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Lebanon's Eventual Transition to a Floating Exchange Rate System: Balancing Flexibility with Stability

by

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ABSTRACT

Lebanon's longstanding fixed exchange rate regime collapsed in the wake of the country's 2019 financial crisis. This paper examines the underlying causes of the collapse, offering a new policy framework based on a floating exchange rate system and detailing its superior qualities. However, the paper cautions against a hasty transition without strengthening economic fundamentals. Instead, it argues that transition should proceed first by adopting a managed float, during which the country can increase its fiscal space to enable increased investment in idle capacity and the productive sectors, balancing flexibility with financial stability. Further economic imperatives must be addressed before a fully floating regime can be adopted. The paper concludes by outlining a roadmap for a smooth transition from the fixed exchange rate to a managed float and finally to a fully floating system.

KEYWORDS: Financial crisis, Monetary policy, Monetary sovereignty

1. INTRODUCTION

Over the past two decades, Lebanon accumulated unsustainable fiscal and external imbalances. A significant current account deficit created substantial financing needs. Capital inflows slowed significantly after the Syrian civil war in 2011, and the central bank stepped in to close the gap by drawing down on foreign reserves while trying to attract capital by offering high interest rates.

However, Lebanon experienced a sudden stop in late 2019 as mass protests paralyzed the country, triggering a bank run. Confidence eroded and capital inflows dried up, leaving the central bank unable to sustain the fixed exchange rate policy. A cascade of crises ensued, including a banking[1] and currency crisis, followed by a sovereign debt default[2] in 2022. Between 2019 and 2022, the economy shrunk by 40 percent and the Lebanese lira lost around 98 percent of its value against the US dollar. Inflation soared, leaving the Lebanese to grapple with a weakened purchasing power. In response to the foreign currency shortage, the central bank introduced multiple currency practices, and the commercial banks imposed ad-hoc capital controls on USD-denominated accounts.

Further compounding the crisis was a lack of a decisive and clear policy from authorities who also failed to act on IMF recommendations to stabilize the crisis.[3] While it is plausible to believe that the correction to the imbalances—resulting from the real depreciation of the currency and a subsequent boost in competitiveness—should have allowed the economy to recover; the

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[1] Lebanese banks became severely undercapitalized, with inadequate capital and high leverage ratios. Their heavy exposure to foreign-denominated debt has made them vulnerable to exchange rate risk and external shocks. As the local currency collapsed, foreign currency liabilities further exacerbated asset–liability mismatches. The IMF's 2023 Article IV Consultation stressed the need for bank restructuring to address solvency and liquidity issues.

[2] As of 2021, Lebanon's external debt had skyrocketed to over 400 percent of GDP, a consequence of the dramatic economic contraction in economic activity. One third of the government's total debt is denominated in foreign currency.

[3] In a statement from May 2024, the IMF noted that "the unaddressed economic crisis continues to weigh heavily on Lebanon's population," emphasizing that "these policy measures fall short of what is needed to enable a recovery from the crisis. For further information, see International Monetary Fund. 2024. IMF Staff Concludes Visit to Lebanon. May 22, 2024. Washington, DC: International Monetary Fund. https://www.imf.org/en/News/Articles/2024/05/22/pr24173-lebanon-imf-staff-concludes-visit

transitional phase has been held back by structural deficiencies in the economy and an inability from authorities to agree on a fair distribution of financial losses among stakeholders.[4]

This paper delves into Lebanon's tumultuous economic landscape. It begins by outlining the flaws inherent in the fixed exchange rate policy, before making the case for a floating exchange rate system, underscoring how Lebanon can optimize its policy space to drive growth under such a system. However, the paper cautions against a hasty transition and recommends a phased one, during which a managed floating system could serve as a steppingstone before the government would be able to fully float the currency. The phased transition would empower Lebanon to make effective use of its enlarged fiscal space to gradually strengthen the economy, correct imbalances and enhance confidence. In the final section, the paper provides a roadmap that Lebanon can pursue to successfully transition into a floating exchange rate system.

2. THE PROBLEM WITH THE FIXED EXCHANGE RATE SYSTEM

A pegged currency typically reduces exchange rate risk for international trade and investment, provided the country can hold the peg. Foreign investors may feel more confident investing in a country with a stable currency because it reduces the risk of currency depreciation that erodes the value of their investments. In Lebanon's case, the long-standing fixed exchange rate, established by the central bank in 1997 and maintained until the financial crisis in late 2019, was widely regarded as a cornerstone of economic stability. An implicit policy consensus emerged around this approach: given Lebanon's high political risk,[5] the country would be better off with a fixed

[4] Proposed measures involved reducing the obligations of various stakeholders, with the central bank writing off a portion of its government debt holdings, leading to a corresponding reduction in its bank deposits and placements liabilities. Banks, in turn, would absorb part of the losses by applying haircuts to large deposit accounts, above a certain threshold. This would shrink the debt stock, re-distributing the losses and stabilizing the financial system. The Hassan Diab government's financial recovery plan presented in 2020, developed with the international financial advisory firm Lazard, proposed a similar plan to restructure Lebanon's debt and impose haircuts on various stakeholders, ensuring that banks, large depositors, and the central bank would share the cost of recovery. However, the plan was not approved despite arguably being the most equitable recovery plan ever presented by a Lebanese government since the crisis.

