

## Currency Board: A Path to Economic Recovery in Lebanon

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### Executive Summary

Today, the Lebanese pound suffers from a loss in confidence and soaring velocity. The currency has lost more than 80% of its value and Lebanon's inflation has reached levels higher than those currently registered in Zimbabwe, Syria, or Sudan. This paper argues for establishing a currency board in Lebanon with the support of a credible international expert on currency board. The currency board would almost immediately stabilize the Lebanese pound and transform it into a currency with falling velocity able to attract capital seeking arbitrage opportunities. This stability would immediately stop inflation and currency devaluation creating a framework enabling public sector and banking reforms and laying down the foundations for renewed economic growth.

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## A. Lebanon: A Severe Currency Problem

Lebanon is currency suffering from a currency problem, producing hyperinflation and devaluation and adding to the pain associated with the economic meltdown. Back in 2015, monetary discipline was sacrificed to attract foreign funds. The monetary system resulted in the collapse of the pegged exchange rate of the Lebanese pound (LBP) and the adoption of an unofficial managed float.

### 1. Troubled Currency Adding the Pain of Economic Meltdown

Lebanon currently suffers from a highly unstable currency. The inflation rate is estimated at of 287% per year, higher than Zimbabwe, Syria, or Sudan. Inflation in Lebanon is driven by the depreciation of the Lebanese pound (the increase in the exchange rate of the dollar). In the black market, the Lebanese pound has lost more than 80% of its value compared to the official rate. Real GDP in Lebanon contracted by 6.7% in 2019 and by another 25% in 2020, according to IMF projections.<sup>1</sup> Given the combination of negative growth and the sharp depreciation of the currency, GDP measured in US dollars, at an average exchange rate of LBP 5000 per dollar for 2020, is expected to drop to \$18 billion from \$52 billion in 2019, based on IMF figures.

The Lebanese pound continues to collapse with the loss of confidence and the continuous increase in currency in circulation. The banking system (including the Banque du Liban, or BdL) lent \$32 billion and 70 trillion LBP to the Lebanese government plus \$24 billion and 22 trillion LBP to the private sector. Therefore, at the current market exchange rate of LBP 8500 per dollar, total bank loans are around \$67 billion (\$74 billion at the average rate of LBP 5000 per dollar for 2020). In current conditions, with a shrinking economy, neither government nor the private sector can pay their debt and banks will remain insolvent.

On March 9, 2019, the government defaulted for the first time in Lebanon's history on a \$1.2 billion Eurobond. The total public debt consists of 85.7 trillion of LBP-denominated debt and \$33.3 billion of foreign currency debt. At the current market exchange rate level (8,500 LBP per US dollar) the debt is \$43 billion; at an average rate of 5,000 LBP per dollar, the debt would be around \$50 billion. The government is struggling to find the correct approach for the negotiation with creditors.

This insolvency triggered a run of depositors driving the banks to impose capital controls on old dollar deposits (deposits made prior to November 2019). Therefore, three currencies are currently in

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<sup>1</sup> IMF World Economic Outlook database, October 2020.

The World Bank estimates Lebanon's growth in 2020 at -19.2%; see *Lebanon Economic Monitor: The Deliberate Depression*, World Bank Group, Fall 2020.

circulation in Lebanon: the Lebanese pound, the US dollar (fresh dollars), and US dollar deposits stuck in Lebanese banks (old dollars, also called “Lollars”). The market value of old dollar deposits is currently 33 cents on the dollar and decreasing with the devaluation of the Lebanese pounds.

## 2. Role of Monetary Policy in Amplifying the Crisis

Back in 2015, capital outflows started to take place. Instead of reducing the money supply to maintain the exchange rate peg, the central bank kept expansionary monetary policy going. BdL doubled its holdings of public debt from around 30% of the total in 2015 to around 60% today. At the same time, BdL used unconventional financial operations (“financial engineering”) to attract capital inflows and support the peg. Effective combined yields in LBP and USD were approximately 17% on a 10-year loan.

The central bank sacrificed a normal, disciplined monetary policy to attract foreign funds at extraordinary and artificially high interest rates to prop up the balance of payments and the currency. It worked for a while, and then the fundamental unsoundness of the policy led to exchange controls, depreciation of the currency on the black market, high inflation, depression, and large losses to banks.

