LIBYA'S SHADOW ECONOMY

APRIL 2017

Executive Summary

Libya has been in a state of turmoil since the overthrow of longtime leader Muammar Gadhafi in 2011. Conditions deteriorated significantly after a power struggle between rival political factions escalated in the summer of 2014. Civil, security, and social services have since collapsed in many parts of the country, as the power struggle between rival political forces increasingly cripples the ability of state institutions to respond to public needs. Moreover, Libya is experiencing an economic crisis, characterized by a drop in GDP, the drastic depreciation of the Libyan dinar, a severe liquidity shortage and rapid inflation.

While economic hardship is felt across the social spectrum, communities that have experienced armed conflict and displacement are particularly vulnerable. The post-revolutionary violence, which in 2014 transformed into a protracted civil war, has caused the displacement of up to 800,000 Libyans and the UN currently estimates that there are around 400,000 people in need of food assistance.[1] Furthermore, with the collapse of the state and the rise of the black market and the liquidity crisis, certain key commodities are no longer easily accessible or affordable for a large percentage of the Libyan population: for example, the price of one loaf of bread is now five times higher than it was in 2014, rising from 0.05 Libyan dinars to 0.25 Libyan dinars per loaf.[2]

The Libyan dinar has lost much of its value since 2014, creating a large gap between official and black market exchange rates. Attempts at economic stabilization after the revolution were hindered by inconsistent policies, mismanagement and corruption, as well as the structural deficiencies of the banking sector. Deteriorating security conditions inhibited the recovery of the oil industry and the generation of additional revenue streams. Public policies to address the crisis have so far proven unsuccessful.

At the same time, the economy is undergoing a process of 'black-marketization' - a vicious cycle, in which the shadow economy both feeds on the liquidity crisis and exacerbates it.[3] The importance of the shadow economy should not be underestimated: it is assumed that more than half of the money circulating in Libya moves within the informal sector. Central Bank of Libya statistics show that out of a cash supply of 42 billion dinars in 2015, 23 billion were circulating outside the banking system. By the end of 2016, this figure had reached 26.5 billion dinars.[4] Therefore, effectively around half of all Libyan currency is managed by the shadow economy. Understanding Libya's economic challenges therefore requires examination of the informal transactions and illicit practices that characterize the shadow economy. Understanding where this money is going, how it is handled, and by whom, has important implications for a wider cadre of international actors including stabilization, peacebuilding, political, and humanitarian agencies engaged in supporting vulnerable Libyan populations.

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1. According to the most recent update of IOM's Displacement Tracking Matrix (September 2016), there were approximately 313,200 IDPs and 462,950 returnees. http://www.globaldtm.info/libya/ The number of IDPs decreased significantly during the latter half of 2016, largely owing to the return of displaced families to the Sirte area. http://documents.wfp.org/stellent/groups/public/documents/ep/wfp289180.pdf
2. https://al-ain.com/article/103786&sa=D&ust=1491059999087000&usg=AFQjCNFUQ-vnY2a2BjlismwvrspbYH-Zyw
3. The term "shadow economy" here refers to commercial and financial transactions taking place outside state control, often involving fraud and corruption.
4. https://cbl.gov.ly/en/wp-content/uploads/sites/2/2016/03/AssetsLiabilities-of-cbl-oct2016.pdf

MERCY CORPS

The humanitarian response has been hampered by the complexity and intensity of the conflict, a lack of resources, and the remote nature of the response following the 2014 departure of nearly all foreign embassies and international organizations. Given their limited presence, humanitarian actors have sought viable remote modalities for expanding their reach and supporting those most in need, often pursuing cash-based methods. However, for cash interventions to be effective, a robust understanding of the local context, the rise of the shadow economy, and viable alternatives to the current liquidity crisis are needed to ensure that humanitarian interventions do no harm, and better understand driving factors that contribute to underlying household vulnerability as well as potential solutions to address those in a principled manner.

This paper therefore seeks to understand the background and current role of the Libyan shadow economy and the ways in which it relates to the ongoing liquidity crisis, with an emphasis on informal business dealings, banking, and financial transactions. In pursuit of this objective, this paper will not only discuss black market activities, but also conventional business and banking circles that are part of shadow networks. Equally, there are positive local initiatives that can be leveraged by humanitarians in order to avoid engaging with and indirectly supporting the complex network of the shadow economy, which will also be presented in the paper.

Findings

- The economic crisis and the rapid rise of the shadow economy since 2014 has a significant impact on vulnerability of Libyans;
- State's growing budget deficit, restrictive banking policies, peripheral security and precarious political conditions pave the way for an acute shortage of liquidity and prices inflation;
- With a large majority[5] of Libyans on State payroll, salaries continue to be paid, but civilians face concerning challenges to access incomes;
- Informal monetary transactions have increased as businesses and individuals seek alternative ways to obtain cash;
- Elaborate schemes exploiting the growing gap between official and black market exchange rates have placed additional strain on the State budget and aggravated inflation;
- A lack of transparency and accountability within the banking sector erodes consumers' trust and nurtures unsustainable economic patterns;
- Militias and armed actors are heavily involved in the shadow economy, engaging in financial fraud, extortion and robbery;
- Despite significant efforts, policymakers and the Central Bank of Libya have largely failed to tackle the liquidity crisis or curb manifestations of the shadow economy;
- Some commercial banks and financial service providers have devised new payment methods such as electronic payments and travellers' cheques to help alleviate the impact of the cash shortage; these methods may prove useful channels for reaching beneficiaries in Libya

5. World Bank estimates indicate that the government employs up to 70% of all salaried Libyans.

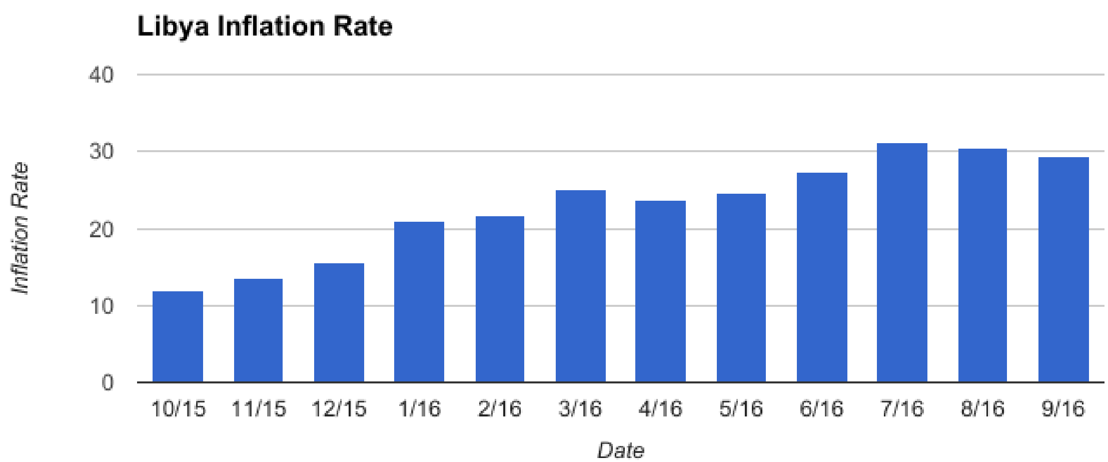
Libya's Shadow Economy (Table of Contents)

I. Social Impact of the Crisis and Initiatives to Alleviate it

The liquidity crisis has had a severe socioeconomic impact, affecting everyday life in multiple ways. Market price increases, a lack of availability of key commodities and services, and severe depreciation of the dinar have heavily impacted the daily lives of many Libyans. Further compounding this is an inflated public sector, significant delays in the payment of salaries, and bank liquidity shortages. It has bolstered the black market, which is able to deliver certain services that the banks cannot, and pushed people to engage in informal economic interactions.

Daily Repercussions of the Crisis

Libyans not only have less cash to spend, but also less purchasing power given the cost of living has increased substantially.



*Source: www.tradingeconomics.com | Bureau of Statistics

Due to the low level of industrialization, over 80 percent of food items are imported,[6] and prices are directly affected by currency depreciation. Wholesalers and retailers base their pricing on the black market exchange rate, necessarily driving prices higher. The price of milk, for instance, has more than doubled since 2014.[7] The price hike has also modified trade patterns: while European products used to be more widely available, merchants now increasingly import cheaper Turkish goods. Subsidized food items, such as bread, have also become more expensive, albeit less significantly.[8] The inflation rate, which was 2.4 percent in 2014,[9] reached 9.8 percent in 2015 and skyrocketed to 25.3% for the January to June period in 2016.[10]

Scarcity and the dynamics of informal distribution networks heavily affect pricing for certain goods such as fuel and cooking gas. While theoretically subsidized and abundantly available, these commodities are often in short supply given informal agents control their distribution. These same agents are subsequently also able to adapt their prices to levels of demand under their control. Such unpredictable price hikes have further eroded the standard of living for the average household and made the situation of the most vulnerable HHs even more tenuous.

