

"Eight steps to pull the Lebanese economy back from the brink", Op-ed in The National, 28 Oct 2020

The article titled "[Eight steps to pull the Lebanese economy back from the brink](#)" appeared in The National on 28th Oct 2020 and is reposted below.

Eight steps to pull the Lebanese economy back from the brink

Without the immediate implementation of these comprehensive reforms, Lebanon is heading for a lost decade

Lebanon is engulfed in a long list of overlapping and connected problems –fiscal, debt, banking, currency and balance of payments crises – that together have created an economic depression and a humanitarian crisis. People are going hungry: food poverty has affected some 25 per cent of Lebanon's own population. But the fiscal and monetary instability has caused [more than just a shortage of bread](#).

Confidence in the banking system has collapsed. The Lebanese pound has depreciated by 80 per cent over the past year.

Inflation is at 120 per cent and hyperinflation – a runaway increase in prices – is on the horizon.

Unemployment has risen to 50 per cent, leading to mass emigration and depleting Lebanon of its main asset: its human capital.

The [explosion at the Port of Beirut](#), combined with the Covid-19 lockdown, created an apocalyptic landscape.

It aggravated the country's economic crises. The cost of

rebuilding alone exceeds \$10 billion – more than 35 per cent of the this year's GDP – which Lebanon is incapable of financing.

Prospects for an economic recovery in Lebanon are dismal. The new government must recognise the economy's large fiscal and monetary gaps and implement a comprehensive, credible and consistent reform programme.

The immediate priorities are economic stabilisation and rebuilding trust in the banking and financial system.

Lebanon desperately needs a recovery programme – akin to the Marshall Plan that helped rebuild Europe after the Second World War – of about \$30-35bn, in addition to the funds to rebuild Beirut's port and city centre.

To achieve this, the new government will have to implement rapidly an agreement with the International Monetary Fund, based on a national consensus. The confidence-building policy reform measures over the next six months must include:

A credible capital controls act to protect deposits, restore confidence and encourage the return of remittances and capital back into the country. Credit, liquidity and access to foreign exchange are critical for private sector activity, which is the main engine of growth and employment.

The restructuring of public, domestic and foreign debt to reach a sustainable ratio of debt to GDP. Given the exposure of the banking system to the debt of the government and central bank (known by its French acronym, BDL), public debt restructuring would involve a restructuring of the banking sector, too.

A bank recapitalisation process that includes a process of merging smaller banks into larger banks. Bank recapitalisation requires a bail-in of the banks and their shareholders (through a cash injection and the sale of foreign subsidiaries and assets) of some \$25bn, to minimise a haircut on deposits. This will require passage of a modern insolvency law.

Monetary policy reform is needed to unify the country's multiple exchange rates, move to inflation targeting – that is, price stability – and shift to greater exchange rate

flexibility. Multiple rates create market distortions and incentivise more corruption. The BDL will have to stop all quasi-fiscal operations and government lending. Credible reform requires a strong and politically independent banking regulator and monetary policymaker.

Reform the Electricite du Liban (EDL), the country's largest utility, and appoint a new board to improve governance and efficiency.

Reform the inefficient subsidies regime that covers electricity, fuel, wheat and medication. These generalised subsidies do not fulfil their purpose – only 20 per cent goes to the poor.

All that the subsidies do is benefit rich traders and middlemen and they are the basis of large-scale smuggling into sanctions-ridden Syria. Subsidies reform should be part of a social safety net to provide support for the elderly and vulnerable.

Pass a modern government procurement act. This would help prevent corruption, nepotism and cronyism.

Restructure and downsize the public sector. Start by removing the 20 per cent of public sector “ghost workers” – people on payrolls who don't actually work for the government – and establish a National Wealth Fund, a professional holding company that would independently manage public assets. These include basic public utilities like water, electricity, public ports and airports, Lebanon's carrier Middle East Airlines, the telecom company Ogero, the Casino du Liban, the state-run tobacco monopoly and others, in addition to public commercial lands.

These assets are non-performing, over-staffed by political cronies and suffer from nepotism. In most cases, they are a drain on the treasury.