[5] In Lebanon's case, political risk arises when uncertainty about the political process prevents the ability to make accurate forecasts regarding key economic indicators such as inflation, the budget deficit, and economic growth. The uncertainty is driven by the instability in the political system and the lack of good governance.

exchange rate policy. Allowing the currency to float would have likely led to severe fluctuations, potentially with substantial and sudden depreciation of the currency, resulting in drastic consequences for economic agents. Savers holding deposits in local currency would have experienced a decline in the real value of their savings, eroding their purchasing power. Importers with contracts denominated in foreign currency would have experienced cost hikes, squeezing their profit margins and forcing them to pass on this cost in the form of price increases. High inflation passthroughs would have eroded confidence in the currency, and uncertainty over future exchange rates would have deterred investment. Investors with assets in local currency, such as bank deposits, and government and corporate bonds, would have faced significant losses. Companies and the government—with debt denominated in foreign currency—would have seen their debt servicing costs rise in local currency terms. This is all plausible for a highly dollarized[6] economy like that of Lebanon, where most of the saving, investment and transactions are in foreign currency. Regardless, there are more compelling reasons why the fixed exchange rate is a flawed policy, particularly when applied over the long term.

2.1 Tighter Policies

A fixed exchange rate leads to a tighter monetary policy, resulting in an economic slowdown. The central bank retains the ability to set interest rates, but typically chooses not to lower it because lower interest rates lead to capital outflows and capital outflows place downward pressure on the currency, thereby forcing the central bank to interfere to maintain the value of the currency. Therefore, under a fixed exchange rate, the central bank is compelled to keep interest rates high to attract capital. On the other hand, the prioritization of exchange rate stability constrains the policy space as fiscal expansion leads to downward pressure on the currency and forces the central bank to intervene by selling foreign currency to support the peg. Only when the country experiences productivity improvements or enhanced competitiveness can the

[6] The dollarization rate of deposits in Lebanon gradually increased, from around 65 percent in January 2016 to over 71 percent by 2019. For further information, see International Monetary Fund. 2019. Lebanon: 2019 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Lebanon (IMF Country Report No. 19/312). Washington, DC: International Monetary Fund. https://www.imf.org/en/Publications/CR/Issues/2019/10/17/Lebanon-2019-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-487772

government spend without worrying about adversely affecting the value of the currency. In this case, the capacity of the economy meets the increased domestic demand without relying on additional imports. In Lebanon's case, the fiscal deficit, rather than being a direct result of a well-crafted expansionary policy, is primarily due to financial mismanagement[7] and widespread corruption. According to data from the Lebanese Ministry of Finance, capital expenditure between 2010 and 2018 averaged approximately 7 percent of total public expenditures, reflecting limited-to-moderate levels of investment in infrastructure and development projects.

2.2 Unsustainability

Another problem associated with the fixed exchange rate system resides in its unsustainable nature. To maintain the fixed exchange rate, the central bank must buy its own currency when it falls below the target value, using foreign exchange reserves. With a persistent trade deficit and insufficient capital inflows, the central bank is forced to use foreign reserves to maintain the peg. The question then becomes how long the central bank can maintain draining reserves without running out of those reserves or adversely affecting the perception of economic agents. Over time, the misalignment between the fixed exchange rate and the country's underlying economic fundamentals makes the real exchange rate overvalued,[8] and makes it much harder for the central bank to defend it. Those conditions collectively influence investors' perceptions that the fixed exchange policy is unsustainable and that the central bank would soon struggle to finance imports and to service its debt, leading to capital outflows and speculative attacks against the currency.

[7] For instance, Lebanon's state-owned electricity company, Électricité du Liban (EDL), has been draining government finances since 1992, with roughly USD 40 billion spent to cover the deficit, in what represents 40 percent of Lebanon's government debt. EDL's inefficiency persists to this day, with hours-long blackouts exacerbating Lebanon's energy crisis. For further information, see Konrad-Adenauer-Stiftung. 2020. Keeping the Lights On: A Short-Term Action Plan for Lebanon's Electricity Sector. https://www.kas.de/en/web/libanon/single-title/-/content/keeping-the-lights-on-a-short-term-action-plan-for-lebanon-s-electricity-sector

[8] A 2019 IMF report suggests that the Lebanese Lira is overvalued by more than 50 percent. For further information, see International Monetary Fund. 2019. Lebanon: 2019 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Lebanon (IMF Country Report No. 19/312). Washington, DC: International Monetary Fund. https://www.imf.org/en/Publications/CR/Issues/2019/10/17/Lebanon-2019-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-487772

In Lebanon, the high dollarization rate among depositors, which itself signaled the lack of confidence in the ability of the central bank to maintain the fixity, combined with a slowdown in deposit growth and a sharp decline in capital inflows, all made the financial system weaker and more vulnerable. As Lebanon consistently imported more than it exported, it also failed to attract sufficient capital inflows to offset the imbalance, compelling the central bank to intervene to support the peg. While this drained foreign reserves, it also constrained policy options and pushed the central bank to adopt unconventional monetary policies in the form of as financial engineering.