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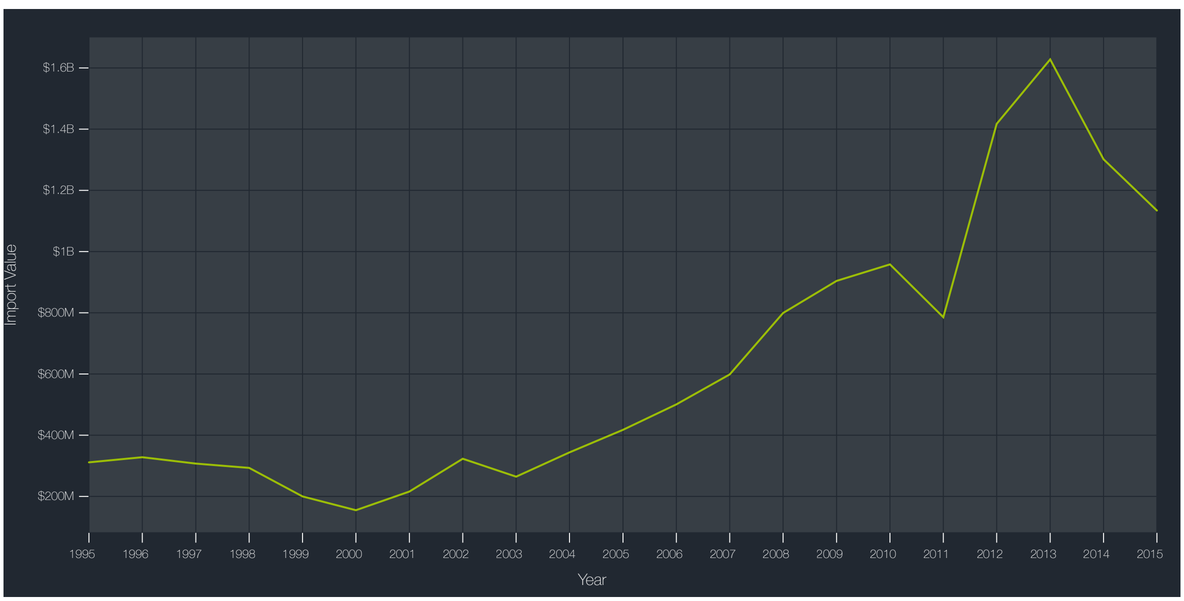
6. http://libyaprospect.com/index.php/2016/03/22/dollar-crisis-imposes-pricing-over-food-commodities-in-libya/
7. From 1.25 to 2.5 dinars for one imported brand. Other brands are now at almost 4 dinars.
8. While one loaf cost 0.05 LYD in 2014 it now costs 0.25 LYD.
9. https://cbl.gov.ly/en/wp-content/uploads/sites/2/2016/03/consumerpriceindex-andConsumer-Price-Index-by-Commodity-Groups.pdf
10. Central Bank figures cited in: https://www.libyaobserver.ly/economy/central-bank-libya-inflation-rates-skyrocketed-during-first-half-2016

Compounding this absence of key commodities is an absence of key services, such as medical treatment and higher education, forcing many Libyans to seek these services abroad. Unfortunately, the depreciation of the currency and the decision by the CBL to lower foreign currency allowances has made it extremely difficult for Libyans to afford travel abroad. Many Libyans now struggle to pay for foreign medical treatment abroad or to pay for tuition fees at foreign universities.

The crisis has also taken a toll on private businesses, such as small and medium-size construction companies. The demand for private housing construction - which boomed in many parts of the country in 2012 and 2013 - has plummeted as most people are no longer able to afford such large expenditures. At the same time, the price of imported materials and finishings continue to fluctuate. As a consequence, many construction companies have had to cease or suspend operations. While there are exceptions to this rule, such as the case of the proliferation of new upscale cafés in Tripoli, private businesses continue to suffer due to a lack of demand and the lack of affordable materials.[11]

People's day-to-day problems are not only attributable to the liquidity crisis but also to the rise of the shadow economy. In fact, the intersection of the shadow economy and the liquidity crisis has a far broader impact than simply businesses and services. For example, inflation is exacerbated by the fraudulent practices of food importers, who use their position as importers to take advantage of return. The depreciation of the dinar, for example, is linked to the monopoly of black market traders in the sale of foreign currency. Food, is perhaps the greatest concern. The liquidity crisis and shadow economy have doubly impacted food security; on the one hand, an absence of cash has prevented Libyans from purchasing food items on the market; separately, real food imports have decreased as importers focus on earnings from speculative currency exchange rather than the legitimate market. With the Libyan food market being almost entirely dependent on foodstuff importation, this progressive fall in imports (see graph below) will further decrease availability and trigger price inflation.

Foodstuff Imports since 1995



Foodstuff imports since 1995; http://atlas.media.mit.edu
Source: http://atlas.media.mit.edu

11. These individuals decisions to invest despite the crisis are likely linked to fears of money further losing value and lack of trust to place money in banks.

Individual Strategies to Mitigate the Liquidity Crisis

An assessment conducted in Libya by World Food Program in September 2016 reported that 23 percent of Internal Displaced Persons households sold their assets as a coping mechanism, whereas 9 percent stated that they did not do so because they had already exhausted this coping mechanism.[12] Mercy Corps reported that selling gold and silver to currency traders, in the black market, is a common coping mechanism put in place by those, especially in Tripoli, in need of cash to access basic services and goods.[13]

Negative coping mechanisms are not limited to those most in need. In order to obtain cash, ordinary Libyans have found different ways to manipulate monetary transactions and bypass banking restrictions. Each subsect of Libyan society has found their own coping mechanisms; while some have found means to profit, others have simply found ways to survive. These strategies will be explored in the following section.

Average Libyans have most often leveraged community relationships in order to generate liquidity. One interesting example is the use of personal relationships in the private sector to generate liquidity, such as individuals with family members or friends who own cash generating businesses, such as gas stations. Owners of private gas stations are required to pay the national fuel supplier through bank transfer or certified cheques, and they would therefore need to deposit cash at the bank. Instead of doing that, business owners may give the cash to chosen friends and family, and instead recover cheques to deposit on their bank accounts.

Some financial products have been diverted from their intended purpose, such as the murabaha, an interest-free loan introduced after the 2013 Islamic Banking Law. Commercial banks started offering this loan for the purchase of vehicles, or less frequently furniture and electronics. However, most subscribers use it to obtain cash through a procedure known as tawarruq or "turning (back) into paper". They could purchase a car with the murabaha and then resell it on the market or back to the car dealer. In practice however, when the customer asks the car dealer for an invoice to present to the bank, the car dealer - well aware of the scheme - starts by asking the customer if he wants the car or the cash. If the customer wants the cash, the car dealer adds his percentage to the transaction, sometimes reportedly as high as 10 percent. Bank employees are also aware of this and add their own percentage. Reportedly, some in the banking sector are now trying to fight the phenomenon of tawarruq.

Unfortunately, militias and more maligned actors have also found 'coping mechanisms.' Interviewees indicated that simply having connections at a bank or the ability to blackmail bankers can also provide access to more cash than the average customer is able to obtain beyond the withdrawal ceiling. For example, local thugs and members of militias in charge of security at a bank branch may cash checks worth more than allowed, offering bank employees a percentage. Incidents have been reported where people queuing to withdraw money objected against such methods, prompting the militia to temporarily shut down the bank branch. As a result, extortion is usually ignored.

Businesses have adapted to - or used - the cash crisis by applying different pricing. Some points of sale would accept payment in certified cheques only if customers accept to pay a higher price for the purchased items than they would pay in cash. Also, black market dealers and individuals with access to cash at the bank would accept a certified cheque and return a lesser amount in cash. Finally, the black market continues to find ways to exploit the cash crisis by offering two different prices when selling foreign currency or gold. Buyers may pay up to 10 percent more if a cheque or bank transfer is used rather than cash.

12. http://documents.wfp.org/stellent/groups/public/documents/ena/wfp290979.pdf?_ga=1.112828164.1455990693.1491431270
13. http://reliefweb.int/report/libya/we-will-stay-here-idp-vulnerability-assessment-libya-december-2016

Financial Sector Initiatives to Mitigate the Liquidity Crisis

Insufficient electronic payment infrastructure has made it difficult for customers to adapt to the lack of cash. Emergency measures taken by the CBL to reduce the inflation rate and counter the liquidity shortage, such as currency sales and transfers, only deepened the crisis. So did the split of the CBL into rival branches (east and west) and their decision to have new banknotes printed separately. Some commercial banks did however respond to the crisis, introducing new electronic payment processes to reduce customer reliance on cash for daily transactions.

Findings of an assessment recently conducted with IDPs settled in the coastal areas of Libya,[14] showed that as an alternative to cash, people are increasingly using e-cards and cheques. This is the case, especially, for IDPs families currently settled in Benghazi.

