

Libya beyond the Revolution: Challenges and Opportunities



Prepared by a staff team led by Ralph Chami, and comprising Ahmed Al-Darwish, Serhan Cevik, Joshua Charap, Susan George, Borja Gracia, Simon Gray, and Sailendra Pattanayak

Middle East and Central Asia Department

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Contents

| | |
|---|----|
| Acknowledgments | v |
| Introduction | 1 |
| Conflict Devastates the Economy | 2 |
| Financial Sector Reforms on Hold | 7 |
| Economic Recovery Takes Hold amid Risks | 8 |
| Rapid Recovery Allows for Early Action on Medium-Term Reform | 11 |
| Diversification to Underpin a New Growth Strategy | 15 |
| A Comprehensive Agenda Calls for Sustained Commitment | 19 |
| Figures | |
| 1. Oil Production Collapsed | 3 |
| 2. Revolution Had a Devastating Effect on the Economy | 4 |
| 3. Supply Bottlenecks Pushed Prices Higher | 5 |
| 4. Loss of Hydrocarbon Income Worsened Fiscal and External Accounts | 6 |
| 5. Libya Ranks among the Most Hydrocarbon-Dependent Countries | 9 |
| 6. Public Finances Have Become More Dependent on Hydrocarbon Revenues | 10 |
| 7. Short-Term Challenges | 10 |
| 8. Medium-Term Challenges | 11 |
| 9. Heavy Reliance on Untargeted Subsidies Should Give Way to a Cost-Effective Social Protection Framework | 12 |
| 10. Libya Exports Almost Nothing but Hydrocarbons | 15 |
| 11. High Unemployment is a Structural Problem (2010) | 16 |
| 12. Libya Scored Poorly in All Measures of Governance (2010) | 18 |
| 13. Despite Reform Efforts, Business Conditions Did Not Improve | 18 |
| 14. Low Financial Intermediation Limits Private-Sector Development | 19 |

CONTENTS

Tables

| | |
|---|---|
| 1. Economic Shock from the Revolution is Expected to be Temporary | 4 |
| 2. Loss of Hydrocarbon Revenues Hits Public Finances | 6 |
| 3. Financial Indicators Likely to Have Worsened during the Conflict | 8 |

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Libya beyond the Revolution: Challenges and Opportunities

Libya's popular revolution of 2011 has unleashed the potential for more diverse and inclusive growth. In the short term, the country faces the complex and costly tasks of rebuilding its economy, infrastructure, and institutions, and responding to the demands of its population, especially for improved governance. The conflict that accompanied the revolution had a severe impact on the economy, which is heavily dependent on hydrocarbons, but the contraction is expected to be temporary. The restoration of hydrocarbon production is already well advanced, and reconstruction efforts will boost non-hydrocarbon output growth in the coming years. Libya's wealth opens a choice of paths for the future: it can fall into the trap of many resource-rich countries that have become overly reliant on revenues from finite natural resources and failed to diversify their economies, or it can pursue a course of sustainable, inclusive development led by increased private-sector activity.

The National Transitional Council (NTC) has taken steps to promote a peaceful political transition, to normalize economic conditions, and to set out a national reform agenda. In the short term, the authorities must restore security, bring hydrocarbon production fully online, exercise fiscal discipline, resuscitate the banking system, and maintain macroeconomic stability. But Libya also faces the formidable challenges of responding to the underlying causes of the revolution and building a democratic regime in the midst of heightened regional risks and global uncertainties. Therefore, medium-term efforts should focus on capacity building, infrastructure renewal, private-sector development, improving education, job creation, and putting in place an effective social safety net, within a framework of transparent and accountable governance.

At the request of the Libyan authorities, international financial institutions are engaged in policy consultations and technical assistance, aimed at maintaining macroeconomic stability and developing an institutional infrastructure to promote economic diversification and employment growth.

Conflict Devastates the Economy¹

Hydrocarbons have long dominated the Libyan economy, accounting for more than 70 percent of GDP, more than 95 percent of exports, and approximately 90 percent of government revenue. With about 3.5 percent of the world's proven crude oil reserves, Libya has a prominent position in the international energy market. Before the revolution, its output was 1.77 million barrels per day of crude oil (equivalent to 2 percent of global output) and close to 0.2 million barrels-equivalent of natural gas.

Following the lifting of earlier United Nations (UN) sanctions in 2003, economic activity increased steadily for seven years. During 2004–10, average real GDP growth was approximately 5 percent, annual consumer price inflation averaged less than 4 percent, and official foreign assets increased from \$20 billion at end-2003 to \$170 billion at end-2010. While the non-hydrocarbon sectors grew rapidly, underpinned by an ambitious public investment program, Libya remained one of the most hydrocarbon-dependent countries, with its exports among the least diversified in the world; its small private sector was handicapped by the ubiquitous dominance of the state and by crippling institutional failures. Consequently, social and governance indicators remained poor, job creation was lackluster, and dependence on expatriate workers increased.²

Violent protests in Libya erupted on February 17, 2011, escalating rapidly into conflict. The UN Security Council imposed sanctions on Libya on February 26, which were broadened on March 17 to include a mandate for limited foreign military intervention and a freeze on Libya's foreign assets. On October 23, the NTC declared liberation after defeating the military forces of the former ruler, Moammar Gaddafi. The NTC announced the formation of a new, transitional government on November 22 and plans to hold parliamentary elections by June 23, 2012. The bulk of Libya's foreign assets were unfrozen on December 16, clearing the way for normalization of the foreign exchange market.

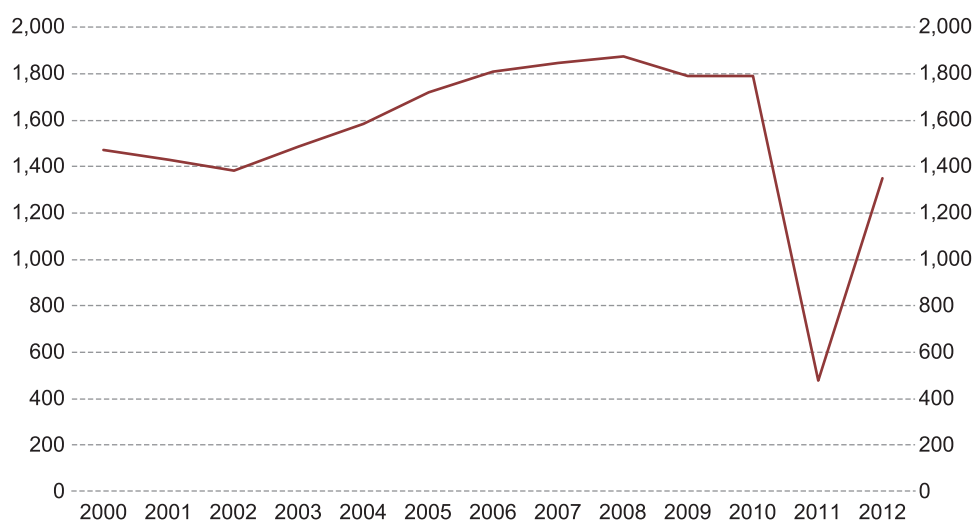
As a consequence of the conflict, crude oil production fell to 22,000 barrels per day in July 2011, although output was restored rapidly in the last quarter of 2011 to half the pre-conflict level (Figure 1).

