

"Capital Controls and the Stabilization of the Lebanese Economy", by A Citizens' Initiative for Lebanon, 5 Feb 2020

The article titled "Capital Controls and the Stabilization of the Lebanese Economy", written by A Citizens' Initiative for Lebanon was published on 5th January, 2020 in [An Nahar](#) and is also posted below.

This note is the latest in a series of analysis by an independent group of citizens who met in their personal capacity in December 2019 to discuss the broad contours of Lebanon's financial crisis and ways forward.

Capital Controls [\[1\]](#) and the Stabilization of the Lebanese Economy

Summary:

In mid-October 2019, Lebanese banks shut down their branches, imposed informal capital controls and blocked depositors' access to their deposits. These informal capital controls are unprecedented in Lebanese banking history and are not based on legal grounds. To make matters worse, they have been applied without any transparency and in an arbitrary manner. In line with [our 10-point action plan](#) to avoid a lost decade, Lebanon urgently needs to replace these informal controls with formal (i.e., based on laws and regulations), focused and effective capital controls that are an integral part of a macroeconomic comprehensive program for monetary and financial stabilization

and economic recovery. Well-designed capital controls are essential in slowing down the outflow of capital and stabilizing Lebanon's external finances until confidence is restored in the Lebanese banking system and economy.

What are capital controls?

Formal Capital controls are lawful restrictions placed by government authorities on the flow of capital, i.e. on foreign currency transactions. These restrictions are designed by governments, implemented by banks and financial institutions and are typically enforced by a central bank.

Capital controls can take many forms outright prohibition of any international transaction or, alternatively, any international transaction above a certain threshold; restriction depending on the type of the transaction debt vs equity investments, short term vs long term, or capital account versus current account. Iceland, for example, restricted capital account transactions in 2008 but allowed current account transactions in other words, no restrictions were placed on imports taxation of international transactions and, finally, requiring licenses or approvals for certain international transactions such as payments for imports of inputs to industries and other economic activity.

The type of capital controls that will be required in Lebanon will vary depending on the program for monetary and financial stabilization and economic recovery, and more specifically, the foreign exchange regime.

Why are capital controls required in Lebanon?

Capital controls are needed to slow down the outflow of capital from Lebanon. The key reasons for imposing capital controls are:

- the large net negative foreign currency position (net reserves) of the Central Bank of Lebanon [\[2\]](#). BDL is not in a position to meet the banks' foreign exchange requirements.
- the need to limit the rapid decline in foreign exchange reserves and, therefore, the loss of confidence in the

ability of BDL in maintaining the exchange rate peg and the depreciation of the LL in the parallel market.

Given the large exposure of Lebanese banks to BDL, it will be very difficult to restore confidence in the banking system and stem the outflow of deposits without capital controls.

There are currently over \$170 billion in deposits in the Lebanese banking industry. Given the lack of confidence in Lebanon's economy and financial system and given the lack of trust in the ability of the political establishment to lead the country out of the financial crisis, most deposits will likely be transferred out of the Lebanese Lira (out of the banking system, and out of Lebanon at the earliest opportunity. A panic run on the banks will put many banks at risk of failure and depositors will lose their deposits. Furthermore, the LL is likely to depreciate even further below the current unofficial market rate which is itself more than 40% lower than the LL 1505-1515/US\$ official BDL rate.

The informal capital controls that were introduced in October 2019 are unfair to depositors. Well-designed capital controls can 1) limit rapid currency fluctuations in Lebanon's case, to slow down the rapid depreciation of the LL, and 2) contain panic runs on banks until confidence is restored if they are part of a credible and comprehensive macroeconomic fiscal financial stabilization program.

What do capital controls mean in the Lebanese context?

Lebanese banks have put in place informal capital controls since mid-October 2019. The alleged rationale is to avoid a panic run on the banks which could result in banks seeing all their deposits withdrawn at the same time. Despite the informal capital controls, about US\$1.6 billion were transferred between October 17, 2019, and the end of 2019. It has been reported that these transfers were carried out when banks were closed to the public. This has fueled widespread anger and in some cases, violence against the banks.

The informal capital controls have been implemented in an arbitrary manner, with each bank and in some cases, each bank

manager deciding how much foreign currency to allow each depositor to withdraw on a weekly or monthly basis or which transactions to honour. To date, there have been no less than three court rulings in favor of depositors who challenged the legality of the banks' sequestration of their deposits.

Formal capital controls should 1) replace the informal controls with legally sound, transparent, fairly and uniformly applied controls; 2) give time for a credible and comprehensive stabilization program to restore trust in the financial and economic system; and 3) lead to the phasing out of the multi-tier exchange rate system in line with the stabilization program.

How can capital controls be introduced in Lebanon?