A comprehensive IMF programme that includes structural reforms is necessary. It is the way to restore trust in the economy and win back the trust of the private sector, the Lebanese diaspora, foreign investors and aid providers. This would then attract funding from international financial institutions and

[Cedre Conference](#) participants, including the EU and the GCC. Such measures, if properly executed, would translate into financing for reconstruction and access to liquidity. They would also stabilise and revive private sector economic activity. Without the immediate implementation of these comprehensive reforms, Lebanon is heading for a lost decade. *Nasser Saidi is a former Lebanese economy minister and first vice-governor of the Central Bank of Lebanon*

Comments on Lebanon's financial sector post-Beirut blast, S&P Global Market Intelligence, 12 Aug 2020

Dr. Nasser Saidi's comments appeared in the article titled "[After blast, Lebanon's 'uninvestable' banks face sector rebuild, depositor pain](#)", published by S&P Global Market Intelligence on 12th August 2020.

Comments are posted below:

*"Lebanon doesn't have the fiscal space to fund the reconstruction of the public sector infrastructure destroyed in the explosion, and has no ability to borrow either because no one will lend to the country," former vice-governor of the Lebanese central bank Nasser Saidi told S&P Global Market Intelligence. He said the **banks will need to restructure, sell assets and consolidate.***

"The bankers and the central bank are trying to resist that and push the burden of adjustment on to the government and depositors," said Saidi, who has also held the positions of

Lebanon's minister of economy and trade, and of industry, and is president of consultancy Nasser Saidi & Associates.

"The banking system will have to be restructured," said Saidi. "Banks will have to downsize, sell the assets they hold abroad and repatriate the proceeds, sell their real estate holdings, and rebuild their balance sheets if they want to stay in business ... there will be M&A."

Saidi estimates that about 60% of Lebanon's debts are due to interest rate increases designed to protect the pound, and criticized the central bank for failing to officially devalue the currency.

Saidi said Lebanon could solve the crisis by enacting capital controls, unifying the pound-to-dollar exchange rate, restructuring state-related debts and removing general subsidies. Up to \$30 billion is needed to restructure the public sector, and a further \$25 billion to restructure and recapitalize the banking sector, he said.

How to save Lebanon from looming hyperinflation, Article in The National, 31 Jul 2020

The article titled "How to save Lebanon from looming hyperinflation" was published in The National on 31st Jul 2020. The original article can be accessed [here](#) & is also posted below.

How to save Lebanon from looming hyperinflation

To bring the country's economic chaos to an end, it is important to examine how it all began

In June 2020, Lebanon's inflation rate was 20 per cent, month-on-month. In other words, prices in the country were, on average, 20 per cent more than they were a month before. Compared to a year earlier, in June 2019, they had nearly doubled.

Lebanon is well on its way to hyperinflation – when prices of goods and services change daily, and rise by more than 50 per cent in a month.

Hyperinflation is most commonly associated with countries like Venezuela and Zimbabwe, which this year have seen annual inflation rates of 15,000 per cent and 319 per cent, respectively. Lebanon is set to join their league; food inflation surged by 108.9 per cent during the first half of 2020.

When hyperinflation takes hold, consumers start to behave in very unusual ways. Goods are stockpiled, leading to increased shortages. As the money in someone's pocket loses its worth, people start to barter for goods.

What characterises [countries with high inflation](#) and hyperinflation? They have a sharp acceleration in growth of the money supply in order to finance unsustainable overspending; high levels of government debt; political instability; restrictions on payments and other transactions and a rapid breakdown in socio-economic conditions and the rule of law. Usually, these traits are associated with endemic corruption.

Lebanon fulfils all of the conditions. Absent immediate economic and financial reforms, the country is heading to hyperinflation and a further collapse of its currency.

How and why did this happen?

Lebanon is in the throes of an accelerating meltdown. Unsustainable economic policies and an overvalued exchange rate pegged to the US dollar have led to persistent deficits.

Consequently, public debt in 2020 is more than 184 per cent of GDP – the third highest ratio in the world.

The trigger to the banking and financial crisis was a series of policy errors starting with an unwarranted closure of banks in October 2019, supposedly in connection with political protests against government ineffectiveness and corruption. Never before – whether in the darkest hours of Lebanon's civil war (1975-1990), during Israeli invasions or other political turmoil – have banks been closed or payments suspended.

The bank closures led to an immediate loss of trust in the entire banking system. They were accompanied by informal controls on foreign currency transactions, foreign exchange licensing, the freezing of deposits and other payment restrictions to protect the dwindling reserves of Lebanon's central bank. All of this generated a sharp liquidity and credit squeeze and the emergence of a system of multiple exchange rates, resulting in a further loss of confidence in the monetary system and the Lebanese pound.

