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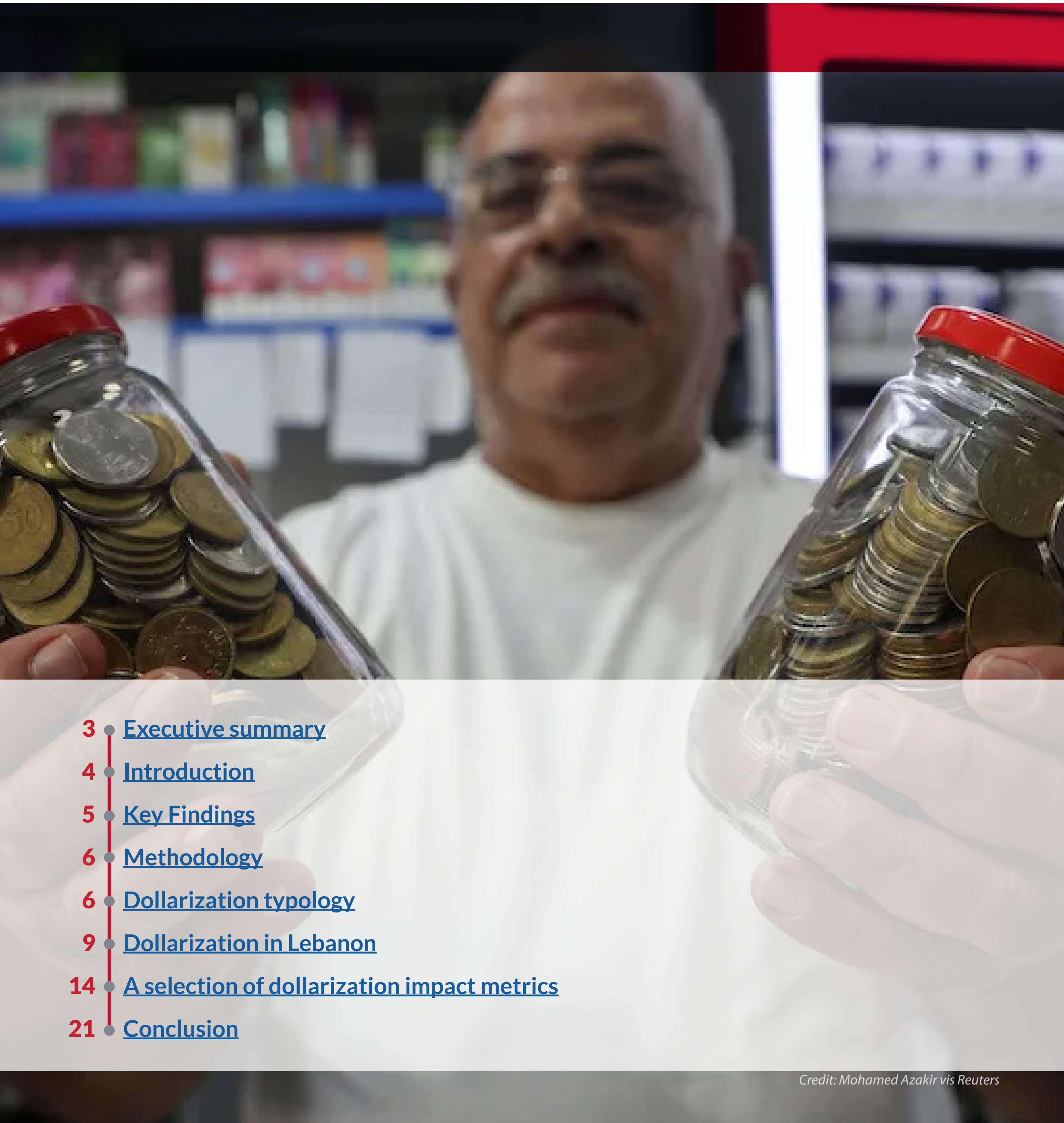
Thematic Report

End of the Lira? The Impact of Dollarization on Lebanese Households

November 2023



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The Lebanon Crisis Analytics Team (LCAT) provides reactive and in-depth context analysis to inform the aid community in Lebanon. The information and analysis contained in this report is therefore strictly to inform humanitarian and development actors and associated policymaking on Lebanon.

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Executive summary

Though it never officially adopted the U.S. dollar (USD) as legal currency, Lebanon has for decades exhibited the hallmarks of a dollarized economy. This state of de facto dollarization is the result of Lebanon's economic history, characterized by high import dependency, foreign currency-based public debt, diaspora remittances, and low confidence in the local currency. Developments since 2019, notably the rapid depreciation of the Lebanese pound (LBP), have fuelled the emergence of more complete and market-driven forms of dollarization, which may eventually necessitate government adoption of official, or de jure, dollarization. The merged 2023 and 2024 budget law, currently under discussion in the parliament, contained provisions for dollarizing taxes and tariffs, a sure step in the direction of de jure dollarization. Although this controversial part of the law was suspended by the Budget and Finance Committee in October, the issue of dollarizing taxes is likely to be raised in future budget discussions. The days of the Lebanese pound seem numbered, necessitating an examination of how dollarization has affected Lebanese households and communities.

Multiple indicators point to the extent and degree of de facto dollarization and how it negatively affects households. Contemporary dollarization of domestic consumption, which began in 2019 during the economic crisis and accelerated in 2023 with the rapid indexation of payments to USD, has decimated residents' purchasing power by removing most Central Bank-supported import subsidies. By September 2023, Lebanon's consumer price index (CPI) had increased by almost 5,000%,[1] an alarming rate for LBP-earning households, whose salaries have not kept pace with inflation. Salary adjustments in both the private and public sectors have been insufficient to preserve purchasing power as commodity prices increase. The food survival minimum expenditure basket pass-through effect reached 100% in June 2022, indicating high price sensitivity to the LBP-USD parallel market exchange rate. As shown in a recent LCAT report,[2] the dollarization of fuel caused a dramatic drop-off in night-time light reflectance (NLR), one indicator of economic vulnerability. De jure dollarization would formalize and exacerbate this trajectory that has already significantly impacted the lives of Lebanon's most vulnerable citizens.

Recent policy changes signal a clear shift in the direction of de jure dollarization, including the dollarization of civil servant and Lebanese Armed Forces wages, customs fees, electricity tariffs, and telecom bills. Embracing the USD would help restore the value of government revenues and unify Lebanon's disparate exchange rates. However, these macroeconomic benefits, while necessary for Lebanon's public finances and to unlock financial assistance from the International Monetary Fund, will be devastating if applied without a robust social protection strategy. Attempting to raise state revenues through dollarized taxes threatens to place an unmanageable burden on families who already receive next to zero support from the state. In the case of public sector wages, the dollarization of salaries strips employees of even a base level of protection. With minimal spending on social services allocated in the 2024 budget, aid actors will likely be called on to play a central role in filling significant gaps in the state's social safety net. The capacity of aid actors to meet these calls is strained by an overall reduction in aid funding allocated to Lebanon, complicated now by the threat of a regional conflict. Most significant gaps exist in the health and education sectors, where planned social service spending remains close to zero.

[1] Mercy Corps Lebanon Crisis Analytics Team, Lebanon Consumer Price Index Data Analysis Hub.
[2] Mercy Corps Lebanon Crisis Analytics Team, Night-time Light Reflectance: Potential Uses in Lebanon September 4, 2023.

Introduction

The negative economic effects of unsustainable monetary policies often prompt a country's population to shift their assets to alternative stores of value that preserve consumer purchasing power. In many cases, this shift takes the form of dollarization, entailing replacing a severely depreciated fiat currency with another stable and widely used currency, usually the US dollar (USD).[3] Dollarization can take many forms, including full, partial, official de jure, or unofficial de facto dollarization, each with its own characteristics and effects. While it might provide short-term stability, dollarization often limits a state's ability to implement independent monetary policy due to a central bank's reduced influence or control over its currency and exchange rates, and a decreased capacity to respond to economic shocks, often due to heavy dependency on foreign currency reserves. Beyond monetary policy, foreign currency-denominated consumption growth often proves burdensome for vulnerable households dependent on depreciated national currencies, negatively affecting their financial stability, livelihoods, and living standards.