Capital controls (قيود على رأس المال) in Lebanon can only be imposed by law and even then, for a finite period of time. Capital controls require either an act of Parliament or, if a government is so empowered, by legislative decree (مراسيم تـرشيعية). The legislation needs to identify the types of controls that should be introduced for how long, and how these controls are to be enforced by the monetary and banking authorities and regulators. Legislation should define the principles and the broad parameters for banking and capital controls ensure transparency and good governance and provide adequate checks and balances to avoid abuse and additional market distortions.

The specifics of capital controls should be set by government policy and BDL regulations. *Capital controls should be embedded in the government's comprehensive program for macroeconomic and monetary reforms, financial stabilization and economic recovery.* They should not be a substitute for stabilization nor a cause for delaying fiscal, structural, and financial reforms.

Capital controls are too important to be left to BDL and the banking system to decide. They are an instrument, albeit temporary, of economic policy and they have a material impact on depositors. To be effective, they must have a solid legal basis including constitutional legitimacy and have the

necessary political backing for the monetary and banking authorities to enforce these controls.

There are those who have made the case that existing legislation the 1963 Money and Credit Code and its amendments, gives the Governor of BDL wide powers that could be used to introduce capital controls. There are three problems with this argument. First, even by the admission of its proponents, there is no clear mandate for BDL to impose capital controls and, were it to do so, these will be easy targets for legal challenges. Second, such an expansive view of the powers of BDL will set a bad precedent including raising issues of accountability and, therefore, undermine confidence in the banking industry for decades to come. Third, introducing capital controls through BDL circulars does not relieve the government and the political parties that are represented in it from the responsibility of backing formal capital controls. There is no substitute for legislation whether through Parliament or by legislative decree to ensure that capital controls adhere to the following principles:

- **Appropriate:** The controls should be bound by legislation to deliver the appropriate level of restrictions on capital account transactions. Controls are more effective when they are simple, wide reaching, and do not leave room for arbitrary decision making:
- Controls should not affect foreign exchange accounts that are below a certain threshold which would not materially affect the country's overall external balances. Account holders should be allowed to transfer a maximum amount every year from LL to US\$ or from a resident account to a non-resident account.
- Controls should not affect capital that reaches Lebanese banks after a certain date (what is commonly referred to as "fresh money").
- The financing of current account transactions should be allowed while imbalances in the current account should be addressed via other measures (e. import duties).

- **Fair:** Controls should be applied fairly to all citizens and all depositors should have access to their deposits on the same terms and conditions. Decisions related to the implementation of controls should be subject to review (by the enforcing authority) and appeal (through the judicial system).
- **Limited:** Legislation should place a time limit a sunset clause on all controls. Previous experience shows that countries have kept controls in place for a few years. How long the controls will be needed in Lebanon will depend on the government's stabilization program.
- **Transparent:** BDL and the Minister of Finance should present joint reports to the Council of Ministers every six months justifying and providing evidence of the effectiveness and the need for the continuation of controls. Parliament, too, should review these reports make them public and keep the pressure on the Council of Ministers to hasten the lifting of controls.

Are capital controls “bad”?

Capital controls lead to inefficient capital deployment, market distortions, slow growth, slow investment in socially desirable sectors such as education and healthcare, and, most importantly, scare away non-resident capital including FDI which is essential for productive investment and job creation. Capital controls can also cause a lot of damage to the perception of risk associated with that country. Once capital controls are used, it can take years for a country to outlive the perception that it is likely to use these controls again. Without countervailing measures, the country risk rating will be negatively affected for years to come.

Capital controls create incentives for evading enforcement and, therefore, present opportunities for abuse and corruption. The more latitude government and BDL officials have in determining when and how to apply the controls, the weaker the oversight functions and, hence, the easier it will be to evade the controls. The experience of countries in

licensing access to FX which is not recommended for Lebanon, shows how pervasive corruption can become. Any application of controls should be accompanied by appropriate measures for the accountability of BDL and regulators for their implementation of the controls.

Despite all this, capital controls are urgently required. Introducing capital controls in Lebanon is not to be taken lightly. Some objections have been raised to capital controls on the ground that they would irreparably damage the reputation of Lebanon's banking industry. Others would argue that the damage has already been done by the unjustified bank closures, informal controls and payment restrictions and that these should urgently be revised to be fit for purpose and regularized. We are squarely in the latter camp.

Capital controls are needed in Lebanon as a tool of last resort and not an instrument of industrial policy:

- They are necessary to stabilize the economy and manage, to the extent possible, the LL/US\$ exchange rate in order to avoid a crash landing of the LL which will have devastating effects on the vast majority of the Lebanese population, over and above the 40% effective depreciation of the LL on the parallel market. It is, indeed, a stopgap measure and not a silver bullet, nor an alternative to genuine economic reforms;
- They are necessary to buy time to provide for an orderly restructuring of the financial sector;
- They allow for the reduction of interest rates which can help kick start investments and start generating growth.