## 3. An Unofficial Managed Float

The Diab government released a reform program in April 2020 recommending wiping out banks’ capital and adopting a managed float instead of the current peg. The Money and Budget Committee of the Parliament rejected the government’s plan and the massive explosion in the Port of Beirut on August 4 led to the resignation of the Diab cabinet. Lebanon has since taken no serious action to resolve the economic meltdown.

Practically the only policy that was implemented in response to the crisis was the central bank’s switch from a pegged exchange rate to an unofficial managed float. The LBP was left to float on the black market while BdL intervened, injecting dollars from its foreign exchange reserves to slow the path of devaluation. The results have been catastrophic: the Lebanese pound sank instead of floating and foreign exchange reserves have melted away. The devaluation of the LBP fueled hyperinflation, and people who were already losing their jobs and businesses because of the recession were hit with a monumental increase in prices. As a result, 55% of the population fell below the poverty line in 2020, versus 28% a year earlier.

Lebanon is a country with weak institutions where the central bank continues to print money to finance the fiscal deficit and monetize the public debt. In this context, a managed float will not restore trust in the Lebanese pound. On the contrary, as we have seen, a managed float has resulted in persistent

depreciation of the currency and depletion of BdL's foreign reserves while capital controls have continued indefinitely.

BdL still has \$17.5 billion in foreign reserves. After it burns through the usable reserves, the central bank will need to find new sources of funding subsidies, or end its financing. The current cost of subsidies is around \$500 million per month, based on the declarations of BdL's governor, or \$287 million per month, based on the figures provided by the Ministry of Economy and Trade. The current unofficial managed float is therefore unsustainable and *"the real question regarding BdL's FX subsidy for imports of critical and essential goods, is when and how to remove it, not whether."*<sup>2</sup>

## B. Currency Board: A Solution for the Currency Crisis

Lebanon still has enough FX reserves to establish a currency board at a reasonable exchange rate and free up Lebanese pounds from capital controls. It is very important however to learn from the case of Argentina, appoint the top expert on currency boards worldwide to help in the process and set the exchange rate based on a market mechanism.

### 1. Establishing a Currency Board in Lebanon

A currency board is not, as some pundits assume, a board of wise people who meet together and decide what to do with monetary policy. This would be the definition of the central council of Banque du Liban. A currency board is a rule-based monetary arrangement issuing Lebanese pound notes and coins convertible on demand into fresh dollars at a fixed rate of exchange. The reserve levels (both floor and ceiling) would be set by law and equal to 100% or slightly more, of the central bank's LBP liabilities. As reserves, the currency board holds low-risk, interest-bearing bonds, denominated in foreign assets such as US dollars (USD), or gold.

The best course of action for creating a currency board would be for Parliament to change the Code of Money and Credit. A currency board can also be established by a change in central bank policy, but if it is not written into law, it will not be credible since people will fear a reversal of the policy.

Based on Banque du Liban's own figures, its Lebanese pound-denominated liabilities are as follows: currency in circulation is 30 trillion LBP, while LBP-denominated financial sector deposits at BdL are 54 trillion LBP. Therefore, the currency board should cover around LBP 84 trillion of central bank liabilities. On the other hand, Lebanon holds gross foreign exchange reserves reported at \$25.9 billion. This amount includes Lebanese Eurobonds and funds lent out to banks, leaving around \$17.5 billion in net

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<sup>2</sup> Lebanon Subsidy Reform Note, World Bank, December 2020.

foreign reserves. The \$17.5 billion in net foreign reserves would be sufficient to cover 100% of the central bank's LBP-denominated liabilities, without touching the gold reserves, at an exchange rate of LBP 8000, 7000, 6000, or even LBP 5000 per US dollar. However, it is extremely important to let market forces determine the exchange rate, following the example of the currency board in Bulgaria advised by Professor Steve Hanke in 1997.

The remaining \$17.5 billion of net foreign currency reserves of the central bank would be ring-fenced to guarantee convertibility into fresh dollars of 100% of the Lebanese pound's monetary circuit. The circuit includes currency in circulation and Lebanese pound-denominated deposits issued by the central bank. However, it would **not** cover liabilities denominated in US dollars, euros, or other foreign currencies. The currency board could use gold as an anchor commodity or a basket of currencies. To reduce the risk of reserves falling below 100% of liabilities, it would be desirable to have all reserves denominated in the anchor currency, or to hedge against exchange risk for reserves held in third currencies, which may be expensive.

