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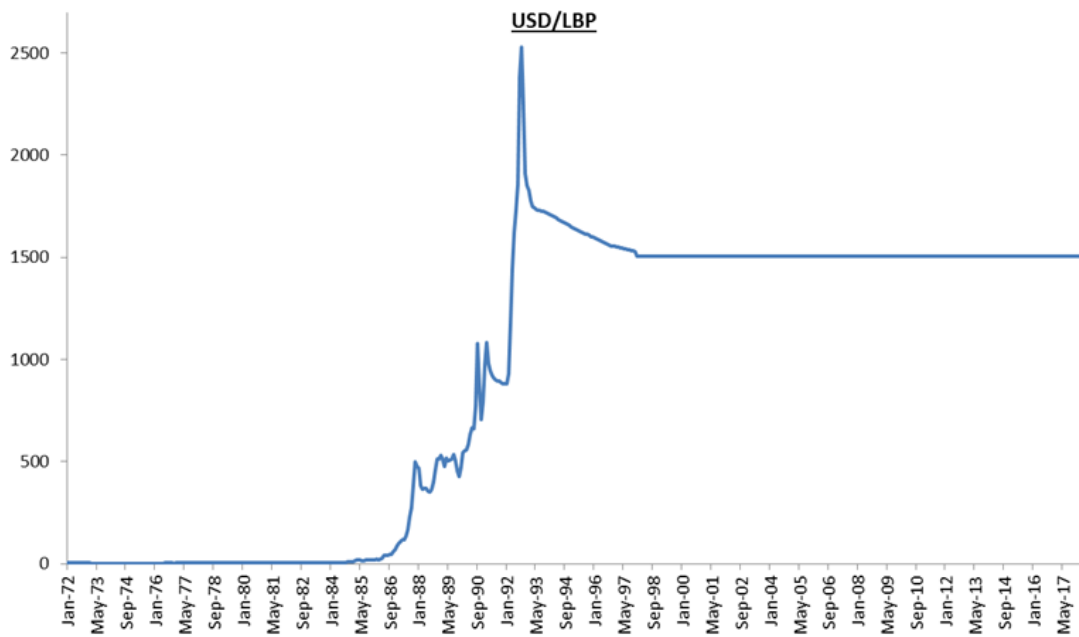
While the debate over the optimal currency system continues to pour lots of ink, reality is that **pegged exchange rates regimes remain the most adopted worldwide during and after the Gold Bullion Standard period.** The International Monetary Fund (IMF) indicates that up to the mid-1970s, 87 percent of emerging economies had a particular type of fixed exchange rate. Following the collapse of the Bretton Woods system of fixed exchange rates dating back to the 1970s, larger economies began to float their currencies and were followed by some emerging markets. However, according to Reinhart and Rogoff (2004) who developed a new system of classifying currency regimes, 59% of the 153 countries under consideration in their model had in fact a type of peg such as de facto or crawling during the post 1980s era.

Evidence indicates that **emerging and developing economies are very different from developed countries when it comes to choosing an exchange rate regime.** Calvo and Reinhart (2000) demonstrate that “floating exchange rates are far from a panacea for emerging markets and that this policy advice misses a number of important real world considerations that are crucial for developing countries”. Large exchange rate volatility in emerging and developing countries, such as large depreciation has a recessionary impact, particularly through abrupt adjustments in the current account.

Hence, **whatever is the cost of pegging the exchange rate; it will remain more advantageous for emerging economies when compared to a pure floating regime.** In fact, “currency crises become credit crises as sovereign credit ratings often collapse following the currency collapse and access to international credit is blocked”. Moreover, when investors’ confidence is lost, domestic interest rates volatility will become chronic and exchange rate swings seem to be more damaging to trade with the pass-through to inflation far higher in emerging and developing economies than in developed countries.

