“To restore the Lebanon central bank’s credibility, independence is key”, Op-ed in The National, 15 Aug 2023

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To restore the Lebanon central bank’s credibility, independence is key

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Lebanon is now dealing with the greatest financial crisis in history, the heavy legacy of Riad Salameh, the former governor of Banque du Liban. The new governor, Wassim Mansouri, has pledged that the central bank “must completely stop financing the government outside of a legal framework”, calling for a state financing law to be passed by Parliament.

This is unnecessary and a dangerous precedent that previous governors like Edmond Naim rejected. The Money and Credit Code, or MCC – Lebanon’s banking law – provides a wide measure of independence to the BDL with specific and strict conditions on financing government. The MCC legal strictures were violated, including the operating principle that the central bank does not grant credits to government and the public sector (MCC Article 90). How was this done?

The BDL financed unsustainable budget deficits (averaging 8.4 per cent of gross domestic product between 2014 and 2019) and monetised public debt, attempting to reduce the growing burden of interest payments. Wasteful government spending includes subsidising electricity generation by Electricite du Liban, which touched $1.8 billion in 2018, or 3.1 per cent of GDP. This was the biggest drain on public finances, while the company provided about three hours of electricity a day. Public debt mushroomed from 139 per cent of GDP in 2014 to 172 per cent in 2019. This accelerated to 282.3 per cent in 2022, while current account deficits widened from 26.2 per cent to 28.5 per cent of GDP between 2014 and 2019.

The BDL expanded its public sector financing through providing preferential funding at subsidised rates for housing and real estate, education, tourism, innovation and SMEs. This amounted to quasi-fiscal spending: BDL financed activities that should have been government budget financed under parliamentary scrutiny. The BDL expanded quasi-fiscal spending without public disclosure or transparency as to amounts and beneficiaries. This resulted in an absence of accountability, growing clientelism and the financing of activities at the behest of politicians and their cronies, widening the web of corruption.

Marketed under the heading of “financial engineering”, the BDL bailed out the banking system in 2015 to the tune of $5.3 billion (about 12.5 per cent of GDP) without approval from the BDL’s governing council, government or Parliament. The BDL financing was a costly and vain attempt to offset the effects of its failing exchange rate policy and overvalued parity. But the BDL financing was convenient for successive governments since they did not have to foot the bill and raise taxes.

More generally, the increasingly higher interest rates that the BDL was paying to attract deposits from commercial banks and capital inflows to increase its foreign currency reserves and defend a highly overvalued fixed parity of the Lebanese pound led to a sharp contraction of credit to the private sector. The overvalued real exchange rate acted as a tax on exports and sucked in imports, leading to a growing current account deficit. Lebanon’s productive sectors were crowded out by the BDL’s fixed exchange rate policy, unable to get access to finance from the banking sector.

The stage for economic and financial collapse was set by the BDL’s financing of the twin current account and budget deficits. The BDL-Ponzi scheme burst, triggered by bank closures in October 2019, loss of confidence and a run on the banks. Eventually, the government defaulted on the March 2020 Eurobond. The government of Hassan Diab, the prime minister at the time, prepared a financial recovery plan that comprised fiscal, banking and structural reforms. This was sabotaged by the BDL and vested political and banking interests resisting reform and the required recapitalisation and restructuring of the banking sector.

Similarly, an IMF Staff Level Agreement from April 2022 remains stalled with no sign of willingness from Lebanon’s caretaker government and politicians to implement the required reforms agreed with the Fund. With government no longer able to tap domestic or foreign debt markets, increasing recourse was made to BDL financing by drawing down foreign currency assets (in effect, customer deposits that the banks had deposited at the BDL) and printing money. This led to a collapse of the exchange rate (98.5 per cent depreciation) and triple-digit inflation rates approaching hyperinflation (296 per cent in 2023), real GDP declining by 40 per cent and an increasingly informal (non-tax paying) cash-based economy, with a growing dollarisation of transactions. The net result of the BDL’s financing activities was accumulated losses exceeding $76 billion that were offset on the BDL’s balance sheet by creating fictitious “other assets”, as mentioned in the Alvarez & Marsal Forensic Audit report.

Mr Mansouri and the newly empowered governors of the BDL have the daunting task of resolving some of the institution’s legacy issues. They have proposed rebuilding trust via proposals including budget approval and enacting financial reforms (a capital control law by the end of August, as well as a financial capital restructuring law). The BDL needs to move to a floating exchange rate regime, shift away from distortion-creating and corruption-spreading multiple rates under the existing Sayrafa platform, to a single platform (for example Bloomberg or Reuters) and adopt a monetary policy targeting inflation.

To stop financing government, the MCC provides the power to the central bank, if it decides to do so, to lend to government under the conditionality it imposes. Such a conditional loan should be in Lebanese pounds to avoid further depletion of foreign currency "reserves" (now under $6.3 billion). This will force government to tap the local foreign exchange market if it needs to fund FX spending, thereby bearing the exchange rate depreciation effects of its FX borrowing. This would impose market discipline on the government, which has been absent under existing policy.

As part of the conditionality, the BDL should request that the government undertake a shock-therapy set of policies. Restoring confidence in the economy will stem from deep and comprehensive economic reforms. These should include restructuring the public debt and the banking system (including the BDL and its losses), governance reforms and the removal of subsidies by immediately phasing out transfers to non-performing, corruption-ridden national councils, state-owned enterprises and government-related entities.

There should also be a fiscal strategy to sustainably improve the state's finances, by reducing the size of government and revenue mobilisation (for example, by broadening the tax base and improving the efficiency of tax administration) and rationalising spending by implementing public procurement reform. While credible financial restructuring tops the list of reforms needed, this must be supported by the institution of checks and balances, public accountability as well as transparency and disclosure.

Lebanon is paying the price of years of unsustainable, fixed exchange rate, fiscal and debt policies. Outrightly refusing to fund the government will instead force its hand to go to the IMF, with its funding (as well as any international aid and financing) dependent on implementing, not empty promises, but reforms. Otherwise, the BDL will lose any remaining credibility and, once again, revert to being a government financier, thereby risking a prolonged hyperinflationary period. Restoring credibility to the BDL requires its standing firm on its independence from government and Parliament, as well as forcing politicians to be held accountable for their inaction and irresponsible policies. Absent comprehensive reforms, Lebanon will continue its descent into its infernal abyss.