Libya's Liquidity Crunch and the Dinar's Demise: Psychological and Macroeconomic Dimensions of the current crisis

By Jason Pack

21 April, 2017

EXECUTIVE SUMMARY

Libya faces an ever-worsening currency and liquidity crisis which cannot be surmounted without a stable political solution that definitively concludes the struggle for power and legitimacy ongoing since 2014. Yet, the root of the crisis lies not in politics but in the deepening distrust toward Libya's public financial system as a whole. The banking system, which appropriates Libya's oil income and sovereign wealth, is the locus of unique popular disdain. In addition, General National Congress Prime Minister Ali Zeidan vastly expanded the budget in 2012 and 2013, when oil prices were high and Libya was relatively stable; this left his successors with a range of financial commitments they cannot meet.

Compounding these budgetary woes is the emergence of a new predatory social and criminal institution: currency traders who double as smugglers of foreign currency out of Libya. These villains try to capitalize on three overlapping factors: the public's distrust of the banking sector, their need for foreign currency, and the spread between the official and black-market rates of the Libyan dinar. These currency 'smugglers' managed to drive the value of the dinar down from 6 to 10 dinars per U.S. dollar in the space of three days in mid-April 2017, while profiting from the trading arbitrage opportunities thus generated.

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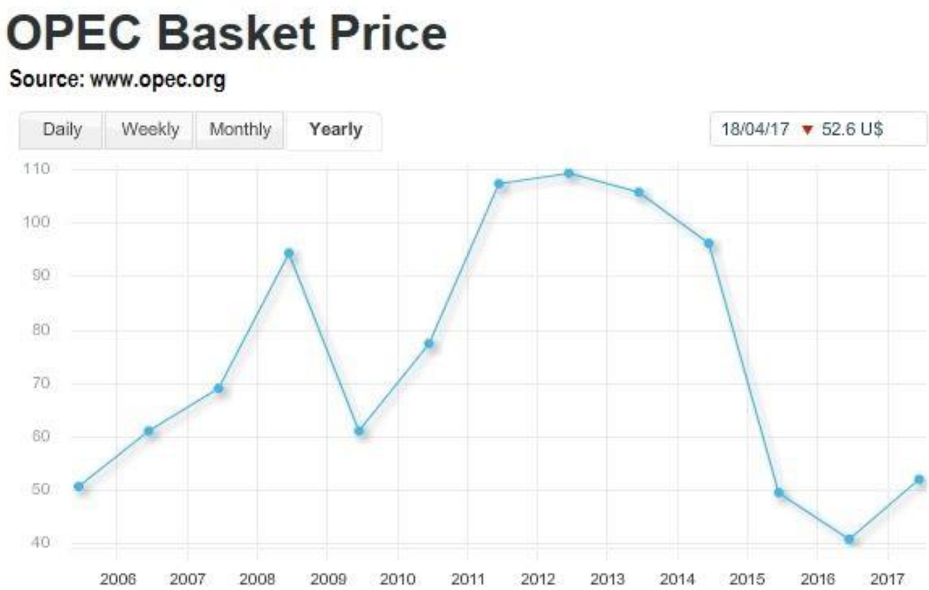
Given the existing budgetary commitments and the psychological legacy of the past few years even if a political resolution to the post-2014 civil war was miraculously achieved, this cannot by itself solve the financial crisis. Confidence in banks will remain low and the currency crisis will persist unless a future political reconciliation is itself built on an agreement on key economic and fiscal rules that can help any successor government restructure the economy and incentivize the Central Bank of Libya (CBL) to undertake major structural decisions such as the official devaluation of the Libyan currency. Until this widespread public distrust of the country's institutions is overcome with an agreement on overarching rules governing how oil money is distributed in the new political system and how the new economy operates, it will be impossible to solve the root causes of the liquidity crunch.



This report contextualizes the liquidity and currency crisis, examines ongoing developments, and looks at how it affects the economy as well as the lives of ordinary Libyans.

KEY PLAYERS

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- The internationally-recognized Central Bank of Libya (CBL) in Tripoli, which nominally operates under the Government of National Accord (GNA), and receives payment for all of Libya's oil sales.
- The rival CBL in Bayda, under the Tobruk parliament – although illegitimate in international law, it borrows from commercial banks in the eastern region. (It imported 4 billion paper dinars from Russia, bucking Libya's established convention of only printing money in the U.K.)
- Audit Bureau of Libya in Tripoli, which has a mandate to audit the revenues and expenditures of the government and although technically this mandate does not include monetary policy, the Audit Bureau frequently vocally proposes solutions to monetary issues. The Audit Bureau also attempts to intimidate the Tripoli CBL and the GNA to try to influence the GNA's spending priorities and budget.
- Commercial banks that are structured to best serve the interests of large depositors.
- Large depositors and businessmen – who, being 'insiders', have tended to withdraw their banking assets.
- Families from the Zliten-Misrata corridor and their associates, who have a dominant grip over the black-market on hard currency.
- Owners of big jewelry shops, who purchase cheap used jewelry with LCs, transform it into gold bullions, sell the gold to Turkey and Gulf countries, and then bring foreign hard currency to sell in the black-market, thus creating more pressure on local currency.
- Kleptocrats who obtain fraudulent letters of credit (LCs) which they use to smuggle foreign currency out of Libya while not bringing the requested amount of goods back into the country as per the terms of their LCs. These kleptocrats are usually connected to powerful militia leaders.

