

## Libya: Building Political Consensus around Economic Objectives

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## **Executive Summary**

- Despite all the political divisions, most Libyans will agree that action is needed to stabilize their country's economy as they witness deteriorating living standards, rampant inflation and a currency that is steadily weakening in parallel markets.
- Already under the Qaddafi regime, it was acknowledged that to remain sustainable, Libya's economy needed urgent diversification, subsidy and banking reforms and private sector development. But the ongoing political and security crisis has added a number of economic difficulties:
  - State revenues have decreased, due to severe disruptions to oil production and lower global oil prices.
  - State spending on public wages remains high due to a large number of ghost employees and the decision to provide those instrumental in toppling Qaddafi with a state salary.
  - International reserves are dwindling, thereby putting pressure on the currency peg and increasing inflation, as imports are more difficult to obtain.
  - The criminal economy is growing and there is a risk that illicit activities are being 'normalized' due to the security situation and a lack of governance and regulation.
  - There is pressure on the country's independent national economic institutions to take sides in the conflict and actively contribute to the political divisions.
- Consensus is building between conflicting parties that no-one is likely to gain from a non-functioning economy, except potentially extremist groups. Political adversaries and economic leaders are increasingly showing willingness to come together to find solutions.
- While there are plenty of other areas that need discussing, including political ones such as the composition of the Presidency Council and other amendments to the Libyan Political Agreement, restarting a national dialogue with the objective of fixing the economy could provide an opportunity to rephrase shared solutions in terms of a functioning, inclusive economic model.
- A renewed economy-focused could start with finding answers to five intertwined questions:
  - How to get energy production and exports back on track?
  - How can the Central Bank of Libya help curb inflation and stabilize the currency?
  - How can the limited resources of the state budget be spent fairly and effectively?
  - What can be done to curb the illicit economy?
  - How to bolster the unity and independence of national economic institutions?

## The Issue

Despite all the political divisions, most Libyans can probably agree on the fact that action is needed to stabilize their country's economy. The current economic malaise is on the one hand caused by suboptimal oil revenues due to disruptions in production, a lack of investments, and low oil prices. On the other hand it suffers from disputes over governance and pressure on national economic institutions to take sides in the ongoing political crisis.

Instead of the tangible, positive change that citizens expected after the warring parties signed the Libyan Political Agreement (LPA), Libyans have seen living standards deteriorate, rampant inflation and a currency that is steadily weakening in thriving parallel markets. Indeed, the precarious situation has negatively impacted citizens' trust in Libya's national authorities and has kept the position of the Presidency Council of the Government of National Accord (GNA) weak, as it struggles to get funds to live up to its ambitions.

With the country staring into the economic abyss, conflicting sides are recognizing that inaction would lead to a lose-lose situation. A consensus seems to be arising that, to find solutions, they will have to work together, somehow. With oil production in May 2017 for the first time back up to 2014 levels, domestic and international stakeholders believe that with the right people around the table and the right amount of international pressure, new agreements can be formulated.

In recent months, many meetings have taken place between members of the business community, politicians and those in charge of the relevant national economic institutions. The meeting in Abu Dhabi between the head of the GNA, Fayez al-Serraj, and general Khalifa Haftar, in early May, illustrates that this renewed sense of urgency has reached the highest levels of Libyan politics.

Proposals for an inclusive economic revival are being circulated and have the potential to help build bridges between Libya's conflicting sides. This EDA Insight provides a background on the Libyan economy and assesses both long term economic challenges as well as the additional complications caused by the civil wars. It concludes by identifying five key issues an economy-focused political dialogue could concentrate on.

## Why Is It Important?

- Restarting a national dialogue with the objective of fixing the economy could allow for refocusing the current discussions away from the political deadlock and provides an opportunity to rephrase shared solutions in terms of a functioning, inclusive economic model.
- A stable Libya is needed for a stable region and sound economic performance is at the heart of that. The resource-rich country tends to be a pole of attraction for expat workers from neighboring countries and its local population is used to a redistributive economic model.
- The depression of the formal economy and a lack of governance have led to the (further) growth of an illicit economy. The longer the crisis continues, the more likely smuggling and other criminal activities will be embedded in Libya's political economy for the long term.
- Libya's oil industry is sufficiently large that production levels can impact global oil prices. Libya was exempted from participating in the historic OPEC agreement to curb production due to its ongoing conflict. Stability is likely to increase investments in Libya's oil and gas industry.