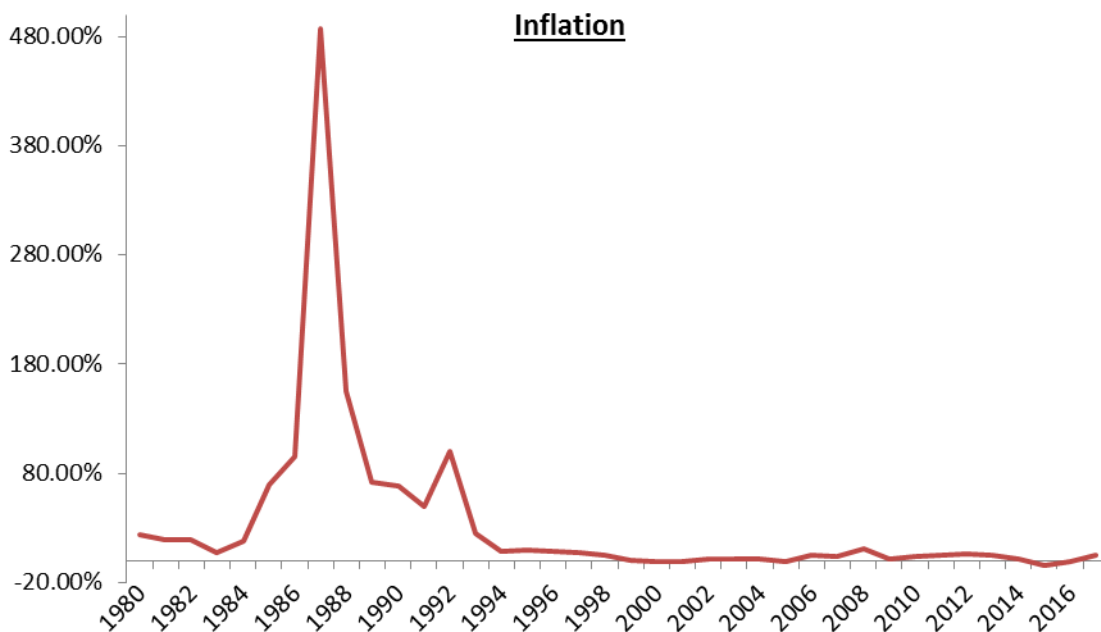
Lebanon has been pegging its currency (LBP) to the United States Dollar (USD) since end 1997. Before the 1975 war, Lebanon had a floating exchange rate regime with the USD/LBP rate fluctuating between 2.2 and 3.5 from 1964, date of the creation of BDL and 1980. Then the exchange rate started to depreciate and reached a peak of 2528 LBP/USD in September 1992. A stabilization process was therefore launched and the exchange rate appreciated constantly until it hit 1507.5 LBP/USD in December 1997 and was only allowed to fluctuate in a small range of 1500-1515 LBP/USD.

Why the Peg is the Best Option for Lebanon?



Source: Banque du Liban (BDL)

The adopting of the peg came as a result of the hyperinflation that the country encountered during the eighties of the last century. The hyperinflation period stretched from 1985 till 1992 with inflation recording a low of 50% in 1991 and a high of 487% in 1987. The national currency depreciated by more than 470% going from 85 LBP/USD at end 1986 to 455 LBP/USD by end 1987. The authorities failed to respond to stop the inflation as the intensification of capital outflows led to the large depreciation of the currency knowing that Lebanon relies mostly on imported products for its consumption. Regarding its resources in foreign currencies, the country depended on the exports of tourism services which were hit by the the ravaging war.



Source: CAS

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The dollarization rate has increased in tandem with the high inflation and fluctuated according to changes in the economic and political stability. The deposits in USD constituted around 25% to 30% of total deposits before the war of 1975. The dollarization rate fluctuated during the war reaching 86.2% in 1987 and remained above 70% until 1993. US dollar deposits reached a low of 58.3% of the total in 1997 and a high of 76.3% in 2007, a year where political and security instability was at its highest and 74.1% following the assassination of prime minister Rafic Hariri.