Multiple exchange rates are particularly nefarious. They create distortions in markets, encourage rent seeking (when someone gains wealth without producing real value) and create new opportunities for cronyism and corruption. Compounded by the Covid-19 lockdown, the result has been a sharp 20 per cent contraction in economic activity, consumption and investment and surging bankruptcies. Lebanon is experiencing rapidly rising unemployment (over 35 per cent) and poverty rates exceeding 50 per cent of the population.

With government revenues declining, growing budget deficits are increasingly financed by the Lebanese central bank (BDL), leading to the accelerating inflation. The next phase will be a cost-of-living adjustment for the public sector, more monetary financing and inflation: an impoverishing vicious circle!

We are witnessing the bursting of a Ponzi scheme engineered by the BDL, starting in 2016 with a massive bailout of the banks, equivalent to about 12.6 per cent of GDP. To protect an overvalued pound and finance the government, the BDL started

borrowing at ever-higher interest rates, through so-called “financial engineering” schemes. These evolved into a cycle of additional borrowing to pay maturing debt and debt service, until confidence evaporated and reserves were exhausted.

By 2020, the BDL was unable to honour its foreign currency obligations and Lebanon defaulted on its March 2020 Eurobond, seeking to restructure its domestic and foreign debt. The resulting losses of the BDL exceeded \$50 billion, equivalent to the entire country’s GDP that year. It was a historically unprecedented loss by any central bank in the world.

With the core of the banking system, the BDL, unable to repay banks’ deposits, the banks froze payments to depositors. The banking and financial system imploded.

As part of Lebanon’s negotiations with the IMF to resolve the situation, the government of Prime Minister Hassan Diab prepared a [financial recovery plan](#) that comprises fiscal, banking and structural reforms. However, despite the deep and multiple crises, there has been no attempt at fiscal or monetary reform.

In effect, Mr Diab’s government and Riad Salameh, the head of the central bank, are deliberately implementing a policy of imposing an inflation tax and an illegal “Lirafication”: a forced conversion of foreign currency deposits into Lebanese pounds in order to achieve internal real deflation.

The objective is to impose a ‘domestic solution’ and preclude an IMF programme and associated reforms. The inflation tax and Lirafication reduce real incomes and financial wealth. The sharp reduction in real income and the sharp depreciation of the pound are leading to a massive contraction of imports, reducing the current account deficit to protect the remaining international reserves. Lebanon is being sacrificed to a failed exchange rate and incompetent monetary and government policies.

What policy measures can be implemented to rescue Lebanon? Taming inflation and exchange rate collapse requires a credible, sustainable macroeconomic policy anchor to reduce the prevailing extreme policy uncertainty.

Here are four measures that would help:

First, a “Capital Control Act” should be passed immediately, replacing the informal controls in place since October 2019 with more transparent and effective controls to stem the continuing outflow of capital and help stabilise the exchange rate. This would restore a modicum of confidence in the monetary systems and the rule of law, as well as the flow of capital and remittances.

Second is fiscal reform. It is time to bite the bullet and eliminate wasteful public spending. Start by reform of the power sector and raising the prices of subsidised commodities and services, like fuel and electricity. This would also stop smuggling of fuel and other goods into sanctions-laden Syria, which is draining Lebanon’s reserves. Subsidies should be cut in conjunction with the establishment of a social safety net and targeted aid.

These immediate reforms should be followed by broader measures including improving revenue collection, reforming public procurement (a major source of corruption), [creating a “National Wealth Fund”](#) to incorporate and reform state commercial assets, reducing the bloated size of the public sector, reforming public pension schemes and introducing a credible fiscal rule.