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Letters of Credit and the Informal Exchange Rate:

Government of National Accord (GNA) vs Central Bank of Libya (CBL)

Constantly lacking cash on hand despite a continual expansion of the money supply, the Libyan government faces an ongoing challenge with providing letters of credit to importers. The GNA's favored approach to overcome the liquidity crunch was predicated upon gradual or acute currency devaluation. According to Sami Zaptia of the Libya Herald, "The Presidential Council (PC)/GNA have been pressuring the CBL to devalue the LD from its current official exchange rate of LD 1.4 to the dollar to a rate closer to the sky-high black-market of LD 8 to the dollar. This they feel would cancel the effect of subsidies, solve the liquidity problem and reduce the black-market exchange rate and reduce bank corruption associated with hard currency/letters of credit distribution." This dynamic has been reiterated to USLBA by a coterie of GNA ministers who all feel that the CBL has tied their arms behind their backs by taking away monetary options, in an attempt to force the GNA to enact subsidies reform.

Yet, the Central Bank of Libya has no attractive options either; apparently declining a GNA proposal to devalue the dinar in late 2016, it has so far continued to inject money in to the banking system and encourage electronic payment. Again according to Sami Zaptia of the Libya Herald, "Elkaber, on the other hand, feels that a good part of the black-market value is psychological and political. He does not believe that devaluation alone can act as, as he put it, a 'magic wand', but needs to be part of a comprehensive 'package' of reforms and policies." In short, the GNA wants the CBL to 'act first' on the monetary side, while the CBL wants the GNA to 'act first' by curtailing spending. Such are the political fault lines surrounding this issue.

Even if it was resolved, there are technical impediments as well. Libya lacks modern banking infrastructure, and money paid to cover salaries is quickly withdrawn and not circulated in the economy. As a result, the CBL lacks money to pay for anything else, government investment projects are suspended, and commercial activity is in persistent decline.

LATEST DEVELOPMENTS AFFECTING THE BANKING SYSTEM

Throughout March 2017, political rivals and their allied militias contested control of export terminals in Libya's 'oil crescent'. The combatant parties (Libyan National Army/Benghazi Defense Brigades) pledged not to disrupt oil production and exports to guarantee continuous operation by the National Oil Corporation, and both ostensibly sought to honor that arrangement even as they feuded for control of the ports. Confidence in the banking system continues to deteriorate as the fighting or the threat of future fighting continues, thus accelerating the liquidity crunch as Libyans are keen to withdraw and hoard money. Despite a lack of precise figures, there is no doubt that the lack of accessibility of credit and liquidity is providing a significant break on the Libyan economy certainly in upwards of 5% of GDP.

The economic disarray affecting the country's foreign reserves, oil income, and exchange rate policy is likely to have significant impacts on the country's balance of payments and by extension its imports. Imports, which have sharply fallen in the last three years, are likely to drop further in the coming months as Libya struggles to find the cash to provide importers with the LCs needed.

Libya is continuing to print more dinars – 150 million at the end of March – and this monetary expansion is certain to worsen inflation, i.e. depreciation of the dinar's black-market value. GNA ministers-designate, the CBL, and the Audit Bureau met in Tunis March 29-31 but failed to arrive at any decisions which could alleviate inflation and lack of liquidity.

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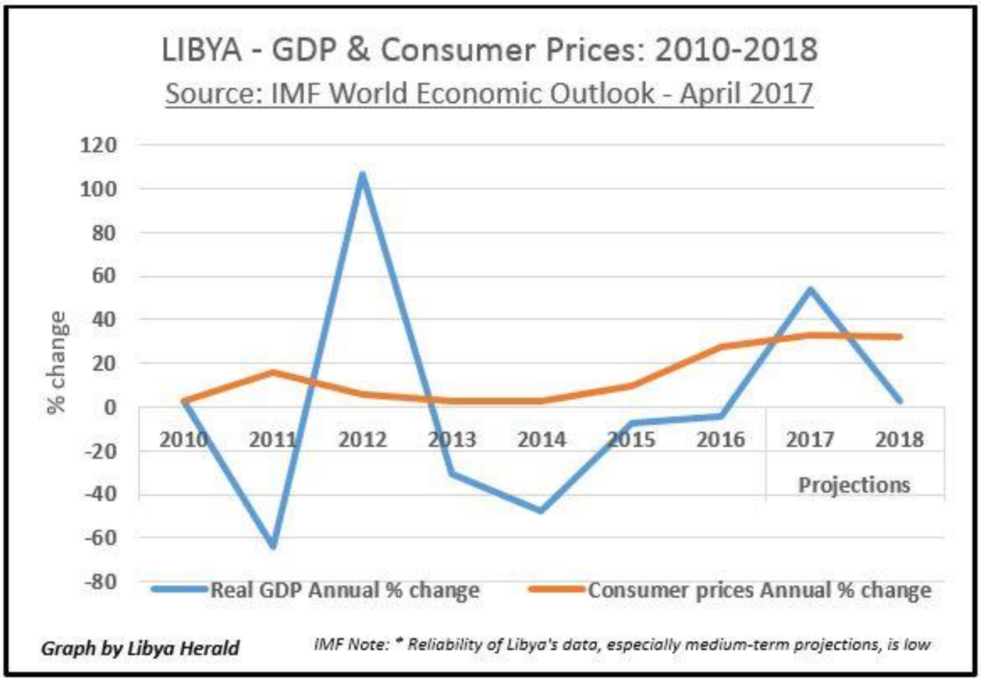

These discussions of what is 'essential' and 'non-essential' in the budget were constrained by the public's sense of entitlement to the inflated salaries that the National Transitional Council (NTC) and the range of victorious actors in the anti-Qaddafi coalition promised in 2011 as a 'payoff' for defeating Qaddafi and that Prime Minister Ali Zeidan further increased in 2013. As such, salaries comprise roughly half of Libya's budget. Moreover, informed sources report that the CBL has been unable to provide LCs to importers according to the schedule set at the start of 2017, meaning that shipments of many goods will be delayed or curtailed.

