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Socioeconomic impact of currency devaluation

Libya

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Contents

Introduction

Households, especially the most vulnerable, were challenged by multiple shocks in 2020: a pandemic, intensification of conflict, depletion in oil revenues amid several blockades on oil ports, lack of job opportunities, and a liquidity crisis where 85 percent of households were unable to withdraw any cash from banks[1]. As of February 2021, a total of 604,307 people was estimated to be food insecure[2], of which 41 percent are WFP beneficiaries.

On the 23rd of October 2020, the two opposing forces – the Government of National Accord (GNA) and Haftar's Libyan National Army (LNA) – came into a ceasefire agreement ending an 8-month blockade on oil ports. The agreement allowed for a board meeting between the divided central banks for the first time in five years. The board decided to apply a devalued exchange rate across the country, at a rate of 4.48 Libyan dinars (LYD) to the U.S. dollar (USD) starting from the 3rd of January 2021[3]. In December 2020, the post-tax official rate was set at LYD 3.5/USD and the informal rate reached LYD 5.8/USD.

A currency devaluation means that imports will get more expensive and this might trickle down to domestic retail prices, reducing the purchasing power of households, especially the vulnerable. In this paper, we assess the political situation, the wider macroeconomic context (oil sector, GDP growth, accounts imbalances, and structure of external sector), and developments in the cost of minimum expenditure basket (MEB) and its food components to understand whether the country is in a position to sustain imports; to safeguard the livelihoods of the most vulnerable; and where the exchange rate might be headed looking ahead.

The analysis in each section presents the current situation (*status quo*) and forecasts for 2021. Furthermore, two main scenarios are presented to understand how purchasing power of households might be affected by the interplaying multiple factors.

[1] JMMI Report, November 2020
[2] MSNA/HNO 2021
[3] Reuters: Libya's divided central bank agrees exchange rate after first meeting in years, December 2020

Key findings & recommendations

- Political stability and revenues from the oil sector proved to be the key drivers of economic growth. They play a role not only on how much the currency devaluation will affect general price level, but they can also determine fluctuations of local currency in the first place[4].

- The political conflict and diminishing oil revenues resulted into the most severe economic contraction since 2011 (-41 percent in 2020). The recent ceasefire agreement between the two opposing forces and the formation of a new presidential council are expected to lead to political stability in 2021, with positive effects on the oil industry. Following the ceasefire agreement, the oil sector recorded an instant rebound in oil production levels; Q-o-Q[5] production increase by 658 percent, passing from an average of 121 thousand barrels per day in Q3 2020 up to 917 in Q4 2020. Oil production and oil prices continued increasing in the first two months of 2021 as well.

- Political stability, oil revenues, and government budget balance are very interlinked. The government budget ran into deficits in 2011 (end of Gaddafi's rule), 2014 (political instability leading to the establishment of two rival governments), and 2020 (intensified conflict and blockades on oil). If the ceasefire agreement holds in 2021, oil revenues are predicted to be restored to 2010 level (pre-crisis) and the government budget could record a surplus in 2021. This might reduce the risk of income loss for most workers – the majority of whom are government employees. Nevertheless, currency devaluation forced the government to lift the 163 percent tax on the sale of foreign currency (the second most important income source for the government). Given the importance of oil and tax revenues from sale of foreign currency, the overall balance of government budget will mainly rely on the net effect of changes in these two particular revenues against any upcoming governmental decisions towards expenditures.

- Currency devaluation is expected to result into an increase in prices of imported goods. Increased import costs will be channeled to traders, wholesalers, and will eventually lead to an increase in the retail price of imported goods. Being an essential commodity, food has an inelastic demand curve. This means that households (the end consumers) will eventually bear the burden of the devaluation as they will pay a higher price to access the same quantity of food they used to buy before the devaluation took place.

[4] i.e. political stability and recovery in the oil sector will increase oil exports and the supply of hard currency; excessive supply of hard currency will eventually appreciate the local currency and stabilize prices or at least curtail the magnitude by which prices increase.

[5] Q-o-Q: Quarter over Quarter

- A significant proportion of domestic demand for cereals (especially wheat followed by barley and maize) is met through imports. In 2019, a total of 1.3 million tons of wheat, barley, and maize were imported and only 0.2 million tons of those three cereals were produced, suggesting high price volatility for this commodity.

