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Contact Information

Chief Economist : Dr. Ali Bolbol

ali.bolbol@blom.com.lb

1) *Introduction:*

Over the past 20 years, it was repeatedly argued that the Lebanese fixed exchange rate was overvalued, sometimes by as high as 50%. What is surprising is that the fixed system has held for 22 years, from 1997 to 2019, despite all criticisms to the contrary. But, ultimately, the system ran out of luck, and it was raptured into a dual system by November 2019.

It was the first time in its recent history that the free Lebanese economy experiences such a system of exchange rates, and very little of its economics is known to the public. So what we intend to do in this introduction is to fill this gap by providing preliminary notes behind the theory and empirics of the dual exchange rate. We will first provide some background on its origin and features; then we will discuss in some details the relation between the equilibrium exchange rate and the dual rate; and we will end with how well all these aspects fit the new Lebanese exchange rate framework.¹

2) *Economics of Dual Exchange Rates:*

To start with, a dual exchange rate (DER) system is defined as a parallel market for foreign exchange transactions that is legal. In turn, a parallel exchange rate market is created in response to a balance of payments crisis; and the objective is to rely on the parallel foreign exchange market to avoid the undesired effects of the overshooting of a unified exchange rate on domestic prices, while maintaining control over international reserves. However, unless the adoption of parallel markets is accompanied by severe foreign exchange controls they fail to insulate international reserves from capital flows. Hence, virtually all dual systems assign all capital outflows (or capital account transactions) to the parallel rate, whereas they differ in their assignment of current transactions. The upshot is that a dual system leads to a depreciation of the parallel rate rather than to a continuing loss of reserves, while at

¹ The analysis will draw primarily from the following sources: Kiguel, M. and O'Connell, S. (1994). "Parallel Exchange Rates in Developing Countries: Lessons from Eight Case Studies" World Bank, *Policy Research Working Paper Number 1265*; Ghei, N. and Kamin, B. (1996). "The Use of the Parallel Market Rate as a Guide to Setting the Official Exchange Rate", Board of Governors of the Federal Reserve System, *International Finance Discussion Papers Number 564*; and Azar, S. et al. (2020).

"An IS-LM-BP Model for Lebanon: A Simple Empirical Analysis", *International Research Journal of Finance and Economics, Issue 177*.

the same time putting a lid on inflation. As important, the dual regime allows initially for efficiency gains in the allocation of foreign exchange while protecting, temporarily, the real incomes of groups subsidized by the overvalued official rate.

In fact, it is concern about the adverse effects of a maxi-devaluation of the official rate on income distribution and real wages that induces the authorities to select tightening of foreign exchange controls over across-the-board devaluations of the official rate. But though the dual market typically reflects a systematic bias against official devaluation, exchange controls are ultimately extended over a broader set of current account transactions, thus causing a higher demand for foreign exchange in the parallel market that can only be partially met by the supply provided from exporters of goods, tourists, and workers abroad, all of whom may find it profitable to divert foreign exchange from the official to the parallel market. More crucially, this chain of events means that it is usually portfolio decisions and expectations that play a central role in determining the parallel premium in the short run, for example the parallel exchange rate will depreciate and the premium will increase in anticipation of a devaluation of the official rate or an increase in the money supply; but in the longer run it is current account influences that dominate as more imports are "diverted" to the parallel market for foreign exchange and the premium increases accordingly. Indeed, over longer periods it is the parallel exchange rate, rather than the official rate, that becomes the key determinant of cost push influences on domestic inflation.

What this shows is that the dual exchange rate system provides short-term insulation of domestic prices by channeling most current account transactions to the official foreign exchange market. The effectiveness of parallel systems in insulating domestic prices is greatest during the first year, however, but is ineffective in the long term. In other words, parallel foreign exchange markets can at best provide temporary insulation, and mainly when the pressures for devaluation are generated by short term capital outflows; their scope is much more limited when official devaluation is needed to deal with balance of payments problems resulting from generalized excess demand caused by expansionary domestic policies. In this sense, macroeconomic fundamentals matter most. In particular, the premium reflects inconsistencies between policies affecting domestic absorption (namely monetary and fiscal policies) on the one hand, and the official exchange rate on the other. Even in the short term, if there were no clear efforts during this "temporary" period to correct monetary and fiscal policies to restore external balance, then it is doubtful that even macroeconomic gains (in terms of less reserves loss and lower inflation) will be larger than the costs engendered by the dual rates in terms of microeconomic distortions and corruption².

² The drawbacks of dual exchange rates include the following: first, exchange controls allow the authorities to maintain a persistently misaligned official exchange rate -- perhaps coupled with inappropriate fiscal, monetary, and commercial policies -- without losing all their international reserves, thereby distorting relative prices in the economy and inhibiting the growth of exports;

second, because parallel market regimes often involve the rationing of foreign exchange at subsidized rates to those with preferential access to the authorities, exchange controls encourage the development of rent-seeking behavior among private entrepreneurs;

lastly, the introduction of exchange controls, which by their nature are hard to enforce and profitable to evade, tends to promote a culture of law evasion among private entrepreneurs that may spill-over into other areas such as tax compliance or adherence to other economic and financial regulations.