### Box 1: Libya's Political History in a Nutshell

In 1951, the United Nations (UN) declared Libya an independent Kingdom under the Sanussi Monarchy. Before independence, from 1911 until 1943, the territories now making up for Libya were ruled by Italy, which took over governance from the Ottoman Empire. With Italy's defeat in World War II (1939-1945), and until independence, Libya's eastern and western territories were administered by Britain, and the south by France.

The Sanussi Monarchy was overthrown in 1969 by a group of young army officers led by 27-year old Mu'ammer al Qaddafi, who was inspired by Gamal Abdel Nasser's Egypt. Qaddafi ruled Libya until a civil war in 2011 led to his removal and death. An international intervention, authorized through UN Security Council Resolution 1973 and executed by NATO and partners, assisted in the fall of Qaddafi's regime.

With the intention of rebuilding Libya's political institutions, elections for a transitional General National Congress (GNC) took place in 2012. In June 2014, GNC members were supposed to hand over power to a new House of Representatives (HoR). But they refused, while at the same time the HoR elections were declared invalid by Libya's Supreme Court. A second civil war followed and left Libya with two competing governments and parliaments.

In December 2015, a UN-brokered agreement led to the establishment of a Government of National Accord (GNA), though this did not bring an end to the conflict or to the multiple claims to national authority.

## Oil, Gas and Failed Attempts to Diversify

Before the Libyan civil war of 2011, the Libyan economy was doing quite well, but was also known to face a good number of medium and long term challenges. Many of the fundamental issues Libya struggled with reflect those generally associated with oil exporting countries, such as a large public sector wage bill, a lack of incentives for private sector activities and high spending on subsidies.

Oil in commercial quantities was discovered in Libya in the late 1950s and changed the country dramatically. Libya had become an independent state only several years prior and was considered one of the poorest member states of the UN, including with regard to human capital. For the first years of its existence, Libya scraped by on revenues generated from leasing military bases to foreign powers and substantial budget support, predominantly from the same foreign powers, the United Kingdom (UK) and the United States (US).

Close to European markets and deemed of high quality, Libyan oil was attractive for many Western firms and exploration and production were ramped up quickly in the years after discovery. Given that before this overwhelming international attention, Libya had attracted little interest from investors, the impact on society cannot be underestimated. To illustrate, between 1962 and 1968, Libya's gross domestic product (GDP) rose from 177.2 to 853.3 million Libyan pounds. Growth rates stood close to 20 percent per

annum and Libya's GDP per capita quickly grew to one of the highest in its region.<sup>1</sup>

Oil, and later gas, were indeed a blessing for Libya's state coffers and also turned out to be a driving force behind the unification of regulations and policies of the three regions that were at the heart of Libya's initial governance system. But at the same time, the lucrative energy industry removed all incentives for a private sector and prevented any diversification of the economy. The capital-intensive hydrocarbon industry still generates around 95% of total government revenue, though only 2% of local employment as the industry relies heavily on technical expat workers – even though many of them have left due to the conflict.<sup>2</sup>

Income from oil nevertheless has found its way back into society. The state revenues have financed a large number of public sector jobs and have enabled generous subsidies on fuel, food and electricity. In 2016, the public sector wage bill had risen to around 60% of GDP.<sup>3</sup> In 2012, explicit state subsidies amounted to \$11.5bn, which translated into 13.8% of GDP.<sup>4</sup> As a consequence of the subsidies, a number of goods in Libya are significantly cheaper than in neighboring countries, allowing for a large black market.

Libya is also an import-dependent country and the international reserves generated from the oil and gas industry are necessary to finance imports. Only 1% of Libya's territory is classified as arable land and the country imports 90% of its cereal requirements.<sup>5</sup>

### Box 2: Libya's Oil and Gas Industry

Map Source: US Energy Information Administration (EIA)

At 48 billion barrels, Libya holds the largest proven crude oil reserves of Africa and the 9<sup>th</sup> largest globally. Production currently takes place in six large basins – Sirte, Murzuk, Ghadames, Cyrenaica, Kufra and offshore. The Sirte basin is the largest of these, holding 80% of recoverable reserves. Most crude oil exports are destined for European markets, first of all Italy, followed by Germany and France.

Libya also holds the fifth largest proven natural gas reserves in Africa. In 1971, Libya became the third country in the world, after Algeria and the US, to begin exporting liquefied natural gas (LNG) through the Marsa El Brega plant, which predominantly serves southern European markets. From 2004 onwards, the export capacity for Libyan gas increased dramatically with the Greenstream pipeline and the Western Libya Gas Project, mainly serving Italy.