Non-hydrocarbon economic activity was affected by the destruction of infrastructure and production facilities, disruptions to banking activity, limited access to foreign exchange, and the departure of expatriate workers. Consequently, with an estimated 50 percent contraction in non-hydrocarbon

¹ This report is based on data available as of January 2012.

² Pre-revolution statistics indicated an unemployment rate of 14 percent at end-2010. After the revolution, however, officials in the Ministry of Labor and Capacity Building adjusted the estimated end-2010 unemployment to approximately 26 percent.

Figure 1. Oil Production Collapsed
(In thousands of barrels per day, annual average)



Sources: U.S. Energy information Administration; and IMF staff estimates and projections.

output, total real GDP in 2011 was 60 percent lower than in 2010 (Figure 2 and Table 1).

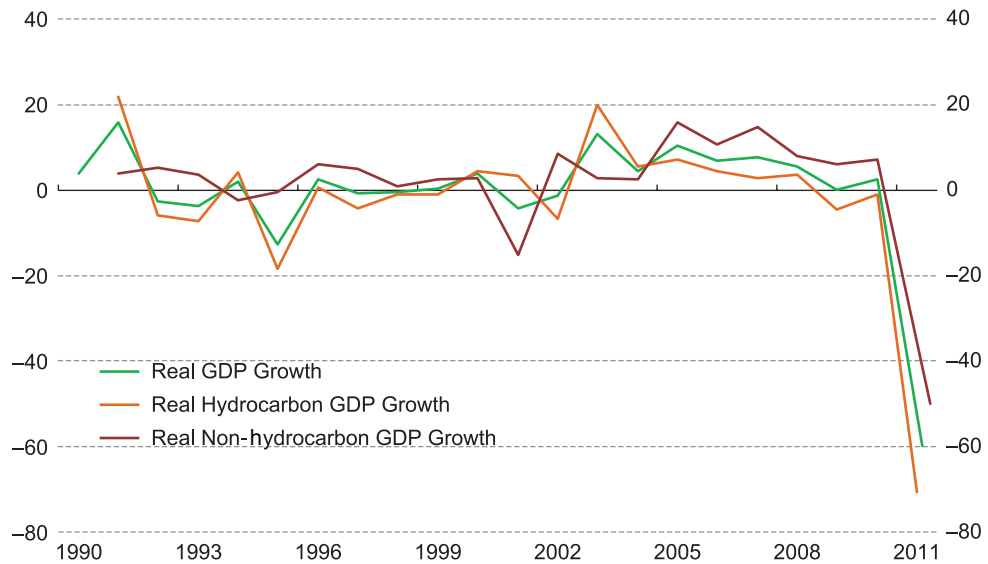
The Central Bank of Libya (CBL), lacking access to its foreign assets, was unable to sell foreign exchange; the parallel market value of the Libyan dinar (LD) fell, at one point reaching a low of half its official value.³ With the unfreezing of foreign assets in late 2011, however, the spread between the official and parallel market exchange rates narrowed to less than 10 percent in early 2012. Even so, the consumer price index (CPI) increased significantly in 2011, reflecting physical constraints on imports, domestic supply limitations, and monetary expansion as well as exchange rate depreciation on the parallel market (Figure 3). Although the availability of consumer price data during the conflict was limited, estimates indicate that the CPI increased by about 20 percent in 2011.

The loss of hydrocarbon income during the conflict reduced Libya's current account surplus. Exports declined from \$48.9 billion in 2010 to \$19.2 billion in 2011, while imports dropped from \$24.6 billion to \$14.2 billion during the same period. As a result, the current account surplus narrowed from 21 percent of GDP in 2010 to less than 4½ percent of GDP in 2011 (Figure 4).

The 2011 budget was reallocated to address the drop in hydrocarbon revenues, humanitarian needs, and a disruption of most capital expenditures, as well as first-quarter policy changes, including increased salaries. Revenue is

³The official current exchange rate has been pegged to the SDR at LD1 = SDR 0.5175 since June 14, 2003.

Figure 2. Revolution Had a Devastating Effect on the Economy
(Annual percentage change)



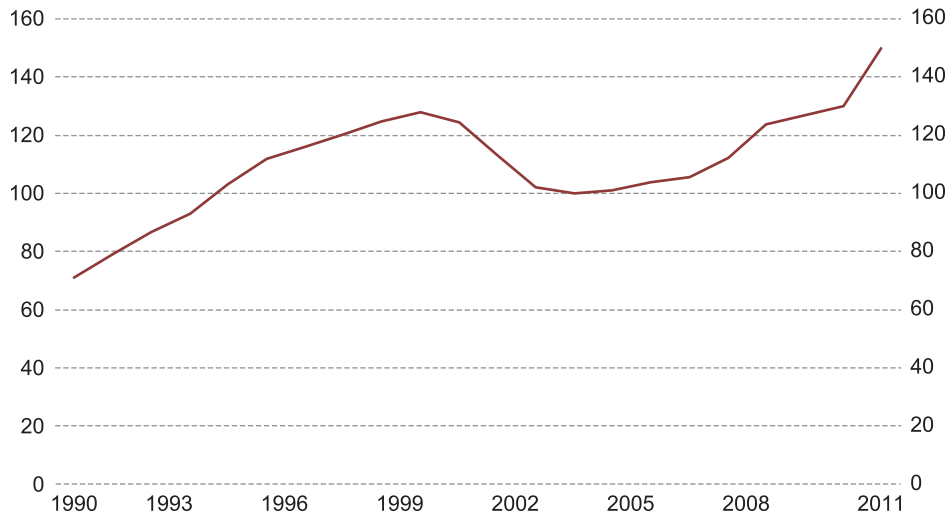
Sources: Country authorities; and IMF staff estimates.

Table 1. Economic Shock from the Revolution is Expected to be Temporary

| | 2010 | 2011 | Proj. 2012 |
|--|------|-------|---------------|
| Real GDP, annual percentage change | 2.9 | -60.0 | 69.7 |
| Non-hydrocarbon | 7.0 | -50.0 | 20.0 |
| Hydrocarbon | -1.2 | -70.9 | 163.3 |
| CPI inflation | | | |
| End-period | 3.3 | 19.2 | -10.4 |
| Period average | 2.5 | 14.1 | 1.9 |
| Overall budget balance, percent of GDP | 4.9 | -42.8 | -6.8 |
| External current account, percent of GDP | 20.8 | 4.4 | 11.2 |
| Total foreign assets (\$ billion), of which: | 172 | 174 | 174 |
| Gross official reserves | 103 | 106 | 82 |
| Oil production, millions of barrels per day | 1.77 | 0.51 | 1.35 |

Sources: Country authorities; and IMF staff estimates.

Figure 3. Supply Bottlenecks Pushed Prices Higher
(Consumer price index, 2003 = 100)



Sources: Country authorities; and IMF staff estimates.