A review of the literature shows that Lebanon has rightly adopted a pegged exchange rate in the Nineties following a period of hyperinflation and an increase in the dollarization rate of deposits. Economic literature reveals that fixed exchange rate systems carry many advantages to countries that adopt them. Obstfeld and Rogoff (1995) identify three main reasons as to why central banks adopt a currency peg. First, the uncertainty that arises from the volatility of a floating exchange rate might have an adverse effect on transaction costs, international trade, and investment, and, in turn, compounds the distortions individuals experience in insuring their capital in incomplete asset markets. Second, pegging the domestic currency, usually to one used in a country with minimal inflation, is a convenient way to pin down the price level and restrain domestic inflation pressures. Third, a fixed-exchange-rate system is empirically efficient in the task of disinflation following periods of extreme price-level-instability.

Studies agreed that if trade consists of a large fraction of a country's GDP, i.e. the country is small and open, then the costs that come with currency instability are substantially high in the aggregate. As mentioned previously, a fixed exchange rate reduces transaction costs and currency risk which pose a threat to trade and investment. Hence, if an economy is significantly small and open, a fixed exchange rate system is a dominant strategy to follow (Frankel, 1999). Moreover, Gali and Monacelli (2005) model a small open economy in which they test the welfare implications of different monetary policy rules. They find that in a small open economy, in particular, an exchange rate peg generates stationarity of the domestic price and CPI levels, yielding lower welfare losses stemming from price fluctuations.

Lebanon has a high ratio of trade to GDP and is de facto a small and open economy, thus pegging gains more in importance. Lebanon's GDP reached 52.7 billion USD in 2017, with total trade (value of imports plus exports) amounting to 21.8 billion USD or 41.5% of GDP. Additionally, Lebanon mainly exports to South Africa, the UAE, Saudi Arabia, Switzerland, Syria, Iraq, and Kuwait. Its main imports originate from China, France, Italy, Germany, Russia, the US, Saudi Arabia, Egypt, Turkey, and Kuwait. Lebanon is relatively small compared to most of these economies. Furthermore, Guerron (2013) characterizes a country as a small open economy when it takes the interest rate on its debt as given, i.e. it has no substantial control over the premium it pays on its debt. Given this definition and the relative openness and size of Lebanon, the Lebanese economy can be considered a small open economy.

A fixed exchange rate system tames inflation and anchors policymakers to their commitments. High inflation can substantially harm investor confidence. This becomes especially problematic when a large portion of investment and credit is foreign. Investors and creditors are less likely to risk their capital in a country with an unpredictable inflation rate, and if they do, they will ask for a large premium. Therefore adopting a pegged exchange rate provides the small open economy that is dependent on foreign direct investment with more credit and lower premiums on its debts. Moreover, workers, managers, and other price setters then expect that inflation will be lower in the future. This drives them to set wages and prices accordingly which yields actual lower inflation.

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Although inflation in Lebanon has been relatively stable throughout the past two decades, it is the peg that brought down the hyperinflation of the 1980s and early 1990s. Lebanon had experienced a hyperinflationary period during the mid-1980s and early 1990s. Malmendier and Nagel (2015) argue that personal experiences play an important role in shaping expectations and find that, empirically, differences in experiences strongly predict differences in inflation expectations. The hyperinflation experience in Lebanon adversely affects inflation expectations, especially if the commitment of policymakers to a fixed exchange rate system is abandoned.

Moreover if an economy has non-developed capital markets, then fixing the exchange rate can spare it from many losses that arise from large variations in the value of its currency. When capital and financial markets are immature, then a small number of currency trades can provoke large currency fluctuations and, in turn, uncertainty. In fact capital markets in Lebanon are small and have very few contributions to the financing of the economy. Furthermore, a significantly small fraction of businesses in Lebanon are large and open to the idea of going public to finance their investments; they would rather borrow from the strong banking sector. We can confidently say that financial markets in Lebanon are substantially immature. In turn, a fixed exchange rate system can eliminate the losses from currency fluctuation that might arise due to this imperfection.