The reasons behind the high percentage of people using cheques/vouchers (more than 60 percent) in Benghazi, are multiple:

- **Trust:** IDPs currently settled in Benghazi are from Benghazi and surrounding areas. They still have relatively easy physical access to their trusted bank branches. Moreover, trust is extended all across the financial circuit: service and good providers, banks, and people.
- **Programmes stimulating the use of cheques and vouchers:** Banks in Benghazi are promoting programmes stimulating the use of vouchers and cheques. Deals have been brokered by banks with vendors and suppliers who are currently accepting these methods of payment.
- **Willingness of vendors to accept cheques/vouchers:** more than 200 shops in Benghazi are currently accepting cheques/vouchers and debit cards on a regular basis.

Bank for Commerce and Development

In the late 1990s, this privately owned bank was the first to connect all of its branches nationwide with a network for instant money transfer and to accept cheques between accounts in over 30 branches. At the time, cheques would take weeks to clear when transferred between banks. These progressive services made the BCD the bank of choice for many traders and business people. Its large network of bank branches put the BCD in a good position to offer solutions in the context of the current crisis. In addition to their certified cheques being more widely accepted than those of other banks, they put in place two different plans to tackle the cash problem.

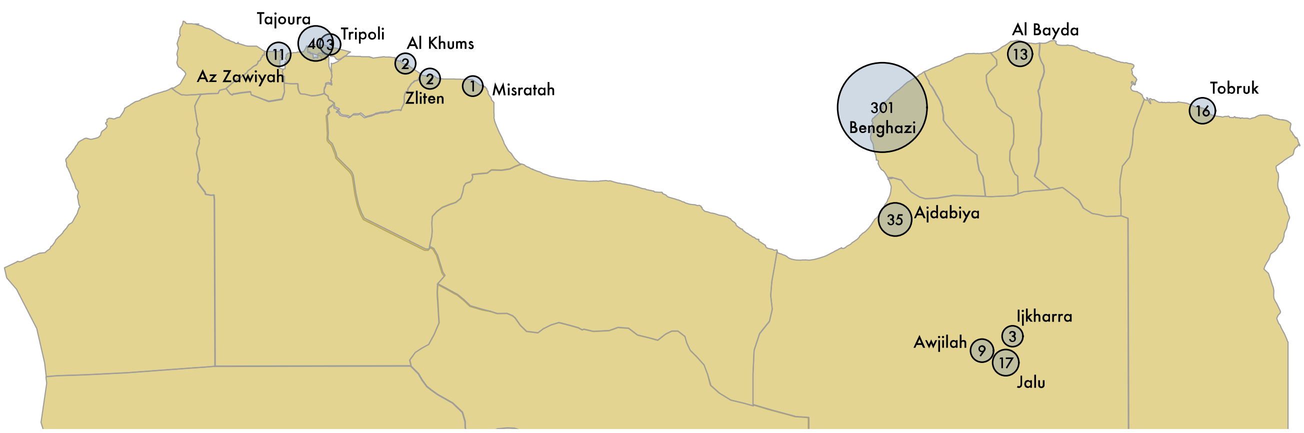
The Bank for Commerce and Development has initiated two initiatives, Edfali and Travelers Checks, both of which will be described below. The success of these initiatives is largely due to the large network of the Bank of Commerce and Development.

14. http://reliefweb.int/sites/reliefweb.int/files/resources/unhcr_mercy_corps_idp_assessment_jan_2017.pdf

Pay Me or Edfali (Bank for Commerce & Development)

Pay-me or Edfali is a partnership contract between the bank and retailers introduced in August 2016.[15] When a customer purchases an item from a partner store, the amount is deducted from his bank account. The customer must have an account at the BCD and be subscribed to mobile banking. For the purchase, the customer gives his mobile phone number (which is connected to the account) to the seller, who enters the number and the purchase value into a smart phone application provided by the bank. The customer then receives an SMS from the bank with a summary of his purchase and a pin code to approve the payment. Once the customer communicates the pin code to the seller, the transaction is completed.

According to the BCD, this service has reached 38 million dinars in sales, benefiting 30,000 customers at 400 points of sale. The following map shows the number of points of sale across 13 Libyan cities where this service is available:



As the map shows, the service is most widely available in the eastern region, especially in Benghazi.

Traveler's Cheques (Bank for Commerce & Development)

Due to the liquidity crisis, traveler's cheques (shikat siyahiya) are used domestically as an alternative to cash transactions. Contrary to conventional cheques, these are not limited to a one-time transaction. They have a given value and can be reused by the recipient, circulating in the same way as cash. Moreover, the recipient can cash the cheque or place the money in a bank account without having to wait for a transfer from the original cheque holder's account.

When requesting the cheque book from a BCD branch, the customer can choose the amount he/she wants to convert into a cheques and the denomination or value of the cheques (50, 100, 200, 500, 1000, 5,000 or 10,000 dinars). The customer is required to provide two signatures, one at the bank, and another when making the payment. According to the BCD, sales of these cheques reached 56,387,420 dinars, benefiting 5,000 customers at 17 bank branches.[16]

15. http://www.libyaschannel.com/2016/08/15/
16. Interview with a Libyan banker.

Growth (Moamalat Financial Services)

In 2016, financial services company Moamalat[17] introduced a service called Growth (Namu) that allows customers to purchase goods at sales points with cards issued by five different banks - Jumhouria, Wahda, Al-Tijari Al-Watani, Sahara, and Shamal Africa. Reportedly, 1.2 million cards have been issued by these five banks[18]. The basis of this network's success was the ability of banks to pay retailers in cash for what they accept in card transactions. However there was a rapid decline in banks' ability to fulfill their obligations, and they were only able to cover 20 percent of the total cash owed. This prompted retailers to start returning the Moamalat devices, and the number of sales points decreased from 1,000 to 400 today. Retailers also started imposing a 10 percent fee for card customers, citing the delay in payments by the banks, and accepting card payments only at certain times of the day to pressure banks into paying the sums due.

Raseed (Tadawul Technology)

Financial services company Tadawul Technology[19] specializes in electronic payments in partnership with Wirecard, a German multinational financial services company; through Raseed, Tadawul Technology has a big share of the payment solutions marketplace. In 2014, Tadawul Technology launched Raseed, a network to buy mobile phone and internet credit through 2,000 sales machines distributed around the country, although most effective in Tripoli. The service has been used by 500,000 customers, according to an interview with a Tadawul representative. Though a separate entity, the company is linked to the HB Group - the business empire of Husni Bey, one of Libya's most prominent merchants and investors.

In 2016, Tadawul Technology started a pilot project using the same network and methodology as Raseed, but chose to keep the operation small so as not to encounter the same problem as Growth (Moamalat- described above), namely the inability to pay dues. Now there are 600 cards accepted by 50 machines in Tripoli and four in Benghazi. According to a company manager, Tadawul is in discussions with the CBL and commercial banks to expand its electronic payment services. Furthermore, using the HB Group's existing distribution networks, the company is seeking to implement a mechanism to regulate the financial relationship between the electronic wholesaler and retailer.

Another one of Tadawul's projects aimed at mitigating the liquidity deficiency was the introduction of rechargeable fuel cards to replace the conventional coupons used by the four major fuel distribution companies (Sharara, Libya Naft, Highway services and AlRahila). Tadawul is also working on a system for people to pay their electricity bills through the Raseed network, in cooperation with with GECOL (General Electricity Company of Libya). With this system in place, customers will no longer have to go to GECOL offices, instead paying at Raseed sales points. Tadawul is also working to encourage emerging E-commerce companies, such as Libyan Spider[20], which sells software products and web design services, and Wecard,[21] which in collaboration with Amazon UK, allows its customers to purchase items online in Libyan dinars and have them delivered to Libya.

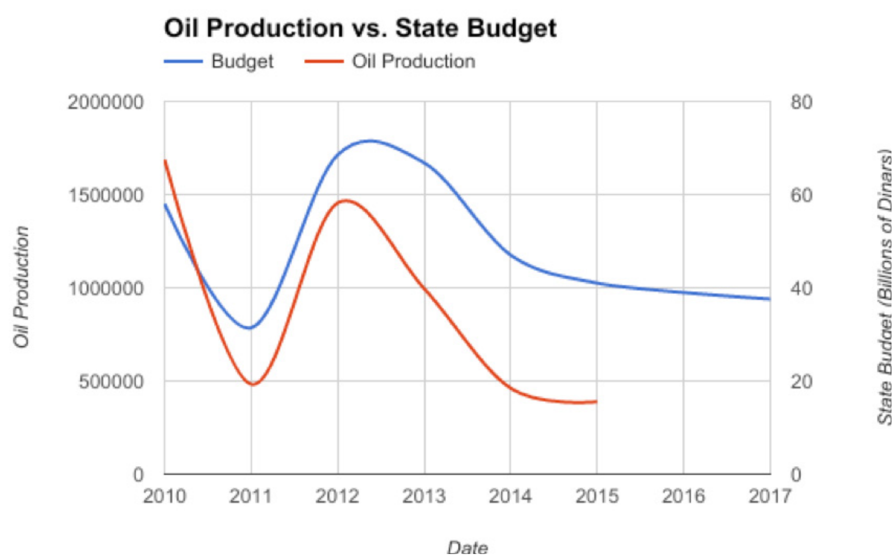
17. https://moamalat.net/en/
18. Interview with Libyan Banker. Also should be available at https://moamalat.net
19. https://tadawul.ly
20. https://libyanspider.com
21. http://wecard.ly/index.html

II. Libya's Liquidity Crisis

During the 2011 revolution and in the months that followed, Libya had already been experiencing an acute liquidity crisis.[22] This episode was short-lived, however, and Libyan funds abroad were soon unfrozen, new banknotes printed in the UK were released, and domestic measures such as cash withdrawal limits were implemented. These measures temporarily restored trust in the banking sector; however, developments since this time have produced a prolonged liquidity crisis that has had serious implications, notably enabling the growth of the shadow economy and significantly undercutting people's purchasing power. The following chapter details how, combined with deteriorating security and political conditions, Libya's growing budget deficit and ill-conceived financial policies spurred the current liquidity crisis and prompted an expansion of shadow economic activity.