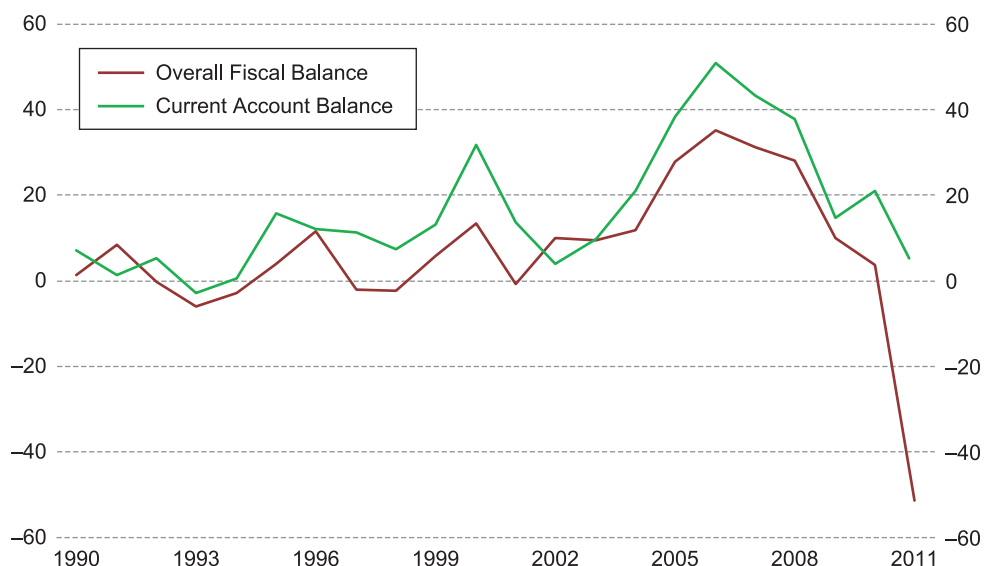
estimated to have declined by 69 percent in nominal terms, from 57 percent of GDP in 2010 to 39 percent of GDP in 2011. Spending on wages rose by approximately 60 percent, driven by a March 2011 public-sector wage increase. The 2011 budget was financed by domestic borrowing of LD 13.5 billion, as well as arrears estimated at LD 6 billion (Table 2).

During and immediately after the revolution, the financial situation of the public sector was precarious, with the government financing expenditures by borrowing from the CBL and by drawing down deposits at the CBL. The money supply increased due to monetization of the budget deficit; currency in circulation doubled from LD 7.5 billion at end-2010 to LD 15.4 billion at end-2011. Although currency in circulation doubled, demand for cash increased even more, resulting in a shortage of liquidity in the banking system, which the CBL addressed by imposing a limit on cash withdrawals by individuals from the banking system.⁴

The economic upheaval in Libya has also had significant spillovers globally and regionally. Prior to the conflict, Libya accounted for 2 percent of global crude oil production, and the loss of Libyan oil exports created a temporary shortfall in the international market. In addition, Libya had

⁴ Currency in circulation was equivalent to approximately \$12 billion at end-2011. The CBL issued the equivalent of \$2 billion in LD in newly printed notes, and reissued the equivalent of \$4 billion in banknotes that had been withdrawn from circulation. The statutory limit on monthly cash withdrawals was equivalent to \$600, although commercial banks imposed lower limits based on availability of cash.

Figure 4. Loss of Hydrocarbon Income Worsened Fiscal and External Accounts
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates.

Table 2. Loss of Hydrocarbon Revenues Hits Public Finances

| | Est. 2010 | Est. 2011 | Proj. 2012 |
|--------------------------------|--------------|--------------------------------|---------------|
| | | | |
| | | (In billions of Libyan dinars) | |
| Nominal GDP | 102 | 46 | 96 |
| Revenue and grants | 58 | 18 | 56 |
| Expenditure, <i>of which</i> : | 53 | 37 | 62 |
| Wages and salaries | 9 | 15 | 18 |
| Subsidies and transfers | 12 | 12 | 15 |
| Overall balance | 5 | -20 | -7 |
| | | | |
| | | (In percent of GDP) | |
| Revenue and grants | 57 | 39 | 58 |
| Expenditure, <i>of which</i> : | 52 | 82 | 65 |
| Wages and salaries | 9 | 32 | 19 |
| Subsidies and transfers | 12 | 26 | 16 |
| Overall fiscal balance | 5 | -43 | -7 |
| External current account | 21 | 4 | 11 |

Sources: Country authorities; and IMF staff estimates.

hosted approximately 1.5 million migrant workers; an abrupt exodus of expatriate workers reduced remittances and added to the already large pool of unemployed in Libya's neighboring countries. More generally,

the intensification of regional turmoil due to the Libyan conflict further contributed to deterring tourism and foreign investment.

Financial Sector Reforms on Hold

Before the revolution, Libya's financial sector had been undergoing reform. Prior to 2007, the five largest commercial banks were fully owned by the CBL. Reforms included partial privatization and the involvement of foreign partners in six out of the 16 banks.⁵ Nevertheless, much of the banking system remains under the control of the government, and state-owned specialized credit institutions play a major role in the financial sector.⁶

The performance of the banking sector had improved: total commercial bank assets increased from LD 14.5 billion at end-2003 to LD 65.4 billion at end-2010. Financial soundness indicators improved over the period, with nonperforming loans declining to 17.2 percent (from 35.5 percent in 2004), loan provisioning increasing to 85 percent (from 51.8 percent in 2004), and the regulatory capital ratio increasing to 17.3 percent, compared to 10.4 percent in 2004 (Table 3).

As a result of the conflict, the banking sector balance sheet is likely to have worsened. Economic disruption will delay some loan repayments, as asset quality has deteriorated (mostly through physical destruction). In addition, loans that may have been made to entities of the former regime may be irrecoverable. Moreover, the threat of legal challenges to the seizure of property by the former regime creates potential risks for the banking sector, particularly if these properties have been used as collateral.⁷

During the conflict, commercial banks suffered from a systemic liquidity crunch despite the doubling of currency in circulation. The shortage of dinar cash was linked to the slow normalization of the foreign exchange market and reflected a breakdown in the banking system infrastructure (in which commercial banks experienced difficulties making payments through the electronic system). The lack of access to foreign exchange constrained commercial bank operations, undermined public confidence in banks, and further prompted the private sector to hoard cash; the hoarding was exacerbated by account holders' fears of difficulty in accessing deposits.

⁵ Foreign participation in the banking system included BNP Paribas acquiring a stake in Sahara Bank (August 2007) and the granting of a license to Unicredit (August 2010).

⁶ Loans by the specialized credit institutions account for about one-third of lending by the financial sector.

⁷ Starting in the late 1970s, tens of thousands of residential and commercial premises were confiscated by the former regime and were given, sold, or rented at below-market rates to new occupants.