In early April 2017, the [black-market rate] of the dinar hit US$0.16 for the first time, with forecasters increasingly concerned it could drop to LYD 10 per dollar (i.e. US$ 0.10) on the black-market by the end of the month. In fact, this happened within a few short days, but then was reversed after various currency manipulators had benefitted from the slide. This comes on the heels of public discontent over rising prices of foodstuffs and basic commodities. With the holy month of Ramadan beginning in the last week of May, the CBL is rushing to open documentary letters of credit for several Libyan companies so that consumers will have ample supply of high-end food items in time for demand to peak. The GNA approved US$ 10.6 billion in LCs and cash-against-documents credit facilities for this specific purpose of keeping supplies flowing and affordable during the Eid festivities that mark the end of the holy fasting month. The move was met with swift condemnation from Abdalla Fellah, head of the Libyan Businessmen Council. Fellah criticized the lack of transparency, alleging that LCs were opened "quickly and for the same companies without informing anyone and in the utmost secrecy and with the utmost speed came the proposals of the CBL and its proposal to the companies supplying." Fellah also remarked that these preferential-rate LCs – at the official exchange rate of 1.4 dinars to the dollar – were only limited to businessmen with favored ties to the CBL. Rising indications of corruption in the issuance of LCs may provoke popular protests or a wave of reprisals or counter measures against specific traders or shipping agents.

BACKGROUND AND CONTROVERSIES

The September 2014 court ruling in Tripoli which declared CBL Governor Sadiq al-Kabir illegitimate – thereby possibly nullifying all of Kabir's subsequent decisions – was kept concealed for over two years. The *Libya Herald* reported on March 12, 2017 that the Eastern Central Bank of Libya (i.e. the branch that derives its legitimacy from the House of Representatives) posted the court ruling to its Facebook page, a move that ostensibly threatens to derail the Presidency Council's funding through the Temporary Financial Agreements which resulted from the PC's negotiations with the CBL in Tunis, Rome, and London. (Yet, in reality, everything is moving forward as if the court case never happened – similarly to the other Libyan supreme court cases ignored by the international community.)

This bizarre chain of events – a secret court decision against a central bank governor who was allowed to continue in his post after being formally dismissed – is unprecedented in the history of central banking. Although some Western diplomats told USLBA they believe the court decision will have no meaning (just as the November 6, 2014 decision relating to the legitimacy of holding the June 25, 2014 election for the HoR has been completely side stepped by all international players), we contend it is bound to have political consequences on Kabir in the court of public opinion: It will only cast further doubt upon CBL credibility and further decrease confidence in the banking system.

TIMELINE: COURT DECLARES CBL GOVERNOR ILLEGITIMATE

- September 2011: National Transitional Council (NTC) appointed Sadiq al-Kabir the CBL governor for a five-year mandate ending in September 2016.
- September 2014: CBL governor is secretly dismissed by the then-newly elected HoR on corruption allegations and refusal to report for questioning. By those privy to this decision, this is seen as part of the larger Tobruk-Tripoli split and not an issue about Kabir's term, mandate, or competence.
- September 2014: In a response letter to the HoR, the governor pledged to step down once his legal remedies have been exhausted. This pledge has since disappeared from both the governor's and the public's discourse.
- October 2014: Governor challenged his removal in the Tripoli Court of Appeal.
- November 2014: Tripoli-based Supreme Court of Libya declared the HoR illegitimate.
- January 2015: Tripoli court of appeal determined it has no jurisdiction over the HoR's decision. The appellate court ruled that the HoR is the only legitimate legislative authority in Libya, a decision contradicting the Supreme Court's position.
- January 2015 – March 2017: The appeals court's ruling is kept confidential.
- April 2015: HoR 'sacks' Kabir a second time. Yet the CBL governor was not successfully removed from his post nor his powers of management of the CBL curtailed. As example, he made staff changes at the CBL later in the year.

- December 2015: The U.N.-brokered Libyan Political Agreement (aka Skhirat agreement) mandates that the new CBL governor shall be appointed by the mutual consensus of the HoR and State Council. (This has yet to happen.)
- March 2017: The CBL in Bayda posted the court ruling as a 'retaliation' for the Benghazi Defense Brigades' (BDB) seizure of the oil crescent and the optic that various parts of the GNA helped the BDB.
- April 2017: The Libyan Dinar plummets and prominent institutions like that of the Libyan Businessmen's Council, the Libyan General Union of Chambers of Commerce and Industry, and the Commerce and Development (C&D) bank all publicly state that devaluation or flotation of the dinar is the only solution to Libya's economic woes. Libya is now in the position whereby its attempts to solve its internal currency/liquidity crisis would normally require IMF consultations and discussions with the US Treasury department.

It is not completely clear who released the court ruling, yet there are two clusters of plausible scenarios:

1)Principled Action/Corrupt opportunism/Public Pressure/HoR faction Scenarios

In certain circles in Cyrenaica (Libya's east), the CBL governor has garnered a reputation as presiding over the destruction of the entire financial system leading to immense financial and humanitarian suffering. Staunchly conservative judges on the supreme court may have chosen to release the ruling as a matter of principle. Furthermore, it could also be an issue of interested parties disclosing the ruling for their gain. After all, the ruling is hand-written on a single piece of paper and court administrative staff appear to have been able to obtain copies and even sell them to interested parties. Alternatively, supporters of the HoR or Field Marshall Khalifa Haftar could have chosen to leak the document, believing such action would strengthen the eastern faction and further the push to ultimately split Libyan institutions.