Financial engineering primarily consisted of subsequent operations: the first involved the central bank swapping local currency-denominated Treasury Bonds for newly issued dollar-denominated Eurobonds of equal value; the second saw the central bank issuing USD-denominated Certificates of Deposit (CDs) to banks at very high interest rates in exchange for "fresh" USD cash; and the third consisted of the central bank providing zero-interest funding to banks, equivalent to the amount they invested in the operation. While these operations significantly increased the liabilities on the central bank's balance sheet, they failed to be offset by a corresponding growth in assets, thereby exacerbating balance sheet imbalances.[9]

2.3 False Sense of Stability

Despite Lebanon's high dollarization rate, the fixed exchange rate policy contributed to a false sense of stability of the financial system, fostering a reliance on imports that averaged around 26 percent of GDP between 2010 and 2018. The central bank was lauded (Cazenave 2021) for stabilizing the domestic currency, and the perceived stability of the financial system spurred not only higher import levels but also significant deposit growth, both in local and foreign currencies, to take advantage of unusually high interest rates. While USD deposits were technically in foreign currency and shielded from the local currency exchange rate risk, banks failed to back them with equivalent, liquid, or high-quality assets. Instead, banks, incentivized by the central bank's financial engineering, re-directed the bulk of their USD liquid assets into

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[9] Economist Toufic Gaspard was an early critic of the central bank's practices, arguing that while gross reserves appeared to grow, net reserves (after accounting for liabilities) were negative. For further information, see Gaspard, Toufic. 2020. Lebanon's Financial Collapse: A Post-Mortem. Maison du Futur. https://maisondufutur.org/documents/pdf_manager/61-policy-paper-025.en.pdf.

deposits at the central bank, effectively becoming highly exposed to the latter[10] and without sufficient dollar assets to back their liabilities—creating a severe currency mismatch.

In other words, banks held USD-denominated liabilities to depositors but invested in illiquid instruments at the central bank. When depositors rushed to withdraw their funds, banks were unable to liquidate these assets to meet dollar demand.

The dollar liquidity of banks plunged to 7 percent prior to the financial collapse in 2019, in comparison to an average of 90 percent during the Lebanese Civil War (Gaspard 2020). Additionally, by the end of 2018, Lebanon's reserve adequacy metric fell below 100 percent, indicating that the central bank lacked sufficient net reserves to cover foreign currency obligations and defend the peg. A 2019 S&P report warned that usable reserves declined to just USD 19.2 billion in 2019, covering only 42 percent of short-term debt[11] and exposing the country to significant rollover risks and difficulties refinancing maturing obligations. These metrics underscored the structural weaknesses in Lebanon's reserve adequacy and highlighted the severe liquidity risks that contributed to the financial collapse.

3. THE FLOATING EXCHANGE RATE SYSTEM: A SUPERIOR POLICY

The floating exchange is a superior economic policy due to several reasons. First, it offers a more accurate valuation of the currency based on economic fundamentals. Rather than masking Lebanon's economic vulnerabilities, a floating exchange rate would have exposed those vulnerabilities and potentially triggered much-needed economic reforms. It may have led to currency depreciation and higher import prices, but the net benefits in terms of an improved domestic capacity and higher export potential would have been significant. In addition, a floating exchange rate offers greater policy space to pursue domestic economic policies, such as full employment and stable growth. While a fixed-exchange-rate regime can enhance the

[10] Seventy percent of banking sector assets consisted of government securities and deposits with the central bank.

[11] Falling short of the Greenspan-Guidotti Rule which require that usable reserves cover 100 percent of short-term external debt

predictability of international trade and investment, such reassurances may be less important if the floating exchange rate can be used to correct imbalances and, with the right policy mix, the government can stimulate investment and growth.

It is important to consider that economic agents are often willing to tolerate some level of exchange rate risk if fundamentals are healthy, imbalances are within acceptable limits, and confidence in the central bank is strong. This implies that the benefits of a floating exchange rate system outweigh those of a fixed exchange rate system. From this perspective, a floating exchange rate is primarily a foundational framework for the government to steer the economy toward a more sustainable growth path.

