Commentary | 25 October 2018

Excerpt from Crisis Group *Watch List 2018 – Third Update*

By International Crisis Group

Libya's Economic Reforms Fall Short

While Libya's first reform package since the fall of Gaddafi in 2011 has had positive initial effects, more must be done to improve the deteriorating economic situation in the country. In this excerpt from our Watch List 2018 annual early-warning update for European policy makers, Crisis Group urges the EU and its member states to address some of the packages' core issues and press the government to create more thorough economic reforms.

Libya has seen two major confrontations in recent months: a standoff between the east-based Libyan National Army and the west-based internationally-recognised government over the control of revenues from oil installations in the Gulf of Sirte in June-July, and recurrent attacks on Tripoli by militias from outside the capital since August. Both were sparked by conflict actors' desire for greater control over economic institutions and the perception that a handful of militias and interest groups in the capital have disproportionate access to the country's wealth. Though in September, the Government of National Accord adopted the first economic reform package since the Qadhafi regime fell in 2011, the fight over resources will remain a central feature of the crisis. The package's measures fall short of what is needed to improve deteriorating living conditions, prevent the defrauding of the state, discourage attempts to change the status quo through violence and create an environment more conducive to a negotiated solution to the disputes that have divided Libya since 2014.

With this background in mind, the European Union (EU) and its member states should consider the following:

- Enhance monitoring of the implementation of economic reforms, press the Government of National Accord and the Central Bank of Libya to limit the allocation of funds on a preferential exchange rate, and prevent fraudulent letters of credit, which could easily allow the embezzlement of public funds, as in the past;
- Persuade the Government of National Accord and the Central Bank of Libya to move forward with more comprehensive policies, including more substantive subsidy reform (particularly of refined fuel), the devaluation of the Libyan dinar and a strategic review of budget priorities, and in the interim undertake transparent oversight of the funds generated by any special exchange rate mechanism;
- Encourage the Tripoli-based government and economic institutions as well as their counterparts in eastern Libya to take concrete steps to unify the Central Bank of Libya, and support an ongoing UN-led financial review of its rival branches in Tripoli and al-Bayda. The Palermo summit planned for 12-13 November, hosted by Italy, offers a chance to do so;
- Prioritise the reunification of economic institutions, starting with the Central Bank of Libya.

Flawed Economic Reforms

Against the backdrop of renewed fighting in Tripoli, public anger over worsening living conditions and widespread accusations that militias were embezzling public funds in the capital, Prime Minister Faiez Serraj signed off on new economic measures on 12 September. The new policies suggest he is determined to address Libyans' economic plight. Ordinary Libyans have suffered from a persistent cash liquidity crisis and falling purchasing power due to the drop in the dinar's value; as a result, the price of consumer goods increased by a record 28 per cent in 2017 alone.

The proposed reforms' main objectives are:

- Reducing the gap between the official exchange rate, fixed at 1.3 Libyan dinars (LYD) to one U.S. dollar (USD) and the black market rate, which has fluctuated at around 6-7 LYD/USD throughout 2018. Militias and their political backers, especially in the capital where the main economic institutions are based, have taken advantage of their ability – often through coercion – to use the official exchange rate for personal gain and to consolidate power.

- Ensuring easier access to foreign currency through the official banking system rather than the black market in order to import goods.

To achieve this end, the government imposed a hefty 184 per cent service fee on the official exchange rate for all foreign currency purchases required for commercial or personal transactions. It in effect created a second official exchange rate of 3.90 LYD/USD. The government modelled this measure on a similar policy from the Qadhafi era; its advocates believe it will help lower the black-market exchange rate and increase liquidity. Proposed by Central Bank of Libya Governor Siddiq al-Kebir and backed by several military and political actors outside of Tripoli – including those trying to break the principal Tripoli militias' stranglehold over economic institutions – Serraj initially opposed it. He relented only following concerted pressure, including from Special Representative of the UN Secretary-General Ghassan Salamé, who saw the reforms as a means of de-escalating tensions in Tripoli and securing a ceasefire. A motivating factor for the militias that attacked Tripoli is the perception – widespread across the country – that dominant armed groups have abused their access to state institutions for personal and political gain.

The reforms are a step toward addressing a deteriorating economic situation, but international experts had advocated a devaluation of the dinar instead and say the service fee model goes against international best practices. The government countered that devaluation is impossible while the Central Bank of Libya is split and state institutions deadlocked. It champions the service fee model as a means of providing greater flexibility, allowing for rapid exchange rate adjustments to identify the market value of the dinar.

To the government's credit, the reforms have shown initial positive effects. Their announcement contributed to a de-escalation of fighting in the capital and an almost 20 per cent drop in the black-market exchange rate. Yet it remains too early to judge their long-term effectiveness, especially since the new system for allocating letters of credit is still being rolled out, and external variables, such as oil revenues, remain highly unpredictable. One immediate downside of the government's unilateral announcement of the measures is that it reduced international pressure on the Tripoli authorities to hold a meeting of the board of the Central Bank of Libya, a necessary step toward its reunification.

Many Libyans, moreover, are already concerned about possible abuses and uncertainties concerning the path ahead. The first concern

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is that interest groups, including militias and political actors, will circumvent the fee-based rate and use the official rate, thus continuing to profit from a de facto double exchange rate system. The decree announcing the reforms is vague on the matter, but ongoing discussions in Tripoli suggest that the government is considering exempting a number of companies and selected goods from the fee-based exchange rate. Such an exemption system should be avoided as much as possible, as it will create opportunities for abuse.

The second concern is how the government will allocate the funds the service fee generates, anticipated to reach 20 billion dinars. Most think that the money should be used to repay public debt and finance development projects. But the decree announcing the reforms states only that the government's Presidency Council will determine how to allocate the funds. Some government officials are worried that Serraj and his entourage could use these funds to buy loyalty rather than finance sound development projects. Another question is whether these funds will go into the regular government budget, which auditors review, or will remain outside the budget line, which allows for less financial scrutiny. The state should establish careful oversight of these funds' allocation.

Next Steps

The Libyan government should follow these initial measures with a gradual reduction of fuel subsidies, which encourage fuel smuggling (another feature of the illicit economy, estimated to cost the state as much as $6 billion annually), and provide adequate targeted cash transfers for poor households to compensate for the increased prices of goods and services. Currently, the only compensation scheme it offers is indirect and consists of awarding every citizen the right to purchase $1,000 at the official exchange rate, which is placed on personal debit cards. This scheme is risky because most people will likely turn to the black market to obtain needed dinars, which would provide black market traders with hundreds of million dollars in commissions.

A proper devaluation of the dinar, replacing the service fee system, is the only way to get rid of the easily abused dual exchange rate. A necessary precondition is to unify the Central Bank of Libya and conduct a review of both of the bank's branches, as agreed by Serraj and the bank's rival heads in late August. Bank unification would halt the eastern government's threats to sell oil through its own (internationally unrecognised) branch of the National Oil Corporation. It would also send a strong signal that stakeholders are serious about bridging the country's divides and stabilising the country.

Reforms will not have an impact overnight, but the package introduced in September is a start. If it merely reproduces corruption and fails to address the needs of ordinary Libyans, violent challenges to the arrangement are likely. The EU and its member states should therefore recognise the crucial task of addressing the underlying flaws in the economic policies proposed in September and press Libya's government and its economic institutions to continue work on more thorough reforms. Concretely, they should support efforts to reconcile economic institutions and reach consensus on economic reforms, and back the UN in developing the economic track of peace negotiations.

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