2)GNA's need for formal devaluation/Tripoli faction Scenario

It stands to reason that, the 'Tripoli faction' to which the CBL governor loosely belongs no longer welcomes the governor in this position or wishes to put the governor under pressure to cooperate more with the GNA. The underlying tension between the GNA leadership (PM and DPM) and the CBL governor adds credence to this possibility; the CBL governor has refused the measures proposed by the GNA to solve the liquidity crisis, particularly the gradual or abrupt devaluation of the Libyan currency.

MONETARY OVERVIEW AND PSYCHOLOGY OF THE LIQUIDITY CRISIS

According to Said Rachwan, a Libyan banking and financial expert who is also the coordinator of the Libyan National Popular Movement, US$140 billion was transferred outside the country by suspicious letters of credits and US$20 billion to the local black-market since 2011. On the other hand, the Central Bank of Libya (CBL) confirmed in 2016 the existence of *at least* 24 billion in local currency outside the banking system; Libyan financial experts say this represents over 90 percent of total liquidity. Suliman al-Shahomy, who founded the Libyan stock market, notes that the current liquidity crisis is characterized by the existence of a large amount of liquidity outside the banking system and the widespread insolvency of public and commercial banks, which signals a lack of confidence in the banking sector. This insolvency is mostly inflicted on the 1.3 million employees and retirees in the public sector, who receive monthly salaries via direct bank deposit. Given the uncertainty surrounding the banking system, salaries are usually immediately withdrawn by individuals from their bank accounts as soon as they are released by the Ministry of Finance.

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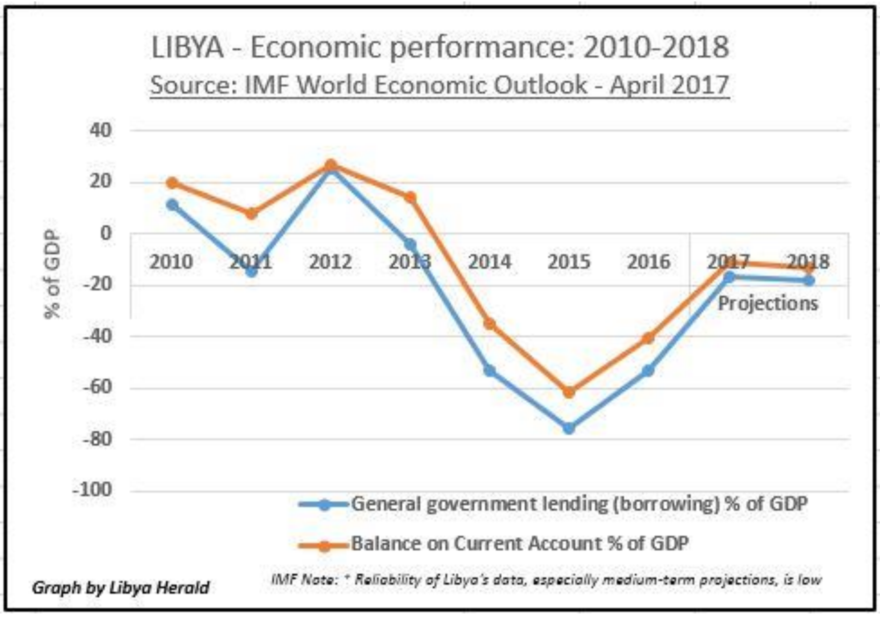

In October 2016, Rajab Msalati, former governor of the CBL (1981-86), indicated that approximately 36 billion Libyan dinars are outside the banking system – or 5,000 dinars per capita. This liquidity is not only being kept outside the banking system, it is largely not circulated in the economy either. Msalati further indicated that the legal prohibition on usury has contributed to the ongoing banking crisis, in that many Libyans have avoided making bank transactions on religious grounds (law 1/2013, dated 07/01/2013 and effective 01/01/2015). The law is seen as religiously sensitive and has been ignored in most academic and professional discussions on the Libyan economy. Nonetheless, it has affected liquidity as current account overdrafting services, which entail interest on overdrafting and are largely used by businesses and suppliers, have been suspended, prompting banking withdrawals in local currency by large depositors. Widespread exiting of the banking system began in 2013 with intense political polarization between liberals and conservatives. It was clear in early 2014 that the country was heading toward some sort of political and military turmoil, which materialized with the contestation of election results and the military confrontation in July, a turning point in the post-revolution political transition process, which opened up the Tubroq-Tripoli split.

Many Libyans, especially businessmen, believed the country would not achieve a desirable political resolution and fled to neighboring countries and Europe in search of better lives. Libyan officials had underestimated these developments and were caught unprepared for the ensuing deposit and savings withdrawals and capital flight.

The attack on the Mabrook oil field (a joint venture between NOC and Total) on February 3, 2015 and the subsequent NOC declaration of force majeure on 11 oil fields caused the first pronounced liquidity crisis when local currency started deteriorating against the U.S. dollar in the black-market. Average citizens' primary source of hard currency as dinars are not convertible to dollars at the official rate in Libya's banks. This black-market exchange rate began being monitored on an hourly basis on social media networks, prompting widespread panic about the dinar's purchasing power. Soon after, depositors queued outside banks.

According to Libyans we interviewed, the period when the black-market exchange rate reached 2 LYD/$1 in late 2014/early 2015 occasioned a psychological shock and signaled a fundamental change in Libya's perception of their currency. Previously, Libyans perceived the liquidity shortage they experienced from 2011 to 2014 as stemming from logistical aspects, budgetary over-commitments by the NTC and GNC, and worsening security conditions. After this psychological barrier was breeched, many Libyans have come to see their currency as essentially without real value – thus setting the dinar on a course of indefinite collapse. The immediate actions of depositors and wage earners were to exit the banking system as a whole and to always prefer hard (i.e. non-Libyan) currency when given a choice.