## 2. Setting the Exchange Rate Under a Currency Board

At the official rate of LBP 1507.5 per dollar, Lebanon is not an attractive place to invest in. At LBP 10,000 per dollar, prices are too cheap in dollar terms. The proper exchange rate in current circumstances (as of January 2020) would be someplace between these rates. The proper rate would be "just right" from the standpoint of ensuring an adequate flow of dollars without valuing Lebanese assets any cheaper than they need to be.

Both empirical evidence and theory show that the proper exchange rate set under a currency board would be stronger than it currently is in the black market. A currency board converts an unstable currency into a stable, fixed-rate currency, backed by a clear mechanism that ensures the ability to convert all the central bank's liabilities into the reserve currency on demand. This mechanism will transform the Lebanese pound from a currency no one wants to keep, with correspondingly high velocity, to a reliable currency that everyone wants to keep, with low velocity. All currency boards established across the world to end currency crises have witnessed this transformation.

The exchange rate will be set using the market rather than making an arbitrary calculation of what the rate ought to be. Once the currency board law is passed, with BdL no longer having a right to print LBP's, the supply of LBP's will be fixed and known as will the amount of forex reserves guaranteeing them. The Lebanese pound will then be allowed to float freely for one month. Doing so will allow market participants to establish a truly market-determined equilibrium exchange rate. At the end of the 30-day

period, the currency board will set an exchange rate close to the rate prevailing at the end of the period. Some degree of judgment will be involved—for example, it may be desirable to set the exchange rate at a round number if it is close to the market rate. Most likely the exchange rate will be somewhere between the official rate and the black market rate.

When Ecuador dollarized, its government arbitrarily chose an exchange rate based on a reserve calculation, which was weaker than the market rate would have been. Ecuador then had an inflation of about 80% the first year after dollarization, so that prices in dollars could catch up from their excessively low levels. To avoid an unnecessary inflation or deflation, it is crucial to let the market decide the exchange rate.

### 3. Lessons from the Current Crisis

There is a crucial difference between a pegged exchange rate under a central bank and a fixed exchange rate under a currency board. Overvaluations in pegged exchange rate systems typically arise from the central bank failing to reduce the monetary base when its foreign reserves fall. The currency becomes overvalued and, as the process continues, it becomes more and more politically difficult for the central bank to reduce the monetary base to preserve the exchange rate, so it devalues.

Under a currency board, the only way to obtain foreign exchange reserves from the board and transfer them abroad will be through giving back the same value in Lebanese pounds. Therefore, a currency board will automatically reduce the monetary base when its foreign reserves fall, preventing any overvaluation of the local currency and eliminating the possibility of a devaluation.

Adjustment of current account imbalances occurs whether the exchange rate is fixed or floating; only how adjustments occur is different. More important than the type of exchange rate itself is its credibility. With credibility, current account imbalances tend to produce offsetting, stabilizing capital flows. Without credibility, capital flows are often destabilizing. A currency board, by providing credibility to the exchange rate, will encourage stabilizing rather than destabilizing forms of adjustment.

### 4. Learning from the Mistakes of Argentina

To avoid repeating Argentina's mistake when it set up its so-called currency board (Convertibility system), it is very important for Lebanon to ask a credible international expert on currency boards, to adapt the currency board rule to the context of Lebanon. In 1991, Argentina's legislature adopted what was termed the Convertibility system. The Convertibility system had two major features that disqualified it from being an orthodox currency board and rendered it a pegged exchange-rate arrangement. It had



no ceiling on the amount of foreign assets held at the central bank relative to its monetary liabilities. The central bank could engage in monetary sterilization, which it did. In addition, it could hold and alter the level of domestic assets on its balance sheet. So, Argentina's monetary authority could engage in discretionary monetary policy, and it did so aggressively.