Table 3. Financial Indicators Likely to Have Worsened during the Conflict

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|--|------|------|------|------|------|------|------|
| Regulatory capital to risk-weighted assets | 10.4 | 10.9 | 11.6 | 11.8 | 12.2 | 14.5 | 17.3 |
| Nonperforming loans to gross loans | 35.5 | 31.7 | 26.1 | 26.2 | 22.5 | 17.0 | 17.2 |
| Return on assets | 0.4 | 0.5 | 0.5 | 0.5 | 0.6 | 1.3 | 1.0 |
| Return on equity | 6.8 | 8.6 | 9.9 | 10.2 | 13.6 | 23.7 | 15.0 |
| Liquid assets to total assets | 49.8 | 59.8 | 60.2 | 68.0 | 73.4 | 74.1 | 74.3 |
| Loan provisions to nonperforming loans | 51.8 | 61.1 | 65.8 | 59.6 | 71.0 | 88.7 | 85.0 |

Source: Country authorities.

The unfreezing of Libya's foreign assets has allowed the CBL to provide foreign exchange liquidity to banks, which should normalize the demand for dinar banknotes and the operations of commercial banking. Moreover, the announcement by the CBL that it intends to maintain the current exchange rate peg has bolstered confidence in the value of the dinar. The restoration of the non-cash payment system should also help reduce the demand for cash.

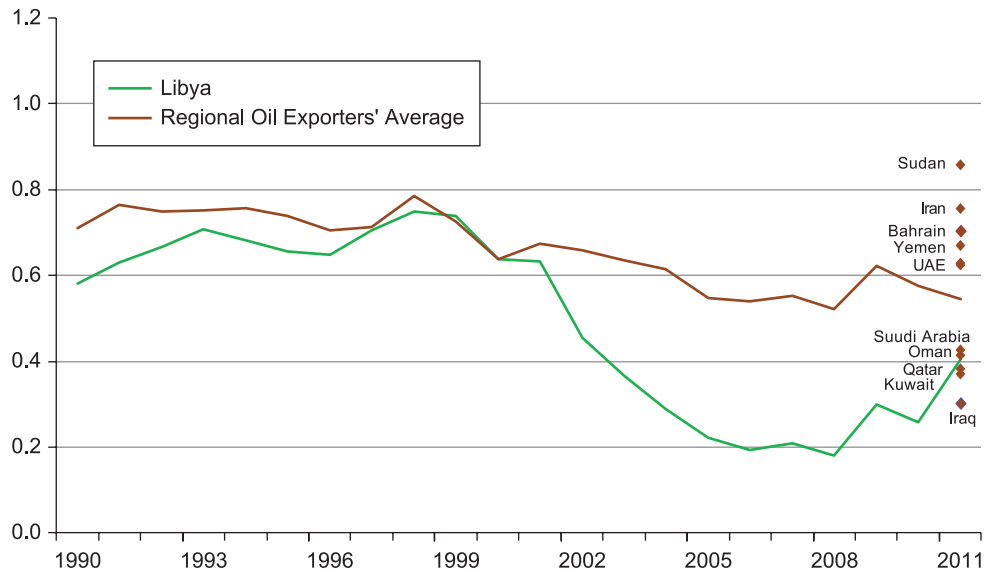
Credit to the private sector declined by about 6 percent in 2011, compared to an increase of 14.3 percent in 2010. The change in the stock of credit during 2011 was affected by loan repayments, primarily through salary deductions, and limitations on trade financing due to constraints on access to foreign exchange. Linkages between the financial system and the real economy are weak, as evidenced by a ratio of credit to GDP in 2010 of less than 20 percent. Nevertheless, reduced bank lending to the private sector is likely to have had an adverse impact on non-hydrocarbon economic activity.

Economic Recovery Takes Hold amid Risks

Economic activity is expected to show some recovery in 2012, concurrent with an improvement in the security situation. Crude oil production has exceeded 1 million barrels per day as of early 2012, and is expected to reach the pre-conflict level in 2014. Non-hydrocarbon GDP is expected to recover by 2014, driven mainly by reconstruction. Although the CPI increased significantly in 2011, consumer price inflation is expected to ease now that imports have resumed and the CBL is withdrawing domestic currency from the system by selling foreign exchange.⁸ The external current account

⁸ Some private capital outflows are expected in light of restoration of access to foreign exchange.

Figure 5. Libya Ranks among the Most Hydrocarbon-Dependent Countries
(Ratio of non-hydrocarbon GDP to total GDP)



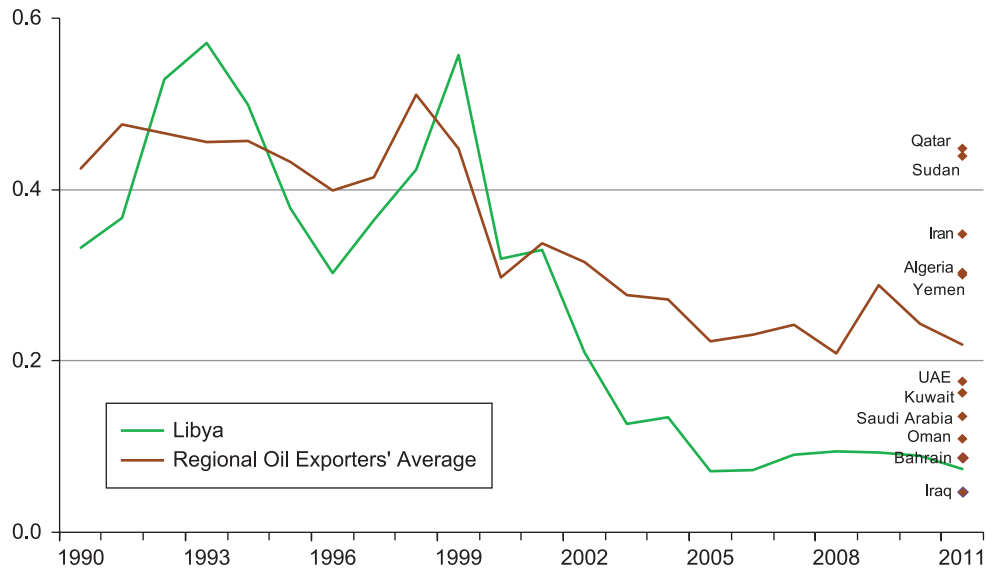
Sources: Country authorities; and IMF staff estimates.

surplus in 2012 will increase with the restoration of hydrocarbon and non-hydrocarbon exports.

Risks to the outlook include delays in normalizing the security situation, and lower international prices for crude oil and natural gas. Uncertainties in the security environment would constrain the economic recovery of the private sector, and could impede the return of expatriate workers who are needed to alleviate workforce bottlenecks. Intensifying strains in the euro area and global economic uncertainties have resulted in deteriorating financial conditions and exacerbated downside risks to global growth. Similarly, although hydrocarbon prices remain high, a deepening of the European crisis and a widespread global economic slowdown could lower petroleum prices and present additional challenges to Libya's hydrocarbon-dependent economy (Figures 5 and 6).