As example, when the author of this report offered in early March of 2017 a highly-educated Libyan student in the United States who was to be returning to Benghazi shortly, 1,000 LYD cash in exchange for US$100, she declined even though the black-market rate was at that time below 7LYD to the Dollar. Even though this transaction was more favorable for her than any black-market rate she could obtain in Libya, and she would certainly need cash dinars to spend on her return home, she told the author, "I don't believe the dinar has any real value. If I am gonna have cash I'd rather just have $100 even than two thousand dinars." This sentiment echoes the classic herd mentality which during a currency crisis facilitates massive inflationary spirals and bank runs.

The psychological components of the currency crisis are compounded by the physical insecurity pertaining to banks and cash. Banks are intimidated by militias, and collaboration and coordination between banking staff and armed gangs to set up and rob large depositors have been confirmed, resulting in arrests. Large depositors' confidential banking information concerning names, dates, and times of bank withdrawals were being disclosed to armed gangs by banking staff resulting in numerous murders, kidnappings, armed robberies, home invasions, and ransom demands, sowing distrust in the banking system and spurring further large-sum withdrawals.

The issue of robberies is only one component of defrauding the banking system – the far larger worry is fraudulent letters of credit that drain Libya of its foreign reserves without bringing in sufficient goods. Those who engage in this behavior are essentially currency smugglers as they take advantage of subsidies on currency just the way their counterparts take advantage of subsidies on petrol and foodstuffs which they then smuggle into other markets and sell at higher prices. This widespread 'kleptocracy' is a large causative factor in the current liquidity and currency crisis, but one for which little precise data is available so we are not able to discuss it at length in this report. On the positive side of the leger, in April, the efforts of the NOC's Fuel Crisis Committee has been able to successfully combat fuel, goods. and livestock smugglers, positively affecting the availability of fuel in rural areas and having a positive effect on vegetable and meat prices. In mid-April, the navy and air force have also begun a crackdown on the waters from Zawiyya to Ras Jdeir. Although, these efforts may spur militia rivalry they appear to be gaining effectiveness in combatting smuggling.

In addition to the instability of the banking sector and 'currency smuggling', there are other concrete legal reasons that have led to the currency shortage. Experts have argued that with CBL imposing strict regulations on opening letters of credit in January 2017, and insisting that they are100 percent backed up in local currency while also limited them to basic food items and medicine, induces businessmen with stakes in the import of non-essential goods move against the CBL by withdrawing large deposits. This assertion would substantiate the press exchanges between the CBL and the Libyan Businessmen Council, and explain how the GNA's stopgap tariff policy is not stemming the collapse of the dinar but rather exacerbating it. In short, there is clear panic among Libyan depositors; pumping more liquidity is not going to solve the problem. Yet this is the solution that both the GNA and HoR have essentially adopted, having more money printed abroad and imported into Libya, without dealing with the underlying structural factors that cause the liquidity crunch.

IMPACT ON HOUSEHOLDERS

Even as depositors queue outside insolvent banks across the country, a walk around Libyan cities and towns shows that paradoxically there are as yet not as many signs of the deepening liquidity crisis as one might expect given its severity. Normal commercial activity takes place around the country: supermarkets, coffee shops, butcher shops, and gas stations are not only open for business, they are crowded. Luxury goods such as automobiles and newly constructed houses, villas, and apartments continue to be sold.

Until recently, Libyans were not especially concerned about their ability to secure basic foodstuffs. Up to March 2017, their primary worries related to hard currency could be said to relate to their ability to travel to escape the domestic turmoil and receive medical care in Tunisia and Egypt, where healthcare services are superior to those provided in Libya. People from the western region of the country have often traveled to Tunisia for medical tourism, but with the collapse of Libyan currency against Tunisian currency – currently 1 LYD/0.33 TND (versus 1 LYD/1.15 TND in 2014 and 1 LYD/1.25 TND in 2010) – Tunisian clinics have confirmed a substantial decrease in the number of Libyans coming to pay for healthcare from out of their own pockets.

To be sure, almost no one is starving in Libya and ordinary Libyans keep stockpiles of food that cover several months and wage savings over multiple years of earnings at their homes; this explains why the public panic doesn't yet match the severity of the current bank insolvency and its implications for the financial system as a whole. Beginning in April 2017, however, Libyans began to convey that they will no long tolerate the rising costs on certain everyday goods. CBL employees are protesting against Sadiq al-Kabir himself. In Tobruk, consumers publicly protested the rising cost of meat and demanded a boycott of butcher shops; the price of lamb has nearly doubled in the past year. The World Bank noted in October 2016 that "Lack of funds to pay due subsidies to importers and distributers of basic food since October 2015 translated into a de facto removal of subsidies to food. As a consequence, shortages in the supply of food emerged and the black-markets prospered".

Despite these crises relating to some everyday goods, others remain unaffected. Miraculously for a country embroiled in a civil war experiencing incredible enmity between regions, cities, neighborhoods, clans and tribes, and a banking system in the verge of total collapse, Libyans still enjoy comfortable lives insides their homes. For example, they don't have to pay utility bills and taxes; cars and gasoline are inexpensive to purchase; they can miss work with little to no accountability; many fraudulently draw multiple salaries from the government into their direct deposit accounts by using the IDs of deceased or fictitious family members.

Salaries have increased as much as fourfold since 2011. Despite these wage hikes, there is a clear decrease in household spending, principally related to uncertainty in the future and decreased purchasing power. If Libya continues to experience extremely high levels of inflation – which could result from continual increases in the money supply by the GNA and HoR – the bank liquidity crunch will no longer remain manageable. Should this transpire, Libyan householders will eventually exhaust their cash savings and likely exit the banking system as they flee to hard currency.