Hanke criticized the system and predicted that it would eventually encounter problems in a 1991 article in the *Wall Street Journal*, "Argentina Should Abolish Its Central Bank." On many later occasions, he reiterated his criticisms and offered proposals about how to fix the underlying problems. Argentinian authorities thought they knew better and persisted in their design. Ten years later, in December 2001, Argentina suspended its debt payments and trading of the peso. On January 6, 2002, Argentina abandoned the Convertibility system and devalued the Argentine peso. Argentina's Convertibility system, which lasted 10 years, was similar to Lebanon's pegged exchange rate system. They were both based on the credibility of the central bank rather than on maintaining 100% reserve coverage of its liabilities, and they both collapsed in chaos. Therefore, we insist on profiting from the experience of a credible international expert on currency boards rather than repeating the Argentinian mistake establishing a convertibility system with less experienced and knowledgeable experts on the topic.

### C. Expected Impact of a Currency Board on the Lebanese Economy

If set up properly, the currency board will immediately end hyperinflation and the devaluation of the Lebanese pound, cut domestic interest rates and kick-start the economy.

#### 1. Feeing up the Lebanese Pound from Capital Controls

A currency board holds 100% external reserves to guarantee the external convertibility of the monetary base (M0) and to ensure that the monetary base changes in a transparent, rule-bound manner driven by market demand. The currency board does not cover liabilities of commercial banks and therefore it will not be concerned with M1 or M2 since they include LBP deposits issued by commercial banks. Nor will a currency board cover M3 or M4, since they include foreign currency liabilities issued by commercial banks.

However, by covering Bdl's LBP-denominated liabilities, the entire monetary supply in Lebanese pounds (M2) could in principle be covered 100% by foreign reserves, because Lebanese banks issued fewer LBP-denominated deposits than what they placed at the central bank. However, how banks will treat M1, M2, M3, or M4 is a separate question from the currency board covering the monetary base.



Therefore, the Lebanese pound circuit will be free from any capital controls, although capital controls set by banks will remain on old dollar deposits. Depositors and currency holders of LBPs will be able to convert their Lebanese pounds into fresh dollars and vice-versa at banks or at the money exchangers at the market rate. They will also be able to withdraw their LBP deposits in dollars or transfer them abroad without restrictions.

Some people have suggested to us that with a fully convertible currency, the Lebanese people would take all their money out of the country, leaving nothing. That scenario ignores that people must have money to live in a modern economy. If money flows out, prices fall (at least in dollars), and there is some point at which it becomes attractive to buy and invest in Lebanon. Anyway, nothing like the scenario has ever happened in any monetary system we know of, even under conditions still worse than Lebanon's. Actually, we know from experience that inflows coming from foreign funds looking for arbitrage opportunities will more than offset outflows eventually fleeing Lebanon.

In the future, financial institutions may decide to hold external assets of their own. Whether to do so or not is an ordinary business decision that depends on balancing the risks and rewards of holding domestic versus external assets. All past currency board systems have operated on this basis and none of them have required, or needed, 100% external reserves other than for the monetary base.

## 2. End of Hyperinflation and Currency Devaluation

Having a currency board will stop devaluation of the Lebanese pound immediately since by design, it exchanges Lebanese pounds for US dollar at a fixed rate. Once the currency becomes stable, inflation will drop to a level that mimics inflation rates in the USA. After putting in place a currency board, annual inflation in Bulgaria dropped from 1,230% in 1997 to 1.7% in 1998 and in Bosnia-Herzegovina from 14% in 1997 to 5% in 1998.

Unlike the managed float that requires the use of foreign reserves to stabilize exchange rate, a currency board would stop the hemorrhage. With the US dollar as the currency board's anchor and reserve currency, the Lebanese pound will become a clone of the US dollar, freely tradable and convertible. This will immediately free up the Lebanese private sector to conduct transactions in Lebanese pounds with confidence, restarting economic growth.

## 3. Decrease in Domestic Interest Rates

Under a central banking system, interest rates include a risk premium related to the instability of the currency. For instance, interest rates in Lebanon averaged around 6% from 2010 until 2018, higher than

in the United States, even though people had not lost confidence in the stability of the Lebanese pound yet. Interest rates then jumped to a much higher level with the loss of confidence in the pound and rose during the current depression rather than falling.