Budget Deficit

In the last years of the Gadhafi regime, public expenditure was already very high, reaching a record 58 billion dinars of planned budget in 2010[23], the year before the uprising.[24] Post-revolutionary governments further increased spending: in 2012, the annual budget was 68.5 billion (the highest in Libyan history)[25] and 66.8 billion dinars in 2013.[26] Meanwhile, oil revenues - Libya's primary source of income - dropped considerably. Having almost recovered from the effects of the revolution by 2012, the seizure of key oil ports by an armed group in 2013 has severely compromised state revenues from the industry.[27] As a result, annual budgets decreased again from 2014 on, reaching a mere 37 billion dinars as allocated by the GNA for 2017.



Various sources of information

22. http://www.sadeqinstitute.org/2012/01/paper-libyas-liquidity-crisis/
23. http://uk.reuters.com/article/libya-budget-spending-idUKLDE6192OD20100210
24. In 2009 spending had been 44 billion dinars.
25. https://www.libyaherald.com/2012/03/15/details-of-libyas-record-ld-68-5-billion-budget-released/
26. http://www.reuters.com/article/us-libya-oil-idUSKBN0EX14520140622
27. Oil exports fell from 1.3 million barrels a day in 2012 to around 300.000 b/d from 2013 onwards, after Petroleum Facilities Guard units under the command of Ibrahim Jadhran seized parts of the Oil Crescent/Gulf of Sirte. The export volume was also affected by technical problems and temporary blockades at facilities elsewhere in Libya. Following the takeover of the Oil Crescent by the eastern army and the lifting of a pipeline blockade in western Libya, output rose to 600,000 b/d in September 2016. http://www.reuters.com/article/us-libya-security-oil-idUSKCN11R0MF http://www.reuters.com/article/us-libya-security-economy-idUSKBN14J1PU

The inflated public sector has long been a significant cost factor for the Libyan state. Staffing costs further increased after the revolution, as hundreds of thousands of ex-revolutionary fighters were added to the payroll. In spite of the high costs, the impact of civil war and a state of growing financial crisis, salaries continued to be paid and were transferred directly into personal bank accounts.[28]

As much as two thirds of the budget following the revolution covered public sector salaries and subsidies (mainly for fuel, food items and electricity).[29] In 2015-2016, the public wage bill reached 59.7% of GDP.[30] The Government of National Accord (GNA)'s 2017 budget of 37 billion dinars includes 20.7 billion for salaries and a further 6.3 billion for basic public goods, services and fuel subsidies.[31]

The post-revolutionary collapse of security and state institutions impeded not only the generation of oil revenue but also that of alternative revenue sources. Many foreign businesses chose not to return after 2011 because of outstanding payments and contractual problems as well due to the security conditions, which deteriorated from 2013 onwards. In part linked to this, non-oil state revenues - from taxes, customs duties, service fees, and communication - were significantly reduced. Customs tariffs had been one of the most important sources of non-oil income prior to 2011 previously generating about 8 billion dinars annually. Institutional restructuring processes and the weakness of regulating bodies also allowed individuals and domestic businesses to avoid taxation. Businesses were opened and properties built without permits, and many people stopped paying their (subsidized) electricity bills.

The combination of big public spending and low revenue, in addition to rampant corruption and mismanagement of funds, created massive budgetary deficits. The deficit rose from 43 percent of GDP in 2014 to more than 75 percent in 2015, although it declined to around 20 percent in 2016[32]. In response, post-revolutionary governments tapped into foreign currency reserves as well as investments abroad. According to the Tripoli-based Libyan Audit Bureau, the CBL's foreign-exchange reserves fell from 105.9 billion dollars in 2013 to 76.6 billion dollars at the end of 2014 and to 55.4 billion at the end of 2016.[33] The World Bank forecasts that the foreign reserve will average around 26 billion dollars during 2017-2019.[34]

Restrictive and Conflicting Banking Policies

Despite attempts to reform the Libyan financial sector in the years leading up to the revolution, the sector has remained structurally weak. Only a limited proportion of the population has access to formal financial services, and loans are often only provided by virtue of personal connections[35]. To further complicate matters, the Islamic Banking Law - prepared under the National Transitional Council and approved by the General National Congress in 2013 - cancelled conventional bank loans, thereby depriving commercial banks of an important source of income and liquidity.[36] Prior to the drafting of this law, loans and advances granted to the public and private sector amounted to 14 billion dinars a year, equivalent to 25% of national deposits and 20% national assets.[37] Although it was intended that the law would come into effect on 1 January 2015, its implementation has lagged and has only partially been

28. According to the CBL board, cited in: United Nations Security Council - Panel of Experts on Libya report, March 2016, p.48 http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_2016_209.pdf
29. In 2012, 14.8 billion dinars were spent on subsidies - the equivalent of 13.8% of the GDP. https://www.imf.org/external/pubs/ft/scr/2013/cr13151.pdf
30. http://pubdocs.worldbank.org/en/456341460208808731/Libya-MEM.pdf
31. http://www.reuters.com/article/us-libya-security-economy-idUSKBN14J1PU
32. https://www.worldbank.org/en/country/libya/overview
33. http://uk.reuters.com/article/libya-security-idUKL5N0XV2SI20150504
34. http://www.worldbank.org/en/country/libya/publication/economic-outlook-fall-2016
35. https://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/Libya%20Full%20PDF%20Country%20Note.pdf
36. "Libya Bank Lending Paralyzed Amid Interest Ban: Islamic Finance ...." 15 May. 2013, http://www.bloomberg.com/news/articles/2013-05-15/libya-bank-lending-paralyzed-amid-interest-ban-islamic-finance. Accessed 30 Jan. 2017.
37. Numbers provided by a source at a commercial bank.

implemented due to several reasons outlined below. Nevertheless, it continues to cause uncertainty in the banking sector and pressured commercial banks to devise Sharia-compliant mechanisms, reducing incentives for banks to issue conventional loans.[38]

Authorities in the east and west of the country have adopted different approaches to the issue of the Islamic Banking Law. The Tripoli-based CBL and commercial banks in western Libya cancelled interest on deposits and loans from 2013, introducing an interest-free loan known as murabaha. The murabaha is offered for specific purchases, in most cases for vehicles, and sometimes for furniture or electronics. In the east, implementation of the law was delayed, and the House of Representatives decided in August 2015 that it should be put on hold for five years until the economy is more stable.[39]

According to a banking source in Tripoli, the transition to Islamic banking was ill-conceived and has been riddled with problems. In his view, the intended purpose of rendering the financial sector more religiously fair and ethical has backfired. Some of the new financial products have been manipulated for personal benefit, and banks have devised new ways to profit from their customers. Having lost the right to charge interest on loans and term deposits, banks subsequently raised fees on transfers and services, such as visa card transactions. Surprisingly, while the law did remove incentives to open saving accounts, it did not automatically have a negative effect on the business community. Merchants benefited from the fact that banks could no longer collect interest on letters of credit (LCs); however, this law has had a negative effect on banks who have less incentive to issue LCs.

Lack of Trust in Banks

Historically, the "banking culture" is not very strong in Libya and it has always been common practice to store money at home or invest in property rather than depositing or saving funds in the bank. In part, this can be attributed to a lack of privacy and the harassment of wealthy individuals under the Gadhafi regime. As the liquidity crisis unfolded in early 2015, people became even less inclined to deposit funds in the bank. Banking sources report it has become commonplace for state employees to withdraw as much of their salary as they can, as soon as the funds have reached their account.