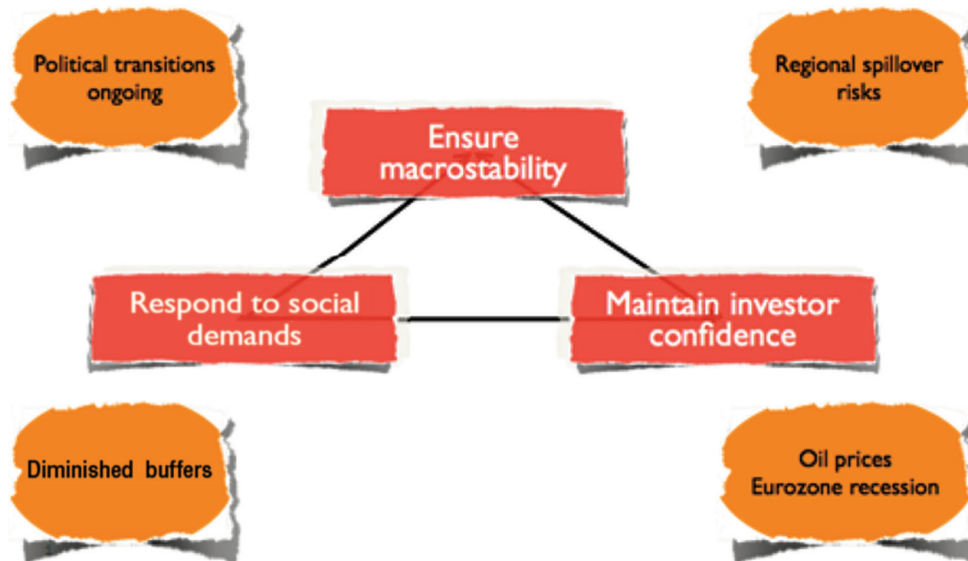
Overall, in light of diminished fiscal and external buffers, the Libyan authorities face significant short-term challenges (Figure 7). While responding to urgent social demands remains a priority, ensuring macroeconomic stability and maintaining investor confidence require greater policy coordination among various institutions. A peaceful political transition, underpinned by commitment to good governance and the rule of law, is essential to securing economic progress.

Figure 6. Public Finances Have Become More Dependent on Hydrocarbon Revenues
(Ratio of non-hydrocarbon revenue to total revenue)



Sources: Country authorities; and IMF staff estimates.

Figure 7. Short-Term Challenges



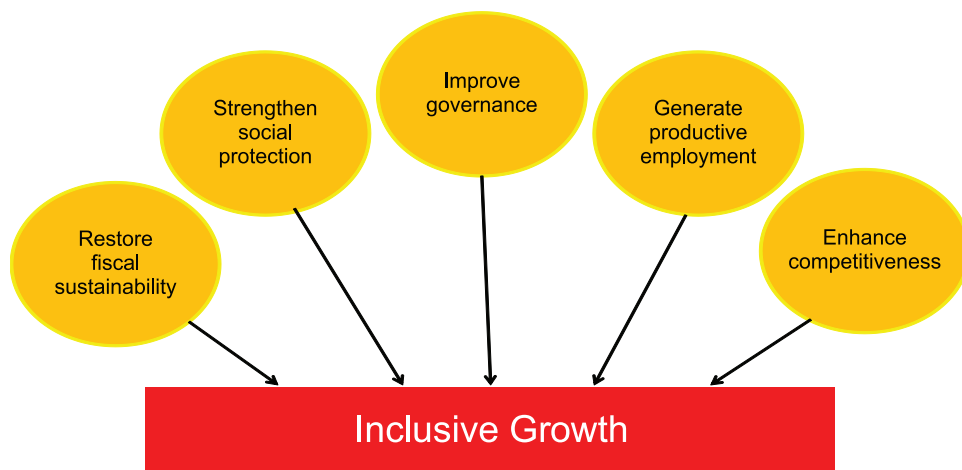
Rapid Recovery Allows for Early Action on Medium-Term Reform

Early planning for the medium term can be a way to reap the advantages of a speedy economic recovery in the short term and inclusive growth over the medium term (Figure 8). To that end, Libya would benefit from developing a medium-term budget framework that ensures sustainable fiscal policies. In the short term, the authorities need to balance recurrent spending pressures against the need for fiscal sustainability and prospects for private-sector development.

Wage increases implemented by the previous regime will raise the wage bill from 9 percent of GDP in 2010 to about 19 percent of GDP in 2012. A high level of public-sector wages will reduce the incentive for individuals to seek employment in the private sector and will undermine efforts to advance economic diversification. The envisaged increase in subsidies will raise expenditures on subsidies from 11.7 percent of GDP in 2010 to 15.9 percent of GDP in 2012. In 2012, revenues are expected to reach LD 55.9 billion (57.9 percent of the GDP), expenditures are estimated at LD 62.4 billion (64.7 percent of the GDP), and the deficit (to be financed through the issuance of government bonds and a drawdown in government deposits at the CBL) is foreseen to reach LD 6.6 billion (6.8 percent of the GDP). Although the government can afford to finance elevated current spending in the short term, the level of recurrent spending is likely to be inconsistent with appropriate budgetary prioritization and fiscal sustainability and will exert upward pressure on the real exchange rate.

Over the medium term, fiscal consolidation will be required to offset the large increase in current spending in 2011 and 2012 and to provide the needed space for capital and reconstruction spending while preserving long-term

Figure 8. Medium-Term Challenges



fiscal sustainability. Capital spending, subject in the short term to capacity constraints, will have to be reassessed given urgent reconstruction needs, efficiency considerations, and the need to assess the limits of the economy's absorptive capacity.

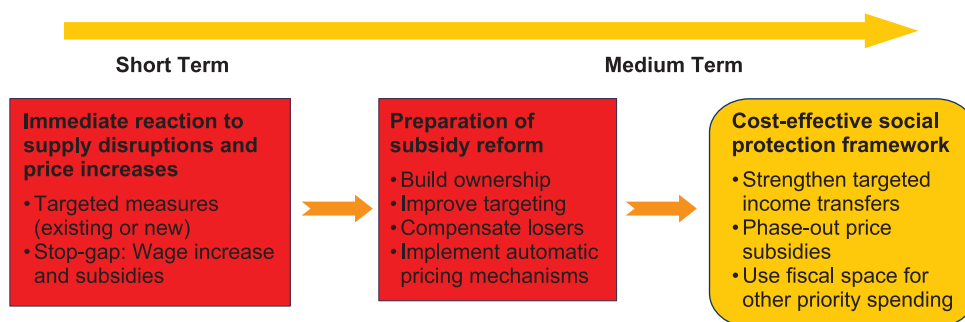
Reforms are needed to contain the wage bill and increase the efficiency of the public sector. Medium-term measures that have been implemented successfully in other countries include reducing reliance on the public sector as the main employer, decompressing the wage structure, aligning civil service remuneration with that of the market, monetizing allowances to make compensation more transparent, introducing performance-based incentives, computerizing payroll and personnel systems, and strengthening the recruitment system to depoliticize government hiring and professionalize the civil service.

Building a Comprehensive and Cost-Effective Social Safety Net

Subsidies and transfers will increase from 11.7 percent of GDP before the revolution to 15.9 percent of GDP in 2012, equivalent to 25 percent of total expenditure. Subsidies will remain elevated and create fiscal pressure. Subsidies affect consumption and production patterns as well as the allocation of resources, with negative implications for the government budget, expenditure composition, and private-sector development. Subsidy reform over the medium term should aim to reduce economic inefficiencies while better protecting low-income households. Universal subsidies, particularly fuel subsidies, are not targeted; they disproportionately benefit higher-income households.