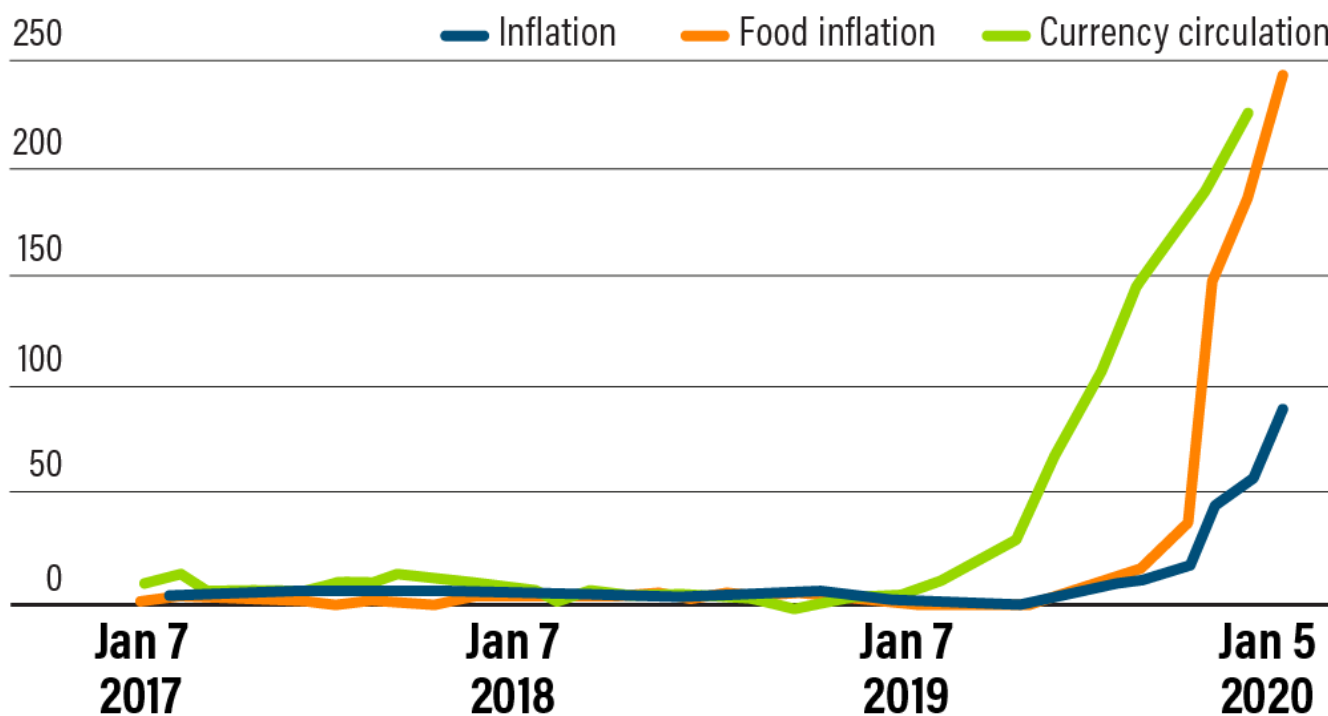
Third, unify exchange rates and move to a flexible exchange rate regime. The failed exchange rate regime has contributed to large current account deficits, hurt export-oriented sectors, and forced the central bank to maintain high interest rates leading to a crowding-out of the private sector. Monetary policy stability also requires that the BDL should be restructured and stop financing government deficits and wasteful and expensive quasi-fiscal operations, such as subsidising real estate investment.

Fourth, accelerate negotiations with the IMF and agree to a programme that sets wide-ranging conditions on policy reform. Absent an IMF programme, the international community, the GCC, EU and other countries that have assisted Lebanon previously will not come to its rescue.

Lebanon is at the edge of the abyss. Absent deep and immediate policy reforms, it is heading for a lost decade, with mass migration, social and political unrest and violence. If nothing is done, it will become “Libazuela”.

Nasser Saidi is a former Lebanese economy minister and first vice-governor of the Central Bank of Lebanon

LEBANESE CENTRAL BANK'S MONEY SURGE IS FUELLING INFLATION (%)



Source: Central Administration of Statistics, BDL, Nasser Saidi & Associates



Forbes Middle East Leaders' Insights: Breaking Down The Lebanese Situation With Dr. Nasser Al Saidi, Jul 2020

Dr. Nasser Saidi was interviewed by the Managing Editor of Forbes Middle East, as part of their Leaders' Insight series, to breakdown the factors leading up to the economic uncertainty in Lebanon and to understand the way forward.

Watch the interview below:

"Saving the Lebanese Financial Sector: Issues and Recommendations", by A Citizens' Initiative for Lebanon, 15 Mar 2020

The article titled "Saving the Lebanese Financial Sector: Issues and Recommendations", written by A Citizens' Initiative for Lebanon was published on 15th March, 2020 in [An Nahar](#) and is also posted below.