Paradoxically, CBL statistics do not show any significant decrease in bank deposits over the past years. According to the CBL, demand deposits reached 63 billion dinars in October 2016, while saving and time deposits amounted to 1.8 billion dinars, in contrast to 52 billion dinars of demand deposits and 3.6 billion in saving and time deposits in January 2014.[40] However, sources report that these figures do not accurately reflect the situation. Salaries are paid as electronic funds and people are not always able to withdraw them, as deposits do not mean the bank has the corresponding cash. Sources also report that CBL figures are skewed due to a multitude of minor mistakes with major statistical implications.[41]

In order to limit the flight of cash, banks gradually imposed cash withdrawal limitations on their customers. Because this measure was not based on CBL directives, withdrawal ceilings differed depending on the bank and area,

38. OECD (2016), The Development Dimension SMEs in Libya's Reconstruction Preparing for a Post-Conflict Economy: Preparing for a Post-Conflict Economy, OECD Publishing, Paris. p.57
39. http://www.libyaschannel.com/2015/08/05/
40. https://cbl.gov.ly/en/wp-content/uploads/sites/2/2016/03/MONEY-SUPPLYoct2016.pdf
41. The example given was a state-owned company that chose to open accounts for 30.000 employees at a commercial bank as saving accounts, without the bank actually being able to deliver the services related to this type of account. The CBL would use this sort of data provided by the commercial bank without any background checks.

but were usually between 200 and 500 dinars. According to banking sources, all banks were short of cash and had resorted to such measures by March 2016. Perceived corruption and links between criminal networks and the banking sector have further eroded public trust in the banks. It is widely believed that many bank employees have been complicit in criminal enterprises (more on these below). These activities have become increasingly sophisticated - including the kidnapping of wealthy individuals or their children - and in many cases perpetrators have clearly used access to customers' confidential information to extract funds.[42] Stirring panic in wealthy circles, those at risk were prompted to withdraw more funds from the bank, further exacerbating the cash crisis.

Impact of the Civil War

The de facto division of the country into east and west has resulted in the creation of parallel governing institutions, to include the Central Bank. In 2014, the Interim Government based in Al-Bayda set up a parallel central bank after the CBL governor in Tripoli refused to comply with House of Representatives (HoR) orders. The National Oil Corporation and the National Audit Bureau were also duplicated.

Following the division, the Tripoli-based CBL largely refused to cooperate with directives from Bayda-based CBL, denying the latter access to currency and participation in operational matters. Commercial banks in the east were also affected, experiencing difficulties obtaining approvals from Tripoli to establish letters of credit (LC).[43] Foreign currency allocations, transfers and LC's, etc. are covered by the Tripoli-based CBL, while the Bayda-based CBL has no control or oversight. In the second half of 2015, the Bayda-based CBL stepped up its attempts to gain control of the financial system. Measures included the opening of a foreign account for oil exports and repeated attempts to obtain deliveries of currency printed in Europe.[44]

In 2016, both CBLs succeeded in having new currency printed abroad. Due to the lack of international recognition, the Bayda-based CBL contracted banknote printing to a company in Russia, while the Tripoli-based CBL had its notes printed in the UK. At the time, the eastern CBL Governor, Ali al-Hibri, stressed that there would be no difference between the banknotes and that they would be distributed throughout the country. However, the move has been met with criticism, including from the international community. In a statement on 25 May 2016, the US embassy endorsed the Tripoli-based CBL's claim that the Russian banknotes were "counterfeit", warning they could "undermine confidence in Libya's currency and the CBL's ability to manage monetary policy".[45] Indeed, the two types of banknotes are not equally accepted in some parts of the country. Both for economic and political reasons, most businesses in Tripoli and Misrata do not accept the Russian-printed banknotes, which can be distinguished from the UK-printed ones by the signature. This is not a problem in other parts of western Libya however, and towns that support eastern Libyan institutions, such as Zintan, have received cash deliveries from the Bayda-based CBL.

Attempts to merge the two CBLs have so far failed. Following a meeting in Tunis in June 2016, rival CBL governors, Al-Sadiq al-Kabir (Tripoli), and Ali al-Hibri (Bayda), said they were ready to work together and accept both forms of currency.[46] Even so, collaboration has been partial at best, and the two banks still operate largely as separate entities. Ruling bodies on each side of the political divide do not recognize rival CBL management and Kabir's position in Tripoli is strongly contested, especially since his mandate officially expired[47] on September 26, 2016.

42. Local source
43. United Nations Security Council - Panel of Experts on Libya report, March 2016, p.49 http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_2016_209.pdf
44. United Nations Security Council - Panel of Experts on Libya report, March 2016, p.49 http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_2016_209.pdf
45. https://www.facebook.com/usembassytripoli/posts/1102692436460493
46. https://www.libyaherald.com/2016/06/05/libyas-rival-central-banks-team-up-for-national-recovery/
47. https://www.libyaobserver.ly/economy/new-power-struggle-emerges-cbl-governor-mandate-expires

Security Challenges for Banks

From 2012, all banks started facing numerous security issues, at first predominantly in rural areas, then also in the cities. From targeting cash transports between bank branches, criminal gangs expanded their operations, soon robbing the banks directly and abducting employees in exchange for ransom. According to statistics provided by sources in the banking sector, at least 28 armed robberies were conducted between 2012 and 2016, killing at least 6 bank employees. The reality is that the number of incidents is likely higher than that recorded by official sources. In several cases, tremendous sums have been stolen. In the single largest confirmed robbery, which occurred in October 2013, gunmen in Sirte robbed a CBL cash van, stealing 53 million dinars and 12 million in dollars and euros.[48] On another occasion, in December 2014, 7 million dinars were stolen from a bank in Tripoli.[49] When the Islamic State group took control of the city of Sirte in early 2015, around 2 million dollars were stored in the city's bank branches.[50] It is unclear whether any of that money remains after IS was driven out in December 2016. With rural areas more affected by such lawlessness, people began travelling to cities to access their funds. Many now choose to withdraw larger amounts to avoid having to make repeat visits. Those in urban areas soon also adopted this habit, prompting an unprecedented demand for liquidity.

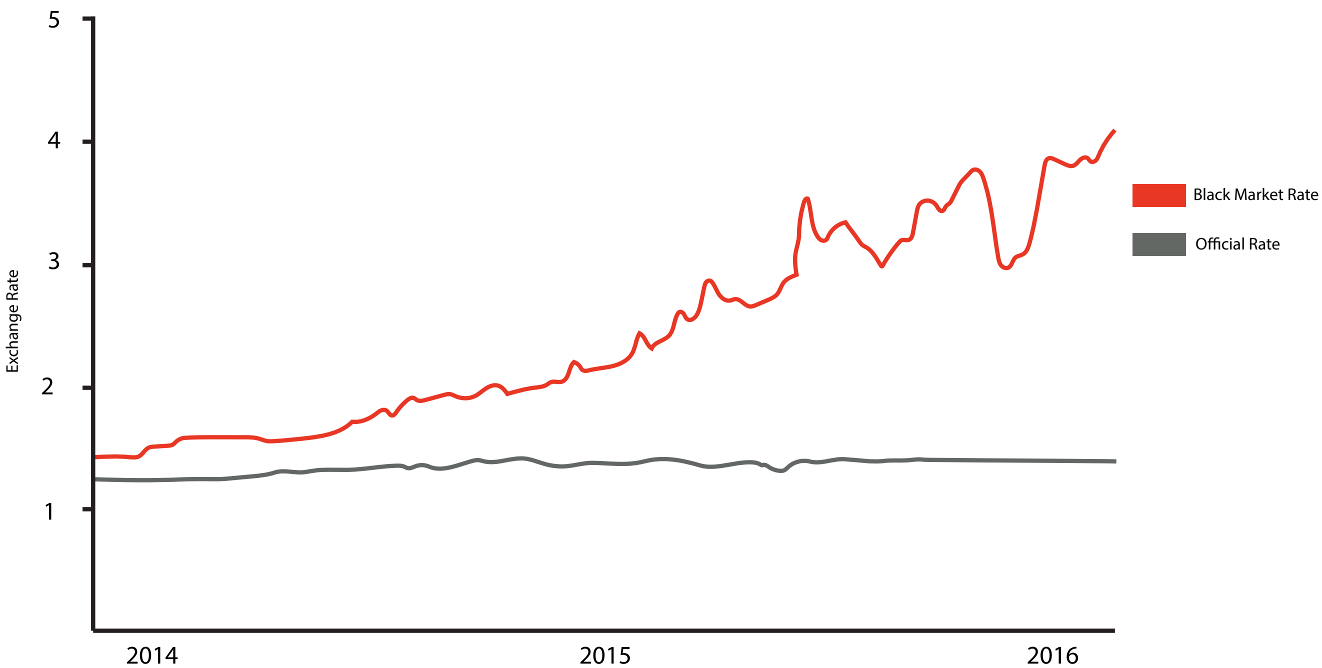
Bank branches have faced further liquidity bottlenecks as a result of such security-related problems. For instance, the region west of Tripoli, from Zawiya to the border, was cut off from the capital in 2014 and 2015 due to clashes and closures of the coastal road. Consequently, cash from the CBL and commercial banks in Tripoli to bank branches in the Western region was mostly transported by helicopter, causing additional costs and delays. However after a military helicopter was shot down near Zawiya in a politically motivated attack in October 2015[51], banks stopped using air transport on this particular route. After the coastal road re-opened in the fall of 2016, two armored vehicles of the National Commercial Bank transporting 1.5 million dinars to Zawiya were hijacked.[52]

48. "Libya robbery: Sirte gunmen snatch $54m from bank van - BBC News." 28 Oct. 2013, http://www.bbc.com/news/world-africa-24721776
49. http://news.xinhuanet.com/english/africa/2014-12/22/c_133869731.htm
50. United Nations Security Council - Panel of Experts on Libya report, March 2016 http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_2016_209.pdf
51. http://www.reuters.com/article/us-libya-security-helicopter-idUSKCN0SL2ND20151027
52. https://www.libyaobserver.ly/crimes/gunmen-hijack-cash-transit-gearing-al-zawiya-city

III. Libya's Shadow Economy

Libya's shadow economy was largely shaped by Gadhafi's policies in the 1980s and 1990s, but its scope and pattern has changed with the recent political environment. The primary driver of the shadow economy has always been the informal currency exchange, and is therefore the focus of this section.

