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Cash crash: Syria's economic collapse and the fragmentation of the state

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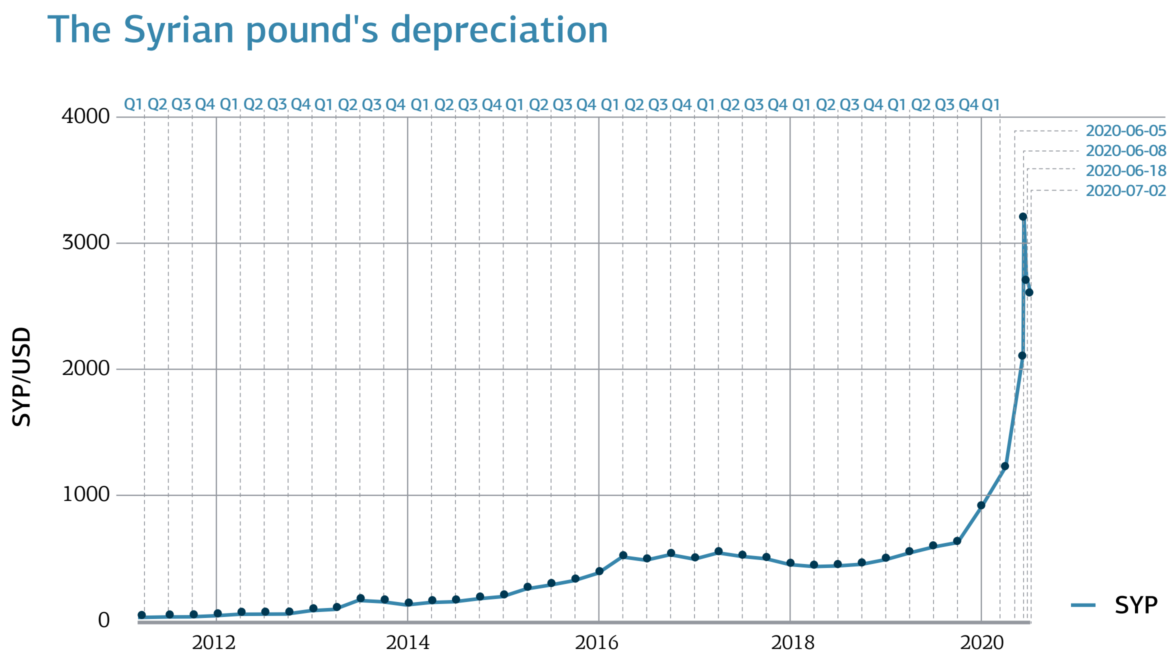
The Syrian economy is currently witnessing unprecedented volatility. To date, analysts have predominantly focused on the impact this crash has had on Syrian households, which are now facing acute financial pressure as poverty rates climb toward 90 percent, food insecurity skyrockets, and famine becomes an ominous possibility. Major political consequences are also coming into view, and significant attention has been given to the possibility that volatility will destabilize and ultimately threaten the regime of Bashar Al-Assad. Although these assessments tend to underestimate the staying power of the Syrian state apparatus, economic volatility in Syria certainly will have an impact on the arc of the conflict itself.

Already, meteoric rates of inflation have splintered the Syrian economy, and in the process they have hardened the regional divisions that exist among territorial actors. Of particular note, this economic instability has accelerated the adoption of foreign currencies in areas that are outside the Government of Syria's physical control. In northwest and northeast Syria, respectively, Turkish lira and U.S. dollars have become sources of bedrock fiscal stability as wider economic turmoil persists. Crucially, the impact of this shift is not only financial. In these areas, foreign currencies have become indexes for highly important commodities, salaries, and consumer goods, while further potential exists for deep impact on a wide spectrum of matters related to commerce and local administration. However, as these areas find refuge in foreign currencies, there has been no respite for Government-held areas, which have been left exposed to volatility. Collectively, this set of dynamics can be summarized as the "dollarization" of the northeast, the "lira-fication" of the northwest, and the immiseration of the rest.

This brief report is a preliminary attempt to understand the impact of these shifts in currency use throughout Syria. As the respective trajectories of each of Syria's three territorial regions diverge, ordinary Syrians will be forced to adapt to new realities, and novel patterns of displacement, crossline commerce, and humanitarian needs are likely to emerge. Left unchecked, this fragmentation may compound the disparities in humanitarian needs that already exist across conflict lines, and it may also raise additional barriers to the donor community's incipient hopes of breaking down the regional divisions that govern the response itself.

Why now?

