# What is the Optimal Exchange Rate Regime Choice for Lebanon?

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Lebanon has always followed a "de jure" floating exchange rate regime, though only in 1997 it had adopted a "de facto" fixed regime to the USD which survived till the summer of 2019, though it crashed down timidly initially but in a big crisis fashion afterwards. What is interesting is that emerging markets have moved towards more flexible regimes in the 1990s; however Lebanon elected to go against this trend, which in retrospect has proven to be costly and a sub-optimal choice.

So in retrospect, and for the sake of future prospects, what would have been or would be a better regime choice for the country? We will analyze this question by investigating the most important determinants of exchange rate regime choice as they apply to the case of Lebanon, in accordance to the table below.

| Characteristic | Preference for Fixed Regime | Preference for Flexible Regime | Preference for Lebanon |
|---|---|---|---|
| Small and Open Economy | ✓ | × | Fixed |
| Monetary Shocks | ✓ | × | Fixed |
| Real Shocks | × | ✓ | Flexible |
| Open Capital Account | × | ✓ | Flexible |
| Lack of Institutional and Political stability | √ | √√ | Flexible |
| Loose Fiscal Policy | × | ✓ | Flexible |
| Monetary Policy Independence | × | ✓ | Flexible |
| Wage Rigidity | × | ✓ | Flexible |
| Foreign Debt | ✓ | × | Fixed |
| Thin Financial Markets | ✓ | × | Fixed |
| Dollarized Balance Sheets | ✓ | × | Fixed |
| Ease of ER Adjustment | × | ✓ | Flexible |
| Control of Inflation | ✓ | × | Fixed |
| Conducive to Growth/Competitiveness | × | ✓ | Flexible |

1) A fixed exchange rate (ER) regime is preferable for a small and open economy because of its dependence on exports and imports and the stability that a fixed ER brings to their volume and prices[1]. And that is true for Lebanon, given its smallness, openness, and especially its imports dependence.

2) Monetary shocks are better handled by a fixed ER regime because of its stabilizing impact on the money market and prices. This holds true for Lebanon, though monetary shocks are not a major and frequent concern for the country

3) Real shocks are better absorbed by a flexible ER regime as it allows the economy to adjust relative prices in a way that is advantageous to the trade balance and economic stability. Such a regime is preferable to Lebanon as most if not all of its shocks are real in nature.

4) With an open capital account, a flexible ER regime can help manage the impact of volatile capital flows by allowing the ER to appreciate (depreciate) with increased (reduced) inflows. This not only eliminates any speculative attack on the currency in case of a fixed ER, but also eliminates the need for costly sterilization and disruptive capital controls. In this sense, a flexible regime would serve Lebanon well *given its open capital account and its heavy reliance on steady capital inflows to finance its current account deficits.*

5) Lack of institutional strength and/or political stability makes it more difficult to sustain a fixed ER regime, though such a regime could be looked at as a policy crutch that provides stability amid the chaos especially if the Central Bank has deep foreign exchange (FX) reserves to support the peg. In Lebanon, given its frequent political instability, institutional weakness, and limited FX reserves, a flexible ER regime is more preferable.

6) With monetary policy dedicated to maintaining the peg, fiscal policy should play a more active role in economic management under a fixed ER regime. But a *loose* fiscal policy is not consistent with a fixed ER regime because it will only be maintained through the loss of foreign exchange reserves; whereas under a flexible regime, the costs of an unsustainable fiscal policy may be revealed more quickly – through widely observed movements in exchange rates and prices. And if this is the case, then a flexible regime may exert an even stronger discipline on fiscal policy. Loose fiscal policy has been the "Achilles' Heel" of the Lebanese economy – not the least because of clientelism and corruption – which would have made flexible ER a better regime choice for the country.

7) According to the "Impossible Trinity", a country can't have monetary independence under free capital mobility and fixed ER[2]. This means monetary policy is rendered ineffective, and fiscal policy has to assume a more stabilizing role, as mentioned earlier. Of

[1] In this context, it interesting to note that most Lebanese exports go to Switzerland and the Gulf countries, so why not peg the LBP to the Swiss Franc, or to a basket of the Swiss Franc and the USD as the Gulf countries peg their currencies to the USD? And since most of Lebanon's imports are from China and the EU, then why not consider pegging the LPB to a basket of the Euro and the Yuan? In other words, why peg to the USD?

[2] Under this regime the interest rates in the country would be determined by interest rates in the country to which the currency is pegged plus a risk premium.

course, a flexible ER regime would restore monetary independence. Under a flexible ER, Lebanon would have benefited from this advantage especially that fiscal policy was unsustainable, had lost its compass, and had become a vehicle for bad governance.