Developments of the Currency Black Market over Time



Various Sources of Information

The currency black market emerged in the early 1980s, and became a key driver of the shadow economy after international sanctions were imposed on Libya; first by the United States in 1986, and later by the United Nations Security Council in the early 1990s. Compounding the impact of sanctions were austerity measures previously implemented by the Ghadafi regime in response to plummeting oil prices in the mid-1980s. Restrictions were placed on commercial and financial activity, as well as on foreign currency sales. This, as well as the heavy bureaucracy in banks and public institutions, enabled the growth of the shadow economy.

In reaction to public discontent over severe shortages of food and basic commodities, Gadhafi removed the state monopoly on imports and exports and reauthorized retail trade in 1988 as part of a first phase of economic reforms.[53] At the same time, he also encouraged the black market to meet people's currency needs.[54] A large number of small businesses and retail stores emerged as a result, with merchants bringing in goods by land, mainly from Tunisia and Egypt, or by sea from Malta. These new trade networks largely escaped customs control and taxation, while the resale and smuggling abroad of subsidized goods drained state coffers. Combined with dwindling oil revenues and - as a consequence - Libya's foreign currency reserves, the value of the dinar had dropped significantly by the early 1990s.

53. Vandewalle, Dirk J.: Libya Since Independence: Oil and State-building, Cornell University Press, 1998, , p. 151
54. Idem, p.161

This period marked the formal establishment of the currency black market. The official exchange rates - pegged to the International Monetary Fund's Special Drawing Right since 1986[55] - no longer reflected the real value of the currency as exchanged in the gold markets of Tripoli and other Libyan cities. At its peak, in 1994, one dollar was worth 3.5 dinars on the black market, almost 12 times more than the official exchange rate of 0.3 dinars.[56] In response, the regime cracked down on shadow economy actors in the latter half of the 1990s, resulting in the closure of many private retail stores.

From 1999, sanctions on Libya were gradually lifted. The regime started adopting semi-open market policies and reforming certain sectors of the economy, while maintaining state subsidies. The CBL was able to reduce the gap between official and unofficial exchange rates to just 2 dirhams (0.02 dinars), with the dinar being exchanged at 1.2 to the dollar. By 2004-2005, the state had managed to reduce the impact of the black market to approximately a tenth of the magnitude it had reached in the early 1990s. Towards the late 2000s, informal currency exchange was used mainly for the purchase of unauthorized goods or goods with high custom charges, such as gold.

During the revolution, the currency black market again briefly returned to prominence as some people used informal channels to funnel money out of the country while others brought money in to support the rebellion against the Gadhafi regime. A temporary and minor cash shortage lasting from mid to late 2011 increased the level of transactions outside the banking system, causing the gap between the official and the black market exchange rate to increase to 2 dinars to the dollar while the official rate rested at 1.2. Indeed, it was not until the onset of the current crisis in late 2014 that the currency black market assumed a role as a key feature of the Libyan economy. This time, however, the situation is markedly different. While in the 1990s the regime had some degree of control over the black market and could manipulate it to its advantage, the present fragmentation of the state means a cohesive response to the effects of black market activity is now especially challenging.

Present Significance of the Shadow Economy

CBL statistics show that out of a cash supply of 42 billion dinars in 2015, 23 billion were circulating outside the banking system. By the end of 2016, this figure had reached 26.5 billion dinars.[57] This means that around half of all Libyan currency is managed by the shadow economy. Contrary to the 1990s, there is now a strong disconnect between the banking system and the currency black market, with the latter possessing strong networks, a great deal of autonomy, and largely damaging impact. Rather than the black market acting in response to the CBL, the CBL now acts in response to the patterns of the black market. In the current climate, it is now the shadow economy that ostensibly sets the economic rules in Libya.

The rapid depreciation of the national currency, both a cause and effect of the liquidity crisis, is driving the shadow economy. The Libyan dinar has almost continuously lost value since 2014. While the official exchange rate has been kept stable at around 1.4 dinars to the dollar[58], the dinar has been in freefall on the black market. From 1.3 to the dollar in April 2014,[59] the rate reached as high as 7.15 in November 2016,[60] and presently stands at 6.2.[61]

55. https://cbl.gov.ly/en/exchange-rate-policy/
56. During the 1990s the official exchange rate was around 0.3 dinars to the dollar, fluctuating slightly based on the SDR. Meanwhile, the black market rate to the dollar fluctuated between 1.8 and 4 dinars. During 2015 the gap was temporarily reduced when the regime devalued the dinar to a one-to-one rate to the dollar. (O'Sullivan, Megan L.: Shrewd Sanctions: Statecraft and State Sponsors of Terrorism, Brookings Institution Press, 2004, p.198)
57. https://cbl.gov.ly/en/wp-content/uploads/sites/2/2016/03/AssetsLiabilities-of-cbl-oct2016.pdf
58. The official exchange rate to the dollar fluctuated around 1.25 for several years until 2015 and then went up to around 1.4.
59. http://www.reuters.com/article/libya-currency-idUSL6N0OJ1QL20140603
60. https://www.libyaherald.com/2016/11/23/libyan-dinar-strengthens-on-black-market-amid-expectations-of-official-devaluation/
61. As of as of February 28, 2017. https://www.libyaobserver.ly/exchange-rates

In the context of the liquidity crisis, the currency black market compensates for the shortcomings of the formal financial institutions. However, it also generates substantial profits for certain individuals and further cements the role of militias and predatory businessmen. For example, in parts of Libya the price of one cooking gas cylinder has risen from the current official price of 3 dinars to the black market price 120 dinars.[62] Frequent supply bottlenecks cause sudden demand hikes and prompt consumers to rush to gas distribution points. This is exploited - and often even provoked - by informal suppliers, who turn their position of strength into monetary benefit. In principle, cooking gas should be available at the official price at distribution centers of the state-owned Brega Petroleum Marketing Company. However, the Company has authorized retail distributors in the past and many sales are now conducted by unauthorized resellers. In addition, it is armed groups who in many parts of the country assume control over the transportation and distribution of gas cylinders, giving them substantial leverage over local communities.

In southern Libya, where the presence of national institutions appears to be particularly faded, militias play an important role in maintaining informal financial systems through agreements reached among the different tribal groups in the area. While urban areas, such as Sabha are particularly insecure due to competition amongst militias, stability in the surrounding area is ensured through a capillary control over tribal boundaries and back markets. Paradoxically, stability enhances the capacity of the parallel market and the capacity of informal financial actors to conduct transactions safely. Consulted sources reported that the area around Sabha, controlled by the Tebu and their related militia, is particularly safe, primarily due to the presence of a local black market where subsidized items not available in the formal market, are sold at a higher rate. For instance, fuel would normally be sold at the subsidized price of 0.15 dinars. However due to a complex network of collaborations, fuels shipments -which are supposed to reach Sabha and the several gas stations in and around the city- are diverted into the abovementioned area and sold at 1 LYD per liter.

The shadow economy and its effects have also impacted the price and the distribution of one of the most important elements of the Libyan diet, bread. The decrease in the national supply of subsidized flour sold to local bakeries, and the already existing black market demand to smuggle flour and other subsidised commodities used in bread making such as cooking oil, across the borders, have both contributed to the rise in bread prices; as a result, the price of one loaf of bread is now five times the price, rising from 0.05 dinars in 2014 to 0.25 dinars in 2017.[63] The shadow economy further impacts the availability of food items by limiting production. In March 2017, focus group discussions conducted by Mercy Corps in Sirte with farmers, buyers and vendors, showed that farmers have to decreased their production due to the lack of purchasing power.

Elaborate schemes to take advantage of the fluctuating exchange rate have not only impacted the availability of key commodities and the price of legally imported goods, but also the price of black market. According to a source knowledgeable on sea smuggling trade, subsidized gasoline is not only smuggled to neighboring countries, but also to European countries across the Mediterranean, namely Malta, and is in many cases traded for alcohol, which is then smuggled into Libya and sold on the black market. Before the conflict intensified in 2014, a bottle of Johnnie Walker Red Label would cost a 100 dinar on the black market; today, the price is reportedly 500 dinar.