Libya is a member of the Organization of the Petroleum Exporting Countries (OPEC). Before the turmoil, in 2010, Libya produced 1.65 million barrels per day (b/d) and the National Oil Corporation (NOC) had plans to add capacity of about 775,000 b/d with enhanced recovery techniques. At the moment, production swings between 300,000 and 750,000 b/d. The NOC has set itself a target of 1.1 million b/d by August 2017 and also retained its vision to increase production to 2.1 million b/d by 2022.



## Mu'ammer Al Qaddafi's Policies and International Sanctions

The challenges inherent to Libya's oil economy were exacerbated by the policies of Mu'ammer Al Qaddafi, who ruled Libya from 1969 to 2011. His economic policies were greatly influenced by his own understanding of economic theory and practice, as cryptically explained in his self-authored *The Green Book*, which functioned as the unofficial constitution for Libya. One key characteristic of Qaddafi's thinking was a strong dislike of private sector activities and private property rights.<sup>6</sup>

At the same time, Qaddafi's foreign policy also left strong marks on Libya's economy, as support for subversive and terrorist groups around the globe had made Libya subject to international sanctions. The US, during Ronald Reagan's presidency, was the first to escalate economic sanctions. By 1986 Washington had prohibited all purchases from and exports to Libya, and had banned all Libya-bound travel.<sup>7</sup>

Initially, such unilateral sanctions hardly hurt Libya's economy as companies based elsewhere, predominantly in Europe, eagerly stepped in to take over business. The real harm came during the 7-year period of multilateral sanctions (1992-1999) which was put in place after Libya was accused of involvement in two airplane explosions, killing 441 people.<sup>8</sup> These sanctions did not bring about regime change, but did fuel popular unrest, crippled the formal economy and spurred the growth of a black market for suboptimal goods at inflated prices.

### Plans to Diversify and Privatize

Multilateral sanctions were lifted in 1999, after Qaddafi complied with the requests of the UN Security Council. The sanctions had negatively impacted Qaddafi's domestic standing and he knew that, in order to survive politically, he needed to accommodate the demands of businesses and citizens for international investment, more openness and positive economic change.

Libya had already once before experimented with economic reforms and privatization when in the 1980s, low oil prices put pressure on the state budget. But back then, privatization did not succeed due to Qaddafi's incoherent policies and a related uncertainty of regulations. After the lifting of sanctions, elements in Qaddafi's regime, including his son Saif al-Islam, seemed slightly more determined.

In 2002, Qaddafi decided to peg the Libyan dinar to the Special Drawing Rights (SDR) of the International

Monetary Fund (IMF), in order to improve the investment climate. Libya also agreed with the IMF undertaking Article IV consultations, the first conclusions of which were published in 2003 and suggested the need for better macro-economic management and removal of trade restrictions and subsidies, among other things.<sup>9</sup>

The IMF's SDR is an artificial currency that was created in 1969 to supplement member countries' official reserves and prevent overreliance on dollars or gold. Its value is currently based on a basket of five major currencies—the US dollar, the euro, the Chinese renminbi (RMB), the Japanese yen, and the British pound sterling.

In the years leading up to the 2011 civil war, plans to privatize and diversify were becoming more concrete. In 2006, the General Planning Council of Libya, in consultation with the Monitor Group, had published a long-term assessment titled *National Economic Strategy: An assessment of the Competitiveness of the Libyan Arab Jamahiriya*. In the wake of this report, several measures were adopted, including the establishment of the Tripoli Stock Market, the Libyan Investment Authority (LIA), an Export Promotion Center and a Privatization and Investment Board, as well as a National Economic Development Board under the leadership of Dr. Mahmoud Jibril.<sup>10</sup>

Thus even under Qaddafi, it was acknowledged that the Libyan economy, to remain sustainable, was in urgent need of diversification, subsidy and banking reforms and private sector development. After the 2011 uprising and until the conflict in 2014, there seemed again to be momentum for meaningful reforms and an appetite from the international community to help Libya on its path to full economic potential.

That said, the ongoing political crisis has now added a number of immediate economic concerns that need addressing before Libyan policy-makers can continue their quest to modernize and diversify the Libyan economy.