Multiple factors have and continue to drive dollarization in Lebanon, namely high import dependency, high levels of foreign currency-denominated public debt, steady foreign currency-denominated remittances, and a rapid loss of confidence in an unstable local currency. In the post-October 2019 period, as the Lebanese pound (LBP) rapidly depreciated, prices of many commodities decreased in USD terms because they were imported at artificially cheap prices thanks to a generous and costly subsidy scheme led by the Central Bank.[4] However, by late 2021, prices began to surge in USD terms as Central Bank monetary policy shifted, entailing an end to the USD-LBP peg and progressively fewer monetary interventions. This marked shift away from "lira subsidization" – once supported by the Central Bank's "financial engineering" regime – negatively affecting household purchasing power and import trends.

[3] Ratna Sahay and Carlos À. Végh, Dollarization in Transition Economies: Evidence and Policy Implications. September 1, 1995.
[4] In an attempt to protect consumer purchasing power, the Central Bank began a new subsidy regime in September 2019 on critical goods and essential items such as medication, fuel, and food. These foreign exchange subsidies were estimated to cost the Central Bank USD 7 billion every year. See: Dagher, Leila and Nehme, Raoul (2021): Lebanon's misguided government subsidies are quickly eating up its foreign reserves. Published in: International Policy Digest (February 18, 2021)

Recent discussions about adopting a USD-denominated state budget in 2024 indicate that official dollarization, or de jure dollarization, is being considered by Lebanese politicians. Their decisions are likely influenced by the fact that official dollarization in Lebanon has already begun to take shape in the form of LBP-denominated civil servant salary payments in USD and a ministerial-level decision allowing many service sector businesses to display prices and accept payments in USD. In parallel with those policies, dollarization is also taking hold due to the growth and entrenchment of the USD cash-based economy.[5]

This paper examines dollarization in the Lebanese context by identifying some of its key characteristics and broader effects, particularly in light of Central Bank policy adjustments. It comprises four sections. The first presents methods used to identify and analyze dollarization generally and in the Lebanese context. The second section examines different types of dollarization in the Lebanese economy. The third section discusses a selection of consumption measurements developed by LCAT to analyze dollarization's impact on households' ability to meet their basic needs. The final section offers some brief analysis and projections.

[10] Lebanese Crisis Analytics Team, June 2023 Crisis Update.

Credit: AP

Key Findings

- Financial and banking laws have historically enabled Lebanese commercial banks to offer accounts and services denominated in foreign currencies, initiating early financial dollarization.

- Pegging the LBP to the USD from 1997 to 2019 contributed to real dollarization – in which USD is used as a unit of account and pricing – of the economy. Maintaining this peg required the Central Bank to attract foreign currency to back up the value of the LBP, through a financial arrangement that proved to be unsustainable by 2019. The economic crisis accelerated dollarization from partial dollarization to full dollarization.

- From 2019, import subsidies of key commodities supported by Central Bank-issued USD lines of credit drove import dependency, nearly emptied the Central Bank's foreign currency reserves, and delayed the real dollarization of domestic consumption.

- Recent policy changes signal a shift toward official, de jure, dollarization, such as allowing civil servants to exchange their LBP salaries for USD through the Sayrafa platform, allowing retailers to display prices in USD, and budgetary discussions around the dollarization of taxes and tariffs.

- By September 2023, inflation, as measured by the rate of change in the LBP consumer price index, had reached almost 5,000%.[6] This is an alarming inflation rate for LBP-earning households, whose salaries have not kept pace with inflation.

- The exchange rate pass-through effect, essentially a measure of the elasticity of import prices to a change in the exchange rate, is a useful measure of the extent of dollarization.[7] The pass-through effect on the food Survival Minimum Expenditure Basket (SMEB) reached 100% in June 2022, indicating an alarming price sensitivity to the LBP-USD parallel market exchange rate.

[6] From a base year of 2013, as calculated by the Lebanese Government's Central Administration of Statistics.
[7] Explained in greater detail in this report, an easy way to think about the pass-through effect is the following. The pass-through is "complete" when an appreciation (or depreciation) in terms of the percentage of a foreign currency causes an equal percentage increase (or decrease) of the price of an imported good (valued in the destination country's currency).

Credit: Anwar Amro/AFP

Methodology

To compile this report, LCAT reviewed the literature on dollarization in Lebanon and in other countries over the past 50 years, state monetary and fiscal policies and pronouncements, and a range of data sets.[8] These enabled LCAT to create a chronological timeline of dollarization in Lebanon, establish a typology of dollarization, and create its pass-through effect indicator to measure the extent of dollarization in Lebanon's economy.

Dollarization typology

Dollarization manifests in multiple forms. As shown in Figure 1, official dollarization (de jure) or full dollarization is an official adoption of a foreign currency, normally the US dollar (USD), as a country's primary or exclusive currency. One such example is Ecuador, which officially adopted the USD after facing an economic crisis during the 1990s, ending the circulation of Ecuadorian Sucres.[9] Partially (de facto) dollarized economies maintain their local currency as the only legal tender but permit financial and payment transactions to be conducted in foreign currency, essentially allowing for the coexistence of two currencies within a system. One example of this is Turkey, where commercial banks allowed depositors to open savings accounts in foreign currency in the early 1980s to preserve stability in the banking system and promote international trade.

The academic literature distinguishes three distinct types of de facto dollarization, namely financial dollarization of assets and liabilities in foreign currency, real dollarization of local pricing in foreign currency, and finally, payments dollarization, under which a foreign currency gains primacy for market transaction purposes (see Figure 1).[10]

[8] Among these are Central Bank statistics, financial and trade data, and the Consumer Price Index.
[9] Paul Beckerman & Andres Solimano (2002). Crisis and Dollarization in Ecuador. The World Bank
[10] Gulde, A. M., Hoelscher, D. S., Ize, A., Marston, D. D., & De Nicoló, G. (2004). Financial stability in dollarized economies. In Financial Stability in Dollarized Economies. International Monetary Fund.

Dollarization

De facto Financial Dollarization	**De facto** Real Dollarization	**De facto** Payments Dollarization	**De Jure** Official Dollarization
Store of value, assets and liabilities. Capital mobility before October 2019. Capital control and higher reliance on USD cash post-crisis.	*Unit of account for transactions and pricing.* Mandatory adoption of LBP in pricing in 1990s. Formal decision to allow retail pricing in US Dollars since February 2023.	*Means of payments, local currency substitution.* Progressive requirement of "fresh" USD for import purposes. Some bills exclusively in USD (generator…)	*All money transactions including budget and tax collection.* Civil servants salaries paid in dollars. *EDL, Customs, Budget…?*

***Figure 1**: A typology of the typical dollarization process.*

The final stage of dollarization, in which a foreign currency becomes a means of exchange, is also sometimes called currency substitution. Dollarization is not necessarily a linear process, meaning one type of dollarization (e.g., de facto real dollarization) can take hold without other forms of dollarization (e.g., de jure official dollarization) being embraced in a country.

Each type of de facto dollarization can exist formally or informally. A currency peg is, for example, more in line with formal de facto dollarization because central banks establish bi-currency parity, which is backed by foreign currency reserves while local currency is used to pay most wages and collection of taxes. The informal or shadow economy often plays a pivotal role in the early stages of de facto payments dollarization, as it develops outside formal financial channels due to a preference to conduct transactions in foreign currency to cope with devaluation risks. Payments dollarization is typically the most cash-based form of dollarization as it entails USD becoming the dominant and preferred currency for conducting day-to-day transactions in the local economy for general consumption, services, savings, and paying wages.