A currency board will eliminate currency risk and reduce interest rates. The sharp drop in inflation, and the existence of 100% dollar reserves against the monetary base, domestic interest rates should mimic the rates prevailing in the United States plus a premium reflecting perceived political risk. The moment a credible currency board is announced, the velocity of the Lebanese pound should drop as people become more willing to hold pounds. Capital should start flowing back into Lebanon seeking to take advantage of arbitrage opportunities provided by relatively higher interest rates on the Lebanese pounds and investment opportunities from a relatively more stable business climate. Consequently, money and credit will expand and interest rates on the Lebanese pound should drop to a reasonable level while still maintaining a modest premium over the dollar interest rate.

Bulgaria established a currency board in mid-1997. Interest rates there dropped from 117% in 1996 to 65.2% in 1997 to 2.4% in 1998. Retail interest rates moved close to German levels as soon as the currency board was introduced. (The German mark was the anchor currency at the time; the euro did not yet exist.) Such a near convergence depends on political risk as well as currency risk being low.

#### 4. Kickstart the Economy

A stable currency helps both the goods sector and the service sector to thrive by making financing more available and affordable. Also, low interest rates and readily available money will provide a path to economic recovery in Lebanon. Banks would facilitate the process. They are already distinguishing between old dollar deposits, which would continue to have restrictions on withdrawals, and new deposits, which would not have restrictions.

Real GDP growth in Bulgaria went from -10.1% in 1996 to -6.9% in 1997 to +3.5% in 1998, the first full year of the currency board.

In the final review of the last IMF Stand-By Arrangement Bulgaria had, in March 2007, the IMF's First Deputy Managing Director said, "Bulgaria is reaping the benefits of sustained sound macroeconomic policies and structural reform efforts with solid real per capita income growth, falling unemployment, and broadly moderate inflation....The authorities have maintained a firm fiscal stance that remains the central policy pillar supporting the currency board arrangement. This is reflected in the record budget

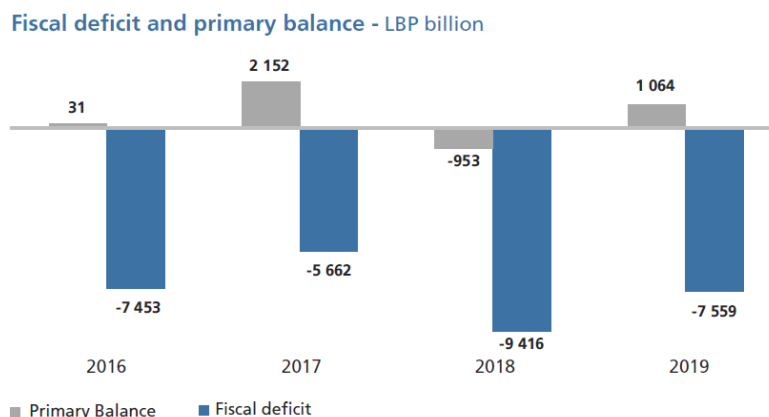
surplus in 2006, which resulted from a strong spending restraint and dedicated revenue collection efforts.”

#### D. Currency Board: Accelerator of Delayed Reforms

The currency board does not eliminate the need for reforms; it actually accelerates reforms. It would remove two of the major channels of corruption: the government’s ability to create inflation and the multiple exchange rates that act to the benefit for some lucky people. Bulgaria and Bosnia, two countries with high levels of corruption that adopted currency boards, have not completely eliminated corruption, but are less corrupt than they were because transparency in the currency promotes transparency in other financial affairs.

##### 1. A Road to Fiscal Balance

Once a currency board is established, we expect government revenue to increase significantly because of the stabilization of the economy (an end to high of inflation and a return of capital inflows). This favorable cycle would improve both nominal and real government income. The below chart shows that the Lebanese government has traditionally had enough income to cover salaries and operating expenses, generating a slight primary surplus, according to official data.



Last year (2020) was no different, based on official data. Revenues are estimated at LBP 13.4 trillion, a decrease of approximately 30% compared to 2019 due to the recession. Personnel costs are estimated at around LBP 10 trillion and current expenditure at around LBP 3.1 trillion, resulting in another year of primary surplus. So, based on those data, Lebanon has no problem paying salaries or operating expenses. However, the Institute of International Finance (IIF) is more pessimistic, expecting a primary deficit of LBP 4.37 trillion in 2020.