8) If nominal wages are rigid, then changes in wages have to come through changes in real wages to deal with unemployment and real shocks. And this can best be done through price changes caused by exchange rate changes under a flexible ER. In Lebanon wages were largely rigid, as more than a quarter of the 1.3 million workers are employed in the public sector and almost all formal private sector jobs are under "long-term" contracts. This would have made a flexible ER a more instrumental regime to deal with Lebanese high unemployment.

9) Large and increasing foreign debt favors a fixed ER regime as it enable the economy to service this debt in a stable and regular manner. This clearly applies to the Lebanese case. However, it is important to note that Lebanon's foreign-denominated debt was relatively not very large. The decision to issue it (called "original sin" in the economic literature) took place in the early 2000s and reached $31 billion at the time of default in March 2020, or at 37% of total debt. So it would not have been insurmountable to service it under a flexible ER regime.

10) Thin and small financial markets support a fixed ER regime since under a flexible regime only a few large transactions are needed to cause extreme volatility in ER. Lebanon fits this feature well as it financial/FX markets are rather tiny. However, here again one can argue that greater exchange rate flexibility *need not imply free floating but adjustable rates (for instance, adjusting the band around a central party or the central parity itself). In this respect, active ER management can help guide the market, including the use of official intervention so as to avoid substantial volatility and serious ER misalignment.*

11) In "dollarized economies" ER volatility can have serious balance sheet effects so a fixed ER regime is more stabilizing and value preserving. Lebanon has been a dollarized economy since the early 1980s – though dollarization has slowed down during 2008-2015 – so a fixed ER regime is a better fit for the country. One caveat to this assignation, though, is that when it comes to commercial banks' balance sheets – which are by far the biggest balance sheets in the system – most of their FX exposure was to the Central Bank, not the private sector or the "government" [3], which would have made any exchange rate changes or adjustments under a flexible ER have a limited or manageable effect on their balance sheet.

12) The ease of ER adjustment is more apparent and less disruptive under a flexible ER regime. That is because it may be more costly in political terms to adjust a pegged exchange rate than to allow a flexible rate to move gradually by a corresponding amount. Authorities must shoulder the responsibility for adjusting a peg, whereas movements in an exchange rate that is allowed -- to some degree at least -- to fluctuate in response to

[3] To elaborate, banks' exposure to BDL was more than $80 billion, whereas their loans averaged less than 30% of deposits.

changes in the demand and supply for the currency can be attributed to market forces. When the political costs of exchange rate adjustments are high, a more flexible regime will likely be adopted – as should have been the case with Lebanon.

13) Countries who follow a fixed ER regime have always on average experienced lower inflation rates than those who adopted flexible ER regimes. That is of course expected, since inflation rates tend by and large to follow the inflation rates of the country to which the currency is pegged, which in all cases is a stable low-inflation country. No doubt, Lebanon had benefited from its fixed ER regime on the inflation front as inflation rates had rarely exceeded single digits between 1997 and 2019.

14) In contrast, countries that have followed flexible ER regimes have experienced on average higher growth rates than otherwise. The reason is that flexible ER helps countries to better adjust their trade balances and improve their competitive positions in international markets. Of course, Lebanon could have benefited from such a flexible regime especially given its limited industrial base and its need for output and export diversification.

It is clear from the above analysis that the balance of the determinants/characteristics should have favored a flexible ER regime in the post-civil war period for Lebanon. But it seems – perhaps convincingly – that characteristics such as balance sheet effects (primarily), thin FX markets, control of inflation, and foreign debt, had tipped the balance towards a fixed ER regime. The irony is that when the fixed ER regime broke down in late 2019, it is the balance sheets of commercial banks and default on foreign debt that have paid most, if not all, of the brunt of the exchange rate crisis. One would never know, had a flexible ER regime been adopted, whether the ER crisis would have been averted -- as crashes are equally likely under pegged and flexible ER regimes -- but my guess is that its cost and burden would have been less, perhaps a lot less, only because FX reserves would not have been lost and wasted to that horrible extent[4].

Lastly, it pays to remember that *the choice of ER regime may change over time*. When inflation is very high, a pegged exchange rate may be the key to a successful short-run stabilization program. Later, perhaps in response to factors discussed above, more flexibility is likely to be required so as to help relieve pressures and to signal the possible need for adjustments to contain external imbalances. This was exactly the situation that Lebanon was in in the mid-1990s, in the sense that the need for stabilization and rebuilding required a fixed ER regime for specific period of time. But around the early 2000s, specifically 2002 the time of the Paris II conference, the ER system should have moved to a more managed, adjustable flexibility. That was missed, of course, and it was missed again around 2015 when balance of payments deficits started to accumulate and BDL had to resort to its financial engineering arrangements. And the rest is history. Hopefully, this history will be remembered and, more importantly, avoided when devising a new ER regime for the country in the post-crisis period!

[4] By Sept 2021, BDL's net foreign reserves were estimated around *negative $68 billion*.

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