Given the above, policy adjustments would call for exchange rate unification. The interesting thing is that unification often takes place rapidly at times of macroeconomic crisis, as multiple exchange rates cease to be useful in protecting international reserve. Unification usually proceeds in two formats, often consecutively: the first refers to the adoption of a single exchange rate for all current account transactions, while maintaining convertibility restrictions and therefore a parallel market for capital account transactions; the second refers to the adoption of a single exchange rate for all external account transactions. As interesting, the choice of the exchange rate regime adopted at the time of unification does not appear to be a critical determinant of success. The key element for successful unification is the clear acceptance of the need for consistency between the unified exchange rate and monetary and fiscal policy. As to speed, quick unification is desirable at times of severe macro-crises, high premiums, and when domestic capital markets are *better* integrated to the world financial markets.

Lastly, a successful unification is one that can be sustained without leading to significant increases in inflation or recurrent balance of payments problems. Sustainable unification requires the adoption of a suitable exchange rate system. In countries where fiscal deficits (or money financed budget deficits) persist and inflation is bound to continue, this means the adoption of a crawling peg or a managed float³. Unifying to a fixed exchange rate in these cases will fail as balance of payments crises will loom in the near future. In general, it is more difficult to unify to a fixed exchange rate, because it needs a credible commitment to maintain external balance. In this case the prerequisites are a strong fiscal balance and sufficient reserves (or quick access to external credit) to withstand external shocks or speculation against the currency. Unification to a fixed exchange rate without these pre-conditions sets up the stage for a reversal.

3) *Equilibrium vs Dual Exchange Rates:*

Determining the appropriate level at which to set the exchange rate is a challenging problem for any country pursuing a managed or fixed exchange-rate policy. Ideally, the long-run equilibrium exchange rate is that rate which equates the trade balance with net capital flows when fiscal, monetary, and commercial policies are sustainable, when foreign asset holdings are equal to their desired levels, and when no exchange rate controls are in place. However, the determination of the equilibrium exchange rate is notoriously difficult, especially if the economy is in the midst of reforms. In a context where a parallel market for foreign exchange exists, it may appear natural to consider the parallel exchange rate as a proxy for the equilibrium exchange rate. The parallel exchange rate usually has the benefit of being determined in a free market, and hence is not obviously “contaminated” by the distortionary effects of government policy.

To elaborate, the emergence of a parallel market usually reflects the existence of an excess demand for foreign exchange at the prevailing official exchange rate (so that foreign exchange must be rationed by the authorities). Successful unification of the exchange market generally requires that the official exchange rate be devalued sufficiently to eliminate excess demand for foreign exchange. Put in another way, successful unification requires

³ A *crawling peg* is a *system of exchange rate* adjustments in which a *currency* with a fixed *exchange rate* is allowed to fluctuate within a band of *rates*. The par value of the stated *currency* and the band of *rates* may also be adjusted frequently, particularly in times of high *exchange rate* volatility.

that the official exchange rate be set at its equilibrium level. In practice, though, some countries might not regard it as feasible, within a short period of time, both to devalue their exchange rate to its long-run equilibrium level and to adjust towards appropriate fiscal, monetary, and commercial policies. They may fear the inflationary and distribution consequences of a very large “maxi” devaluation, and may face strong political pressures against changing particular aspects of government policy. In such a case, the authorities might attempt to implement a gradual process of unification, moving the official rate toward its long-run equilibrium value even as they adjust associated economic policies in the appropriate direction as well.

Whether the authorities intend to implement either a gradual or a rapid unification, they will need to identify the long-run equilibrium value of the exchange rate and, as noted earlier, this task will be fraught with considerable uncertainty. Under these circumstances, the prevailing parallel exchange rate would appear as the obvious proxy for the equilibrium rate, and the authorities might naturally consider the parallel rate to be the appropriate target toward which to move the official rate, either gradually or all at once. However, there are factors that could cause the parallel rate to diverge from its long-run equilibrium value. Some of these important factors are: i) the more overvalued the official exchange rate, especially in the context of more price elastic exports and less price elastic imports, the more the parallel rate will *depreciate* relative to the equilibrium exchange rate⁴; ii) given the asset market function of the parallel exchange market, and because of the size of capital outflows triggered at the time of economic crises, the parallel market rate in these countries will *depreciate* still further and depart from the equilibrium exchange rate; iii) in case of strict and high import barriers, the demand for foreign exchange in the parallel market will be significantly less, and the parallel rate will consequently be more *appreciated* with respect to the equilibrium rate; iv) alternatively, in the absence of import restrictions, but with increasingly more imports are financed through the parallel market, the higher the premium will be and the parallel rate will be more *depreciated* in comparison with the equilibrium rate.

The above considerations suggest that, on balance, the parallel rate is likely to be more depreciated than the long-run equilibrium exchange rate, and hence the official exchange rate in a unified exchange market will in general best be set at a level that is more appreciated than the prior parallel rate.