Subsidy reform is often difficult to implement in the absence of a social safety net to shield low-income households. If the implementation of a

Figure 9. Heavy Reliance on Untargeted Subsidies Should Give Way to a Cost-Effective Social Protection Framework



sophisticated social safety net is not feasible, the government could consider identifying a package of short-term measures to mitigate the adverse impact of price increases, and using some of the savings from subsidy reform to increase public spending to benefit low-income households (Figure 9). The government could use established methods to improve targeting of low-income households, such as categorical or geographical application, or linking benefits to a self-targeting work program or schooling requirement. Although such measures are imperfect, they are more cost-effective in protecting low-income households than are universal subsidies.

Strengthening Public Financial Management

Looking ahead, Libya faces a number of challenges to establishing a robust, efficient, and transparent Public Financial Management (PFM) system and to ensuring sustainable use of its hydrocarbon revenues.⁹ There is a need to set up a clear macro-fiscal policy framework with a consistent fiscal rule reflecting the country's economic objectives and the volatile nature of hydrocarbon-based revenues. The sovereign wealth fund (SWF) managed by the Libya Investment Authority (LIA) and the Budget Reserve Account at the CBL should be fully integrated into this framework. Furthermore, the creation of a macro-fiscal policy unit at the Ministry of Finance would enhance fiscal policy formulation and help make the budget a strategic policy tool linking national policy objectives to macroeconomic performance.

The formulation of Libya's budget remains fragmented, mostly driven by a bottom-up approach that has been largely disconnected from explicit policy or development strategy. Libya would benefit from introducing reforms focused on ensuring a unified budget process (including full integration of recurrent and capital budgets), introducing a medium-term perspective to inform the annual budget, strengthening the policy context of budgeting, and adopting a comprehensive and clear budget presentation. The linkage between policy priorities and budgetary allocations should be strengthened, and a budget preparation calendar established that specifies the roles and functions of different agencies.

The Ministry of Finance is the core institution for fiscal management, and needs to be at the center of Libya's economic policymaking, to ensure that capital and current expenditure decisions are fully integrated, particularly in light of the re-establishment of a Ministry of Planning. An assessment

⁹ At the request of the authorities, the IMF and the World Bank have provided technical assistance in assessing the PFM framework and in enhancing internal governance of the Libyan Investment Authority and have recommended measures to improve accountability and transparency. Both institutions continue to work closely with the authorities in implementing these recommendations.

of investment projects is necessary to decide on priorities within the 2012 development budget.

To increase transparency and accountability and better inform economic policymaking, the thrust of reforms should focus on developing and implementing an internationally accepted budget classification and its associated chart of accounts to set the stage for the establishment of a Government Financial Management Information System (GFMIS), which would improve the comprehensiveness, reliability, and timeliness of budgetary information.

The efficient management of the government's liquid financial assets will require development of a treasury single account (TSA) at the CBL that will consolidate all cash resources. Sub-accounts could enable accounting and control mechanisms required for budget execution. It is necessary to close non-core treasury accounts and to link the TSA to the SWF system. Excess cash balances at line ministry commercial bank accounts should be brought under the TSA, including trust and escrow funds; these accounts should then be swept into the TSA on a daily basis. The payments system should also become more dynamic and centralized. Once a GFMIS accounting system is implemented, the payments system can become fully centralized and integrated with the accounting and control system.

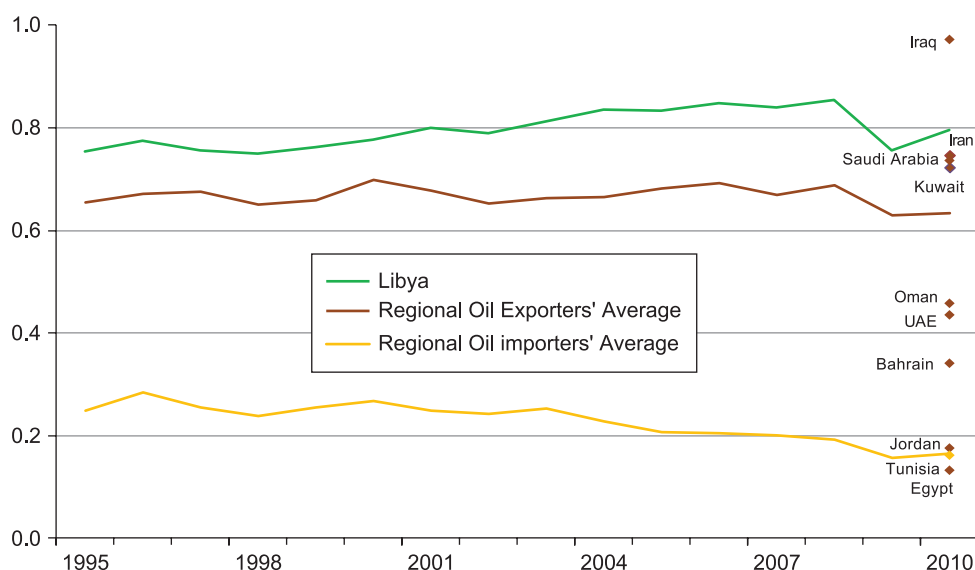
To ensure effective government cash planning, Libya needs to build capacity at the Ministry of Finance and in line ministries for cash flow forecasting. As cash planning becomes more accurate and systematic, the Treasury will be able to identify cash flow forecasting errors and develop the methodology to calculate TSA cash buffer requirements. The cash buffer will have linkages to the SWF system as it interacts with budget execution for stabilization purposes. It will also be important to develop the T-bill market over the medium term for cash management purposes.

Developing a Dynamic and Transparent Sovereign Wealth Fund

Libya would also be well served by improving its SWF system, currently operating through the LIA and the Budget Reserve Account, with clearly defined inflow and outflow rules. Unlike the existing arrangement, it would need to be a dynamic and completely transparent and accountable system. The Budget Reserve Account and the LIA portfolio could be merged to create a single system with two sub-portfolios, with separate portfolio management objectives aligned with their respective stabilization and savings purposes.