Dollarization in Lebanon

Dollarization in Lebanon has been shaped by a combination of local and global factors.[11] Despite the widespread prevalence and use of USD, in addition to an official currency peg from 1997 to 2019, Lebanon has never officially adopted the USD as its legal currency, representing at best a state of de facto dollarization. Throughout the period in which the peg was in effect, the official currency remained the LBP, and the Central Bank maintained exchange rate stability by covering the market's need for foreign currency using national foreign currency reserves.

Financial dollarization

From 1997 to 2019, Lebanon was best described as partially dollarized based on its currency peg and for allowing residents to hold commercial bank accounts in and spend LBP and USD interchangeably. While the peg aimed to provide stability, this also contributed to de facto real and payments dollarization by enabling USD to freely circulate in the economy. Lebanon attracted a notable influx of USD after the civil war, driven by the post-war recovery and reconstruction phase, shaping an economic model that was highly dependent on the consistent inflow of foreign funds in foreign currency. These include inflows of development aid, substantial diaspora remittances, and incomes from a revived tourism sector, as well as real estate projects, mainly SOLIDERE,[12] as part of the reconstruction of Beirut's central district.[13]

[11] In general terms, dollarization entails the partial, widespread, or complete adoption of a global reserve currency over a national currency. Partial dollarization refers to the significant holding of foreign currency-denominated assets, particularly in USD, by residents of a given country. Bennett, Mr. Adam, Mr. Eduardo Borensztein, and Mr. Tomás JT Baliño. [Monetary policy in dollarized economies](). International Monetary Fund, 1999.
[12] Solidere (Société Libanaise pour le Développement et la Reconstruction de Beyrouth) played a pivotal role in the post-war reconstruction of Beirut. Its ambitious projects attracted substantial foreign investment, often denominated in USD, and were a key driver of increased USD transactions.
[13] Beirut Central District (BCD) is the traditional area of focus for business, finance, and high-end commerce in the capital.

Prior to its civil war (1975 to 1989), Lebanon's commercial banking sector played a pioneering role in initiating financial dollarization. Aided by a banking secrecy law in effect since 1956, local financial institutions were able to attract clients wanting accounts and services denominated in foreign currencies. During the Lebanese Civil War, the officially used exchange rate depreciated from LBP 2.3 to the dollar in 1975, to LBP 1,741.3 in 1993.[14] Confidence in the national currency effectively collapsed, driving residents to search for another medium of exchange in which to store their savings and wealth. Moreover, severe currency depreciation led to a decrease in investments, reinforcing a cycle of dependence on imports to cover domestic needs. This early practice laid the groundwork for formal financial dollarization that emerged following the civil war, during which economic turmoil, black markets, hyperinflation, and widespread distrust in the LBP prompted an unofficial cash-based payments dollarization.

Dollarization in times of trouble

When conflict broke out between Israel and Hamas on October 7, many feared Lebanon would be dragged into a regional conflagration. Previously, fears of worsening violence and market uncertainty were enough to drive up USD demand, sending the LBP crashing. The outbreak of the Lebanese Civil War in 1975 prompted many citizens to look for a safer store of value than the LBP, which depreciated against the USD by 500% in 1987 alone.[15] By 1993, only about 32% of total deposits at banks were denominated in LBP.[16] However, in 2023, the potential impact of a conflict is not so clear-cut. Today, the prevalence of a large cash economy may mute the impact on the national currency caused by market panic in the event of widespread Israeli bombardment targeting Lebanon. Cash savings in households are difficult to measure but are likely much higher than in previous decades after the paralyzed banking system pushed residents to convert their savings and investments to cash during the economic crisis (2019-present). Nevertheless, general market unease arising from increased safety concerns, insurance premiums, and the potential closure of key infrastructure such as the airport and ports, would drive price increases. Price increases would likely increase the prevalence of USD in payment transactions, and destabilize the LBP in the short term, but not lead to the considerable depreciation witnessed during the civil war.

To restore confidence in the national currency and economy in 1997, the Central Bank pegged the LBP to the USD at a rate of LBP 1,507.5,[17] which led to both currencies being used interchangeably in transactions and deposited at commercial banks. Equivalence between the two currencies in real terms was questionable, due in large part to historically shaky trust in the LBP. From the early 1990s through 2019, depositors demonstrated inferior trust in the LBP by denominating their savings accounts in USD, with two-thirds of deposits dollarized in the years prior to the 2019 crises, despite the peg and higher interest rates on LBP deposits.[18] According to Central Bank statistics from 2022, foreign-denominated deposits represented 95% of total deposits in Lebanese commercial banks. This reflects the financial dollarization of the economy.

[14] World Bank Data Bank
[15] Martelino, J., Erbas, S. N., Mazarei, A., Eken, S., & Cashin, P. (1995). "IV Currency Substitution and Dollarization". In Economic Dislocation and Recovery in Lebanon. USA: International Monetary Fund. Retrieved Nov 3, 2023, from doi.org
[16] Ibid
[17] In an economic context, a "peg" is a fixed exchange rate system in which a country's currency value is tied to another benchmark such as one currency or a basket of currencies, or a commodity like gold.
[18] 70.43% of deposit accounts were denominated in USD by 2018 according to the Analysis of Lebanon Deposits by BlomInvest in March 2020.

Formalizing real dollarization

Central Bank monetary policies since the 1990s heavily relied on issuing Eurobonds – treasury bonds denominated in USD – as a means of attracting foreign currency and financing government expenditures. Indexing sovereign debt to foreign currency had a formalizing effect on real dollarization, leading to broader use of USD in daily economic activities such as pricing goods and services, namely imported goods; holding foreign currency deposits and private loans; and conducting business transactions in foreign currencies. The close link between the fixed exchange rate policy and Lebanon's sovereign debt meant that the government and Central Bank needed to maintain sufficient foreign currency reserves to defend the peg. The model was largely able to hold until Lebanon defaulted on its sovereign foreign debt in March 2020.

This monetary model proved to be highly unsustainable and vulnerable to financial shocks. Prior to the crisis, government debt servicing represented from 40% to 50% of the total annual budget. This poor allocation of state resources heavily contributed to the degradation of Lebanon's infrastructure and neglected sectors like education and healthcare in addition to investment in other revenue-generating sectors that potentially could grow the economy.

USD flowed into Lebanon through remittances from its large diaspora and international development agencies but struggled to stay in circulation due to large deficits resulting from high government spending and Lebanon's import dependency. High-interest rates led to the absence of sound investments. Instead, the resulting model laid the groundwork for "financial engineering", under which the Central Bank attracted enough USD to Lebanon's banks[19] – and by extension to the Central Bank, which offered commercial banks high returns on large deposits[20] – to justify the sovereign's decision to continue defending the peg. The LBP-USD peg enabled successive governments to operate at a budget deficit covered by borrowing from Central Bank reserves. From 1997 to 2019, this practice, in conjunction with others, led to the accumulation of public debt totaling more than 150% of GDP.[21]

Between establishing the peg and October 2019, the ease with which importers and consumers could exchange between the two currencies undergirded local currency stability, commonly called "subsidized lira" in the post-war period. As the peg held, import levels averaged between 45% and 50% of GDP. Limited domestic production resulted in imbalances in the import bill, largely dominated by petroleum derivatives. The USD-LBP peg and capital inflows supported Lebanon's ability to run up a sizeable import bill while increasing the country's dependency on imported products. Consumers had access to a wide range of imported goods and services, and businesses could import inputs they needed to operate without incurring significant currency exchange costs.

[19] Commercial bank deposit holders benefited from high interest rates, especially during the two years that preceded the 2019 banking crash. Interest rates on saving deposits started to hike in late 2017, two years before the 2019 crash, despite them being already high. During this span, interest rate on LBP saving deposits averaged about 8.3%, while that on the USD saving deposits averaged about 5.4%.
[20] Beirut Today, Breaking Down Banque du Liban's Financial Engineering August 27, 2019.
[21] International Monetary Fund, Lebanon: 2019 Article IV Consultation-Press Release October 17, 2019.