Modern Money Theory (MMT) posits that governments operating under a floating exchange rate and holding no foreign-currency obligations, are not constrained in their spending by any traditional debt or credit limits, but rather by the availability of resources within the economy. This is because they can create money as long as the economy is not fully utilizing its real resources, including labor, raw materials, and technology. Unlike households and businesses, such governments issue their local currency to finance growth at times of economic slack—when unemployment is high, or the economy's productive capacity is underused, or more particularly when certain sectors have idle capacity and need targeted spending. In addition, such governments can also always service and redeem their debts. The only constraint is when the economy operates at or near full capacity, in which case spending causes inflation.

One might wonder if Lebanon could have averted the financial crisis in 2019 had the government adopted a floating exchange rate over the past decade. Under such a regime, the Lebanese pound might have depreciated in response to external shocks, facilitating real economic adjustments. For instance, let us consider key events that strained Lebanon's financial system. The Syrian conflict weakened Lebanon's balance of payments because it reduced exports; the 2014 decline in oil prices diminished capital inflows and remittances[12]; the US Federal Reserve's interest rate

[12] While oil-importing countries are believed to benefit from a cheaper oil price, the impact of oil price drop is more nuanced in Lebanon's case. Both remittances and tourism receipts depend on Lebanese expats who live and work in oil-producing countries affected by falling oil prices.

hikes caused capital outflows from Lebanon, compelling the central bank to raise local interest rates. In addition, repeated domestic political turmoil and the controversy surrounding former Prime Minister Hariri (Barnard and Abi-Habib 2017) in 2017, all the way to the October 2019 protests (International Crisis Group 2019), and more recently the disruption in the global supply chain following COVID-19, all heavily strained Lebanon's financial system. These shocks might have triggered a currency devaluation, with substantial potential benefits. A weaker currency would have raised import prices, curbed excessive imports, and narrowed the trade deficit. Additionally, it would have decreased the relative cost of Lebanese goods and services abroad, making exports more competitive. The central bank would have been able to conserve its foreign reserves for essential imports. Equally important is that the currency, by adjusting to external shocks, could have prevented domestic crises from deepening and mitigated the risk of a full-scale downturn.

However, while this approach seems plausible, it is not without significant challenges. For countries like Lebanon, which are highly dependent on imports and possess a weak productive capacity, a floating exchange rate does not guarantee automatic and smooth economic adjustment. In fact, transitioning to a floating currency without addressing structural economic weaknesses would lead to a sharp and abrupt depreciation, accompanied by heightened volatility and potentially increased poverty and social unrest. These dynamics underscore the complexity of implementing a floating exchange rate in the absence of solid foundations. The next section explores these nuances in greater detail.

4. CAN LEBANON SUSTAIN A CURRENCY FLOAT UNDER CURRENT CONDITIONS?

The answer is arguably no. While a floating exchange rate is a superior policy choice, it also oversimplifies the potential implications that it might bring to economically weak countries like Lebanon. Just floating the currency is not an easy fix; weak economic fundamentals would eventually lead to significant currency volatility, if not sudden and rapid depreciation. This would increase the cost of imports, contributing to inflation and eroding the purchasing power.

Additionally, it would increase the cost of servicing foreign-denominated debt, putting additional strain on public and private sector finances. Reduced consumer spending and investment would exacerbate economic recession and rising unemployment rates.

A floating exchange rate system can be optimal when a country's economic fundamentals are sound. Currently, Lebanon's economic fundamentals, characterized by supply side constraints, a large current account deficit, unsustainable and unproductive capital inflows, and a lack of diversification base, suggest that the country is not well prepared to shift to a floating-rate regime.

4.1 Supply-side Constraints

With poor transport and logistics infrastructure, and a severely underdeveloped energy sector, the Lebanese economy is constrained by severe bottlenecks that reduce its capacity to operate efficiently, produce more goods, and increase exports. Factories operate below their potential, and are unable to increase production to meet external demand. In addition, the recent 2019 crisis triggered a new wave of migration, further exacerbating the brain drain of skilled workers that might have otherwise provided the human capital needed for increasing productivity and innovation. If Lebanon were to pursue a floating exchange rate currency today, the depreciated currency would not increase exports and correct the external imbalance. In other words, as the economy is not self-sufficient in capital goods, the depreciation of the currency resulting from the floating exchange rate will not reduce imports and improve the external imbalance. This is true for many developing countries, often relying heavily on imports of capital goods.

4.2 Large External Deficit and Unsustainable Financing

Examining Lebanon's current account reveals chronic and unsustainable deficit patterns, with the most significant contributor being the negative goods balance as the country remains heavily reliant on imports for essential goods like food and energy. The services balance fluctuated but remained generally positive, reaching a decade low of 2.6 percent of GDP in 2019, compared to 7 percent when the country was a prime tourist destination for Gulf nationals. The transfer balance, which consists largely of remittances sent by Lebanese expat, represents a crucial, yet insufficient, source. While recently remittances constituted a significant portion of the nation's