The structural deterioration of the Syrian economy has been steady throughout the conflict for a multitude of interlinked reasons. A significant decline in production and exports, sweeping destruction, territorial fragmentation, reduced cross-border trade, deleterious monetary policies, plummeting foreign direct investment, and international sanctions are all factors that have contributed to the contraction of Syria's economy since 2011. However, the outright collapse of the Syrian pound is a relatively recent phenomenon. Certainly, the Syrian pound has shed value consistently throughout the conflict, yet it was not until mid-2019 that the currency entered a period of rapid decline that degenerated into extreme volatility beginning in early 2020. This volatility reached its nadir in June 2020, when exchange rates dipped to a record low of 3,200 SYP/USD, and continued to fluctuate considerably on a daily, and even hourly, basis.



The precise triggers of this collapse are disputed. Certainly, there are reports that fear of the U.S. Caesar sanctions prompted a pre-emptive sell-off of Syrian pounds in late May. However, the roots of the pound's decline clearly predate the implementation of the sanctions. Rather, numerous changes to the structure of import subsidies, adjustments to conversion rates, and various schemes to incentivize bank deposits hint at the deeper, structural problem of dwindling reserves at the Central Bank of Syria. As a result of the Central Bank's impotence, authorities have had little success backstopping the Syrian pound. Consequently, the adoption of foreign currencies in Syria's disparate regions has moved ahead unabated. While hard data is largely unavailable, a recent currency assessment indicates a significant increase in the demand for foreign currencies in both **northeast** and **northwest** Syria.

Northeast Syria

While northeast Syria is commonly viewed as a domain of the U.S.-led international coalition, this characterization is both incomplete and somewhat misleading, particularly in economic terms. However, this is changing as economic volatility accelerates the dollarization of northeast Syria. According to an **assessment** by REACH, since the beginning of June, exchange offices in northeast Syria have witnessed an increase in the demand for dollars, far outpacing current supplies. While access to dollars remains uneven, early indicators point to the important structural changes that are underway. To date, this process has taken place on the macro level of the regional economy as well as on the lower, household level.

Nearly every major economic transaction in northeast Syria is now conducted in dollars or indexed to current exchange rates. Prior to the onset of latest instability, the regional economy of northeast Syria was arguably the most internationalized of any area of Syria, due to its heavy reliance on revenues from dollar-indexed commodities and the firm presence of international aid actors. Of the two commodities that serve as pillars of the regional economy — oil and grain — oil was already circulated internationally or across conflict lines. This trade is believed to take place primarily in dollars. Grain pricing, a domain of intense economic friction between the Self Administration and the Government of Syria, has also shifted to dollars as a result of the latest episodes of instability. In late May, as currency depreciation rapidly ate into the value of commodity prices, the Self Administration gave in to the pressure brought by agricultural producers and announced that it would begin to index prices according to the parallel market rate (see: **Syria Update 8 June**). The final leg of northeast Syria's macro-level economy, aid work, was already predominantly conducted in dollars or pound equivalents.[1] Likewise, on 18 June, the Self Administration **announced** a sharp increase in the military and civilian salaries to counter the salary erosion that had occurred due to rising inflation. This is the second pay raise within six months, and like grain prices, authorities also announced that salaries will be regularly re-assessed based on the value of the dollar.

Local consumer and retail markets in northeast Syria have largely resisted the dollarization that underpins civil administration and commodities in northeast Syria. However, the latest bout of volatility has begun to entrench dollar pricing, particularly for high-value assets. Pricing for real estate and land is increasingly taking place in dollars, with conversions to Syrian pounds occurring at the time of sale. Although property owners are nonetheless forced to accept significant write-downs relative to pre-2011 values, anchoring prices to the dollar has mitigated the further risks of exchange rate volatility. Of note, this pricing convention is often merely a reference device, as actual dollars do not circulate in large quantities within consumer markets, and northeast Syria currently lacks the financial infrastructure to bring hard currency or electronic dollar transactions into general use. As a result, Syrian pounds are likely to continue to circulate widely, although gaps are likely to widen between the purchasing power of pounds in northeast Syria and elsewhere in the country.

1 While hard data to quantify the full extent of employment in the northeast Syria aid sector is scarce, there is no doubt that aid activities have created a multitude of jobs in logistics, accounting, finance, engineering, programming, information technology, and transportation in the region.

Impact

- **More leverage to corner the grain market:** To date, the strategic wheat crop has been a driver of commercial rivalry between the Self Administration and the Government of Syria. Should current trajectories continue, the Self Administration will find itself in a commanding position. As the Government of Syria continues to struggle to finance wheat purchases, the Self Administration will likely harden its negotiating positions and assert greater autonomy as a result.

- **Increased trading power with Government-held areas:** Greater access to stable foreign currencies, combined with more generous public salaries, will give northeast Syria a commercial and trade advantage over Government-held territories. Trade patterns — and smuggling — are likely to adapt to this reality.