- Prior to currency devaluation, most traders used to access USD at either post-tax official rate (LYD 3.5 per USD) or the parallel rate (LYD 5.8 per USD) in December 2020. A currency devaluation to LYD 4.48 per USD is 28 percent higher than post-tax official rates; yet, 23 percent lower than the parallel rate. The rate by which import costs will increase is subject to the relative dependency of a particular category on imports and the actual rate by which traders used to import (how much of total cost in LYD was exchanged at parallel market and how much was exchanged at post-tax official rate).

- In January 2021, the minimum expenditure basket (MEB) and its food component witnessed minor fluctuations; however, preliminary data in February 2021 showed a 6 percent increase for both. Monthly price variations were more pronounced for food items of the MEB that are heavily dependent on imports. Vegetable oils – whose demand is met only through imports – witnessed the highest monthly increase (up 33 percent compared with January 2021). Wheat flour increased by 20 percent, and dairy products (condensed milk and milk) increased by 20 and 11 percent respectively. On the contrary, lamb meat increased slightly (up 3 percent) because local production plays a significant role to meet local demand.

- Price increases of imported food items were not only linked to currency value losses, but also developments in international prices of wheat, vegetable oil, and dairy products. Prices of those three food categories have been rising considerably since mid-2020, reaching multiyear highs. Vegetable oils witnessed the most serve increase in prices (up 70 percent compared to June 2020, when prices started to increase).

- At the regional level, price variations across East, West, and South regions followed the same pattern observed at the national average. Therefore, we can expect that any economic or political shocks will have similar effects – in terms of direction and timing – in each region. Yet, the magnitude of this impact might be different.

- Despite similar patterns in price fluctuations, South region has been recording the most expensive MEB (higher than the national average by 20 percent in February 2021), compared with East and the West (lower than the national average by 5 and 4 percent, respectively). Such variations between three regions are worth a revision of assistance level or modalities, suggesting an approach adjusted to the regional level variations rather than to the national average.

- For the overall impact on households 'purchasing power, there are two scenarios.
    - In the first scenario- which assumes political stability and recovery in the oil sector-, purchasing power of households could be challenged by potential price increases, however, income flows and subsidies will minimize the pitfalls of price increases.
    - In the second scenario- which assumes conflict intensification and further turmoil for the oil sector-, Purchasing power of households will be hit dramatically through price increases and potential income reduction or loss, especially if the government will not have the resources to extend social protection schemes.

Political developments in the country

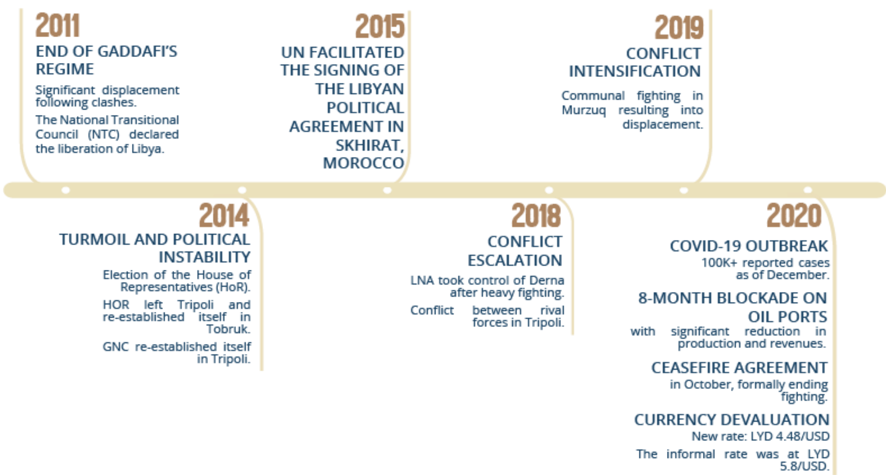
Libya's complex socio-political context has developed into an increasingly protracted conflict since the ouster of Muammar Gaddafi, back in 2011. The end of Gaddafi's regime did not lead to stability as forms of localized armed conflict for the control of key strategic and economic resources persisted in conjunction with the emergence of Islamic State[6].

Protracted turmoil and political gridlock affected the outcome of the 2014 elections, leading to the disintegration of the General National Congress (GNC) into two rival governments, each having its own banking systems and armed factions. The Government of National Accord (GNA) established itself in Tripoli, and the House of Representatives led by general Khalifa Haftar – the commander of the Libyan National Army (LNA) – left Tripoli and re-established in eastern Tobruk[7].