GDP, averaging between 2002 and 2023 approximately 20.23 percent, they reached a low of 12.71 percent in 2019. Primary income inflows have provided some relief by partially offsetting the trade imbalance. On the financing side, Foreign Direct Investment (FDI) has been erratic and insufficient. Non-resident bank deposits, classified under financial account inflows as "Other Investments", have been critical in sustaining Lebanon's external financing needs but have proven unsustainable as well; the decline in deposit inflows in 2019, even after accounting for accrued interest, suggests a contraction in the deposit base, driven by insufficient deposit growth to offset an elevated withdrawal activity. Such dynamics in bank deposits signal a shift in consumer preferences, and more particularly lower consumer confidence, a precautionary motive, and transfers to foreign bank accounts. Therefore, to finance the current account gap, Lebanon has increasingly resorted to drawing down on its foreign currency reserves, ultimately depleting what has been left of those reserve holdings. Overall, this shows that Lebanon suffers from a chronic current account deficit, high import dependency, and unsustainable financing.

Ironically, the financial collapse of the Lebanese currency in 2019 failed to resolve the underlying economic imbalance. Although imports initially declined, they rebounded in 2021, increasing the current account deficit to 15.9 percent of GDP compared to a pre-crisis average of 24 percent. While the recovery in imports has partly been attributed to opportunistic purchases driven by favorable exchange rate valuations, it nonetheless reveals deeper structural issues, including a high dependence on imports and a constrained export capacity.

4.3 Unproductive Capital Inflows

Past research (Baumann 2019) underlines Lebanon's unproductive rentier economy. It contends that the Lebanese economy is built on a model that favors a heavy reliance on banking, real estate, and external capital flows, making it structurally weak and without a productive base. Since this model favors external inflows that financed consumption and speculative activities (e.g., real estate bubbles), the productive capacity of the economy was diminished, and Lebanon became highly vulnerable to global financial shocks. Looking back at Lebanon's 2008–11 growth years reveals that capital flew mostly into real estate and short-term financial assets, inflating these areas and crowding out private investments in the productive, tradable sectors.

This has led to economic distortions, which have also been associated with the Dutch Disease.[13]

4.4 Lack of Diversification

The country's financial system remains closely tied to the Arab Gulf, making Lebanon's economic stability dependent on financial inflows from this area. For instance, between 2003 and 2015, 76 percent of FDI projects in Lebanon came from the Gulf nations, and more particularly from Saudi Arabia, Kuwait, and the United Arab Emirates. In addition, roughly 60 percent of remittances originated from the Gulf region. The Lebanese diaspora working in Gulf countries has played a key role in replenishing Lebanon's foreign currency reserves, but these remittances have historically been influenced by Lebanon's domestic alliances with the Gulf and the Gulf foreign policy towards Lebanon. These combinations of factors highlight Lebanon's fragility in the face of shifting political dynamics in the Gulf states (Assouad 2021). Early in 2008, an IMF working paper (Schimmelpfennig and Gardner 2008) points to a long-standing perception in Lebanon that foreign donors provided an implicit financial safety net. This belief in guaranteed external support persisted[14] through 2018 when international donors at the CEDRE conference pledged over $11 billion in loans and grants, conditional on Lebanon implementing long-overdue economic reforms. However, due to the Gulf shifting policy toward Lebanon and the Lebanese political leadership's failure to implement these reforms, investors and financial stakeholders were left clinging to unfounded optimism about the anticipated aid which never materialized.

Rather than floating the currency under weak economic conditions, Lebanon could have considered an earlier devaluation of the currency. The effectiveness of this devaluation would have largely depended on timing first, and on concurrent economic reforms and the strengthening of economic fundamentals second. While the government can use fiscal policy to cushion the impact on consumers and firms, the opportune time to devalue the currency is during periods of robust economic growth, such as between 2008 and 2011, when businesses were

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[13] The term Dutch Disease typically refers to an economic condition where an influx of revenue—often from natural resources—leads to currency appreciation, making the manufacturing sector less competitive internationally. The concept has evolved to encompass broader dynamics, including the crowding out of the productive, tradable sectors.

[14] Lebanon has benefited from several donor conferences, starting with the "Friends of Lebanon" in 1997 after the Operation Grapes of Wrath, followed by Paris II in 2002 and Paris III in 2007 after the 2006 war, which secured $7.6 billion in pledges.

better positioned to absorb the potential negative impacts of currency devaluation, like increased import costs. Higher growth rates should have provided a cushion against inflationary pressures and helped mitigate the adverse effects on consumer purchasing power. The resulting reduced need to interfere to support the peg would have eased pressure on foreign reserves. Overall, devaluing the currency might have reduced the intensity of the shocks Lebanon faced 10 years later, while not completely averting it. Economic shocks would have come in lighter, much-awaited forms, paving the way for economic rebalancing.

5. THE ROLE OF A MANAGED FLOAT AS A FIRST STEP

In a managed floating exchange rate system (known also as a "dirty float"), the value of a currency is primarily determined by market forces, but the central bank intervenes only occasionally to stabilize its value. This means that the central bank intervenes more flexibly, without a predefined range to smooth out excessive volatility, respond to speculative attacks, and correct misalignments with underlying economic conditions.