In 1998, Paul Krugman wrote a letter to the Malaysian Prime Minister, in which he encouraged him to introduce capital controls. In it, Krugman wrote: "Currency controls are a risky, stopgap measure, but some gaps desperately need to be stopped." [\[3\]](#) Malaysia introduced capital controls as part of a comprehensive stabilization program which resulted in a shallower and shorter recession, and a faster recovery than

other East Asian economies.

Are International Financial Institutions opposed to capital controls?

The short answer is “No”. The IMF has, in recent years, been more flexible about capital controls as long as these are not meant to delay financial reforms. [\[4\]](#) IMF programs have been accompanied by capital controls in many countries, most notably in Iceland. The IMF Articles of Agreement rule out capital controls, but they carve out an exception. [\[5\]](#)

The IMF recognizes that formal capital controls may be needed in some very specific circumstances, such as the risk of drastic and rapid depreciation of the currency, the risk of depletion of foreign reserves and the onset of a crisis in the banking industry. However, IMF requires, as most Lebanese would, that capital controls be accompanied by a comprehensive program for economic, fiscal, structural and financial sector reforms.

In summary, Lebanon urgently needs to replace the informal and haphazard capital controls with formal capital controls to ensure fair, transparent, and regulated flows of capital and depositors’ access to their bank deposits. Capital controls, if introduced for a limited period of time and as part of a broader program for financial stabilization and economic recovery, do not mean the end of the liberal economic order nor the demise of the Lebanese banking and financial industry. Quite the contrary, they could be an integral part of a much needed program of economic, fiscal structural, and financial sector reforms that put s the economy back on the path to recovery.

Signatories (in their personal capacity)

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Institutional Endorsements

LIFE

Kulluna Irada

[1] We will use the term capital controls to refer to formal capital and banking controls in the rest of this paper

[2] Hereafter referred to as BDL, the acronym for Banque du Liban

[3] Paul Krugman, "Free Advice: A Letter to Malaysia's Prime Minister," Fortune September 28, 1998.

[4] IMF, The Liberalization and Management of Capital Flows: An Institutional View November 14, 2012

[5] Article XIV, Section 2, of the IMF Articles of Agreement makes an exception for transitional arrangements: "A member that has notified the Fund that it intends to avail itself of transitional arrangements under this provision may, notwithstanding the provisions of any other articles of this Agreement, maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member (...) In particular, members shall withdraw restrictions maintained under this Section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the general resources of the Fund."

"The Trouble with the

Creeping Expropriation of Depositors", by A Citizens' Initiative for Lebanon, 24 Jan 2020

The article titled "The Trouble with the Creeping Expropriation of Depositors", written by A Citizens' Initiative for Lebanon was published on 24th January, 2020 and is posted below. Click [here](#) to access the original article.

This note is the second in a series of analysis by an independent group of citizens who met in their personal capacity in December 2019 to discuss the broad contours of Lebanon's financial crisis and ways forward.

While appearing to do nothing, policymakers are in fact tacitly responding to the crisis. They are doing so by allowing a maxi-devaluation of the LBP, while simultaneously weakening the rights of depositors without imposing pain on bank shareholders, as is legally required. In line with our recently released [Ten Point Plan to Avoid a Lost Decade](#), we call for an immediate stop to these policies, which we argue are socially inequitable and economically inefficient.

A Toxic Policy-Mix

The first element of this mix is the steep depreciation of the LBP. The LBP market rate is in free fall, now heading to nearly twice the official rate. While depreciation is necessary to reduce the current account deficit, it has been made much larger than necessary by inaction on the fiscal front. Deteriorating tax collection (down by 40 percent already) is generating an additional deficit in the primary balance of about \$4 billion. With no other choices

available, this will be increasingly financed by the Banque du Liban (BdL) injecting LBP liquidity, thus accelerating inflation and depreciation in the future.

While runaway inflation and devaluation constitute in effect a tax on people's real incomes, the creeping expropriation of deposits extends this effect further to their hard earned savings, even when they had sought protection by saving in dollar accounts, which represent close to 75 percent of deposits.

This started when the BdL left banks to self-manage a soft system of capital controls, which allowed them to sequester small depositors, while some large depositors were able to escape. The BdL also allowed banks to pay for deposit withdrawals from dollar accounts *at official LBP rates*. The BdL later capped interest on deposits, but not on banks' loans. It also required banks to pay half of the interest on dollar deposits in LBP, again at the official exchange rate.

Given these precedents one would expect "Lirasation" at a discounted exchange rate to continue to expand in the future, first to all the interest, and later to the principal. Indeed, in a recent publicly televised broadcast the Governor of the BdL declared that banks are only obligated to pay depositors in LBP at the official rate, a statement that is not supported by the Code of Commerce or case law.

Why this Policy?