Once a currency board is established, we expect government revenue to increase significantly because of the stabilization of the economy (an end to high of inflation and a return of capital inflows—see the previous question). This favorable cycle would improve both nominal and real government income. With a currency board, the government of Lebanon can maintain a primary surplus, generating enough income to cover salaries and operating costs.

Under the current central banking system, the IMF expects a fiscal deficit of -16.5% of GDP in 2020, while the IIF projects the fiscal deficit at 9%. IIF projections are more consistent with the actual figures for the first 8 months of 2020.

Under a currency board on the other hand, besides the increase in income discussed in the previous sections, the sharp decrease in interests rated should significantly reduce Lebanon's interest payments and consequently the overall fiscal deficit. Furthermore, a currency board cannot issue credit nor can it make loans to fiscal authorities and state-owned enterprises. Consequently, such a regime imposes discipline on an economy through a "hard budget constraint" and forces government to undertake previously delayed reforms. Therefore, a currency board will help the restructuring process, because it would increase the sustainable debt level of Lebanon and reduce the losses creditors would incur if a currency board is not set up.

For the sake of comparison, recall that Bulgaria established a currency board mid-1997. The fiscal deficit in Bulgaria dropped from -12.7% of GDP in 1996 to -2.5% of GDP in 1997 before becoming a surplus in 1998. We recommend establishing the currency board with the support of the IMF, as in Bulgaria and Lithuania. This would allow the IMF and the international donor community to provide temporary funds to finance a one-year transition period. We expect Lebanon's funding needs to be limited in time and in amount if a currency board is established.

Lebanon's government spending was about 31.6% of GDP in 2019, according to the IMF. Singapore and Taiwan (as well as Hong Kong and Macau) spent 14 to 21% of GDP on government. To anyone who has traveled to those places, it is hard to see what they lose by spending so much less than Lebanon. On the contrary, almost all public functions seem to work better in those countries than in Lebanon. The difference is that they have a clearer idea than the Lebanese government does of what the government can do effectively and what it cannot.

In other publications, we have made detailed proposals for other reforms to the Lebanese economy that would go well with a currency board. For a summary, see our [paper](#) “BELIEF in Lebanon—Blueprint to Establish Leading Infrastructure, Economy & Finance in Lebanon.”

In the IMF Article IV consultation of July 14, 1997, near the end of Lithuania’s first IMF program during the currency board period, IMF Executive Directors noted that “over the period of the program supported by the Extended Arrangement, a stable macroeconomic framework had emerged, outward-oriented trade policy had been pursued, and budgetary management had been improved significantly.”

The IMF Executive Board assessment issued on May 4, 2006, shortly after Lithuania repaid its last outstanding obligation to the IMF, observed that “Directors welcomed the continued rapid growth with low inflation, and observed that Lithuania’s performance over the past five years ranks among the best within the European Union (EU). Directors attributed this impressive outcome to strong macroeconomic policies, firmly supported by the currency board arrangement that has served the economy well, the implementation of wide-ranging structural reforms, and integration with the EU.”

## 2. Reducing Banks’ Losses and Giving Hope to Depositors

Depositors will never be able to get their money back without a healthy banking system, and a healthy banking system requires a healthy economy. Under any realistic scenario, no matter what the monetary system, some bank deposits will remain frozen for some time. A currency board, by promoting a healthy economy, will shorten that time compared to persisting with the current system.

A currency board will reduce banks’ losses on both their public and private sector portfolios. As we discussed previously, a currency board disciplines government finance, enhancing the government’s capacity for market-based borrowing and its ability to repay debt. Additionally, a currency board will improve the private sector portfolio of banks by stabilizing the economy and providing the most important ingredient currently lacking for growth. Banks would still have to deal with their losses; however, those losses will be smaller under a currency board.

Old dollar deposits will remain subject to capital controls until a national consensus to handle them is established. The market value of old dollar deposits, currently 33 cents on the dollar, will depend on the market’s estimation about the size of debt restructuring and on the trust in the ability of the government and the private sector to service the remaining debt. A currency board will re-establish trust and allow the problem to be handled in a much better context of a stable economy.