The Lebanese Lira: A subsidy unto itself

The pre-crisis fixed exchange rate was effectively a subsidy unto itself. The government purchased fuel, grains, and other essential commodities like pharmaceuticals in international markets using foreign currency reserves and controlled their domestic prices in LBP. This strategy was sustained into the crisis era in different forms, as part of the government and Central Bank's efforts to curb the effects of inflation, largely by printing LBP for fiscal expenditures. The Central Bank allowed importers to benefit from significant discounted exchange rates to obtain USD through 2021, which enabled them to keep their prices low, hence delaying the real dollarization of imported consumer goods prices. When the Central Bank decided to cease issuing USD lines of credit at premium discounted exchange rates, the Central Bank established its own "official" foreign currency exchange platform Sayrafa,[22] on which importers (and later others) could obtain USD. At times the platform failed to deliver needed exchanges on time, prompting importers to turn to parallel market exchangers to secure USD for their operations, which resulted in an increase in local prices and more demand for foreign currency. Fuel prices, an example of a heavily subsidized and locally consumed imported commodity, began to rise after the government removed the subsidy on fuel imports in August 2021 (see Figure 2).

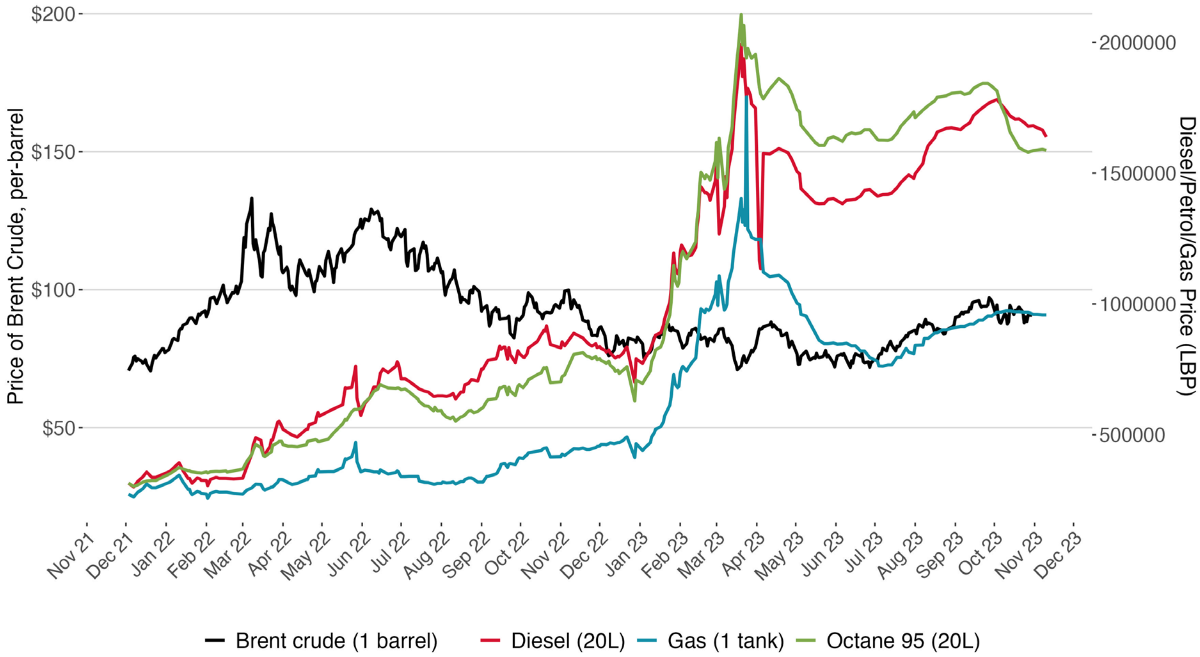

***Figure 2**: Fuel prices in Lebanon.*

On June 2, 2022, the Ministry of Tourism issued circular 9/2022 stipulating that the tourism sector would be able to set prices in USD.[23] Businesses covered under the circular were the first to legally list prices and charge customers in USD. On March 2, 2023, Caretaker Minister of Economy and Trade Amin Salam issued decree 1/33 announcing that supermarkets would be allowed to set prices in USD.[24] Customs dollar exchange rates were increased again in April 2023 to LBP 60,000 and in May 2023 to LBP 86,000, before being adjusted to the Sayrafa rate.

[22] The Sayrafa exchange platform was established by the Lebanese Central Bank in 2021 to conduct monetary interventions and counter sharp LBP depreciation. Sayrafa originally enabled business entities and individuals to exchange LBP for USD at a discounted rate. In late 2022, the Central Bank worked with the government to disburse public sector salaries in USD using the platform's rate. Sayrafa was discontinued in July 2023. However, public sector employees still obtained their salaries in USD beyond this date, at the last registered Sayrafa rate (LBP 86,000).
[23] Ministry of Tourism, Ministry of Tourism - News & Events.
LBCI, Ministry of Tourism: Establishments allowed to set price lists in US dollars June 2, 2022.
[24] Ministry of Economy and Trade, Decision 1/33 March 2, 2023.

The official removal of subsidies backing the local currency, particularly those affecting essential commodities like fuel, played a significant role in accelerating the process of real dollarization. When the majority of these subsidies were lifted, prices of essential goods surged, sparking inflation and eroding LBP purchasing power. Today, only imported wheat for flatbread (khobz) and some medicines continue to receive state subsidies.

Unofficial capital controls, cash economy, and formal payments dollarization

Commercial banks defaulted on their liabilities to depositors following a rush on withdrawals in late 2019. In response, commercial banks implemented unofficial capital controls on USD-denominated deposits. This led to depositors losing trust in the financial system and the national currency. As the official peg held, a parallel exchange market emerged to exploit the loss of trust in the devaluing LBP.

The Central Bank issued several circulars that allowed depositors access to a very limited portion of their USD deposits.[25] Despite this limited measure, commercial banks' unofficial capital controls post-October 2019 contributed to the emergence of the dollarized cash economy. Depositors lost trust in the banking sector after their deposits were subject to haircuts[26] and capital controls, prompting many to rely on informal means to store the value of their savings, including cash USD and collectibles. Resulting saving habits expanded the dollar cash economy that grew to USD 9.89 billion in 2022 according to the latest World Bank estimates.[27] Unrecorded cash savings became the primary source for informal investments in informal economic growth, raising the potential for tax evasion and money laundering. Delays in implementing financial reforms, such as restructuring the banking system and adopting a modernized and revised taxation regime, threatened to further degrade Lebanon's financial credibility and international reputation.

Rapid indexation of payments to USD began in earnest in 2023, as part of an accelerated strategy to bring disparate exchange rates closer to the LBP-USD parallel market exchange rate. This began a period of payments dollarization, in which civil servants and Lebanese Armed Forces members received wages in USD based on the Sayrafa platform exchange rate. Moreover, customs fees, electricity tariffs, and telecom bills were partially dollarized – meaning they were paid in LBP according to the Sayrafa exchange rate – in line with decrees issued by the Council of Ministers. Indexing to USD in the post-2019 era was an essential measure to restore the value of government revenues and eventually unify Lebanon's disparate exchange rates, a major International Monetary Fund (IMF) requirement to unlock state financial assistance.[28]

[25] On April 21, 2020, the Central Bank issued circular 151, which allowed account holders to withdraw LBP from their USD-denominated balances at a rate of LBP 3,900 per USD 1 (BdL, Decision 13325 Intermediate circular 582 - Basic circular 151). Subsidies were gradually lifted and in August 2021, the Central Bank increased the exchange rate on its fuel import lines of credit from LBP 3,900 to the parallel market exchange rate (Reuters), ending the last standing subsidy that alone cost the government USD 3 billion per year. In the same month, the Central Bank enabled depositors with "old" USD deposits (The central bank ranked USD deposits that were denominated to USD before October 2019 as "old deposits") to obtain an annual amount of USD 9,600 through circular 158 in monthly withdrawals of USD 400 and their equivalent at the LBP 12,000 exchange rate. The Central Bank amended circular 151 on December 9, 2021 and increased the exchange rate on withdrawals from USD-denominated accounts to LBP 8,000, and imposed a monthly ceiling of USD 3,000 (BdL, Decision 13377 - Intermediate circular 601 - Basic circular 151). In July 2023, the Central Bank amended circular 158 and allowed depositors to withdraw USD 400 per month without the LBP equivalent, which ended the volume haircut on USD deposits (BdL, Decision 13563 - Intermediate circular 674 - Basic Circular 158)

[26] Circulars 151 and 158 restricted the amount of USD that depositors could withdraw, effectively imposing haircuts depositors.