Saving the Lebanese Financial Sector: Issues and Recommendations

In order to restore confidence in the banking sector, the government and the Banque du Liban (BDL) need a comprehensive stabilisation plan for the economy as a whole including substantial fiscal consolidation measures, external liquidity injection from multi-national donors, debt restructuring and a banking sector recapitalisation plan. Specifically, the Lebanese banking sector which will be heavily impaired will have to be restructured in order to re-establish unencumbered access to deposits and restart the essential flow of credit. A task force consisting of central bank officials, banking experts and international institutions should be granted extraordinary powers by the BDL and the government to come up with a detailed plan which assesses the scale and process for bank recapitalisation and any required bail-in; identifies which banks need to be supported, liquidated, resolved,

restructured or merged; establish a framework for loss absorption by bank shareholders; consider the merits of establishing one or several 'bad banks'; revise banking laws; and eventually attract foreign investors to the banking sector. In the meantime, we would recommend the imposition of formal and legislated capital controls in order to ensure that depositors are treated fairly and also ensure that essential imports are prioritised.

How deep is Lebanon's financial crisis?

The financial crisis stems from a combination of a chronic balance of payments deficits, a liquidity crisis and an unsustainable government debt load which have impaired banks' balance sheets, leaving many banks functionally insolvent.

Even before the government announced a moratorium on its Eurobond debt on March 7th, public debt restructuring was inevitable, as borrowing further in order to service the foreign currency debt was no longer possible and, dipping into the remaining foreign currency reserves to pay foreign creditors was deemed to be ill-advised given the priority to cover the import bill for essential goods such as food, fuel and medicine. Moreover, with more than 50 percent of fiscal revenue dedicated to debt service in 2019, debt had clearly reached an unsustainable level.

At the end of December 2019, banks had total assets of USD 216.8 billion (see Table 1). Of these, USD 28.6 billion were placed in government debt, and USD 117.7 billion were deposits (of various types) at BDL, which is itself a major lender of the government (see Figure 1 for the inter-relations between the balance sheets of the banks, the central bank, and the government). Banks also hold more than USD 43.9 billion in private loans. Already, the banking association is assuming that approximately 10 percent of private sector loans, such as mortgages and car loans, have been impaired due to the economic crisis. Other countries facing similar financial and economic crises have experienced much higher non-performing loan rates. For instance, the rate rose to above 35 percent in Argentina in 1995 and neared 50 percent in Cyprus in 2011.

Well before the decision to default however, Lebanon's banks have **had limited liquidity in foreign currency** and have been rationing it since last November, as the central bank was not releasing sufficient liquidity back into the banking system. Even banks that have current accounts with the Banque du Liban do not have unfettered access to their foreign currency deposits. The BDL has had to balance a trade-off between defending the Lebanese pound peg, releasing liquidity or continuing to finance government fiscal deficits and has chosen to prioritise maintaining the peg and covering the country's import bill.

Table 1: Consolidated commercial bank balance sheet (USD million)

	December 2016	October 2019	Dec 2019
Assets			
Reserves	89,755	153,301	118,191
o/w cash	460	597	467
o/w BDL deposits	89,295	152,705	117,723
o/w CDs in LBP	22,972	31,867	
o/w CDs in USD	21,900	22,699	
o/w required reserves in LBP	2,677	2,544	
o/w required reserves in USD	16,043	18,621	
o/w remaining deposits in LBP	15,288	43,292	
o/w remaining deposits in FCU	10,414	33,682	
Claims on the private sector	51,040	47,836	43,912
In LBP	15,660	14,459	13,745
In USD	35,380	33,377	30,167
Claims on the public sector (T-bills)	34,722	31,652	28,665
In LBP	19,195	16,592	14,642
In USD	15,384	14,859	13,815
Foreign assets	23,100	21,326	17,969
Fixed assets	5,212	5,262	5,257
Resident securities portfolio	0	1,588	1,600
Unclassified assets	482	1,231	1,227
Total Assets / Liabilities	204,311	262,196	216,822
Liabilities			
Deposits of residents	128,534	133,677	126,590
In LBP	51,014	42,412	
In USD	77,520	91,265	
Deposits of non-residents	33,961	36,625	32,451
In LBP	4,529	3,752	3,140
In USD	29,432	32,873	29,311
Public sector liabilities	3,951	4,722	4,895
Liabilities to non-resident banks	6,280	9,661	8,829
Bonds	271	448	272
Capital base	18,240	20,630	20,723
Unclassified liabilities	13,073	56,433	23,062

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Banque du Liban. (2019). Consolidated Balance Sheet of Commercial Banks. Retrieved from <https://www.bdl.gov.lb>.