A rampant "Lirasation" of deposits offers a magic solution to the public debt and banking sector problems. While the value of dollar deposits in banks would be reduced by as much as the LBP, bank assets would be much less affected, because they are largely denominated in dollars (loans to private firms, Eurobonds, and deposits at the BdL). If all deposits are "Lirasised" and the LBP stabilizes at its current rate of 2000LBP/\$, we calculate that banks would gain about \$50

billion, a massive wealth transfer from depositors to banks' owners.

Devaluation would also wipe out LL denominated sovereign debt, but it would increase the cost of servicing the remaining public debt dominated in dollars (Eurobonds and BDL deposits). However, it will be possible to finance the costs of a necessary restructuring of the remaining debt, held mainly by banks, by using up only part of the massive gain of the banks. At the end, the main burden of debt reduction and banking sector restructuring will be borne by depositors.

Costs of this Policy

The current approach to the debt problem comes at unacceptably high costs:

- It is unfair and discriminatory. Lebanon's lower and middle classes will be decimated not only by lower real wages and pensions, but also by a liquidation of the wealth and lifetime savings accumulated by generations of expatriate and resident Lebanese. It is completely unprecedented to put the burden of loss on the depositors while shielding banks' shareholders from such pain.
- It is inefficient. It will lead to a sharper contraction of the economy than necessary and a reduction in its growth prospects, for four reasons. Wealth destruction will push down demand. Many private firms will go bankrupt because their borrowings are mainly in foreign currency while their income is in LBP. Confidence in banks will collapse leading to severe financial disintermediation. And inflation will accelerate further because of "too much" Liras in the system.

In the second half of 2001, Argentina went through a similar experience. A sudden stop of inflows led to a bank run. Soon after, deposit withdrawals were sharply curtailed (the

“corralito”) and the ARS1/1\$ currency peg was abandoned. A law was passed to convert all dollar deposits (which were predominant, as in Lebanon) into pesos at ARS1.4 for \$1. The market rate collapsed however to ARS3.9 for \$1, reducing the value of dollar deposits by 64 percent. A deep recession followed, with GDP collapsing by 12 percent. But there were two major differences with Lebanon: the banks held little public debt, and the exports improved rapidly. The resulting recession in Lebanon can be expected to be far more destructive, especially that Lebanon’s exports are unlikely to rebound as fast as in Argentina.

Creeping Lirasation is also illegal. The Money & Credit Code of 1963 and its various amendments which is the legal framework for money and payments, does not provide a mandate or authority for the Central Bank to force the payment of interest in a different currency than in the deposit contract, let alone to force deposit conversion into LBP at below market rates. Such actions would require the passage of a ‘nationalisation law’ by Parliament and possibly, an amendment of the constitution.

To stop Lirasation, we recommend adopting the market rate as the legal reference for foreign currency deposit repayments. This calls for a mechanism to establish a market rate at all times, similar to the flexible exchange rate regime which characterized Lebanon’s experience from 1949 till 1996 and which allowed it to weather domestic and external shocks.

The 10-point comprehensive plan that we have proposed calls for a quick adjustment in the fiscal accounts to reduce inflationary pressures, especially by curbing corrupt practices. It also calls for an immediate moratorium of debt repayment, and for an orderly reduction of public debt. This would be place the burden on bank equity, and by limiting haircuts to the 0.1 percent of depositors who account for more than 35 percent of all deposits. A well-devised policy package along the lines we recommend will be not only be socially

fairer, but it will also lead to a faster recovery.

Signatories

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"Road Map to an Orderly Restructuring of Lebanese Public Sector Debt", Article in An-Nahar, 21 Jan 2020

The article titled "Road Map to an Orderly Restructuring of Lebanese Public Sector Debt", written by A Citizens' Initiative for Lebanon appeared in An-Nahar's online edition on 21st January, 2020 and is posted below. Click [here](#) to access the original article.

We believe Lebanon's public sector debt is unsustainable. In line with our recently released [Ten Point Plan to Avoid a Lost Decade](#), we strongly recommend that the Lebanese government commences with a comprehensive restructuring effort – one that brings down the debt burden to a level the country can afford. Using scarce international reserves to make future Eurobond payments will be a mistake. Equally, the bond-by-bond rescheduling approach being discussed postpones the inevitable and is costly and inefficient. Sovereign debt restructurings are not un-precedented and best practices do exist. But for

the effort be successful, it should be part of a broader stabilization and reform package.

How large is Lebanon's debt?

Repeated government deficits have led to an extraordinary accumulation of public sector indebtedness. From \$25 billion in 2000, gross debt had mushroomed to \$90 billion by the end of 2019—the equivalent of 150 percent of GDP. Lebanon today is the third most indebted emerging economy worldwide.