[27] The World Bank, The Normalization of Crisis Is No Road for Stabilization Spring 2023.

[28] On April 7, 2022, the IMF reached a Staff Level Agreement with Lebanon outlining a set of reforms that the Lebanese government should implement to unlock USD 3 billion in state financial support.

Credit: Mohammad Yassine

A selection of dollarization impact metrics

Since Lebanon's economic and financial collapse began in force in late 2019, Lebanese residents' purchasing power has drastically decreased. The LBP has depreciated by 98% and even though it was expected that basic survival consumption would become cheaper in foreign currency, the prices in USD have slowly risen and effectively returned to their pre-crisis levels. This shift has led to the emergence of dollarization in consumption markets, placing pressure on the entire financial system to follow the same trend.

The following are indicators used to identify the dollarization effect and a description of what they tell us about contemporary Lebanon.

Subsistence products inflation rates

Inflation rates, a core economic metric, gauge how prices for goods and services change over time. They play a pivotal role in determining Lebanese residents' living standards and livelihood opportunities. Dollarization entails inflationary pressure – in both USD and LBP – resulting in price increases, especially for imported items that comprise a significant portion of subsistence products.

Figure 3 displays price visualizations for basic and essential food items in Lebanese markets. USD prices began catching up to pre-crisis levels as early as 2021. All items visualized in the graph share broadly similar price patterns.

A couple of exceptions are notable. Wheat derivatives like packed flour, which benefit from some of the last remaining general consumption subsidies, demonstrate delayed effects from dollarization. Increases in global commodity prices also accelerated and amplified the price increase for some imported items like sunflower oil and sugar.[29]

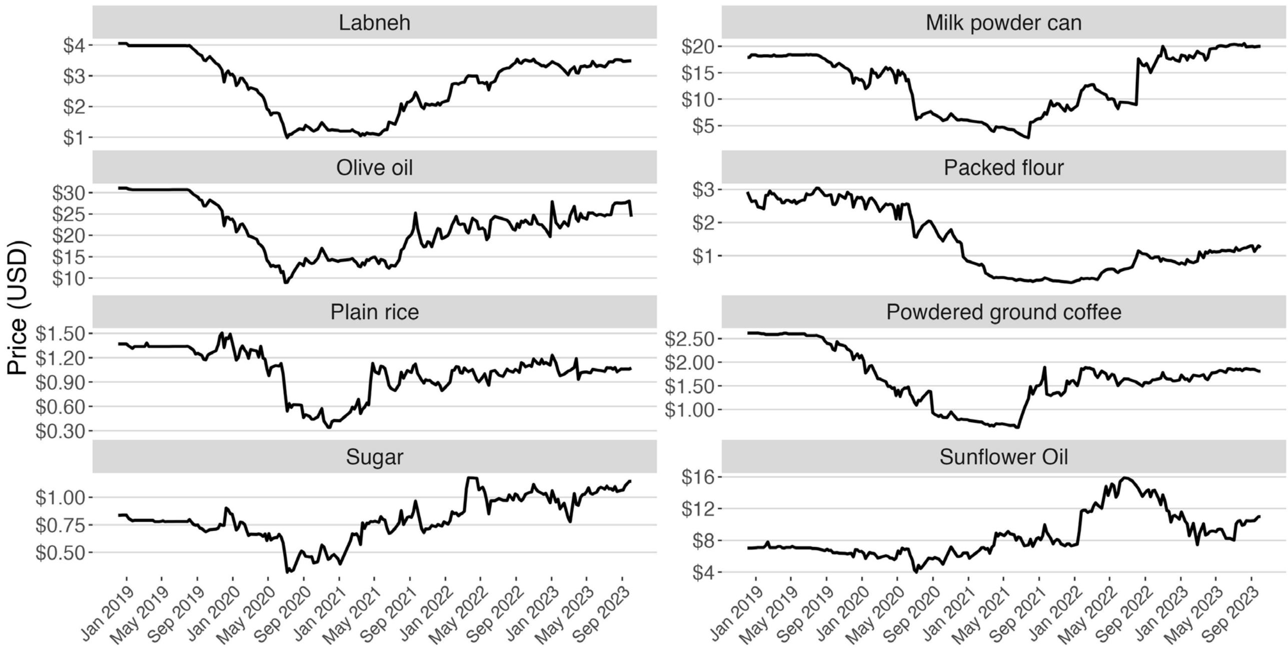

***Figure 3**: The USD price of the common food items from December 2018 to October 2023. Price data obtained from the Republic of Lebanon Ministry of Economy & Trade.*

Food Survival Minimum Expenditure Basket (SMEB)

The SMEB refers to a set of items required to cover the monthly basic needs for the survival of a household of five. It comprises three components covering basic needs such as food, shelter, clothing, healthcare, and transportation: the food basket, non-food items, and non-food services. The Minimum Expenditure Basket (MEB) covers a wider range of items for "dignified" living. The SMEB serves as a benchmark to estimate the survival affordability for vulnerable households.[30] It differs from the consumer prices index in that it reflects a family's survival costs, using a combination of rights- and expenditure-based approaches. It is calibrated and monitored on a monthly basis and is used as a tool for humanitarian cash programming.

The evolution of SMEB prices (in USD terms) since late 2019 is indicative of how the USD progressively became dominant among domestic consumers in Lebanon. As shown in Figure 4, the negative correlation between the LBP-USD parallel market exchange rate and SMEB USD prices observed before 2021 has dissipated, despite the limited impact of exchange rate fluctuations on USD prices since 2022. Moreover, USD price fluctuations have narrowed over time, particularly as the USD became the primary currency for pricing and USD prices stabilized amid parallel market exchange rate shocks.

[29] Grain prices increased globally following Russia's invasion of Ukraine in February 2022, the effective blockade of major export outlets in Ukraine, and sanctions being leveled on Russia by the international community. Russia and Ukraine are both major grain and seed derivatives exporters.
[30] This concept was introduced first in 2014 to estimate the basic needs of refugee families in Lebanon.
UNHCR, 2022 Update of the Non-Food Expenditure Basket Basic Assistance Sector September 2022.