On 17th December 2015, the United Nations facilitated the signing of the Libyan Political Agreement to end hostilities and bring unity to national institutions. Yet, rivalries continue to impair the success of the agreement[8], whose effectiveness was questioned in 2017 by Haftar, marking the failure of reconciliation talks between the two opposing coalitions[9].

After an escalation between July and August with LNA taking over control of Derna and increased fighting in Tripoli, tensions between the two conflicting authorities eased by end of 2018. However, conflict reignited in the Western region in 2019 and tensions continued into 2020, until the 23rd October, when the GNA and Haftar came into a ceasefire agreement, ending a 8-month blockade on oil ports[10]. The formation of a new presidential council was concluded in early February 2021; a formation of a transitional government will follow. The continued conflict since 2011, has caused casualties, displacement and destruction of key infrastructure. In 2020, the blockade of the oil sector for most of the year coupled with restrictions to curb the spread of the COVID-19 have further deteriorated the already weak economic situation, with a negative impact on food security.

Figure 1: Timeline of key events, 2011-2020



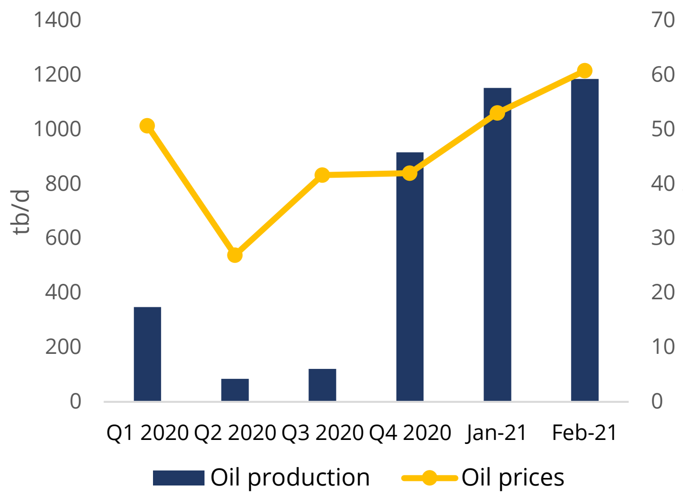
Source: National and international press

[6] The Guardian: Libya's transitional rulers' hand over power to elected assembly, August 2012
[7] United States Institute of Peace: Libya Timeline: Since Qaddafi's Ouster
[8] Al Arabiya: Libyan deal on course, but who is on board?, 25 December ,2015
[9] BBC: Libya Profile – Timeline, April 2019
[10] Ahram: Foreign forces ignore Libya exit deadline under fragile truce, January 2021

Oil revenues and GDP growth rates

The extractive sector plays a key role in the economy; oil revenues captured 55 percent of total government revenues in 2019[11], 98 percent of total exports in 2019[12], and 42.4 percent of total GDP in 2018[13]. The year 2020 witnessed a massive drop in both oil prices and production (down 37 and 66 percent, respectively) against 2019 levels. The slump in oil prices was associated with a global decline in demand following COVID-19, while the drop in oil production was linked to an OPEC agreement to cut off production, and more importantly, intensive blockades on Libya's major oil ports and terminals starting January 2020. The political conflict and diminishing oil revenues resulted into the most severe economic contraction since 2011 (-41 percent in 2020[14]). The economic collapse had adverse effects on the non-hydrocarbon economy as well; water shortages were prevalent, with reported sabotage of water wells. Power outages persisted throughout 2020; only 13 of 27 power plants were functioning[15].

Figure 2: oil production and prices in 2020 and 2021



Source: OPEC monthly bulletins

The ceasefire agreement that was implemented in October 2020, had an instant rebound impact on oil production levels; Q-o-Q production increased by 658 percent, passing from an average of 121 thousand barrels per day in Q3 2020 up to 917 in Q4 2020[16]. In February 2021, oil production recorded 1,186 thousand barrels per day (131 percent higher than February 2020 average).

If the agreement holds in 2021 and the regain in global oil prices persist[17], oil revenues will increase substantially and hence government revenues. The increase in government revenues might reduce the risk of income loss for most workers – the majority of whom are government employees. In addition, the country – that relies heavily on oil exports – will experience an increase in foreign reserves and supply of USD, which should make the local currency stronger.