## Additional Economic Problems Caused by Conflict

The 2011 and 2014 civil wars in Libya have added several intertwined economic problems. At the same time, the collapse of global oil prices compounds the Libya-specific issues. Once again, this underlines the volatility and uncertainty associated with an economic model based purely on oil and gas exports.

In broad terms, the developments of the past six years have added the following economic difficulties:

- State revenues have decreased, due to severe disruptions to oil production and lower global oil prices.
- State spending on public wages has increased due to a large number of ghost employees and the decision to provide those instrumental in toppling Qaddafi with a state salary.
- As a result of the continuous budget deficit, international reserves are dwindling, thereby putting pressure on the currency peg and increasing inflation as imports are difficult to obtain.
- The criminal economy is growing and there is a risk that illicit activities are being 'normalized' due to the security situation and a lack of governance and regulation.
- There is pressure on the country's independent national economic institutions to take sides in the conflict and actively contribute to the political divisions.

Libyan policymakers should not forget the fundamental long-term challenges and the policy proposals and reforms that are awaiting discussion in national political institutions. However, given the current circumstances, they should start with tackling issues that, after six years of damaging conflict, require immediate action.

The time seems ripe to discuss and overcome those issues. Consensus is building that none of the significant conflicting parties is likely to gain from a non-functioning economy and political adversaries and economic leaders are showing willingness to come together to tackle these issues as best as possible.

While there are plenty of other areas that need discussing, including political ones such as the composition of the Presidency Council and other amendments to the LPA, a renewed dialogue could focus on building a shared vision around five intertwined economic themes and questions:

### **1) How to get energy production and exports back on track?**

Given the importance of the oil and gas industry to Libya's political economy, controlling production has become a strategic objective for parties to the conflict. Despite the fact that the warring parties have generally refrained from deliberately damaging the industry and its vital infrastructure, closures and blockades have been used for political purposes. The protracted nature of the conflict, as well as fighting over control of facilities, has damaged terminals and a good number of pipelines, including the ones from

Sharaha to Zawya and from Zaggut, Dahra and Bahi to Es Sider.<sup>11</sup>

The Sirte basin, which is the most important in terms of production, has witnessed fighting between several groups, including the Libyan National Army (LNA), the Benghazi Defence Brigades (BDB), the Misrata-dominated Banyan al Marsous, the Petroleum Facility Guards, and Daesh. The LNA has been able to take control of the oil facilities in Ras Lanuf and Al Sider, thereby restarting production and ensuring the revenues reach the Central Bank of Libya (CBL).

In the southwest of the country, armed groups temporarily halted production at the El Sharara field and managed to stop output of the Wafa oil and gas field by blocking the pipelines.<sup>12</sup> Most of these blockades are being resolved through local mediation, indicating that groups on all sides have political or financial motivations to protect the infrastructure. That said, the situation in the southwest remains uncertain and could lead to more violence in the short term.

Overall, in combination with lower oil prices, the disruptions have caused revenues from oil production to fall steeply. According to the OPEC revenues fact sheets, oil revenues amounted to US\$29bn in 2013, but only to US\$9bn in 2014.<sup>13</sup>

Stopping the fighting over infrastructure is a first step. Next steps should include repairing damaged infrastructure and re-attracting foreign investments. The NOC has a self-set target of 1.2 million barrels/day (b/d) by end of 2017 and expects to increase production to at least 1.6m b/d by 2022. The NOC's chairman Mustafa Sanallah has estimated that Libya needs around US\$20bn of investment to achieve that target.<sup>14</sup>

In recent months, Sanallah has lobbied extensively abroad for international investments, thereby lifting a self-imposed moratorium on such investments.<sup>15</sup> Several companies that were previously active in Libya are making plans to return as soon as the security situation allows for this, including the Egyptian General Petroleum Corporation (EGPC).<sup>16</sup> Recently, Russia's largest state-owned oil producer Rosneft expressed interest in increased cooperation. Still, many foreign companies and investors remain hesitant due to the security situation as well as due to fears of further oversupply and declining oil prices.

### **2) How can the Central Bank of Libya help curb inflation and stabilize the currency?**

The decline in oil revenues, combined with ongoing spending, is leading to the depletion of Libya's foreign-exchange reserves (see Figure 1). Given the country's



peg as well as its strong import-dependency, this has led to pressure on official exchange rates. The dinar is pegged to the IMF's SDR, but movements in the parallel currency markets show a strong pressure to devalue the dinar. The official exchange rate stands at 1.4 dinar to the US dollar, but in the black markets, a dollar can cost 6-8 dinars, sometimes even more. Speculative currency traders have exacerbated the situation.