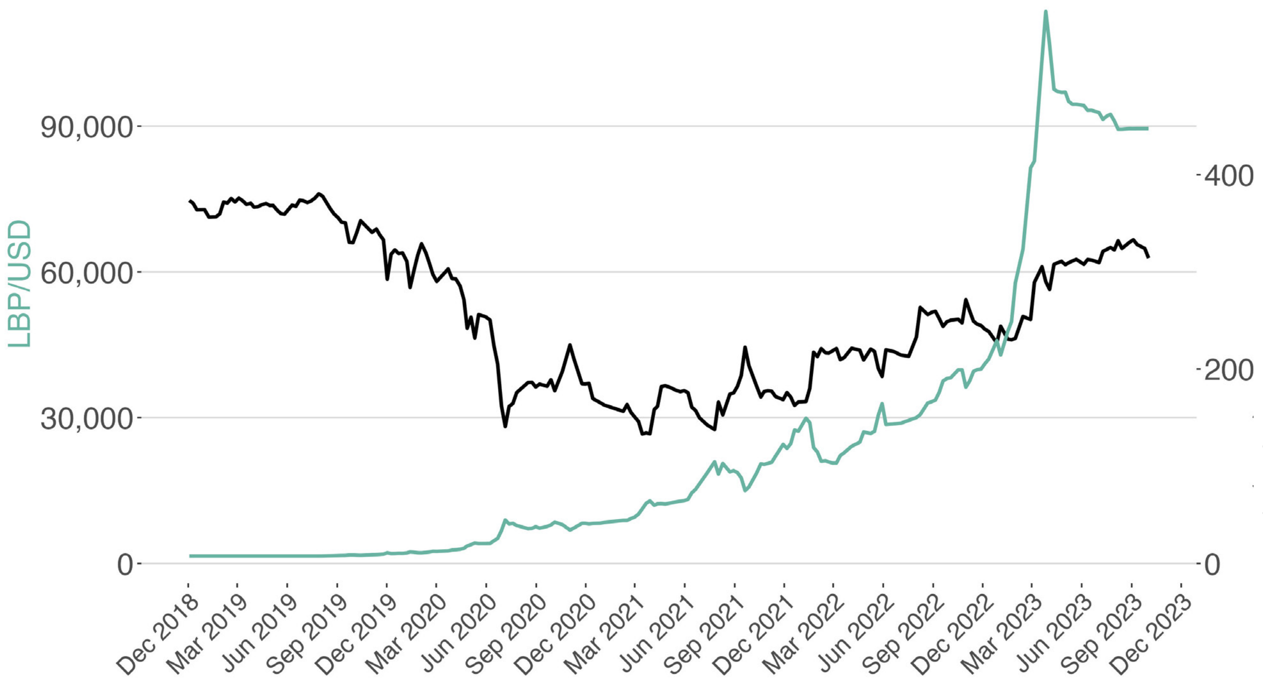

Figure 4*: The evolution of SMEB prices in USD against the LBP/USD exchange rate.*

Public Sector Salaries and Minimal Wages

	Pre-Crisis Public Sector Salaries		Post-Crisis Evolution of Public Sector Salaries					
				Public Sector Salaries in USD Based on Different Exchange Rates Through The Crisis				
				Sayrafa Rate (LBP)				Parallel Market Rate (LBP/USD)
	Public Sector Base Salaries in 2017 (LBP)	Public Sector Base Salaries in 2017 (USD=1500 LBP)	Public Sector Base Salaries since September 2022 through April 2023 (LBP)	28,500	45,400	60,000	86,000	89,000
Basic Entry Salaries	675,000	450	5,675,000	200	125	95	66	63
	1,350,000	895	6,350,000	223	140	106	74	71
	2,025,000	1,343	7,025,000	246	155	117	82	78
	2,700,000	1,790	8,100,000	284	178	116	94	90
Examples of Higher Salaries for Higher Ranking Employees	5,000,000	3,334	15,000,000	526	330	250	174	167
	7,000,000	4,667	19,000,000	666	418	316	221	212

Figure 5*: The evolution of public sector salaries 2017 through April 2023.*[31]

[31] Mercy Corps Lebanon, Lebanon Crisis Update, September 2022.
Business News, Salary Scale Ratified by Parliament, July 19, 2017.

Before the 2019 crisis, public and private sector minimum wages sat between LBP 450,000 and LBP 675,000 (ranging between USD 350 and USD 450 in real terms). This made public sector salaries across the salary scale average between USD 1,500 and USD 2,000. Figure 5 shows how these salaries deteriorated as the national currency depreciated through the crisis, despite the government's attempts to curb the effects of dollarization by allowing public servants premium access to the Sayrafa exchange platform, through which they exchanged their LBP salaries for USD.

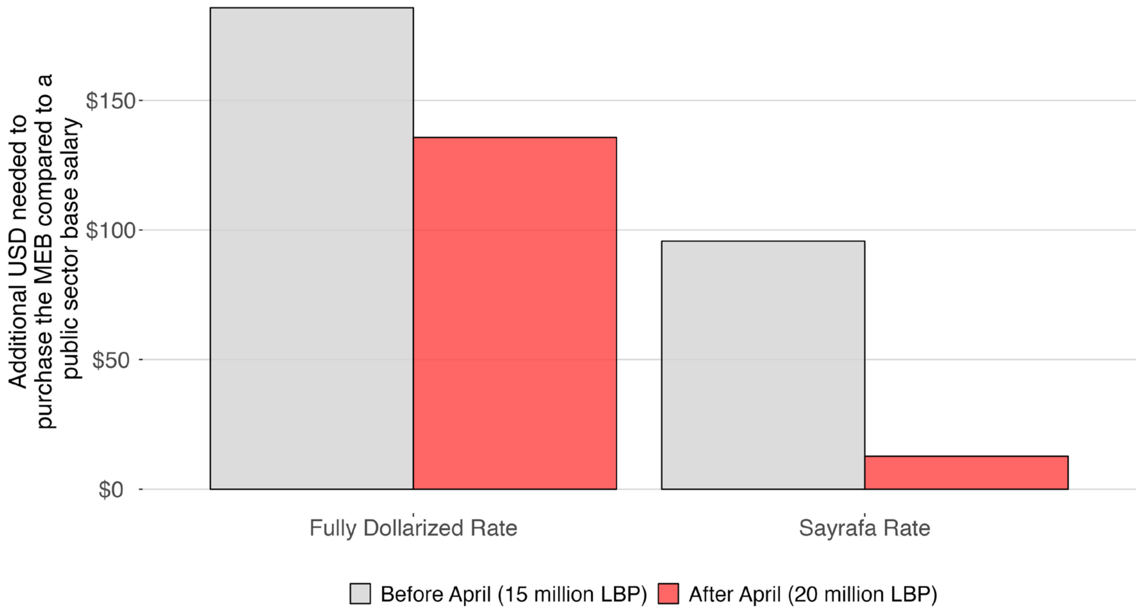

Figure 6: *The additional USD cash needed by an employee in the public sector to purchase the Minimal Expenditure Basket in April 2023.*

Over time, a need for USD-denominated salaries developed as the private sector either converted a percentage of salary payments to USD or adopted a monthly USD bonus or stipend policy to support their employees. However, the government has largely failed to support public sector salaries affected by currency depreciation. The latest official minimum wage increase became effective in April 2023, when public sector salaries increased by 25%. However, this adjustment fell short of making up for the deteriorated purchasing power of those salaries.[32] Figure 6 displays the USD needed to purchase the MEB compared to the public sector base salary. Salaries paid out at the Sayrafa rate provided significantly more purchasing power than salaries paid at the fully dollarized rate. In September 2023, the difference between the Sayrafa and the parallel market exchange rate decreased to 3%.[33] Consequently, public sector employees lost even the small advantage of receiving their salaries via the platform.

[32] The average LBP-USD parallel market exchange rate for April 2023 was LBP 97,814, the price of the SMEB was LBP 27,214,884 (USD 278) and the MEB was LBP 33,814,613 (USD 346).

[33] As a commercial exchange platform, Sayrafa was discontinued in July 2023. However, public sector employees still obtained their salaries in USD beyond this date, at the last registered Sayrafa rate (LBP 86,000).