Note: In December 2019, commercial banks have netted the results of the swap operations with BDL, thus explaining the large swing in Reserves (asset side) and Unclassified liabilities.

Reducing public debt to a sustainable level will require deep cuts in government and central bank debts. This in turn will

have a significant impact on bank balance sheets and regulatory capital. **For most banks, a full mark-to-market would leave them insolvent.** To avoid falling short of required capital standards, BDL has temporarily suspended banks' requirements to adhere to international financial reporting standards. But suspending IFRS cannot continue for a long period, as it effectively disconnects the Lebanese banking system from the rest of the world.

What will be the impact of the sovereign default on the banking sector?

Today, Lebanese banks are not able to play the traditional role of capital intermediation by channelling deposits towards credit facilitation. In most financial crises, public authorities are able to intervene to recapitalise the banks and central banks are able to intervene to provide liquidity. Unfortunately, in Lebanon, the state has no fiscal ammunition and the central bank is itself facing dwindling foreign exchange reserves. **This leaves the banks in a highly precarious situation.**

In a sovereign restructuring scenario where we assume a return to a sustainable debt level of 60% debt to GDP ratio and a path to a primary budget surplus, depending on the required size of banking sector in a future economic vision for the country, **we estimate the need for a bank recapitalisation plan to amount to \$20 to \$25 billion** to be funded by multi-lateral agencies and donor countries, existing and new shareholders, and a possible deposit bail-in. Under all circumstances, we strongly advocate the protection of smaller deposits. In addition, special care has to be taken during any bail-in process to (i) provide full transparency on new ownership; (ii) avoid concentrated ownership; and (iii) shield the new ownership from political intervention either directly or indirectly. It is also worth noting that additional amounts of capital will be required to jumpstart the economy and provide short term liquidity.

Leaving the banking sector to restructure and recapitalise itself without a government plan would take too long and

Lebanon would turn even more into a cash economy, with little access to credit, little saving, low investment, and low or negative economic growth for years to come. Economic decay would ultimately lead to enormous losses for depositors, and serious hardship to the average Lebanese citizen.

What should be the goal of financial sector reforms?

The primary goal of financial sector interventions must be to restore confidence in the banking sector and restart the flow of credit and unrestricted access to deposits. In addition to rebuilding capital buffers and addressing the disastrous state of government finances, we would advocate reforming the financial sector in order to avoid banks' over-exposure to the public sector in the future, incentivising them to lend instead to the real economy. This must include a prohibition of opaque and unorthodox financial engineering and improving banks' capacity to assess local and global markets.

Confidence in the financial sector will also require a strong and independent regulator. Lebanon has a unique opportunity in that regard as there are 13 vacancies in the regulatory space that need to be filled by end of March: four vice governors of the Banque du Liban, five members of the Commission of Supervision of the Bank (current members due to leave by end of March), three Executive Board members of the Capital Markets Authority, and the State Commissioner to BDL. These nominations should be completed following a transparent process shielded from political and sectarian influence ensuring candidates possess the requisite competencies.

