of transactions undertaken in cash to make tax collection easier.

C. INTRODUCE A MANAGED FLOAT OF THE LIRA

After the successful restructuring of the financial system and the implementation of confidence-restoring reforms, exchange rates should be unified around the Sayrafa platform rate for all foreign currency transactions. This includes the collection of taxes, import duties, and currency conversions made at money changers. Sayrafa's role should transition from an instrument to intervene in foreign exchange markets to a central bank clearing house. Foreign exchange transactions should primarily be undertaken amongst banks and financial actors rather than with the central bank.

With the policy recommendations above in place, the lira will be in a position to enter a managed float. Only when the lira has stabilised at a reasonable and sustainable level – governed by increased confidence and market forces – should the central bank intervene to protect the exchange rate from extreme volatility with its remaining foreign exchange reserves. Overall, the central bank should maintain a conservative approach to initiating currency market interventions.

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