IMPACT ON BUSINESSES

The Libyan economy is wedded to oil exports which generate hard currency revenue, which is then used to pay for everything else. (Despite having barely any direct trade with the United States, Libya's economy is tied to the dollar, because most oil is traded in dollars.) The large dollar liquidity generated from oil sales is not only being kept outside the banking system but is also largely uncirculated in the economy. The immediate impacts have been:

- The CBL releases funds, as part of government's budget, only for salaries and expenses to run administrative and bureaucratic structures;
- Investment projects by the government have been suspended (infrastructure, housing, etc.), which are awarded to local and international contractors and highly profitable as they are inflated;
- Substantial decrease in retail business economy, while consumption remains high by comparison;
- Substantial decrease in car and auto parts sales;
- Many furniture and luxury items businesses closed;
- Substantial decrease in sale of construction materials, industrial tools, and machineries;

- Almost total disappearance of foreign manpower, which is a direct indicator of the state of economy and consumer spending.

Different Attempts to Contain the Dinar's Black-market Nosedive

Both those who would like to see al-Kabir evicted and those who would like him to stay in place but take action to defend the Libyan currency propose a range of strategies to contain the slide of the dinar: some favor flotation, others tariffs on imports, and others a total freeze in LCs at the current rate and the imposition of a new exchange rate such as 4 LYD to US$1. At present, it is the GNA blaming the CBL for the liquidity crunch and hence the ensuing problems with LCs. This last interpretation was supported by the fact that Deputy Prime Minister Ahmed Maetig has on multiple occasions publicly and privately taken responsibility for the February 2017 decision to raise the [import tariff funded through LCs to 100 percent for non-essential items]. Tariffs of this sort – intended to increase state revenues, rather than just to protect a specific sector – are supposed to be collected in advance, at the opening of letters of credit and payment of cash against documents. The Libyan Businessmen Council, the only legally recognized Libyan business council, criticized the measure and requested reconsideration given the immediate effects on prices of importation of goods.

According to various public and private comments, Maiteg would have preferred to avoid this measure and just reform the exchange rates, but as the CBL is in control of the money supply and related matters and the CBL did not take steps to float or devalue the dinar, etc., Maiteg used his GNA portfolios over imports and legislation to pass the tariff measure. Maiteg knows how unpopular the tariff is and how much distortion it creates in the market. He only supports the measure as a temporary stopgap to plug the escape of hard currency via LCs at the official dollar rate. Therefore, he and other knowledgeable and economically sophisticated players in the GNA are hunting around for a political opportunity

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for a more lasting solution. They know that the Libyan public is not ready to have subsidies and entitlements granted under Ali Zeidan taken away now and that any politician who attempts to do so could find his head on a platter. Yet in the meantime while these politicians kick the can of extraneous budgetary commitments down the road, it stands to reason that the powers in the GNA who conceived this tariff are not going to provide a loophole for companies which export 'non-essential' items to Libya and would prefer to circumvent the measure.

In short, this piece of legislation is likely to remain on the books until the official rate of the dinar is devalued, the current CBL governor is replaced, subsidies and salaries are completely reformed, or the GNA collapses. It is not known how the tariff is being enforced and it is, of course, possible that enforcement is lax and variable.

That such a measure has been adopted shows that too much momentum exists for the current system and that the GNA and its supporters simply lack the levers of power to enact either flotation or fixed devaluation for the purposes of LCs in the face of opposition from the CBL.

MEASURES TAKEN BY THE CENTRAL BANK

The Central Bank of Libya has, to date, deployed only limited, inefficient options to address the crisis, fearing political blowback if bold measures were selected.

Injecting More Money

- The CBL continues to import goods and inject money into the banking system to cover salaries. New quantities are immediately and completely withdrawn in just hours.

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- The CBL decided to permit depositors a one-time withdrawal equivalent to $400 in local currency. It is unclear whether this amount would be withdrawn in cash or transferred to an electronic card. The CBL indicated the measure would be more frequent if revenues in hard currency are improved.

Electronic Payment

The CBL has encouraged electronic payment, however many Libyan experts have confirmed that the banking system has no proper infrastructure. Software and information technology companies working in banking solutions in several African countries indicate that Libya has never been ready to implement a banking system for electronic payment which requires a combination of infrastructure and culture to function effectively. According to an October 2010 World Bank analysis, Libya is among the Middle East and North Africa's countries with the lowest potential for mobile banking.

MODERNIZING LIBYA'S BANKING INFRASTRUCTURE

A payment clearing and settlement hub (the National Payment System) was discussed in 2002 and implemented in April 2008 with the assistance of American and Swedish companies. The system – which is owned, housed, and operated by the CBL – is composed of a core banking system, automated teller machines (ATMs), automated checks processing, automated clearing house (ACH), real time gross settlement (RTGs), and point of sale (POS) servicing. A high level of security is needed to protect a payment clearing and settlement hub from threats external and internal. However, this does not appear to be in place; a CBL source told us that CBL staff, including senior officials, have behaved carelessly with regard to security, demonstrating a lack of familiarity and training in protecting secure information.

The electronic banking system, which has not been updated since 2008, did not have sufficient time to take root culturally in Libya in the three years prior to the revolution.