- **Damascus may be forced to lash out by other means:** Faced with a steeply asynchronous power dynamic, the Government of Syria may seek to even the playing field by using what leverage it does have by undertaking military campaigns, sabotaging cross-line service agreements, fomenting tribal or social upheaval in the northeast, or imposing conditions on cross-line medical aid.

- **Widening inequality regionally:** Even within northeast Syria, access to dollars is uneven, and the stability that access to dollars does impart will not be felt universally. This may widen the needs gap within communities and across the region.

Northwest Syria

To an even greater extent than in northeast Syria, economic volatility has driven opposition-held areas of northwest Syria toward the wholesale adoption of a foreign currency: the Turkish lira. The precise extent to which Turkish lira has entered use in northwest Syria is not clear, yet indicators suggest its use is now widespread. According to an **assessment** by REACH, dollars and Turkish lira are widely accepted, and in some instances even imposed, in local markets. However, there are still reports of shortages of both currencies, and access remains irregular. On the whole, the expansion of the Turkish lira is one aspect of a long-running economic reconfiguration that is calibrated to bring northwest Syria more fully into sync with Turkey economically and administratively (see: **Northern Corridor NOSAP**). Holistically, growing trade volume has increased capital flows between northwest Syria and Turkey and revived commercial and industrial activity, although the benefits of this economic revitalization have been uneven. In practical terms, integration with Turkey has limited the impact of the pound's volatility in northwest Syria.[2] Nonetheless, although volatility has accelerated the adoption of the Turkish lira, it is important to note that the Syrian pound has long been in the process of a gradual phase-out in northwest Syria. As it accelerates, this process has had a growing impact in two separate but interrelated domains: administrative and governmental operations, and commercial activities.

Due to the administrative linkages connecting Turkish-controlled areas of northern Syria to corresponding provinces in Turkey, local administration has been a primary vector for the spread of Turkish lira in Syria. Both governance bodies in northwest Syria — the Syrian Interim Government (SIG) and the Salvation Government — have now adopted the currency at scale. In March 2018 the SIG began to pay the salaries of many armed combatants, administrative employees, and aid workers in Turkish-administrered areas of northwest Syria — excluding Idleb — in Turkish lira via transfers conducted through the Turkish National Post Office (PTT). In June 2020, the Salvation Government followed suit and also began to pay many salaries in Turkish lira.

The process of adopting the Turkish lira as a commercial currency has been piecemeal and slower than in the administrative realm. Although large-scale commercial transactions have long been conducted in Turkish lira, it was not until the volatility of the Syrian economy began to reach a fever pitch in late 2019 that the use of Turkish lira was expanded to transactions conducted in local markets. In December 2019, shipments of Turkish lira in five, ten, and twenty lira banknotes began to circulate as the SIG took the first steps to phase out the Syrian pound in northern Aleppo (see: **Syria Update 4 December 2019**). At that time, traders and craftsmen in northwest Syria began to refuse payments made in Syrian pounds, and local councils in both Azaz and Afrin issued decisions to price gold in Turkish lira. Shortly thereafter, in January, SIG authorities indexed bread prices in various locations to either Turkish lira or dollars in order to stabilize prices and spare bakers the effects of instability (see: **Syria Update 27 January**). Following suit, the Salvation Government also began to calculate bread prices in dollars according to the daily exchange rate, and it began to issue **fines** to bakeries that violated the new bread pricing system. On 15 June, the Salvation Government's economic authority **instructed** commercial traders and exchange houses to circulate low-denomination Turkish **coins and**

2 Since then, prices began to stabilize, goods became widely available, agricultural production improved and with the steady recovery of local manufacturing and industry (see: Syria Update October 2), employment opportunities returned to many Turkish-administered areas.

banknotes to be used "for everyday transactions in liberated territories instead of the Syrian pound." As a result, additional Turkish banknotes and coins have been put into circulation in a bid to restore stability.

Impact

- **The circulation of Turkish lira will likely stabilize prices more than anywhere in Syria.** Prices for basic commodities, food items, and fuel are likely to be set in close coordination with those in Turkey (the source of most commercial goods that circulate in the area). As the use of the lira becomes more widespread, these markets may be insulated from shocks caused by fluctuations in the value of the pound elsewhere in Syria.

- **The widening adoption of the Turkish lira will deepen Turkey's investment in northwest Syria, but it does not fundamentally change it.** Turkish rehabilitation and investment have already set northwest Syria on a seperate trajectory to that of neighboring areas held by the Government of Syria. Initiatives to normalize the use of Turkish lira will likely accelerate this process, thus drawing the areas further into Turkey's orbit and entrenching Turkey's overarching state-expansion practices in northern Syria.