More particularly, rather than depleting reserves by controlling the exchange rate on a continuous basis, the central bank maintains and builds foreign reserves over time. If fundamentals suggest a depreciation (e.g., due to a higher trade deficit or high inflation), the exchange rate should be allowed to depreciate. The idea is to avoid frequent, heavy-handed interventions, and let the exchange rate adjust naturally in response to underlying economic conditions. Only then can the central bank build confidence in the currency. During periods of economic stability or low exchange rate, the central bank could buy and accumulate foreign exchange reserves, providing a buffer that can be used in times of economic distress and effectively keeping these reserves for when they are truly needed. This effective management of reserves is what characterizes a managed floating exchange rate system.

Additionally, a managed floating system offers the advantage of balancing stability and flexibility. Arguably, as elaborated later, this system could provide Lebanon with the opportunity to leverage fiscal policy more freely, ultimately resulting in reducing its dependence on capital inflows to maintain financial stability while growing the economy. It offers the stability of a fixed exchange rate because the central bank can intervene in the foreign exchange market to prevent highly disruptive exchange rate swings, thus enabling the economy to cushion itself from severe external pressures and subsequently preventing abrupt and financially destabilizing severe devaluation.

Alongside stability, a managed float offers a great deal of flexibility. With a managed float, the government has more leeway to use fiscal policy for targeted economic objectives, either by increasing spending or by cutting taxes. In times of economic downturn, the government can run higher deficits to maintain employment and boost growth. The central bank, in its part, can use monetary policy to balance goals like controlling inflation. When higher government spending leads to a weakening of the exchange rate, it could indicate the need for more targeted spending. In the case of overheating, fiscal tools such as raising taxes can be employed to manage aggregate demand.

A body of research discusses the advantages and disadvantages of each exchange rate regime, stressing the benefits of the hybrid system like a managed floating system. Olivier Jeanne and Charles Wyplosz (2001) argue that neither a fixed nor a floating exchange rate system is a panacea. A fixed-rate regime provides short-term stability but creates weaknesses in the long term as economic fundamentals worsen. The result, as they contend, is that the fixed exchange rate becomes misaligned with the country's economic fundamentals, driving speculative attacks. Moreover, fixed-exchange-rate regimes drive economies toward sharp, disruptive, and sudden devaluations when faced with a balance-of-payments crisis. As the peg collapses, it triggers a currency crisis that spills over into a banking or financial crisis. Conversely, a floating exchange rate system offers more flexibility and allows economies to utilize economic policies to drive economic growth. However, they often lead to currency volatility, which can be harmful for investors and consumers, ultimately undermining confidence and causing economic disruption, particularly in emerging and developing economies with underdeveloped financial systems. Hybrid or intermediate exchange rate regimes, such as the ones combining elements of both fixed and floating systems, might be more appropriate.

Levy-Yeyati and Sturzenegger (2005) offer evidence that managed floating regimes are frequently applied in practice, even when countries officially claim to follow other exchange rate systems. Managed floats, therefore, represent a practical choice to address challenges in developing economies. Frenkel and Rapetti (2009) highlight the importance of retaining a degree of policy autonomy, which managed floats can support. They argue that managed floating regimes strike a balance between ensuring stability and providing the flexibility needed to adapt to external shocks. Calvo and Reinhart (2002) maintain that many emerging economies with official floating exchange rate regimes do not allow their currencies to float freely in practice. Instead, they frequently intervene in the foreign exchange markets to stabilize their currencies due to concerns about the economic and political risks associated with exchange rate volatility, coupled with the inflationary effects of a depreciating currency.

According to insights provided by Professor L. Randall Wray for this paper (March 2025), no country operates at a fully free-floating exchange rate. While many countries claim to do so, in practice, most adopt a managed float, albeit without public acknowledgment. The reason is that sporadic fluctuations of the currency, *caused by speculative trading, short-term capital flows, shifts in market sentiment, or trade imbalances, are often smoothed out by deliberate targeted interventions by the central bank.*

6. FROM MANAGED FLOAT TO FULL FLOAT: PREPARATION AND TRANSITION STRATEGIES

Although a weaker currency should make exports more competitive and stimulate growth, supply-side constraints limit production. Even with a depreciated currency, export volumes might not increase substantially, while higher import prices cause inflation. Therefore, when the government increases spending, the resulting rise in demand would lead to higher imports, straining the trade balance and exerting pressure on the exchange rate. This dynamic can undermine the effectiveness of government spending, potentially fueling inflation and causing financial instability, thus negating the intended benefits of fiscal expansion. MMT recognizes that persistent current account deficits constrain the impact of deficit spending and exacerbate imbalances rather than correcting them.