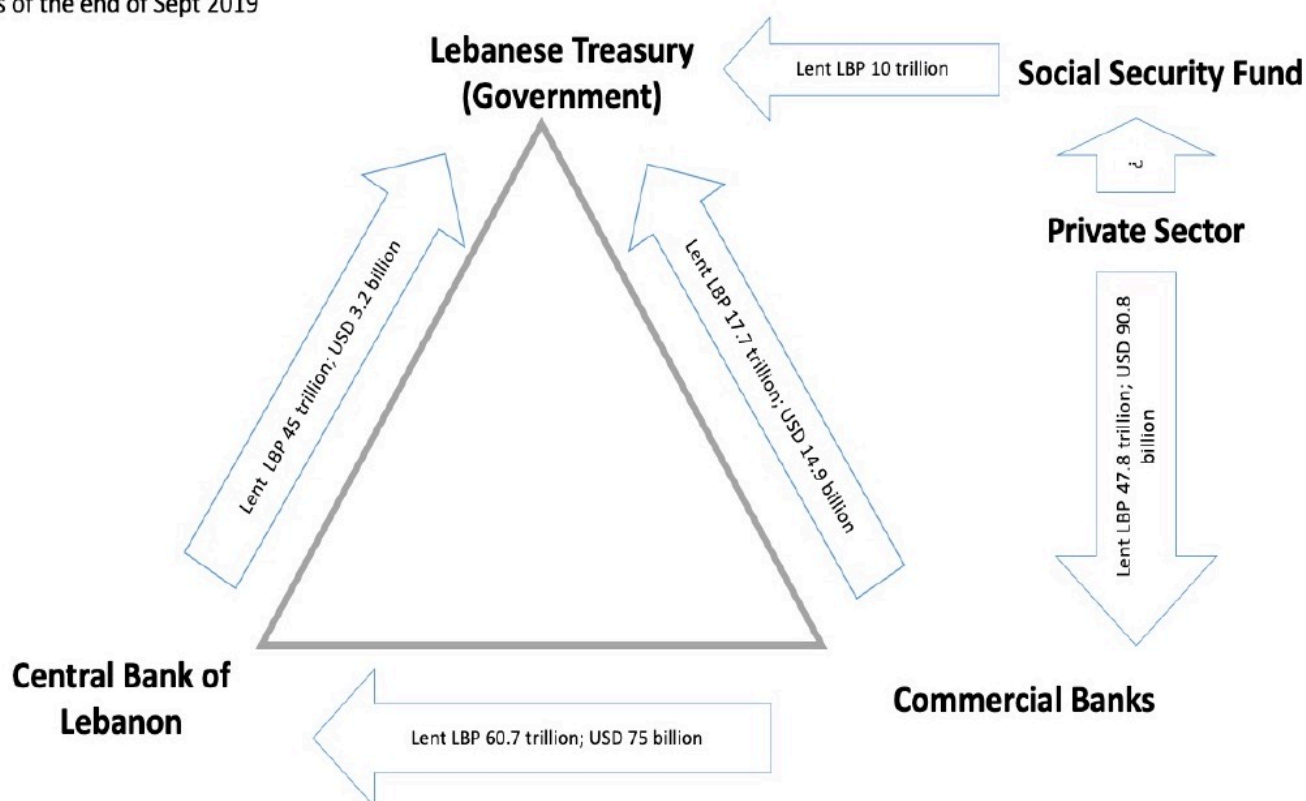
In addition to these nominations, a revamp of the governance of the regulatory institutions has to be undertaken following a thorough review. In order to enhance risk management and avoid a repeat of concentrated lending in the future, the monetary and credit law should be amended to prohibit excessive risk taking related to the government, which will have the double benefits of forcing a more disciplined sovereign borrowing program and encourage a more diversified use of bank balance sheets directed at more productive areas of the real economy. Providing a framework to curtail so-

called “financial engineering” transactions should also be addressed in order to discourage moral hazard and enhance the transparency and arms-length nature of any such operations in the future.

Finally, any future model will also require a migration towards a floating currency, and revised tax and financial sector laws and regulations, encouraging greater competition including from foreign banks. It is worth noting that while a devaluation of the LBP would have a positive direct effect on the balance sheet of banks, it would hurt their private sector borrowers, as most of these loans are dollar denominated, and thus, would lead to higher level of NPLs, hurting banks through second order effects.

Figure 1: Net obligations of Lebanese government, central bank, commercial banks and social security fund (as of September 2019 due to lack of some data as of December 2019).

As of the end of Sept 2019



How do we restructure the financial sector?

Saving the financial sector will require **empowering a task force** consisting of BDL officials, BCCL officials, independent financial sector experts, and Lebanon’s international

partners, including multilateral-agencies.

Bank equity should be written down to reflect the reality of asset impairment with existing shareholders being allowed to exercise their pre-emptive rights to recapitalize banks with their own resources or by finding new investors, thus reducing the burden on the public sector, multilateral agencies, donors or depositors. Certain banks could be wound down or resolved by the government. Banks that are liquidated or placed into resolution would transfer control to the government, though current bank administrators can remain in place so that regular business transactions can continue. Some banks may be too small to consider “saving” and should go into liquidation. The purpose of this process would be to restructure (or wind down) insolvent institutions without causing significant disruption to depositors, lenders and borrowers. The first step in the resolution process is for shareholders and creditors to bear the losses in that order. If the bank has negative equity after this stage, it can begin by selling key assets, such as real estate or foreign subsidiaries before resorting to a capital injection.