However, this is not the whole story. This debt is likely to continue rising as a result of two additional factors:

- The larger the FX depreciation, the higher the debt/GDP ratio. On the positive side, a large portion of the debt is in Lebanese Lira (LBP). A Foreign Exchange (FX) depreciation will therefore reduce the “real” value of debt. As an indication, if the FX settles at LBP2260/\$ (i.e., a 50 percent depreciation), gross debt, when measured in USD, will drop from \$90 billion to \$71 billion. However, and by the same token, an FX depreciation will reduce the country's USD-measured GDP. Again, for illustrative purposes, a 50 percent FX depreciation, when combined with a 20 percent inflation and an 8 percent recession, will reduce GDP from \$60 billion in 2019 to \$44 billion in 2020.¹ Consequently, despite the FX-led dilution of LBP debt, debt to GDP will actually rise from 150 percent in 2019 to 161 percent of GDP in 2020.
- Deepening recession and public sector deficits will need to be funded through increased debt. First, the 2020 (and beyond) recession will result in a public sector deficit that will have to be funded through debt. Second, the official (IMF, World Bank, Cedre, etc.) funding support that the country needs will be debt creating. Finally, important quasi fiscal “holes” including, most prominently, BDL's necessary recapitalization as well as the arrears recently accumulated by the fiscal authorities, will have to be

recognized and will inevitably lead to significantly higher debt.

Is Lebanon's debt sustainable?

No. The easiest way to see this is by examining what it would take to service the existing stock of debt. Given the \$71 billion debt figure cited above (which is the debt calculated after the FX

depreciation dilutes the LBP debt but before any new debt is accumulated as described above), a conservatively assumed 7 percent interest rate would lead to \$5 billion (annually) in interest

payments. Moreover, if one assumes a seven-year maturity on the debt, there will be an additional \$5 billion in annual principal repayments. Combined, this \$10 billion represents almost a quarter of 2020's GDP. Seen in even starker terms, this amount is actually larger than the projected government revenues for 2020.

Lebanon's debt service burden is not a new phenomenon: it has been large and growing for years now. The government has sustained it thus far by borrowing the debt service and adding the amount to existing debt. However, a future repeat of this approach is extremely unlikely. First, the amount of new debt required to service the existing debt (\$10 billion annually) is, in the foreseeable future, almost certainly impossible to raise in capital markets. Second, even if "borrowable", this will add to an already extraordinarily high level of debt. 2

What's the "right" level of debt for a country like Lebanon?

The academic literature on debt "tolerance" indicates that emerging economies cannot sustain high indebtedness and that, when they do accumulate it, defaults often ensue.³ The literature's

conclusion is that, to avoid defaults, an emerging country should hold a relatively "low" debt load. So, what defines "low"? "Investment grade" countries, that is countries seen as having strong

and healthy economies, offer a good benchmark. Historically,

those countries have defaulted only 3% of the time. On average, those countries' debt load amounted to 60 percent of GDP. To

expand the universe a bit wider, countries that are rated three notches below "investment grade" and have defaulted 10 percent of the time, have held a debt load of 80 percent of GDP.

As such, we believe the above range (60-to-80 percent of GDP) is a maximum medium target for Lebanon's sovereign debt. We would be even more aggressive. Lebanon's institutional and political fragilities severely challenge the public sector's ability to generate the budget surpluses needed to service debt over time. We would therefore argue that the lower part of that range is more advisable. Given that Lebanon's debt today is (at least) 160 percent of GDP, achieving the medium-term target of 60 percent of GDP will require a dramatic debt restructuring effort.

Does a restructuring necessarily mean a "hair cut"?

Not really. Even though the previous section defined sustainable debt in "percent of GDP" terms, the reality is not all debt is created equal. An extreme example illustrates the point: a 100-year bond with zero coupon entails a dramatically smaller debt burden than, say, a 10-year bond with a seven percent coupon.

A more sophisticated way of thinking of the debt load then is to think of it in terms of net present value (NPV). In effect, this means thinking of debt along three different axes: i) the debt's notional amount; ii) the debt's interest rate; and iii) the debt's maturity.

How should the restructuring effort look like?

Following international sovereign restructuring experiences, we would recommend a "menu approach". Some investors will prefer a principal reduction so long as the interest and maturities remain unchanged. Others will prefer to keep the principal unchanged but could accept lower interest rates and/or extended maturities. The governing principal should be that all creditors are

asked to give the same NPV concession.

Once the negotiations with creditors are completed, the Lebanese government would announce an “exchange offer” where it retires the existing debt and issues a new set of securities. Some of the new bonds will have lower principal (“discount bonds”) while others will have similar principal (to the existing bonds) but lower interest and longer maturities (“par bonds”). There is also an argument for including “sweeteners” into the exchange (including “warrants” that only pay if the Lebanon grows in the future). International experience suggests that creditors value these warrants thus improving chances of a successful operation.

Is a sovereign debt restructuring a “big deal”?

Yes it is. However, sovereign restructurings are not rare either. Since 1980, there has been 111 cases of sovereign debt restructurings—roughly three a year. This does not mean that debt

restructuring is cost-less or “normal”. There is ample empirical evidence that a stigma, measured by the country’s market risk premium, persists. Nonetheless, restructurings have occurred across the globe and they do not spell Lebanon’s ability to finance itself in international markets in the future.