Critics of MMT argue that developing countries face significant challenges in implementing MMT-inspired policies without adverse effects. They claim that spending often results in currency depreciation, which raises import costs, worsens the balance of payments deficit, and increases the burden of foreign-denominated debt. This can erode investor confidence, trigger capital flight, and deepen economic instability. In contrast, MMT proponents like Tymoigne and Wray (2013) argue that spending should avoid financing excessive consumption or reinforce external dependencies, such as reliance on critical imports like food and energy. Instead, Tymoigne and Wray advocate that MMT policies should direct fiscal resources toward productive investments—such as infrastructure development—that build future capacity or boost domestic production in strategic and competitive export industries. Such measures can generate foreign exchange, reduce trade imbalances, and create a more sustainable economic foundation.

In MMT's view, government spending and taxes should be reframed as a tool to achieve full employment and price stability, rather than to reflect a deliberate decision to "balance the budget." The fact that the government sets tax rates and spending levels doesn't mean that it can target some specific deficit level because the size of the deficit depends on how the economy responds.

According to Wray (2012), while a floating exchange rate system alone may not effectively address external imbalances, MMT offers a framework to tackle such issues. This is because spending—when directed toward productive sectors and capacity-building investments—ensures that economic growth occurs without a heavy reliance on imports. In Lebanon's case, supply-side constraints that have historically limited Lebanon's export potential can therefore be addressed through a well-targeted capital expenditure program, with investments in energy, transport, logistics, ports, and manufacturing capabilities. These will reduce business cost, increase efficiency and make Lebanese goods more competitive internationally, thereby increasing export volumes.

Additionally, well-targeted investments in infrastructure would remove bottlenecks and drastically expand the economy's supply capacity, and a parallel industrial policy would support areas with competitive advantage, enabling the country to produce goods domestically that it previously imported. This process, known as import substitution, helps reduce reliance on foreign goods, improving the trade balance and bringing in much-needed foreign currency.

Focusing on the sectors that hold comparative advantage, furthermore, can position Lebanon as a key regional player (McKinsey & Company and Ministry of Economy and Trade, Lebanon 2018). Provided improvements in infrastructure and regulatory systems, industries such as food processing, high-end design, and pharmaceuticals show strong potential for growth. Additionally, Lebanon holds significant potential to become a key regional player in agriculture due to ample water supply, particularly when modern technologies and methods are applied to produce higher-value crops and products. Sectors such as software development and IT services are also competitive given Lebanon's relatively strong human capital. Over the long term, Lebanon has the potential to compete against neighboring resource-rich and labor-intensive economies, including the oil-exporting Gulf states and the low-cost labor markets of Egypt and Syria. An interesting approach is to capitalize on Lebanon's human capital to attract efficiency-oriented FDI (United States Agency for International Development 2007) in the tradable service industries like business consulting, legal and accounting, audiovisual production, engineering, consulting, data processing, and web development. In this context, remittances and migrant expertise could be harnessed to foster investment in these industries.

With an increased policy space, the government can make effective use of fiscal spending to expand the productive capacity of the economy, thus effectively addressing the structural problems that underlie the current account deficit. Two major goals will be achieved: first, as exports grow, the trade deficit shrinks, reducing pressure on the currency and decreasing Lebanon's reliance on foreign reserves and borrowing. Second, a targeted expansionary fiscal policy would create jobs and stimulate economic growth, addressing Lebanon's high unemployment rates and supporting growth and development. A more stable financial system would emerge, paving the way for a smooth transition into a fully floating exchange rate system.

7. A ROADMAP

There are several milestones Lebanon should achieve before transitioning into a floating exchange rate system. While neither exhaustive nor intended to be followed in a strictly chronological order, these milestones can be summarized as follows.

Phase 1: Implementing a Crawling Peg Policy

A crawling peg is a rigid form of managed floating system that combines the stability of a fixed exchange rate with the flexibility of periodic adjustments, reducing excessive volatility and preventing overvaluation. This system allows the central bank to manage the currency within a specified range, adjusting it incrementally based on predetermined rates, based on inflation and trade balances. As stability improves, the central bank can gradually shift to a managed float without strict limits. For a crawling peg to function effectively, however, two conditions should be met:

1. **Effective reserve management**: The central bank must ensure that the crawling peg policy is sustainable by accumulating sufficient reserves to defend the exchange band while making sure the real exchange rate is not highly overvalued. With these measures in place, Lebanon can avoid the pitfalls of speculative attacks and unreasonably high interest rates that stifle investments.
2. **Institutional reform:** The public needs to trust that the central bank can manage the exchange rate responsibly. Without transparency[15] and accountability,[16] the central bank's policy decisions may appear erratic and politically motivated,[17] undermining public and investor

[15] Transparency means that the central bank provides clear, accessible information about its policies, decisions, and goals, allowing the public and investors to understand the rationale behind its actions.

[16] Accountability means that the central bank is answerable for its actions and policies, with mechanisms in place to assess its performance and rectify mistakes, which requires periodic performance review before an independent oversight body to ensure that it is acting in the country's best interests.