While a currency board will likely reduce banks' losses, how those losses are allocated will have to be a negotiated process that is beyond the scope of the currency board. The banking system can rebound, though. Less than four years after Bulgaria adopted a currency board in mid-1997 to end a currency and banking crisis, the IMF described Bulgarian's banking system as "generally sound."

It is worth mentioning that the currency board system had success in Estonia despite a banking crisis that resulted from a combination of bad loans in Soviet-era banks and mistakes by new bankers with no previous experience in a market economy. An IMF press release from 2000 remarked, "The policy of strict adherence to the currency board arrangement has served Estonia well and the currency board arrangement remains the cornerstone of the authorities' policy framework." Like Estonia, Lithuania succeeded despite problems in its banking system arising from mistakes by new bankers with no previous experience of a market economy. Lithuania did not draw from its Stand-By Arrangements of 2000 and 2001, which it treated as precautionary.

Bulgaria was engulfed in a major banking crisis, too. The stability and confidence that was injected into the economy abruptly ended the banking crisis. The 1999 Organization for Economic Cooperation and Development (OECD) *Economic Survey of Bulgaria* stated, "By mid-1996, the Bulgarian banking system was devastated, with highly negative net worth and extremely low liquidity, and the government no longer had any resources to keep it afloat." However, the OECD also observed, "By the beginning of 1998, [six months after the installation of its currency board,] the situation in the commercial banking sector had essentially stabilized, with operating banks, on aggregate, appearing solvent and well-capitalized."

### 3. Reducing the Cost of Subsidies

We expect the cost of subsidies to grow under current policies, accelerating the depletion of BdL's foreign reserves given the continuous depreciation of the Lebanese pound. BdL is paying the difference between the official selling rate of LBP 1515 per dollar and the market rate. Therefore, the higher the market rate goes, the higher the cost of subsidies. In order to slow down the loss of reserves, the caretaker cabinet was considering eliminating many subsidies. Prices for remaining subsidized items would be calculated based on an exchange rate of LBP 3900 per dollar rather than LBP 1500.

A currency board will stop high inflation, stabilize prices, and induce an appreciation of the Lebanese pound from the market rate. Unsubsidized goods will become cheaper since households today purchase unsubsidized items at the market rate (around LBP 8500). Therefore, under a currency board, if the

government decides to reduce or end subsidies, higher price for formerly subsidized items will at least in part be offset by the lower prices for unsubsidized goods.

To summarize, a currency board will not solve the problem of finding external sources of funding for subsidies, but neither will central banking. External funding in both cases will remain contingent to reforming the subsidies program. However, a currency board will help restrain the cost of the program, by stabilizing the pound, while the central bank will make it higher, by creating further depreciation and a bigger gap with the official rate.

### E. Conclusion

When talking about a currency board, we are not discussing some merely hypothetical system. Currency boards have existed for more than 170 years, in more than 80 countries, and continue to exist today. There is a long and deep historical record to consult for answers about how they work in practice, and the record is good.

Some people are afraid that under a currency board, possible US sanctions on Lebanon would cripple the board. This problem would equally apply to both the central banking system and the currency board. As is currently the case with the central bank, assets can be held in forms to which sanctions do not apply. For example, assets can be held in Eurodollar securities that do not clear in the United States, or can be held in other currencies and hedged against changes in the exchange rate with the dollar.

Other observers have called a currency board a “nuclear option,” implying that it is so extreme that Lebanon should not consider it. We reply that if now is not the time to consider a change to the currency system, when Lebanon is suffering its worst peacetime depression ever and one of the world’s worst inflation rates, when will it ever be time? The current system clearly needs to change. We add that the list of places that have currency boards today is varied. It includes Hong Kong, Macau, Bulgaria, Bosnia, Gibraltar, Djibouti, and others. All have one thing in common: monetary stability, which has produced a sense of normality in the economy. It is Lebanon, and not those places, that is the extreme case.

It is noteworthy that many of the world’s major financial centers either have currency boards now (Hong Kong, a center for all types of financial dealings; the Cayman Islands, a center for securities; Bermuda, a center for insurance) or have currency board roots (Singapore, Bahrain, Abu Dhabi). These financial centers have been extraordinarily successful in attracting capital. A currency board could help Lebanon once again become a financial center.