Are debt restructurings disruptive?

They don’t *have* to be. If handled properly, they can be cooperative and relatively smooth. Best practices do exist. First, retaining good legal and financial counsel is crucial as the negotiations

will be complicated. Second, it is best not to wait too close to the next maturity before announcing the intention to restructure. The more advance notice creditors are given, the better. Third, Communication matters. In announcing the intention to restructure, the sovereign should make it clear that this is not meant as a “hard default”. By the same token, strong-armed/cramdown

tactics should be avoided if the objective is to reach an orderly and cooperative workout. Finally, fairness and

contextualizing the restructuring as part of a broader macro package are crucial requirements for an orderly effort.

Will creditors be open to a restructuring effort?

Creditors are more likely to be open to restructuring efforts if they are part of a comprehensive macro package that includes official foreign support. It is worth keeping in mind that Lebanese

debt is currently trading at a large discount and investors have already priced in a restructuring. They will therefore be open to offering concessions so long as the value of the new bonds is at or above the market value of the bonds they currently own. In other words, the bar for a deal is not too high and the timing is ripe for entering restructuring discussions with creditors.

We also believe that a credible and well-designed debt workout can actually be advantageous to creditors. If the restructuring is undertaken as part of a strong reform package, a Lebanon without a debt overhang will emerge as much more “creditworthy”. This will translate into a lower “risk premium” which, in turn, could take the value of the new (i.e., post NPV-hit) debt above current valuations. This is not a theoretical possibility: most successful sovereign restructurings have resulted in a country’s bonds, even after a large NPV hit, trading well above the pre-restructured bond levels. For this to be the case, though, the importance of a proactive, orderly, equitable and well-run restructuring process cannot be overstated.

Should the Government be selective in what debt it restructures and what debt it spares?

At the broadest level, comprehensiveness and equality of treatment should be the guiding principle. The size of the debt itself, as well as the challenging fiscal/growth backdrop over the

next few years, mean that the restructuring effort should touch all public sector debt and not just the Eurobonds.

That said, the arguments for selectivity are complicated and

not straightforward. First, shortdated LBP debt will be hit hard by the FX depreciation so is probably best spared. Second, while debt issued under Lebanese law (treasury bonds and BDL claims) is legally and politically easier to restructure, it's also debt the government will have easiest access to in the future. As such, there is an argument to treat it preferentially. Third, penalizing non-resident creditors is appealing politically and even morally (since most foreign creditors are institutional investors who weren't coerced to own the bonds and knew the risk they assumed). However, foreign creditors won't be as cooperative as locals during negotiations and may complicate the process including through lawsuits. In that regard, actions that complicate the Republic's future return to the capital markets should be avoided if possible. The bottom line is that there is no straightforward answer to the question of selectivity. The broad principal is that successful restructurings are ones where investors perceive the effort as "fair" and reasonable.

Is restructuring sufficient to reduce the debt burden?

No. The stock of debt is too large to be brought down solely through a debt restructuring. There are other ways to reduce the burden. As we argued in our [10-point plan](#), there is scope for the judicious usage of state assets including privatizations and securitizing future cash flows. Moreover, and as part of any future (large) depositors' bail in, there is room for swapping some deposits into concessional debt. Finally, the public sector should also assume some of the future burden by running primary surpluses that can be used to gradually lower debt over time.

Is debt reduction alone the answer to Lebanon's problems?

Absolutely not. It is but one part of the solution. The main argument of our 10-point plan was that a comprehensive stabilization and reform program is a must. Debt restructuring has to be

part of a larger macro package—one that deals with the banking sector, with BDL's balance sheet, and with private debt. More importantly, a successful debt workout is one that, in parallel,

convinces creditors that the “flow” issues that created the problem in the first place have been dealt with. This, in practice, means addressing Lebanon's endemic fiscal issues, its large external imbalances, as well as the other parts of the macro policy toolbox such as FX and monetary policy.

Creditors will give the sovereign significantly better terms if they perceive the macro framework as credible and sustainable. There are plenty of examples where restructuring proposals that

were advantageous to creditors ex ante were rejected because the creditors didn't think the sovereign can follow through with its macro promises.

Will legal complications render restructurings impossible?

We don't believe so. But they are not straightforward. As noted above, retaining good legal counsel will be crucial to the effort. A broad point is that a cooperative approach will increase the

chances of achieving the thresholds needed for a smooth and orderly restructuring.

Lebanese Eurobonds are issued under New York Law and have broadly standard terms including cross default clauses and a 7 days grace period for principal repayments and 30 days for coupon payments. A quarter of the principal holders are needed for acceleration of the Eurobond's repayment.