Adopting a fixed exchange rate system eliminates monetary policy independence to a certain extent, but the elimination is an advantage in itself when policymakers use this independence for personal gain. Many developing countries have suffered from corrupt governments and harmful economic intervention in favor of interest groups. Monetary policy is indeed a powerful tool, which if abused, can incite painful crises. One example of how corrupt officials abuse monetary policy is by printing bank notes in excess to generate "seignorage", profits from 'selling' bank notes to those who are willing to hold them. Under a fixed exchange rate system, this phenomenon is limited by the threat of losing the peg and the benefits that accompany it. The most recent example of how politicians abuse the monetary policy is the case of Venezuela, where hyperinflation has cast a cold and dark shadow on its economy.

Consequently, the presence of a large amount of corruption in the political sphere in Lebanon, leads naturally to embrace a pegged exchange rate policy in order to preserve monetary policy from political interferences. Transparency International ranked Lebanon 143rd out of 180 countries in its Corruption Perceptions Index in 2017 (the closer the rank to 180 the higher the corruption in the country). Moreover, the hyperinflation period experienced by Lebanon during the civil war was due to the acceleration of money growth arising from the financing of budget deficits by the central bank. Therefore, given a floating exchange rate system and a soaring budget deficit, it is not improbable that policymakers push for debt financing by the central bank. Given the lack of credibility, policymakers, therefore, need to be tied by a strong commitment mechanism which can be provided by a currency peg. The mitigation of inflationary policies influenced by corrupt officials will also aid in attracting foreign direct investment to Lebanon.

Even if a country is characterized by free movement of capital, it doesn't mean that it should adopt a floating exchange rate regime. Since investors' expectations and confidence are key to a small open economy, economic and financial stability becomes a main pillar for the authorities. Hence the impact of free capital movement on the exchange rate has to be amortized through the intervention of central banks. For example during periods of large inflows of capital, central banks intervene to stop the appreciation of the currency that may hit the competitiveness of their countries' exports. Hence central banks will accumulate foreign

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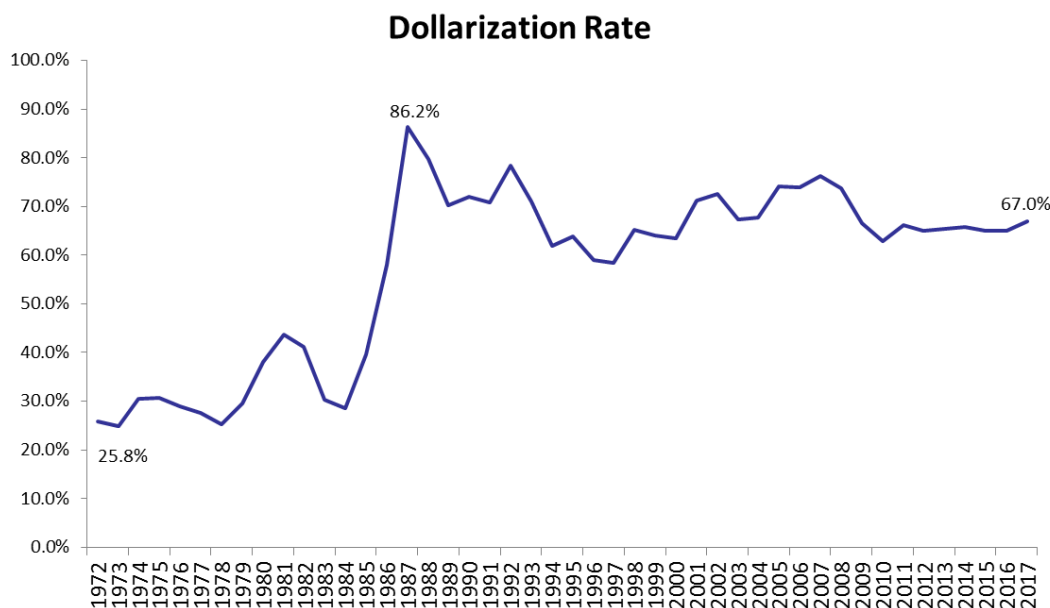
reserves. According to the IMF, when an economy experiences acceleration in capital inflows if the exchange rate is fixed and prevented from appreciating, this may lead to inflationary pressures and an appreciation of the real exchange rate through higher domestic inflation. However, this can be avoided using “sterilized operations” through open market operations to offset the inflationary pressure that comes with the inflow of liquidity.