A currency devaluation is a decision by the government to make a downward adjustment to the value of a country's pegged currency relative to another currency, group of currencies or standard. A country may decide to devalue to combat trade imbalances, but a devaluation will also make imports more expensive and as a result could spark higher inflation and thus decrease the purchasing power of the population.

Consumer price inflation in Libya was estimated at 15.6% for 2016 and prices are forecasted to keep rising for the next two years.<sup>17</sup> The main causes of inflation are supply-chain disruptions due to conflict, a lack of liquidity in banks and the weakening currency. To increase liquidity, several foreign governments have shipped dinars to Libya.<sup>18</sup>

### 3) How can the limited resources of the state budget be spent fairly and effectively?

In mid-April, the foreign ministers of the G-7 came together in Italy and among other things recommended that in Libya 'all oil revenues generated by the NOC must be transferred to the CBL, which must put the funds at the disposal of the Presidency Council'. The statement reflects the funding difficulties that the Presidency Council of the GNA is experiencing ever since its establishment.

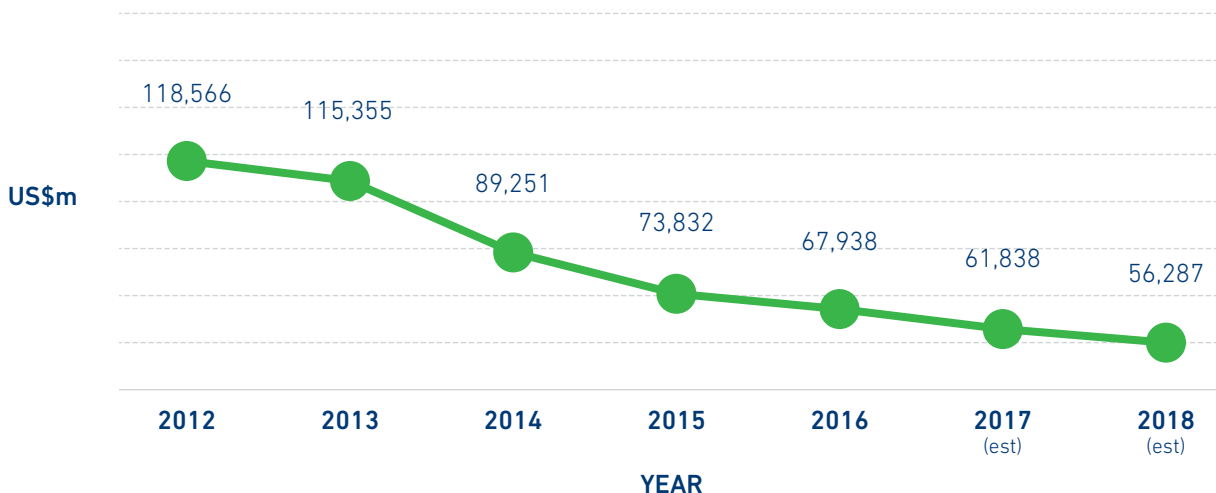
Recently, the CBL launched a foreign exchange system for individual Libyan households. As part of this new initiative, the CBL had sold around US\$100 million of foreign currencies at the official exchange rate by mid-April.<sup>19</sup> At the same time, the recently published 2016 annual report of Libya's Audit Bureau is warning for the damaging impact of widespread corruption in Libya's banking sector.<sup>20</sup>

The Libyan Central Bank is the entity responsible for disbursing funds to the government. But as it has positioned itself as above the conflicting parties the bank is reluctant to provide the GNA with more than emergency spending, given the fact that the GNA has not been approved by the Libyan House of Representatives (HoR) - a requirement stipulated in the 2015 Libyan Political Agreement.