The area that may well complicate the restructuring effort relates to the collective action clauses required for modifying the terms of the Eurobond. The contracts foresee creditors' meetings that can modify bond terms so long as 75 percent of bond-holders consent. This includes changing amounts payable, reducing/cancelling principal, and modifying currency of payment. Any such resolution passed in this manner would be binding on all holders regardless of whether they voted in favor or not. However, there is no collective action

clause across series. As a result, outstanding Eurobonds would have to be restructured series by series. Ownership structure of each Eurobond could thus be an important factor when negotiating with creditors. Our recommendation is that the Government approaches all bondholders across the different series with a single restructuring proposal but we wouldn't rule out the eventual possibility of differential treatment based on ownership structure.

Summary

In summary, we call on the Lebanese Government to immediately initiate a plan to proactively address the unsustainable debt burden. An organized, fair and credible debt effort that is part

and parcel of a broader reform and stabilization program is imperative for Lebanon's eventual recovery and its longer-term economic stability and growth.

Signatories in their personal capacities

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"Lebanon's Economic Crisis: A Ten Point Action Plan for Avoiding a Lost Decade", by A Citizens' Initiative for Lebanon, 6 Jan 2020

The article titled "Lebanon's Economic Crisis: A Ten Point Action Plan for Avoiding a Lost Decade", written by A

Citizens' Initiative for Lebanon was published on 6th January, 2020 and is posted below. Click [here](#) to access the original article.

An independent group of development specialists, economists and finance experts met in Beirut late-December to discuss the ongoing economic crisis and the path forward. This note summarizes the deliberations and puts forth a ten-point action plan meant to arrest the crisis and place the country on a path of sustained recovery.

How did we get here?

The economic crisis is, at its core, a governance crisis emanating from a dysfunctional sectarian system that hindered rational policymaking and permitted a culture of corruption and waste. The country, led by the public sector, lived beyond its means. Decades of pursuing this model left the economy with high debt and a bloated banking sector.

Inevitably, the dramatic debt increase resulted in an expanding debt-servicing burden. The large yearly funding needs rendered the country vulnerable to external and regional shocks. As external financial flows into Lebanon slowed, the central bank resorted to desperate and extremely expensive efforts to attract them. Ultimately, this proved unsustainable. Since October, we've had a virtual cessation of capital inflows and a sharp acceleration of outflows.

Where are we now?

This situation leaves the country with three simultaneous crises.

The first is a balance of payments and currency crisis. For 2020, we estimate the gap between USD supply and USD demand at \$8 billion. If this gap is not filled, the economy will

experience difficulties including the servicing of external debt, imported goods' shortages, currency devaluation, and economic contraction.

The second crisis is that of public finance. Beginning with a 10 percent of GDP deficit in 2019, government revenues are now collapsing under the weight of the recession and the banking crisis described below. Inflation-adjusted spending is also crumbling. We estimate a \$3 billion primary budget deficit (excluding interest payments) for 2020. In the current situation, funding this deficit will prove challenging.

The third crisis is that of the banking system. With almost half of banks' assets invested in Lebanese sovereign risk including with the Banque du Liban (BDL) and another quarter representing risky private sector claims, banks are effectively insolvent and illiquid. Despite the loose and inefficient capital and banking controls recently put in place, the sector is experiencing a deposit run. In similar international experiences, the central bank usually steps in and provides the liquidity that banks need. However, the BdL is constrained by its limited USD reserves and by fears that an oversupply of LBP would lead to further currency weakening.

Consequences of continuing on the current path

Persisting with the current ad hoc approach to policy making will lead Lebanon on a path of implosion and political disintegration. We foresee seven consequences:

1. ***The economy will experience a deep recession.*** USD shortages will force the economy to adjust to lower imports. Bank and capital controls will hit a private sector that is dependent on liquidity and credit; business closures, salary reductions, and layoffs have already become common. The public sector will retrench given difficult financing conditions. Under this

scenario, we forecast the economy will experience a double-digit contraction in 2020—i.e., a recession equivalent to what the US experienced during the Great Depression.

2. ***The Foreign Exchange (FX) will weaken sharply.*** The LBP will adjust downwards to bring the supply and demand of USD into balance. Left to its own devices, we estimate the FX could lose up to half its value leading to high inflation. In turn, this will have a massive negative impact on the cost of living, the availability of essential goods, food and healthcare, businesses and unemployment.
3. ***Capital and bank controls will intensify.*** Banks will continue rationing deposit withdrawals and external transfers. The private sector's liquidity crunch will deepen and disorderly and un-managed debt defaults (including on Eurobonds) will prove inevitable. BdL will hemorrhage international reserves.
4. ***Debilitating social conditions will intensify.*** This kind of economic collapse will cause catastrophic wealth destruction. Poverty rates could rise to more than 40 percent of the Lebanese population with 1.6 million people unable to afford food and basic nonfood items. Unemployment will increase and much of the middle class could be eliminated.
5. ***A seismic political shift is likely to occur.*** The current political parties will not emerge unscathed. The security repercussions of social unrest will be significant and difficult to predict.
6. ***Without addressing the root causes, the crises will prove long lasting.*** To put it in stark terms, this would become a decade long economic crisis—one from which chances of recovery are significantly dim. A “lost decade” will result from this scenario.
7. Finally, ***international financial support is likely to fall far short*** of what is needed to relieve the economy.