One potentially useful tool to support asset sales and re-establish normal banking activities quickly would be to create a ‘bad bank’ consisting of the bank’s non-performing loans or toxic assets. A ‘bad bank’ makes the financial health of a bank more transparent and allows for the critical parts of the institution to continue operating while these assets can be sold. Bad banks have been used in France, Germany, Spain, Sweden, the United Kingdom and the United States, among others, to address banking crises similar to the current Lebanese situation. ‘Bad banks’ can be established on a bank-by-bank basis, managed by the bank itself (under government stewardship) or by the government on a pooling basis. The challenge in Lebanon is neither the BDL nor the largest banks have sufficient capital buffers to fund the equity of such a bad bank.

If the bank equity remains in the red once key assets have been sold (or transferred to a ‘bad bank’), absent sufficient

recapitalisation funds, a bail-in may be considered. A bail-in refers to shrinking of the bank's liabilities, consisting mainly of deposits, by converting a portion into bank equity.

Nationalization is impractical in the Lebanese context. While transferring control of operations away from bank management teams that have lost credibility will be necessary, nationalization is impractical in the Lebanese context since the government is effectively insolvent. Also, state-owned banks may be used to further serve political interests and can be easily misdirected and mismanaged by becoming platforms for politically motivated lending, hiring and pricing.

Does Lebanon need fewer banks?

We believe that a market like Lebanon requires fewer banking institutions and a round of consolidation is imperative to make the system more robust and competitive as well as more diversified business models in order to serve a broader spectrum of economic activity. Mergers will require first full clarity on banks' financials. As such, this crisis could be seized upon to achieve this outcome. Academic research in this area confirms that while bank consolidation can lead to higher fees and potentially higher loan rates, it also provides greater financial stability and less risk taking. Larger banks can also attract investors more easily, especially high-quality long-term shareholders.

In most countries experiencing a financial crisis, those banks that are overexposed to troubled assets have been absorbed into large healthy banks. However, in Lebanon, as most large banks are heavily exposed to central bank and government debt and non-performing loans they are unable to play the consolidator role. **We therefore believe that a consolidation can be best achieved by a combination of unwinding smaller banks, resolving some banks and merging larger banks** which would facilitate new equity fundraising, and cost cutting with fewer branches required in an increasingly digital world. Larger banks will also be able to afford to invest in newer IT systems and risk management systems over time and be viewed as better credits by foreign correspondents.

Conclusion. The solutions exist, the time to act is now!

Signatories (in their personal capacity)

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Institutional Endorsements

LIFE

Kulluna Irada

"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."

Comments on the protests in Lebanon & closure of banks in Asia Times, 25 Oct 2019

Dr. Nasser Saidi's comments on the Lebanese protests and closure of banks appeared in the article "Lebanon's shuttered banks bracing for dollar run" published by Asia Times on 25th Oct 2019.

The full article can be accessed at: <https://www.asiatimes.com/2019/10/article/lebanons-shuttered-banks-bracing-for-dollar-run/>

Comments are posted below:

"It was a mistake to close the banks," Dubai-based economist Nasser Saidi told Asia Times by phone.

"When you shut down the banks, you create a crisis of confidence because people feel they can no longer access their deposits, so when it opens they will want to access their deposits."

"What you can expect is a rush on the banks, if not a run on the banks" when they finally re-open, Saidi added.

Already, "people are worried about capital controls. You are already seeing a black market or parallel market for Lebanese pounds, and it is increasingly difficult to convert pounds to dollars, if not impossible."

Economist Saidi says he does not believe Lebanon is at "imminent" risk of default.

"The Central Bank and Lebanese banks own something like 90% of the debt ... they have a lot of skin in the game," he said.

For Saidi, confidence in the ruling elite is beyond repair, and a new musical chairs of political faces would most certainly deepen the crisis amidst already depleted confidence in the system.

"They need to have a new government in place as quickly as possible with the main portfolios in the hands of technocrats – not political appointees – and they need to put together as quickly as possible a macro financial fiscal plan to rescue Lebanon. That is the priority right now to avoid the meltdown," he said.

"You cannot expect the people who are source and origin of the problem to reform. You need fresh blood. Besides that, I don't think they have the technical expertise to deal with Lebanon's fiscal and debt problems," Saidi added.

The key word, besides technocrat, will be independent, as past technocrats appointed by political movements were still beholden to those superiors.

Lebanon's political elites control vast chunks of equity in the banks, 50% of whose deposits are owned by the top 1%.

"Any default will wipe out the equity of the banks, and their own deposits are at risk, so it is in their own self-interest that a government of technocrats comes in and helps solve the problem they created," said Saidi.