The Central Bank governor, Sadiq Omar al Kabir, seems generally wary of pursuing a devaluation, fearing an initial spike in consumer prices, which in turn could spark social protests. Nonetheless, domestic and international consensus seems to be building on the need of intervention and the CBL has hinted it is open to discuss this option.<sup>21</sup>

Provided only with the bare minimum, in January 2017, the GNA received LD4.8bn (US\$3.5bn) to cover spending for the first quarter of the year. The CBL has

Figure 1: Libya's Foreign-Exchange Reserves



(Source: Economist Intelligence Unit)

only provided funds for wages and salaries, student scholarships abroad, oil and gas sector development, electricity and essential subsidy items.<sup>22</sup> The disbursed sum was less than a quarter of the 2017 budget that was agreed between the CBL and the GNA in December 2016.<sup>23</sup>

Development spending has drastically been reduced while basic service delivery needs improvement in many parts of Libya. A significant share of the central (emergency) budget is being spent on public sector wages. In the aftermath of the 2011 civil war, a large number of revolutionary combatants were made eligible for state salaries. Due to suboptimal bureaucratic practices, what were believed to be a few thousand beneficiaries, rose to more than 200,000 citizens claiming funds.

Since 2014, many of these beneficiaries have been fighting on opposing sides and the fact that the Central Bank provides them with money can be seen as a factor fueling the conflict. At the same time, it also provides the Central Bank with the ability to cut off funding to a number of militias. Discussions between the parties will need to include ways to reduce the public wage bill, including through an inclusive national identification project and the removal of ghost payees, in order to free up money for service delivery and reconstruction in the most affected regions.

#### **4) What can be done to curb the illicit economy?**

A lack of governance during the past six years of crisis have enabled the (further) growth of a criminal economy in Libya. Smuggling and trafficking has increased due to flaws in border controls, an abundance of weapons, generous subsidies that allow for a thriving black market, and a lack of alternative economic activities. In several places in the south as well as along the western coast line, the smuggling industry has offered attractive employment opportunities – with fast money and limited risks – as well as a way to control territory.<sup>24</sup>

Thus in the wake of the conflict Libya has developed a multitude of 'protection economies', in which local revenues are generated from the protection of legitimate but also illicit forms of trade.<sup>25</sup> The longer the formal economy remains depressed and local uncertainty continues, the more likely illicit activities will grow deeper roots and will get embedded in Libya's overall economic model.

Of these illicit activities, human smuggling receives the most attention from the international community. European governments in particular are predominantly focused on stopping the illegal flows from Libya to Malta and Italy. The main response has been one of enhancing law enforcement, such as through the EU's anti-smugglers operation and through individual deals, such as between Italy and tribes in southern Libya.<sup>26</sup>

But to tackle this problem in a serious and sustainable way, what is really needed is a much better understanding of the economic drivers behind the booming smuggling business and ideas about how to provide alternative livelihoods for those involved.

#### **5) How to bolster the unity and independence of national economic institutions?**

The 2014 civil war pitted two rival parliaments and governments against one another. Before the establishment of the GNA, the national economic institutions in charge of oil production, the budget and investments were seen as the few national entities holding the country together. But even the Central Bank, the NOC and LIA have suffered from political pressure to take sides in the conflict.

Over the past three years, Libya has indeed witnessed the establishment of several parallel and competing branches of these institutions, though most of the breakaway entities have little control over oil and state funds. Realizing that a split is not a solution, in July 2016 the parallel branches of the NOC decided to re-unify, renegotiating among other things the composition of their board and a number of high-level appointments.<sup>27</sup> Indicating the benefits of a unified stance, oil production almost doubled between July and December 2016, to 600,000 b/d.<sup>28</sup>

By remaining united and in charge of the production and export of oil as well as the redistribution of wealth, these national economic institutions can make an important contribution to the resolution of the political crisis. Controlling the state funds, they are at the center of the (solution to the) current political crisis and should use their leverage to draw the political parties towards a workable agreement.



## Conclusion: Seizing the Momentum

Inside and outside of Libya consensus seems to be building to focus on the economy as a means to (re) discover shared interests and objectives. Pressure groups from the oil and gas industry, business councils and the chambers of commerce are all calling for action. Internationally, G-7 ministers have made it clear that those involved, including the Presidency Council of the Government of National Accord, the Libyan Central Bank, the National Oil Corporation and those controlling the oil fields, need to work together to save the Libyan economy.

At the moment, a good number of meetings are taking place and proposals circulate on how to best tackle the current economic crisis. The meeting between Serraj and Haftar in Abu Dhabi shows a growing momentum to overcome Libya's political divides. The Central Bank has a critical role to play and can use its politically neutral stance to push conflicting parties to the table.

While political issues including amendments to the Libyan Political Agreement and the composition of the Presidency Council will be important elements in a new dialogue, they are also likely to be divisive. Restarting the national dialogue with a focus on fixing the economy will provide those involved with an opportunity to rephrase shared solutions in terms of a functioning, inclusive economic model.

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