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Because of this, the Libyan cultural predilection to avoid electronic banking has persisted in the aftermath of Qaddafi's ouster where other pressures have favored a retreat to cash. In addition, the hardware, software, IT companies, and fiber-optic communications infrastructure which Libya needs to conduct business in real time are absent, owing to an inability to attract this kind of foreign investment given the ongoing instability. There are a number of ways in which Libya can gradually modernize its banking infrastructure with the assistance of the international community and multinational corporations: enhance the country's fiber-optic communication network; contribute to the development and installation of the National Payment System, consistent with international standards and norms; provide technical assistance to establish inter-banking communication according to uniformed protocols; improve the low density of ATMs and points of sale. Adopting standards and best practices from neighbors such as Tunisia would benefit Libya. According to Tunisian financial services companies operating in the field of banking solutions, it is more effective to have the interbank electronic clearance run by a separate government company that acts as the hub between CBL and commercial and public banks similar to SIBTEL in Tunisia (*Société Interbancaire de Télécompensation*). This requires a new legal framework and international companies, particularly contractors from neighboring countries, to install and upgrade the system.

MOVING FORWARD: POSSIBLE TEMPORARY POLITICAL SOLUTIONS

Foreign actors need not wait until Libya has sorted out its currency devaluation to illuminate a path out of the liquidity crisis. Given the significance of the psychological roots of the crisis, alleviating these anxieties ought to be a first step. One positive indication thus far has been the resumption of diplomatic activities and embassies in Tripoli by Italy and in Tripoli and Misrata by Turkey. These diplomatic posts have immediate business relevance: the Italian Embassy is helping Libyans obtain Schengen visas, while the Turkish consulate grants visas that facilitate crucial business travel not only to Turkey, but through Turkey to other destinations. Ordinary Libyans and officials alike have responded positively toward the reopening of these embassies and consulates in particular, and it would go a long way toward signaling better things to come if the United States, United Kingdom, France, China, Spain, Germany, and other global powers reestablished diplomatic presences.

For example, high ranking Western and Libyan officials have suggested to USLBA that embedding a handful of Western special operations forces at oil export terminals could go a long way toward restoring Libyan confidence that the ports are secure and in order. This may seem a controversial proposal that would incite a backlash from Islamist extremists, yet doing so would not only prevent the sort of violent conflicts which in March 2017 interrupted production, but would have a stabilizing effect on the dinar. In short, such an international security force could possibly 'pay for itself' and not become a target for jihadis if its optics are managed delicately. As Libyan oil production steadily increases, the country will have more hard currency on hand, hopefully restoring a modicum of trust in the fractional reserve system. In short, the rate of the dinar in the black-market is largely driven by psychological factors and this explains why the dinar spikes every time production is interdicted at either the Ryayana valve in the West or the main Oil Crescent ports in the East. If it were purely cold, hard economic facts, rather than Libyans' Keynsian animal spirits, driving the black-market rate, there would be a long lag between blockades of production and the effects on the currency, as it takes a long time for oil payments to be processed and Libya's macroeconomic fortunes to be affected. And yet in reality, currency traders and kleptocratic currency smugglers capitalize on the sense of panic that sudden decreases or blockages in oil production occasion on the Libyan psyche by quickly hiking the black-marketblack-market dinar rate at exactly the moment that scared Libyans attempt to buy foreign currency as a hedge against a perceived future economic collapse. As such psychology, more than the straightforward supply and demand of the various currencies, determines the dinar rate and allows currency traders to manipulate rates and fleece regular Libyan savers. This dynamic is present in other societies that have a large black-market in currency, yet it is uniquely potent in driving Libya's economic and liquidity woes. Therefore, it must be addressed by public policies targeted for this cultural and structural environment.

Another such policy would be to precisely delineate the CBL's policy options and the role of monetary policy in the Libyan context so to provide more confidence for the public in bankers. This could be combined with issuing a decree as to the required credentials and selection process of future CBL governors.

Some within the GNA have asserted that the gradual devaluation of the dinar to 3.9 or 4 LYD/$1 as opposed to the current 1.4 LYD/$1 in official exchange which could push black-market rates down to 5.8 LYD/$1 via issuance of LCs at the new, higher, exchange rate would promptly ease pressure on liquidity. Yet it would not necessarily immediately calm the psychology which causes flights away from the dinar into foreign currencies. Various Libyan ministers prefer a gradual devaluation tied to a raft of other non-monetary measures, whereas IMF orthodoxy would tend to favor a kind of austerity and one off-devaluation.

Devaluation is not currently preferred by the CBL largely because it is refused by much of the Libyan population. Therefore, even if enacted, it will not likely be able to bring foreign investments and promote exports, akin to when this measure is efficiently used in other countries which export manufactured good. Libya is also not a labor-intensive economy, so devaluation will not likely attract more international investment in any manufacturing sector.

Herein lies the psychological nub of the crisis in Libya: Devaluation would have to be tied to political and confidence building steps to reassure Libyan currency holders. Such steps might include the announcement of a Western capacity building or aid package or the publicizing

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of an agreement between Eastern and Western political blocs that they support such a measure.

In the case of Libya, devaluation may only temporarily slow the run toward hard currency and price increases, but without a larger economic deal setting key fiscal caps on government spending, it cannot be sustainable. Given the current macroeconomic climate, Libya's hemorrhaging reserves and the weak price of oil, there is no magic bullet to stop the crisis. But devaluation could buy Libya time if tied with incremental political progress and the cutting of subsidies. Should the government increase oil revenues and provide hard currency in orderly and restricted manner, confidence in the banking system could be gradually regained and a virtuous cycle could prime the pump of economic activity. These measures could help build the political will needed for the larger structural changes we allude to in the conclusion section of this report.

Opportunities for American and Western Businesses

Despite the liquidity crisis, opportunities remain for Western and specifically American businesses operating in high-demand sectors:

- Solar energy: Libya is currently unable to produce enough energy to meet demand, and thus needs to buy solar panels. (Load peak reached 7200 MW in January 2017 with generation capacity of 4000 MW.)