Is there a better approach?

We think there is. Below we outline a three-year program that aims to arrest the crisis, deal with its root causes and set the country back on a path of recovery. The program seeks to ensure equitable burden sharing of the crisis' fallout while protecting the most vulnerable especially during the period of transition. The ten concrete steps below should be implemented in parallel rather than piecemeal.

1. ***Establish an empowered economic emergency steering committee*** to design, negotiate and implement the program. In parallel, create participatory mechanisms to discuss with civil society the policy package, and to empower citizens to monitor its implementation.
2. ***Replace the ad hoc and self-administered capital and banking controls.*** Controls are likely needed for an extended period even in the best of scenarios. They need to be run in a centralized and transparent fashion backed by proper legislation.
3. ***Decisively deal with public sector debt.*** Immediately announce a moratorium on debt payments (external and domestic), hire legal counsel, and convene a creditor's committee. Our view is that Lebanon's fundamentals justify a debt load ranging between 60 and 80 percent of GDP over the medium term. To reach this target, creditors should be offered a menu of concessions including lower principal, reduced interest rates, and extended maturities.
4. ***Embark on a credible fiscal reform.*** Public spending, currently inefficient, wasteful, and vulnerable to corruption, must be transformed. The electricity sector is but one example. A wholesale governance and regulatory reform program is needed to curb the rent seeking culture. These reforms, along with savings accruing from lower debt servicing, should allow for increased spending on social sectors and infrastructure.

Second, a broad revenue reform is needed that focuses less on raising tax rates and more on addressing weak collection and overt reliance on specific sectors. Third, we recommend the adoption of a binding and credible “fiscal rule” that caps the size of future budget deficits.

5. ***Deal with private sector debt.*** The private sector is facing a severe crisis. Convene a creditor/debtor roundtable to agree on a standardized menu of financial relief actions aiming to safeguard viable firms while orderly liquidating those that aren't. The existing draft *Bankruptcy and Restructuring law* should be promptly passed.
6. ***Repair Bdl's balance sheet.*** BDL is a large lender to the government and has an estimated USD30 billion negative net FX position rendering it vulnerable to devaluations. Until this is dealt with, it is tough to see confidence in the LBP returning.
7. ***Bring the banking sector back to health*** as a prerequisite to reinvigorating the economy. Public debt restructuring and mounting Non-Performing Loans (NPLs) will render many banks insolvent. Complicating matters, banks are highly exposed to the Bdl whose own balance sheet is impaired. Current bank equity is far from sufficient to cover these hits. Our estimates suggest \$20-25 billion of fresh capital is urgently needed. Current shareholders need to assume the losses and be required to bring in fresh capital. This may also necessitate a reduction in the number of banks. In parallel, foreign loans and State assets could conceivably be used to recapitalize the sector (see below). As the above is not likely to be enough, there is a near certain need for reducing portions of large deposits and swapping them into bank equity.
8. ***Preserve social peace through a focus on social justice.*** This involves a distribution of losses that is concentrated on the richest in society while sparing

small bank depositors. Foreign funding should be used to blunt the pain of adjustment. A safety net must be put in place to fight poverty and support health and education. And workers should be helped to transition out of decaying sectors into those that benefit from the devaluation.

9. ***Re-think the FX/monetary policy mix.*** The fixed (and overvalued) exchange rate regime has contributed to large current account deficits, hurt export-oriented sectors, and forced BDL to maintain elevated interest rates. Looking forward, we recommend a more flexible exchange rate arrangement centered around a weaker LBP. However, until confidence in the LBP returns, it will be dangerous to allow the currency to freely float. Some form of currency management will have to be maintained for the medium term.
10. ***Secure a multi-year Stabilization and Structural Reform Facility.*** We estimate that a three-year \$25 billion fund is needed. This facility should be used to shore up BDL's net reserves, help fund the immediate government budgetary needs, finance badly needed social spending, and contribute to bank recapitalization. The economic program recommended above can garner this kind of support, including from the World Bank, the EU, and the GCC. However, it will realistically require an IMF program as an umbrella. We also think there is scope to partly fund this facility with state assets and possibly hoped-for oil and gas revenues. We cannot overstate the importance of good governance, transparency and accountability in this regard.

Conclusion

The consequences of the current path are catastrophic. Delays will only increase dislocation, exponentially magnify the needed adjustment, and place the burden on those least able to shoulder it. A better option is available. It won't be easy,

may at times prove painful and will certainly require a new social contract. But we sincerely believe this approach will pave the way to a better and prosperous future.

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