The SWF system should be based on well-specified and regulated investment criteria. Domestic investments that could have an adverse impact on monetary policy or that could lead to conflicts of interest and fragmentation of the budget framework should be eliminated. Other than

Figure 10. Libya Exports Almost Nothing but Hydrocarbons
(Export concentration index, 1 = maximum concentration)



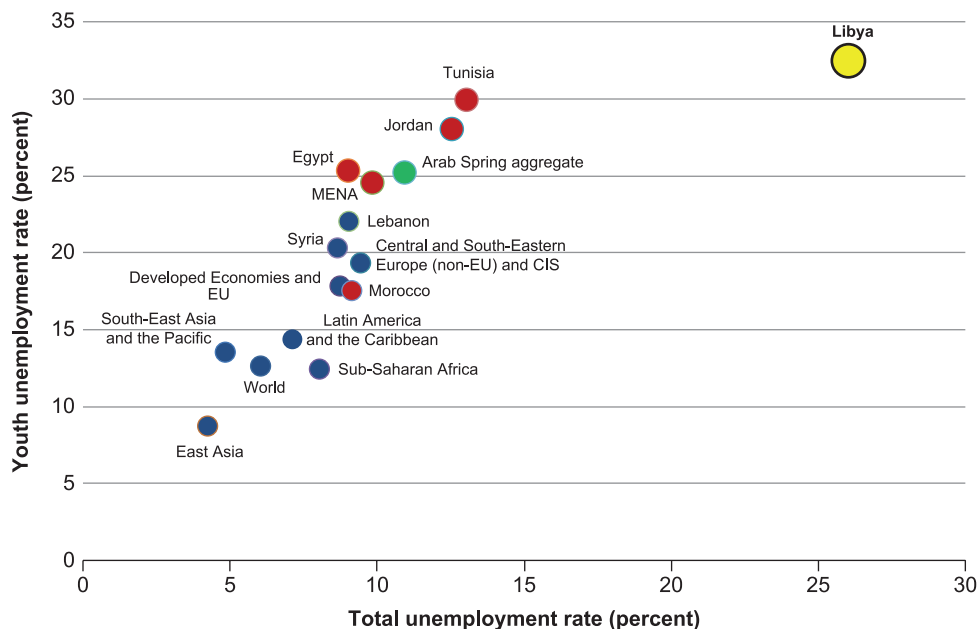
Source: United Nations Conference on Trade and Development.

outflow rules relating to long-term objectives or specified contingency events, outflows from the SWF system would only be earmarked to support the budget directly; all development spending would be channeled through the budget.

Diversification to Underpin a New Growth Strategy

Libya is overly dependent on hydrocarbons. Although non-hydrocarbon economic activity was growing at a rapid pace before the conflict, it still accounts for no more than 30 percent of GDP and a negligible part of total exports. The latest measures of export diversification show that Libya scores poorly compared to other hydrocarbon-dependent economies in the region (Figure 10).¹⁰ Furthermore, unemployment appears to be a structural problem, particularly among the youth, and the identification of policy measures and structural reforms that would create employment opportunities is critical (Figure 11). While considerable potential to expand hydrocarbon production exists, the hydrocarbon industry is capital intensive and therefore can make only a very limited contribution to employment growth. Hence, over the medium

¹⁰ Export concentration is estimated using the Herfindahl-Hirschmann measure of the degree of market concentration, normalized to obtain values ranking from 0 to 1 (maximum concentration).

Figure 11. High Unemployment is a Structural Problem (2010)

Sources: Ministry of Labor and Capacity Building; International Labour Organization; and IMF staff calculations.

term, the main challenges are to reorient the economy away from hydrocarbon dependence and to promote job creation and inclusive growth.

With the implementation of appropriate policies, Libya can continue to benefit from its natural resources, develop a vibrant private sector, and reorient its economy away from hydrocarbon dependence. Achieving these goals requires a range of well-targeted institutional reforms and prudent macroeconomic management.

There is significant scope for diversification into tourism and trade, in light of Libya's rich archeological sites, Mediterranean climate, and proximity to major European markets. The basic legal infrastructure for private-sector development was adopted in 2010; the next step is to ensure that the laws are implemented effectively, which will require coordination among agencies and an efficient and reliable judiciary. Libya will also need to upgrade basic infrastructure, including roads and electricity, with investment targeted at removing obstacles to economic development.

Improving Governance

An improvement in the business environment requires a governance framework that is transparent and includes clear accountability rules. This

framework would foster private-sector development by attracting much-needed foreign expertise and investment, as well as the country's skilled diaspora. Together with local entrepreneurs, the diaspora would help create new investments and job opportunities, and promote inclusive growth.

Prior to the conflict, Libya revamped its legal framework in an effort to improve conditions for private-sector activity. By early 2010, 22 new laws were passed to make fundamental changes to a range of activities including commerce, customs, income tax, the stock market, labor, communication, and land registry. At the time, however, Libya ranked low on international measures of governance, business conditions, and competitiveness (Figures 12 and 13). The World Economic Forum found that Libya had better macroeconomic conditions than the regional average, reflecting primarily its record of large fiscal surpluses and low debt. On most other indicators of competitiveness, however, Libya scored poorly, ranking in the bottom 10 on measures of financial market development, innovation, labor market efficiency, business sophistication, and goods market efficiency. The Economist Intelligence Unit painted a similar picture, with Libya scoring poorly on policies related to private enterprise and competition.

Building Human Capital

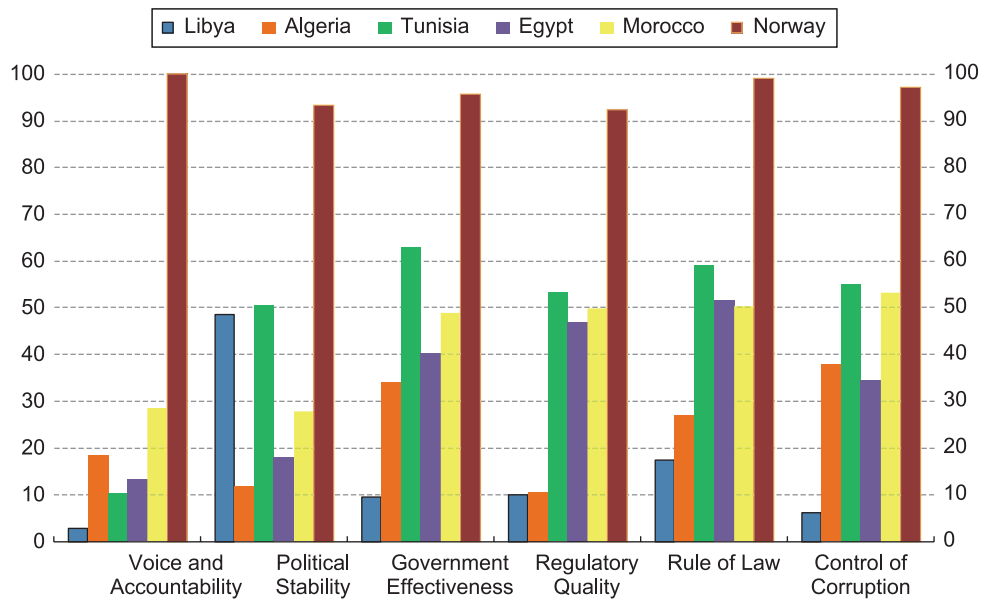
A skilled labor force and a smoothly operating labor market are important for economic development. To complement the governance framework, emphasis should be placed on improving productivity through strengthening the education system and increasing human capital to support the private sector. Libya has a young population—close to 50 percent are below 25 years of age—with a large influx of entrants to the labor market expected in the next decade. Transforming the economy will require a workforce with new skill sets, and private companies may struggle to find qualified and experienced personnel. To meet the demand, it will be important to establish training programs for workers and job seekers, and to reform the education system to reflect new needs, such as language and computer skills.

In addition, the size of the civil service will need to be reduced, and public-sector wages contained to limit growth in the reservation wage. The transition will not be easy: it will be important to strengthen social safety nets to support those in need while allowing the labor market to operate freely and effectively.