- Construction of power plants in southern Libya to stabilize the grid: Except the suspended commissioning of Ubari power plant by the Turkish construction conglomerate ENKA, no electricity is generated in the south and the Chinese lack the historic and diplomatic connections to exploit this market;

- Oil Sector: Libya will continue to provide lucrative investments in the oil sector, whether to explore and produce new hydrocarbon deposits, or in the privatization of the downstream oil sector; including all production, sale and distribution of different petrochemicals.

- Transportation: a stable Libya presents immense opportunities for transit trade investments, bridging European access to African emerging markets, including in shipping and aviation.

Conclusion

The Libyan economy and its currency is headed towards a rapid collapse if the vicious interlinked cycles of inflation and bank insolvency continue. As explained in this special report, the roots of this crisis are deeply structural, but Libya has actually been able to weather the storm quite well over the last 6 years due to plentiful supplies of foreign reserves accumulated from the sale of oil over the last 10 years. These reserves were largely used by the Central Bank to fund the extremely large deficits of the last 4 years. The tipping point of reserve exhaustion and public frustration has only recently been breached. Since then, the Libyan people's trust in the whole financial system has been decimated as they have begun planning privately for the financial meltdown which is around the corner even if publicly Libyan officials have not begun making such long-term calculations.

If Libyans were at first shocked when the dinar plunged to 2 per dollar, at this point they are numb. The black-market rate is now at 8 dinars per dollar and projected to permanently exceed 10 if no macroeconomic readjustments or significant increases in oil production are achieved . Furthermore, Libya's surging inflation may have irreparably damaged the public confidence in the country's local currency. If left untreated, Libya could become like various Latin American economies where housing and car prices are quoted and paid for only in dollars and significant inefficiencies are introduced into the whole economy by the eclipse of the national currency as the primary vehicle of commerce.

A blanket political resolution is necessary, but without this resolution being founded upon a new economic deal governing how oil revenues are managed by the redistributive banking sector, it will be insufficient to permanently rescue the economy no matter how much oil Libya has underneath the ground or how much reserves it has stashed away in Western banks. Prior to whole cloth re-writing the Libyan socio-economic contract, temporary fixes are required in the meantime to calm the psychological drivers of the current crisis. One such fix that is being argued by a range of Libyan actors, from the heads of various banks and business associations to the top ministers of the GNA, is gradual or a one-off devaluation of the Libyan dinar, coupled with a policy to provide dollars at the new rate. If this was done without restrictions to traders and personal consumers it would drive up the value of the Libyan dinar in parallel exchanges and bring back trust and liquidity into the banking system.

However, without the larger structural budgetary element, this step would still be unlikely to put a permanent stop to the dinar's slide relative to the dollar. Another temporary fix would be to find ways to ensure that Libya's oil production and revenues rebound, by addressing the ongoing civil war on the one hand and the budgetary problems which are currently standing in the way of utilizing more investment in necessary oil infrastructure to drive Libya's recovery of crude production. It could also be argued that without a comprehensive economic and political deal, there will be no guarantees that oil keeps flowing as various social sectors have repeatedly demonstrated their willingness to shut off production if they feel they are not fully sharing in its gains.

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Many international analysts and domestic and diaspora Libyan intellectuals believe that Libya needs a major economic deal to underpin a political resolution that can resuscitate the economy and bring back trust to its currency. There are already calls by some Libyans who have been putting forward for some time plans for a Libyan Economic Agreement (LEA) to make the stalled Libyan Political Agreement (LPA) workable. The LEA would establish new fundamental principles and guarantees governing the new economy and its entire Public Financial system. The Central Bank of Libya would have a critical role to play in this framework and could bring back trust to Libya's failing economy in a new way. The basic principal of the LEA is inalienably guaranteeing each locality/municipality (based on population), and each individual citizen, a fixed amount of Libya's resource and sovereign wealth in an . This would then obviate any incentives to fight over resource distribution.

Baring such a comprehensive rethink of Libya's public finances, the country is likely to remain mired in political conflict and economic instability. Nonetheless, while Libya's social contract is waiting to be changed -- from its Qadhafian iteration of popular quiescence in exchange for a modicum of stability and an unequal distribution of the spoils of Libya's oil wealth, to a more equitable and empowering social contract -- structural, economic, monetary, and political reforms are needed so that Libya's sovereign wealth is not irrevocably dissipated.

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The U.S.-Libya Business Association (USLBA) is the only nonprofit member-based trade association focusing solely on the United States and Libya. Since its incorporation in 2005 the USLBA has sought to facilitate opportunities for mutually beneficial trade and investment, enhance the bilateral diplomatic and commercial relationship, and educate the public about the importance of U.S.-Libya economic ties and about the complex issues facing the Libyan economy. This special report constitutes the performance of USLBA's educational function. The USLBA welcomes inquiries about our program and the benefits of membership. Please contact us at information@us-lba.org.

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Most importantly, this research is meant to promote the joint educational aims of the US-Libya Business Association and of the Libyan Investment Summit 2017 hosted by IRN at the Pera Palace Hotel from 9th-11th May 2017 in Istanbul, Turkey.

All companies which find out about this summit as a result of reading this special report (and have not previously registered) shall be granted a 10% discount per attendee by utilizing the promotional code 'LIS10' when registering via either the official event website (http://www.libyainvestsummit.com/).

The Libya Investment Summit will address numerous business opportunities within Libya. The conference will be a platform where many prospects for investment will be presented.. There will be a major focus on construction/reconstruction, banking, infrastructure, risk management, and the oil & gas industries. The issue of the liquidity crisis, impact of possible devaluation of the dinar, and changes in Letters of Credit procedures will also be discussed. Delegates will be able to gain a first-hand insight into the present state of play for conducting business on the ground and have dialogues and discussions with key stakeholders -- learning how to engage in successful business and investment strategies in Libya. Therefore, please utilize this discount code and book your attendance.