- **The transition to Turkish lira will likely speed along the integration of northern Idleb with other Turkish-controlled areas**. Currently, important distinctions do exist between Turkey's presence in northwest Syria. The adoption of lira in all these areas will likely erase some of the differences that distinguish activities in Euphrates Shield and Olive Branch areas, as well as northern Idleb. This may complicate donor-led efforts to operate in northwest Syria while avoiding contentious issues of Euphrates Shield areas in particular.

Government of Syria-controlled areas

To date, the Government of Syria has reclaimed control over more than 70 percent of Syrian territory. Although the Government of Syria has succeeded militarily, it must now adapt and respond to a widening economic challenge. The confluence of global, regional, and local economic conditions place the Government of Syria under pressures that are arguably as great as any it has faced throughout the conflict. Especially pertinent to this challenge is the Government of Syria's uniquely limited toolkit. Whereas administrative actors in northwest and northeast Syria have mitigated the effects of currency collapse by resorting to foreign currency, the Government of Syria cannot make such a pivot. Consequently, as needs are rising, its capacity is diminishing. The result is likely to be misery on a deeper and more widespread basis for Syrians living in Government-held areas. The collapse of the pound will have a pronounced impact in Government of Syria-held areas in two crucial respects: state services and household income.

In all likelihood, state institutions will crumble as the Government of Syria's ability to collect revenues shrinks. Myriad factors are relevant to this collapse. Implicitly, the U.S. Caesar sanctions are designed to limit the Government of Syria's access to foreign currency and global markets (see: **Syria Update 22 June**). However, this impact merely compounds the hardship brought on the pre-existing conditions, such as the pronounced contraction of the Syrian economy. Moreover, reductions in **tax and oil revenues** — once the pillars of the Syrian state budget — are also critical impediments to achieving a stable balance of payments. Syria's most important oil fields are outside the Government's control, while the tax base has been obliterated, and economic volatility has rendered the taxes that are collected virtually worthless. Further currency depreciation is expected, and it will continue to sap the Government of Syria's coffers. Over time, these conditions are likely to require deep cuts to state services, further reductions in subsidies, reduced access to imports, and greater volatility in economic markets as the state's toolkit shrinks.

Whereas civilians in northwest and northeast Syria can look to foreign currencies as partial solutions to halt economic volatility, the options available to civilians in Government-held areas are comparatively limited. In recent months, the Government of Syria has shuttered the informal currency exchange offices (hawala) through which many Syrians receive remittances from abroad. As a result, remittances now move through state-controlled banks and exchanges, which exchange them for Syrian pounds at a rate far below its value. Moreover, while the purchasing power of the Syrian pound erodes by the day, transactions in other currencies have been criminalized. Already, around **9.3 million** people in Syria are food insecure, with more than two million more at risk. The World Food Program has warned of a potential famine if Syria's economy continues its downward spiral. This danger is particularly acute in Government-held areas. Moving forward, as humanitarian conditions continue to worsen, popular unrest is on the rise. This is likely to further manifest itself in a cycle of violence, displacement and migration that will have knock-on effects not only in areas under Government of Syria-control, but also in neighboring territories and internationally (see: **Syria Update 15 June**). Ultimately, however, civilians living in these areas will have limited means of challenging the Government of Syria as they continue to face extreme hardship for the foreseeable future.

Impact

- **Economic collapse has accelerated Syria’s fragmentation, yet in economic terms, the Government of Syria will become even more reliant on regions outside its control.** With the enactment of the Caesar sanctions and the economic collapse of Lebanon, the Government of Syria’s reliance on territories outside of its control as a source of trade and dollar inflows will increase. As a result, racketeering, smuggling, and extortion are likely to flourish. While there is no guarantee that Syrian civilians will acquire needed goods through these channels, it is almost certain that war economy actors will reap enormous profits.

- **State institutions will become even more non-functional.** A lack of vital infrastructure and public revenues will further weaken the remaining institutions of the Syrian state. Service provision is expected to worsen, and state functionality will degrade over time. Such conditions will produce worsening outcomes in education and health, and hardship will mount.

- **Syria will remain a rump state.** Without control over oil resources, the Government of Syria will face a balance of payments shortfall. However, until reconstruction takes place, more fundamental economic challenges will reign.

- **DDR will become more challenging.** Without economic opportunity, livelihoods needs will rise, thus increasing the attraction of military activities. Armed group recruitment is likely to increase, as is the retention of active fighters. Moreover, illicit trades such as narcotics networks will also increase. These activities will not be contained within Syria’s borders.

- **Human flight will rise.** A lack of opportunities is likely to prompt flight by the skilled technicians and trained staff whose ingenuity will be more needed as resources dwindle. Some may flee to parts of northern Syria that show greater stability. Most are likely to seek refuge in host nations in the region or beyond.

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