The dollarization of humanitarian cash assistance
Social assistance for refugees and citizens is dollarized in stages using a hybrid approach, including USD for direct cash assistance and LBP at a negotiated exchange rate (the preferential humanitarian rate) for those programs where dollarization is not possible. The hybrid approach helped to navigate the social, operational, and programmatic challenges of distributing cash assistance in USD. Starting in 2021, the assistance provided through national social safety nets (the National Poverty Targeting Programme, followed by the Emergency Social Safety Net program) and a few humanitarian programs that served host and refugee communities (such as WFP Cash for Work, UNICEF Haddi programs) were dollarized.[34] In May 2023, the UN dollarized the largest cash program for basic needs for refugees.[35]

Consumer price index (CPI)

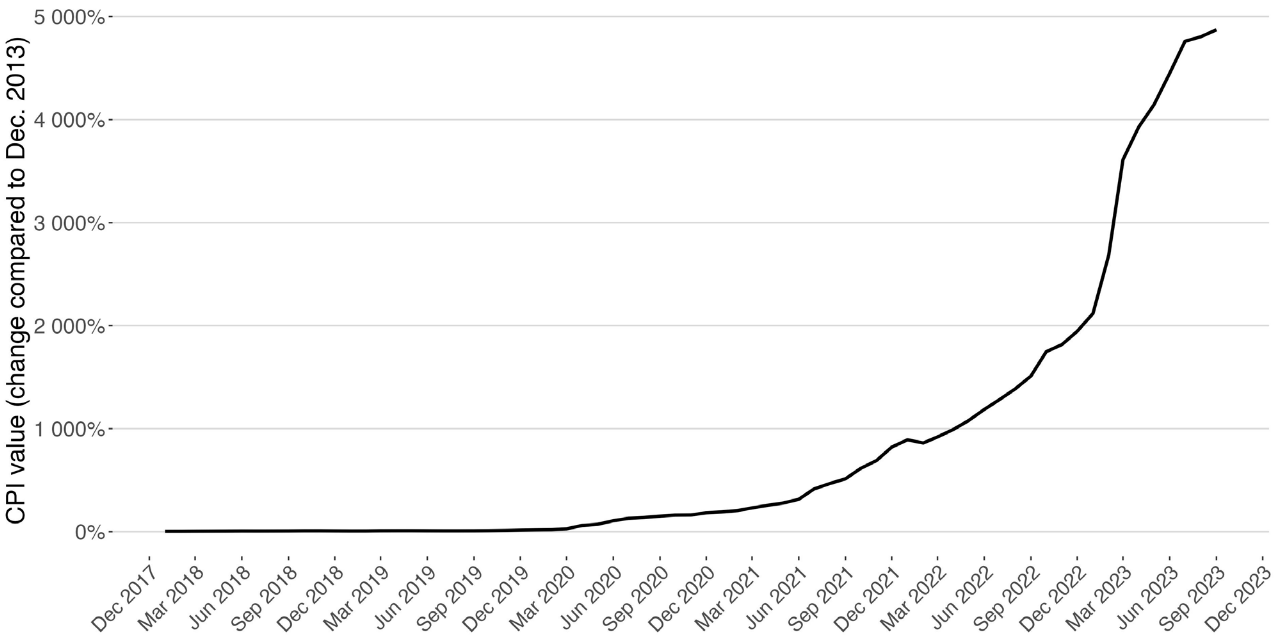

***Figure 7**: The Consumer Price Index from January 2018 to September 2023. CPI data was obtained from the Central Administration of Statistics.*

The Consumer Price Index (CPI) tracks and quantifies changes in the average price level of a predefined basket of goods and services purchased by a typical household over time. It is a key indicator for assessing inflation and its impact on the cost of living. The CPI has increased exponentially during the crisis. It increased by 2,000% from 2020 to 2022 and reached 4,000% by 2023. This accelerated phenomenon reflects the effects of dollarization on domestic price levels, especially since 2022. The CPI demonstrates the magnitude of LBP-earning households' vulnerability facing the spread of the USD in the consumption market that catalyzed the spiraling depreciation of the national currency.

[34] UNICEF, Delivering cash assistance during an economic crisis February 2023.
WFP Support to the National Poverty Targeting Programme in 2022 October 2022.
[35] United Nations, UN statement on the return to disbursement of cash assistance in dual currency May 2023.

Soft boundaries in USD pricing in supermarkets amplified inflation rates, particularly during the 2023 summer months when local businesses aim to attract foreign cash from holidaying expats and tourists. However, those practices negatively affected the local residents' purchasing power. The caretaker cabinet's latest minimum wage increase in March 2023 represented a 1,800% increase compared to the pre-crisis minimum wages, significantly short of the 4,000% increase in the CPI by that date.

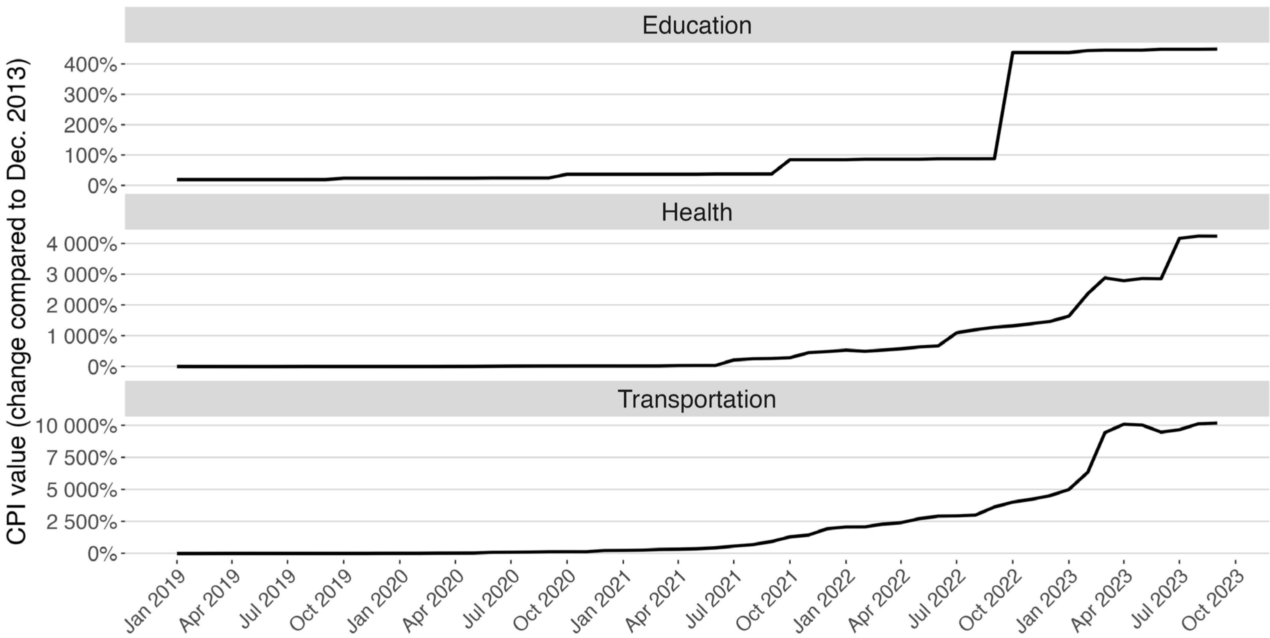

***Figure 8**: The Consumer Price Index of Education, Health, and Transportation from January 2018 to September 2023. CPI data was obtained from the Central Administration of Statistics.*

Adopting the dollar in domestic trade inflated LBP prices across sectors (see Figure 8). Sectors characterized by cyclical pricing, such as education, rentals, or mortgages, exhibit delays in indexing LBP prices to inflation based on the parallel market exchange rate.[36] Conversely, industries like transportation, which are intricately linked to energy costs, exhibit a palpable responsiveness to fluctuations in the LBP-USD exchange rate. This sensitivity became particularly pronounced following the removal of subsidies on imported fuel.

[36] The education component of the SMEB is based on expenditure data collected from Syrian refugees and measured in VASYR. Data collection for VASYR takes place in the summer. Hence, the education component of the SMEB is updated annually and may exhibit delays in indexing to LBP prices, contributing to the sharp increase in September 2022.