4) *Dual Exchange Rates in the Lebanese Economy:*

The dual exchange rate market emerged in Lebanon in November 2019 as a result of a balance of payments (BOP) crisis -- BOP remained in the red throughout the 2011-2019, hemorrhaging close to \$20 billion in deficits -- that was compounded by banking and sovereign debt crises. It saw the parallel rate rise from early November 2019 to late March 2020 by 86%, i.e, from close to 1,500 LBP per dollar to around 2,800 LBP per dollar. The reason behind the crisis was fundamentally unsustainable fiscal policies that drove the deficit ratio to 10% of GDP and the

⁴ With elastic exports and inelastic imports, an overvalued official rate would reduce exports, and increase imports, considerably thus reducing available foreign exchange and putting undue pressure on the parallel rate.

debt ratio to 150% of GDP, that is in addition to reactionary monetary policies and severe deficiencies in public governance⁵.

As expected, what drove the high parallel premium were asset market variables such as increases in the money supply, expectations of devaluations in the official exchange rate, and to a lesser extent capital outflows; for instance, the money supply M1 – currency and demand deposits in LBP – increased by 45.4% between October 2019 and January 2020 to the equivalent of \$12.2 billion. And as also expected, the parallel rate helped reduce the loss of reserves and inflation, as the balance of payments was only \$158 million in January 2020, compared to \$1,380 million in January 2019, and inflation was at less than 10%.

But these are short-term benefits, which judging from country experiences will not last in the long run (let alone the associated microeconomic distortions). This is because the parallel rate will be mostly determined by current transactions in the long term, as more of these transactions are shifted to the parallel market. Currently, perhaps about 40% of imports are transacted at the official rate – minerals, medicine and medical equipment, wheat, and industrial raw materials – but it is doubtful whether BDL will be able to continue with this subsidization as it sees its official foreign currency reserves dwindle (now at less than \$29 billion). If accurate, this level of reserves will allow BDL some time to underwrite these current transactions, but sooner rather than later it will have to stop doing so to protect whatever meager reserves it is left with. And that is especially true given that Lebanon is currently cut off from international capital markets because of its default on public debt.

Barring a maxi-crisis and considering Lebanon's dissociation from global financial markets (factors that would call for swift unification of the official rate with the parallel rate), it is perhaps best for the country to pursue gradual unification, not least so as to minimize adverse social implications. It could start with unification on current transactions then graduate to encompass capital account as well as the removal of exchange controls. But, most crucially, the gradual process should be accompanied by reforming progressively fiscal, monetary, and commercial policies, to help reduce budget deficits, make monetary policy more independent, and enhance the economy's competitiveness⁶. For it is these unsustainable policies, primarily the fiscal ones, that were in disharmony with the exchange rate regime and were behind the breakdown of the fixed exchange rate, made worse by the drying up of capital inflows since 2011. And in this context, it is superfluous to emphasize that a reforming program with the IMF is urgently and badly needed, and frankly is the "only game in town" not only to undertake reforms and debt restructuring but also to facilitate access to capital markets.

Finally, a crucial question remains: unification towards which exchange regime and at what equilibrium rate? It is apparent that after 22 years the fixed exchange rate regime has outlived its usefulness and will be very costly to re-establish and maintain. It is therefore economically wiser to aim towards a less stringent regime, perhaps – as discussed earlier -- a crawling peg regime that combines the virtues of both the fixed and the flexible exchange rate systems. As to the rate that should be adopted, the most likely candidate that proxies equilibrium is the dual rate

⁵ Ironically, economic models assign to expansionary fiscal policy strong impact on the economy under a fixed exchange rate regime, but in Lebanon this policy became counterproductive because of the wastefulness and corruption that characterized public expenditures.

⁶ This would free the monetary authorities from the straightjacket of the "impossible trinity": the loss of monetary independence in the presence of fixed exchange rates and unhindered capital mobility.

prevailing at the time, but this rate could be more *depreciated* than necessary, and have to be adjusted *upwards* depending on the degree of overvaluation of the official rate, the intensity of capital outflows, and the extent of current transactions conducted at the dual rate (not so much import restrictions since these are not strongly prevalent in Lebanon)⁷.

5) *Conclusion:*

In retrospect, the current Lebanese economic crisis has been long in the coming, given how unsustainable fiscal policy was. The breakdown of the fixed exchange rate regime into a dual regime should be considered an opportune time to reform the Lebanese economy on sustained and well-governed grounds. It should also be an opportunity to amend gradually the exchange regime towards a more flexible one. But what is more fundamental than the choice of the appropriate exchange rate regime for Lebanon is the pursuit of macroeconomic policies that are consistent with the exchange rate regime and that serve the long-term viability of the economy.

⁷ At a premium of 86% currently, the Lebanese dual exchange rate is twice as devalued as the average for developing countries in the 1990s when dual rates were still widely used.

* The views expressed in this short paper are not necessarily those of BLOM Bank and they are strictly those of the author*.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department Bab Idriss,
Weygand Str. POBOX 11-1540
Riad El Soloh Beirut 1107 2080
Lebanon.

Chief Economist: Dr. Ali Bolbol

+961 1 991 784

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