Developing the Financial Sector

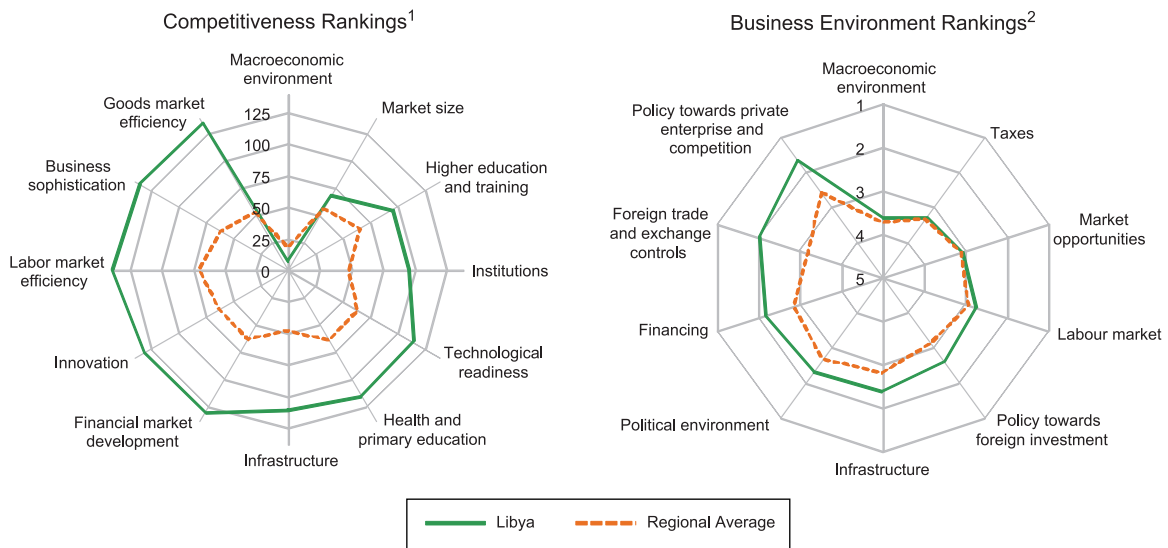
Financial-sector intermediation is necessary to foster private-sector development (Figure 14). Well-functioning banking and financial sectors that provide broader access to finance for small and medium-sized enterprises

Figure 12. Libya Scored Poorly in All Measures of Governance (2010)



Source: Worldwide Governance Indicators, World Bank, 2011.

Figure 13. Despite Reform Efforts, Business Conditions Did Not Improve (2010)

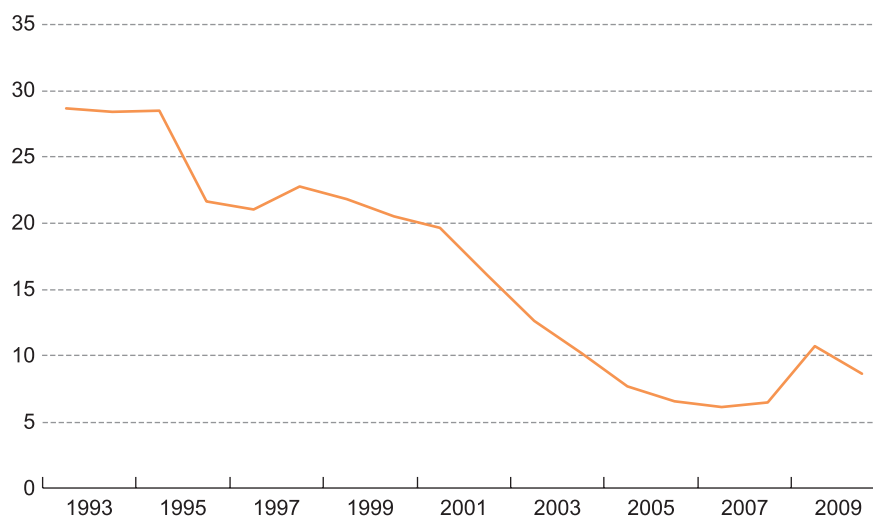


Sources: World Economic Forum, Global Competitiveness Report, 2010–11; Economist Intelligence Unit, Country Forecast, September 2010.

¹ Economies ranked from 1–139, with first place being the most competitive. Regional Average is a simple average of the rankings for Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

² Scores for 2005–09 based on a scale from 1 (very bad for business) to 5 (very good for business). Regional average is a simple average of scores for Algeria, Bahrain, Egypt, Iran, Israel, Jordan, Kuwait, Libya, Morocco, Qatar, Saudi Arabia, Tunisia, the United Arab Emirates, Angola, Kenya, Nigeria, and South Africa.

**Figure 14. Low Financial Intermediation Limits
Private-Sector Development**
(Credit to private sector as a share of GDP)



Sources: Country authorities; and IMF staff estimates.

would help in developing a vibrant non-hydrocarbon sector. In order to resuscitate the banking system, it will be important for the CBL, as banking supervisor, to verify that commercial banks have as clear a picture as possible of the impact of the recent conflict on their balance sheets, and to ensure that they have sufficient capital to cover losses and to continue lending during the reconstruction period. Prudential policies will also need to ensure that banks have diversified funding, as the introduction of a TSA will adversely impact those banks that rely on government deposits as their main funding source.

The development of a domestic debt market could provide the basis for more effective monetary policy and long-term financing to support economic diversification. Fixed-income instruments—including central bank bills that are regularly auctioned—could serve as a means of managing short-term liquidity and for institutions to match long-term assets and liabilities. In particular, an actively traded government bond market could eventually provide a base from which to price dinar-denominated corporate bonds.

A Comprehensive Agenda Calls for Sustained Commitment

Libya has an opportunity to break with the past, modernize the infrastructure of its economy, and create private-sector employment opportunities for its citizens. Bolstered by its sizeable natural resource wealth and the recovery of

the hydrocarbon sector, a post-revolution revival in the country's economic activity should be rapid once the security situation normalizes. But Libya will also need a sustained commitment to comprehensive reforms to achieve its potential. The exchange rate peg to the SDR, which must be accompanied by fiscal restraint to prevent inflation and a damaging appreciation of the real exchange rate, will continue to provide a policy anchor.

It is crucial that Libya advance structural reforms to support private-sector growth, economic diversification, and the creation of employment for its young and growing labor force. Enhancing access to finance for entrepreneurs by developing the nascent financial sector will go a long way to create new employment opportunities and foster the growth of the non-hydrocarbon economy. Such measures need to go hand in hand with strengthening the education system and increasing human capital.

The transition to a new and inclusive Libya will undoubtedly be challenging. To maintain the course and help mitigate the shift to private-sector-led growth, an efficient and comprehensive social safety net will be needed, as well as commitment by the authorities to policy predictability and consistency. Decision making should be supported by reliable data; it will be important to unify the compilation of national statistics under the umbrella of an independent agency, to improve the coverage, quality, and timeliness of statistics. Transparency will help reduce uncertainty, spur investor confidence, and attract the much-needed skilled diaspora, foreign expertise, and investment.