The pass-through effect (PTE)

The pass-through effect refers to the percentage of change in an exchange rate that is passed on to consumer price levels. It explains the degree to which the domestic price level is connected to external factors that affect the exchange rate, including price dollarization. The evolution of this variable over time is a key indicator of dollarization across domestic consumption.[37]

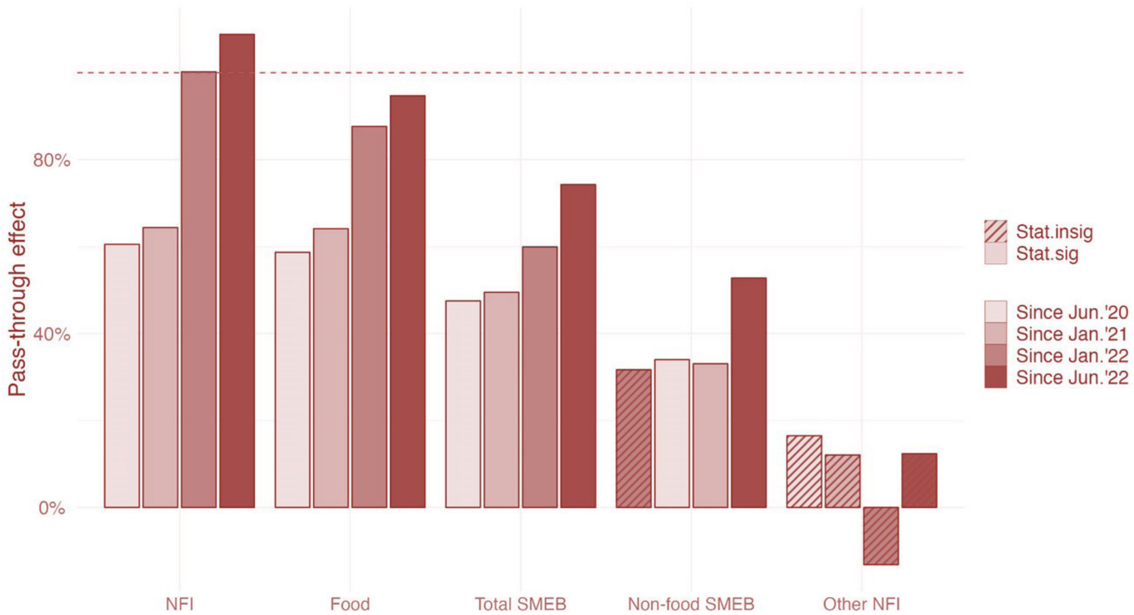

***Figure 9**: The pass-through effect of different minimum expenditure baskets from different beginning months until April 2023. The red line represents a 100% pass-through effect, which is essentially a proxy for full dollarization. Price data obtained from the World Food Programme.*

The PTE on Lebanon's food SMEB has increased gradually since 2021, suggesting that its prices have become more sensitive to the LBP-USD parallel market exchange rate. By 2023, the PTE on the food SMEB reached 100%, marking the full dollarization of this basket. The current trend in the PTE predicts that the dollarization of SMEB non-food items, which are the non-imported components of basic consumption,[38] is following the same path as the food components heavily relying on imports.

[37] Christian Pinshi, Emmanuel Sungani. The Relevance of Pass-Through Effect: Should we Revisit Monetary Policy Regime? International Journal of Economics, Business and Management Research, 2018, 2 (2), pp.224-240.
[38] Non-food-items in the SMEB include bills and payments that cover basic services such as rentals and subscriptions for energy and telecommunication services. Electricity and internet bills are still denominated in LBP at rates inferior to the parallel market exchange rate, which delays the increase in the PTE.

Conclusion

Although for now, the Lebanese government appears to have backed down from passing the first-ever budget with dollarized taxes, de jure dollarization seems a likely path for the country's economy in the medium to long term. This report has shown that the USD has well-established roots in the Lebanese economy, stemming from the country's dependence on foreign currency inflows and a large import bill. Shifting from parallel market-indexed taxes to wholesale adoption of the USD as an official currency for public expenditure and tax collection appears to be the logical next step in this steady slide towards official, de jure, dollarization. While the move may not be implemented in the budget currently under discussion at the parliament, a similar shift is likely to be seen in the coming years.

When accompanied by serious structural reforms and successful tax collection, de jure dollarization can restore fiscal revenues through stable inflows since the USD is assumed to be more stable than many other national currencies. In theory, stable budgets and constant inflows allow state treasuries, state-owned enterprises, and other state institutions to enhance their service delivery, such as better electricity coverage from Électricité du Liban. However, absent accompanying reforms such as adopting a minimum wage and indexing public sector salaries to dollarized prices, the move would merely further erode household purchasing power in the short and medium term.

De jure dollarization as articulated in drafts of the 2023 and 2024 budgets would immediately place a larger burden on households whose incomes have not yet caught up with inflation. Residents would need to allocate an increased portion of their income to electricity and possibly telecommunication bills, consequently tightening their expenditure on food, healthcare, and education. Additionally, the dollarization of customs fees will likely drive an increase in the prices of imported items that constitute a majority of the MEB. This would add to the pressure already placed on households by de facto dollarization, the impact of which has been measured in this report using various metrics showing inflation and purchasing power erosion.

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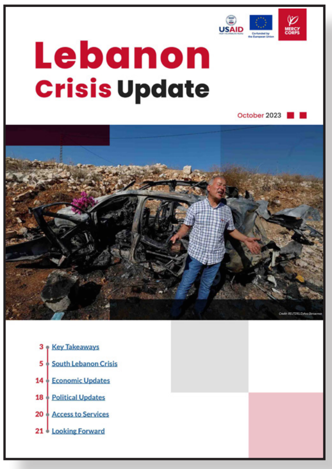

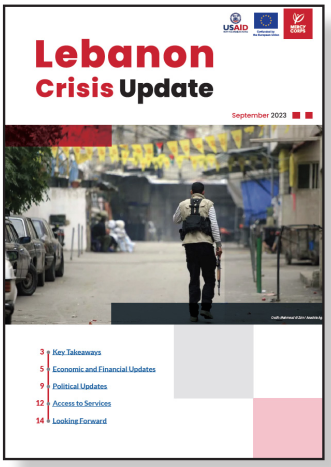

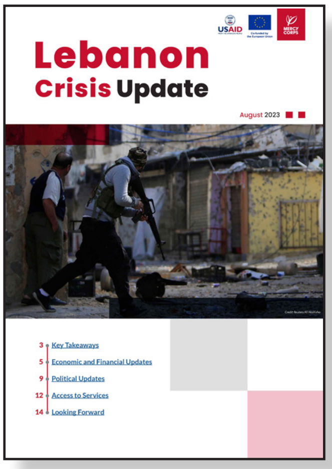

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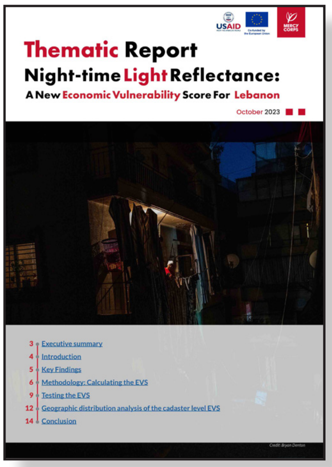

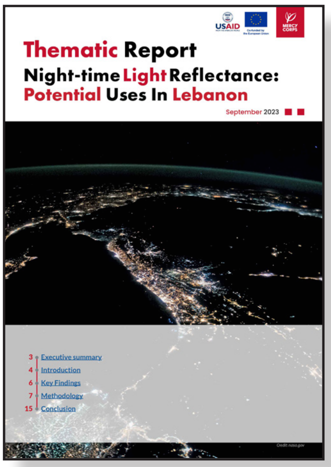

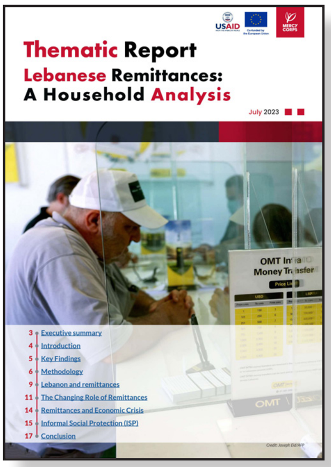

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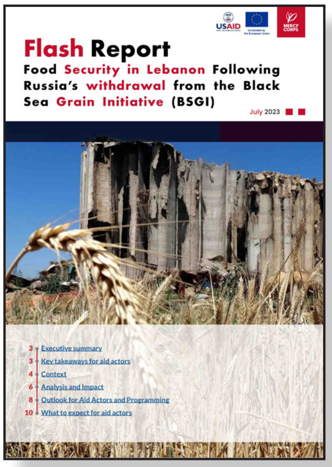

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