62. http://www.alwasat.ly/ar/news/libya/101458/
63. https://al-ain.com/article/103786&sa=D&ust=1491059999087000&usg=AFQjCNFUQ-vnY2a2BjlismwvrspbYH-Zyw

Geography and Features of the Currency Black Market

It is in the traditional gold markets of Libyan cities - mainly in Tripoli, Benghazi, Misrata and Tobruk - that the majority of currency exchanges take place (hence "gold market" is often used as a synonym for "currency black market"). Traders tend to be strongly connected, allowing them to form a nationwide network with international reach. Tripoli has two currency black markets. The older market is located in a street in the old city known as Souq al-Turk, where shops also buy and sell gold and jewelry (it moved here from another old city street known as Souq al-Derj). The second one is in Souq al-Dahra (Dahra market), where most exchange bureaus are labeled as such. This market started in 2013, when the the CBL decided to grant licenses to currency traders, although these licenses never materialized. In other cities like Benghazi and Misrata, the currency market is known locally as the "gold market".

According to a currency trader at Tripoli's Souq al-Turk, the crisis has attracted many newcomers who challenge the families that traditionally controlled the exchange market. The currency trader also stated that the number of traders had risen from around 200-300 pre-crisis to nearly 2,000 traders by mid-2016. This source further claimed that many of the newcomers are businessmen who formerly worked in imports. It is understood that many have turned to currency trading given their businesses have become increasingly less profitable owing to the economic slowdown and reduced customer purchasing power.

The traders of Souq al-Turk gather at different corners of the street for different types of interaction. International transfers are conducted at the so-called "three-street corner", while cash exchanges take place at the "four-street corner". For international transfers, local traders have agents in international market places such as Dubai, who transfer sums paid in cash by customers at Souq al-Turk. Some traders can deal on credit because they, or their relatives or contacts, have money placed in bank accounts abroad.

In summary, several types of actors within the shadow economy can be distinguished; whose complementary actions comprise a functional system:

Currency barons: who dispose of vast international networks. They usually work "behind the scenes" and benefit from high-level protection or immunity.

Banking facilitators: These individuals interact with banks and act as 'front men'. Starting in the 1990s these individuals would obtain foreign currency from their banking contacts and smuggle it abroad. Since 2011 they are also involved in manipulating customs procedures. Individuals of this category are usually managers of private companies and big merchants who use their businesses as cover to carry out deals on behalf of the "barons";

Large-scale black market traders: These individuals are big traders on the black market who manage the trading networks and take care of logistical aspects for the currency exchange.

Small-scale black market traders: These individuals are gold market traders who conduct sales to the public, transport cash, and protect those working behind the scenes.

IV. Interaction between official financial channels and black market

Banking and black market sources interviewed for this report disclosed details about some of the common illicit and fraudulent practices that fuel the shadow economy. Four main types of practice were identified: cash exchange deals; import-export schemes ("documents for collection" and letter of credit); credit/debit card schemes; and cash transfer schemes. Essentially, each of these practices exploits the gap between the official and the black market exchange rate for the dinar. Some schemes involve fraudulent commercial transactions. These practices have a negative impact on public welfare, in that they draw on public funds, fuel corruption, and further erode trust in the banking sector. Importantly, the practices described in detail below constitute the exploitation of services that should ordinarily be available to Libyan individuals and companies through official channels. However, networks of the shadow economy have rendered many of even the most basic banking services exclusive, placing an additional burden on customers in need of foreign currency.

Of note, not all of the money accrued via fraudulent practices returns to Libya. To support the international network of black market transfers, much of it stays in the foreign locations where credit cards are cashed or where transfers arrive.[64] It may be stored in offshore accounts or handed in cash to individuals. In all cases, the money remains in the shadow economy and is dealt at black market exchange rates, making foreign currency largely inaccessible to the average Libyan through formal legal channels.

Black Market Currency Exchange

A few weeks after the fall of the regime, commercial banks returned to their pre-revolution activities, resuming the sale of foreign currency (US dollar, pound sterling, euro) to their customers. At this point, the difference between the official exchange rates at the bank and the black market did not exceed four dirhams per dollar. However, even this small difference was enough for both bank employees and customers to engage in the illegal (yet tolerated) practice of purchasing foreign currency from banks at the official exchange rate and then selling it on the black market.

While the legal amount of foreign currency purchasable by individuals was previously limited to 15,000 dollars per year, some banks systematically allowed their employees to purchase 5,000 dollars a month. Under such terms, employees could generate a profit of 150 dinars ($120 USD) each month from black market sales. In order to curb this and other practices, the CBL gradually reduced the yearly allowance of foreign currency, lowering an individual's annual currency threshold from 15,000 in 2013,[65], ultimately reaching $400 USD per person per year in 2017.[66]

64. While described and often advertised by Libyan banks as "credit cards," these cards are actually better described as :prepaid debit cards." https://bcd.ly/en/online-banking/   For the purposes of this paper, the word "credit card" will be used.
65. http://www.alwatan-libya.net/more-26085-50
66. https://www.alaraby.co.uk/economy/2017/2/2/

"Documents for Collection"

In this scheme, which was largely curtailed in April 2016, a person representing a local business provides an invoice from an import-export company abroad to his/her bank in Libya, as well as an order of payment from his/her account to the benefit of the foreign company. The money is then transferred to a Libyan or foreign individual representing the foreign company. The invoice submitted to the bank by the foreign company is often forged. For example, the foreign company would provide an invoice of $100,000 USD for the delivery of X amount of goods. But the goods that physically reach the Libyan point of entry are worth only $10,000 USD.

According to the Commercial Code, local companies have a quota or annual ceiling for documents for collections transactions, which was $200,000 USD in April 2016. This restriction was frequently bypassed by founding a number of small companies.

In a December 2016 report issued by the Audit Bureau, the estimated total annual value of commodities entering Libya based on "Documents for Collection" was 70 million dinars; however, the actual value of goods entering Libya in 2016 were worth as little as 90,000 dinars. Furthermore, after reaching a peak in 2013, food importations are progressively decreasing. During the last five years the overall imports of Libya have decreased at an annualized rate of -12.8%, from $24.3B in 2010 to $11.4B in 2015.[67] All of this means for the average Libyan is that food-items reportedly imported into Libya are not available, as the imports are fabricated in order to take advantage of shadow economy or move money abroad. The last known "documents for collection" operations were made in April 2016 and reportedly ceased due to changes in the Tripoli-based CBL policies.

Letter of Credit Scheme

The Letter of Credit (LC) is a guarantee from a Libyan bank stating that a local buyer's payment to a foreign seller will be correct and made on time. Banks typically require a pledge of securities or cash as collateral for issuing a letter of credit, as well as collecting a service fee. The scheme is similar to "document for collection", with a slightly different mechanism and there being no annual quota for transactions. The buyer obtains a LC for a much larger sum than the imported goods are worth.

As this practice became commonplace, scores of empty containers reportedly arrived at Libyan ports, sometimes filled with sand or rotten goods to give the illusion of being full. The containers usually leave port warehouses without a customs declaration and there is no system in place to record or track the quantity of goods in port warehouses. The fragmentation of the State and its failure to verify the value and existence of imported commodities allows businessmen the opportunity to profit from the shadow economy, smuggle wealth abroad, and impacts 'the average Libyan' is similar to that of "documents for collection," described above.

Much like "documents for collection," LCs are increasingly hard to acquire because of new regulations implemented by the CBL. Even so, larger Libyan businesses have leverage on banks due to the liquidity shortage, and can threaten not to deposit their money unless they are granted an LC.

67. http://atlas.media.mit.edu/en/profile/country/lby/#Imports

Credit/Debit Card ("Visa card") Scheme

Libyan banks started issuing credit and debit cards in 2005. Their introduction was chaotic however, and banks and customers did not immediately recognize their benefits. Though cards were issued, the total numbers of cards in circulation remained low and reflected merely a fraction of the total number of bank accounts. According to a source, who at one point headed the credit card department at a commercial bank, only 5,000 cards had been issued until 2013. Some commercial banks did not include card issuance in their product packages until 2014, and only because they were facing a shortage of physical foreign currency cash. According to the same source, there are now an estimated 500,000 cards in Libya, of which only 200 are registered and linked to the national ID system. While this does not mean all cards are used for moneymaking schemes, it is perhaps indicative of the scale of the problem described below.

Before the passing of the Islamic Banking Law of 2013, cards were sold for 40 to 80 dinars, depending on the type. After being barred from collecting interest in 2013, commercial banks compensated by adding as much as 150 dinars in additional fees to the sale of cards.[68] Before the crisis, each card could be charged with up to $15,000 USD at the official exchange rate - the annual foreign currency allocation per individual at the time.[69] The CBL gradually decreased this annual allocation as the crisis deepened; it now stands at a mere 400 US dollars per person per year.

The fraudulent use of cards began in 2014, as the lack of physical cash prompted fraudsters to find new ways of dealing in foreign currency. In addition to black market traders selling already charged cards to people at the black market rate, cards would be used to exploit the difference in the exchange rate. The fraudulent process would work as follows: a cardholder travels abroad, withdraws foreign currency and takes it back to Libya to sell it on the black market, profiting from the exchange rate gap. When used as money-making scheme, it usually involves hiring "mules" to carry dozens of credit cards per trip and withdrawing foreign currency in several countries. Often the scheme also involves foreign merchants who facilitate the transaction. In particular, merchants (gold shops, clothing companies) are reported to be involved, converting the money on cards into cash with their point of sale machine for a commission of up to 10%.