In Lebanon, the authorities have a policy of free capital movement, hence the importance of the peg. Lebanon witnessed large capital inflows during the years 2006-2010 with the balance of payments registering a cumulative surplus of USD19.5 billion. During this period the peg was maintained and the central bank foreign reserves reached USD40 billion. The economy benefitted greatly from an increase in capital inflows and FDI through increases in relative stability, and positive spillovers on the financial system, with economic growth averaging 8.5%. In the following years (2011-2017), the balance of payments recorded an accumulated deficit of USD10 billion and the peg remains in place because any devaluation will have an impact on investors’ confidence.

A pegged exchange rate is also a better option when partial dollarization exists as it reduces transaction costs and stabilizes macroeconomic performance through soothing the variation of output and inflation after a foreign monetary policy shock. In an economy where (partial) currency substitution and financial dollarization are dominant phenomena, pegging the currency to the foreign currency used alongside the domestic one can greatly decrease transaction costs arising from day-to-day transactions. If an economy is partially dollarized and the exchange rate is free to float, a foreign shock to monetary policy yields distortions to the behavior of economic agents. In a working paper, Khalil (2018) casts a small open economy model in which he accounts for partial currency substitution and financial dollarization. After exposing the model to different shocks under different monetary policy rules, including a currency peg and interest rate rules, he finds that under a currency peg, a positive shock to foreign interest rate yields the lowest variation in output and domestic inflation.

Moreover dollarization, in the presence of a peg, has the ability to reduce the pass through in interest rates fluctuations in the US by eliminating currency premium and reducing country premium. Frankel (1999) studied the case of many emerging markets and showed that, due to dollarization, the pass through of an increase in interest rates in the United States to the country of the pegged currency is less than one to one. A one basis point increase in US interest rates will translate in less than one percent increase in interest rates in the dollarized economy. In fact “the interest rate differential consists primarily of a country premium, supplemented by a small currency premium”. The currency premium would by definition vanish when an economy is dollarized. And what is more important is that the country premium, which comprises the perceived risk of default, might be reduced when the devaluation risk is very low or non-existent.

The fact that exchange rate stability mitigates the distortions that come with partial dollarization given foreign shocks makes a currency peg more suitable for the Lebanese economy. According to Banque du Liban, the private financial dollarization rate (the fraction of private sector deposits denominated in foreign currencies) in Lebanon reached 68.51% in July 2018 and it reached 86% in 1987. Moreover, currency substitution or transaction dollarization, which occurs when a foreign currency is accepted as a medium of exchange along with the domestic one, is also very common in Lebanon. The dollarization of loans is also pronounced as it reached 37.5% in July 2018, which makes any devaluation having a devastating impact on the economy.



Source: Banque du Liban (BDL)

Contrary to the mainstream belief that a floating exchange rate system ultimately dominates a currency peg in its advantages, fixed exchange rate systems have historically proven to deliver emerging small open economies optimal results in terms of macroeconomic stability. In the language of economics, very few countries tend to choose corner solutions when it comes to their exchange rate systems; most tend to adopt managed floats or de facto/crawling pegs. However, there are certain criteria that render an exchange rate system more fit for a country. The advantages of a fixed exchange rate system tend to suit most of the characteristics of the Lebanese economy mentioned above.

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