[17] In countries without robust institutional frameworks, political pressures may prevent the central bank from maintaining an independent monetary policy. For instance, and as is the case in Lebanon, the central bank may face pressure to finance poorly planned budget deficits or cover the deficit of inefficient state institutions, thus weakening the currency and undermining the exchange rate policy.

confidence. The point is to ensure the central bank's actions are more predictable, and its ability to sustain trust and manage market expectations are more robust because they follow a consistent policy framework—rather than being arbitrary, hidden, or interest-driven.

Phase 2: Transitioning into a Managed Float

Moving to a managed floating exchange rate requires significant economic adjustments to enable Lebanon to better withstand external shocks and maintain investor confidence:

1. **Targeting an accurate valuation of the currency**: Ensuring the currency is competitively priced, rather than overvalued. This can be measured by maintaining a Real Effective Exchange Rate (REER) below 100.
2. **Reducing the current account deficit**: Reducing the current account deficit, potentially to under 3 percent GDP to lower the reliance on external financing. As previously discussed, this can be achieved through a targeted capital expenditure program.
3. **Maintaining adequate foreign reserves**: Ensuring reserves are sufficient to cover three to six months of imports, meeting external obligations.
4. **Reducing foreign-currency public debt**: Phasing out foreign-currency debt rather than relying on austerity or strict budget balancing. Whenever needed, using IMF benchmarks for fiscal sustainability, such as maintaining a Primary Fiscal Balance (excluding interest payments) under 3 percent of GDP and reducing the Foreign debt-to-GDP Ratio to below 60 percent.

Phase 3: Transitioning into a Floating Exchange Rate System

With these adjustments completed under a managed float, the shift to a fully free-floating system requires further economic adjustments:

1. **Targeting productive capital inflows**: Developing and implementing targeted incentives to attract a robust and consistent flow of FDI. These incentives should be designed to channel investments into the high-productivity, tradable sectors, such as manufacturing, technology, renewable energy, and value-added export industries.

2. **Achieving currency sovereignty**: Eliminating foreign-currency government debt to attain full currency sovereignty, enabling effective fiscal spending to stimulate economic growth. Currency sovereignty allows the government to issue its own currency to finance domestic priorities without the constraints of foreign-denominated debt.

3. **Developing financial markets**: Well-functioning financial markets, including robust secondary markets for government and corporate debt, are crucial for adopting a floating exchange rate system. These markets enable effective exchange rate risk management and currency stabilization. In Lebanon, financial market depth is severely lacking, with a minimal secondary market for government debt and an almost non-existent corporate bond market, leaving businesses reliant on bank loans. Developed financial markets would reduce central bank intervention and support a smoother transition to a floating exchange rate system.

4. **Improving governance**: Establishing strong governance is essential for the effective utilization of fiscal spending. Addressing issues such as corruption and mismanagement ensures that public funds are allocated efficiently and reach intended projects or sectors, reducing inefficiencies and curbing corruption. Additionally, implementing structural reforms—such as improving the business environment and streamlining regulatory frameworks—creates a solid foundation for sustaining investor confidence.

8. CONCLUSION

Historically, the focus on exchange rate stability with a fixed exchange rate regime has led to an appreciated currency, making exports less competitive and increasing the trade deficit. To finance this deficit and maintain the currency peg, Lebanon had to continue to attract foreign capital. While this made the financial system highly vulnerable to negative external events, the trade-off resulted in higher levels of unemployment, slower growth, and increased dependence on foreign capital. Years of excessive suppression of the exchange rate in Lebanon have led to a buildup of immense pressures that resulted in a severe market correction in 2019.

In contrast, a floating exchange rate system would act as a stabilizing force, absorbing global and regional shocks while reducing dependence on austerity measures or ad hoc capital controls.

Equally important is that the floating exchange rate system does not constrain monetary and fiscal policies, but offers greater flexibility, particularly when coupled with currency sovereignty and the potential application of MMT-inspired policies to stimulate productive investment and boost exports.

Lebanon’s transition to a floating exchange rate system, however, should proceed through multiple phases aimed at strengthening the country’s economic fundamentals. Phase 1 involves adopting a crawling peg policy to stabilize the currency and requires effective reserve management and institutional reforms to build public trust. Phase 2 involves moving to a managed floating system and necessitates accurate currency valuation, reducing the current account deficit, controlling inflation, maintaining adequate foreign reserves, and phasing out foreign-currency debt. Phase 3 shifts to a fully floating exchange rate system after putting a plan in place to attract foreign investments in the productive sectors, achieving currency sovereignty, developing financial markets, and strengthening governance. While these conditions, required for the transition from the fixed to the managed float and eventually to a free float, should not be viewed as following a rigidly sequential approach, they nonetheless represent what is necessary for Lebanon to build financial stability and resilience. Of particular importance is Phase 2, which represents a crucial move to gradually expand the fiscal space and enable increased investment in idle capacity and the productive sectors, thus boosting exports and building resilience against external shocks.

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