The following is an example of the most common fraudulent use of a credit card: A "mule" travels abroad with 10 credit cards worth a total of $5,000 USD and is put in contact with a Libyan based in the foreign country, who collects the cards and pin codes, goes to dealers to liquefy the cards and then returns to the mule with $4,500 USD cash (having deducted the Turkish dealer's commission). Very often, the foreign currency remains abroad and can be channeled through 'hawala' networks. Other times, money is returned to Libya, at which point militiamen often meet the "mule," relieve him of the foreign currency, and then either trade or reconvert this foreign currency into dinars, whichever is most profitable.

In March 2016, the Libyan Audit Bureau in Tripoli published a document known as the "Raef list" that showed the extent of corruption linked to the credit/debit card scheme at the National Commercial Bank.[70] The investigation revealed the names of dozens of individuals under whose names cards had been charged with sums of money far exceeding the authorized annual allowances. In one case, a card was credited 95 times over a period of six months in 2014, with over 1.1 million dinars in total. The annual ceiling at the time was just 15,000 dollars.

68. The CBL recently issued a ruling banning this additional fee.
69. There is also a commission for every transaction, a fixed fee or a percentage depending on the policy of the bank in question. This increased the cost of one dollar to 1.5 or 1.7 dinars, rather than 1.4, which is the official rate
70. https://www.facebook.com/378224298919756/photos/pcb.1012344212174425/1012341478841365/?type=3&theater

Although these excesses can easily be detected by the CBL, no measures were taken to stop or better control the issuing of cards. The only measure taken was to keep lowering the annual ceiling, which now stands at 400 USD per person a year. Experts believe this will only drive ever-higher exchange rates.[71]

Cash Transfer Schemes (Western Union, MoneyGram)

As with the credit card scheme described above, the cash transfer scheme involves transferring money abroad at the official exchange rate and then cashing the difference when sold either on the Libyan black market, or to customers paying black market rates or higher fees. While this service in theory is available to the public, in practice cash transfers are often monopolized by maligned actors and used exclusively for illicit purposes. For example, in 2015, a bank manager physically reportedly removed computers with Western Union money transfer software from his office and moved them to a villa and monopolized all Western Union transactions. The bank manager subsequently sold foreign currency earned through Western Union transactions either on the black market or directly to customers at black market rates.

Making money transfer services unavailable to the public not only impacts the Libyan economy, but also negatively impacts average Libyans by removing the availability of social services such as health care. For example, cash transfers have predominantly been used by the many African and Asian nationals in Libya (mostly in manual labor and medical professions) to send portions of their salary to their home countries. With the liquidity crisis and rising corruption however, both Libyans and foreign nationals alike have become victims of corruption and reportedly many foreign doctors and nurses employed by the health ministry have quit their jobs because they were no longer able to send remittances as before.

Involvement of Armed Groups

These financial corruption schemes have become an important source of funding for militias, which have seen their resources dwindle with the state's decreased capacity to pay salaries and provide benefits to former revolutionary combatants. From the revolution onwards, armed robbery and extortion contributed to a security environment that accelerated the liquidity crisis (cash bottlenecks in rural areas, reduced trust in banks etc.). As corruption networks and schemes became more sophisticated, so did the ways in which militias were involved.

LC schemes have been particularly lucrative, with militias taking their share either through bank partners or through blackmail and extortion. One of the bankers interviewed for this paper was kidnapped for several days until his bank passed a LC request. Members of the CBL are reported to have been similarly kidnapped. As reported by the United Nations' panel of experts on Libya, one of the most prominent militia leaders in Tripoli and his business associates obtained letters of credit for more than 20 million dollars through the extortion of CBL officials during 2015.[72]

Around 2014, when banks were no longer able to meet the high demand of LCs due to the financial crisis, militias turned to the credit/debit card scheme and quick money transfers. This instigated a fierce battle for control over bank branches between local "security brigades". The corrupt environment made it possible for militias to run organised networks, for instance for the credit/debit card scheme, by having numerous "mules" take cards abroad and return with cash.

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71. Interview with local Libyan banker, Februray 2017.
72. United Nations Security Council - Panel of Experts on Libya report, March 2016, p.199 http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_2016_209.pdf

Sometimes militias use their leverage to exploit existing corruption schemes. In the above-mentioned case involving the bank manager who moved the cash transfer system to his villa, a local militia leader stepped in, seizing the villa, taking the manager hostage and forcing him to grant the militia access to millions of dollars in transfer allowances. This continued for a period of four months until the manager was released.

Official Response to Illicit Practices

In order to put an end to Letters of Credit (LCs- see section IV)) abuse, the Audit Bureau adopted a "name and shame" policy, publishing names of companies involved in the illicit practice of using fake imports to generate foreign currency. However, members of the Audit Bureau have also been accused of using this information to blackmail businessmen and get a share of the profit.

The Central Bank of Libya's (CBL) response has been obstructed by the political division of the country and the split within the institution. For example, in an attempt to curb the shadow economy, the Bayda CBL ordered the withdrawal of some of the banknotes from circulation; however, these notes remain in circulation because the Bayda-based CBL has no authority in western Libya, where reportedly the bulk of Libya's wealth resides. Without a unified approach between the Tripoli-based CBL and the Bayda-based CBL, which is impeded due to existing political divisions, the shadow economy is unlikely to be curbed and larger businessmen whose illicit practices exacerbate the liquidity will continue to operate, to the detriment of the vast majority of Libyans.

IV. Conclusion

Civilians Trapped in Shadow Economy Vicious Circle

The analysis presented within the paper on the relationship between the shadow economy and the liquidity crisis, to include illicit practices, has pushed the Libyan population towards increasing reliance on the black market as mean to access basic services and goods, to include access to cash. Additionally, the liquidity, shadow economy, and accompanying illicit practices have raised the prices of key commodities and resulted in scarcity of others. The vicious circle of shadow economy and liquidity crisis grows exponentially worse each day and exists in a causal nexus with other negative phenomena such as conflict, sociopolitical fragmentation, and the de facto absence of rule of law. Many Libyans report feeling trapped by this predatory cycle.

Shadow Economy and Humanitarian Interventions

Humanitarian agencies are currently facing significant challenges in delivering aid to those in need, due to the flourishing presence of the shadow economy. The large gap between official and black market dinar exchange rate has, indeed, strong repercussions on implementation management, budgeting and planning. With a status quo that does not show any tendency to change, humanitarians must take into consideration the risks related to the shadow economy presence and must plan activities accordingly, in order not to feed a broader predatory system with clear linkages to armed actors. Furthermore, rather than falling into the same trap civilians are currently in, humanitarians must look into alternative mechanisms to conduct financial transactions into and within Libya, when supporting household purchase power and increase the access to basic services.

Alternative payments methods are currently used to avoid recourse to black market (certified checks, mobile phone payments, debit cards), however an intervention to sensitize stakeholders along the market chain is strongly recommended. Payments of goods and services through certified checks are, for example, allowed but prices increase of an average of 10 percent. The space and the incentives for civilians to use the legal framework for economic transactions is progressively shrinking, while the black market and the shadow economy continue to get momentum and to play a central role in daily life of Libyans and migrants.

In navigating through the dilemma of efficiency and bureaucracy humanitarian agencies must be driven by the Do No Harm principle. Increasing the level of accountability towards populations of concern and beneficiaries is the most effective way to mitigate risks and to limit organizational exposure to threats. Community Accountability Response mechanisms that enable a transparent flow of information between humanitarian agencies and beneficiaries should be part of each intervention conducted in Libya as they represent a strong mitigation measure to the threats posed by the hypertrophic presence of the shadow economy in all its aspects.

Vulnerable populations have no alternatives but to engage in the black market to access basic goods and services, abdicating to act into a legal environment.[73] Humanitarian agencies should be fully aware of the dynamics related in order to act respecting humanitarian principles.

Given the restricted space for humanitarians to influence the economic rules and regulations in Libya, the main objective in assisting those in needs must be to support the expansion of "fair systems" already used by financial institutions and service providers to allow a broader access to services and goods to avoid the recourse to black market. In doing this, humanitarian agencies should move out of their usual sphere of operations and engage with banking sector, traders, public institutions and policy makers to ensure those in need are able to receive aid in a timely manner and without having the necessity to engage in the black market.

73. Selling gold and silver to currency traders, in the black market, is the first coping mechanism put in place by those in need of cash to access basic services and goods.(We will stay here, IDP vulnerability assessment, Mercy Corps, December 2016);

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Contributing information sources to this document include public and nonpublic humanitarian information provided by local partners, UN Specialized Agencies, INGOs, nonstate actors, and sources on the ground. The content is compiled by Mercy Corps, is by no means exhaustive, and does not reflect Mercy Corps' position on the aforementioned subjects. The provided information, assessment, and analysis are designated for humanitarian purposes only. Mercy Corps and its Humanitarian Access Team will continue to closely monitor the evolving situation on the ground and inform accordingly.

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