"Overcoming Lebanon's economic crisis", viewpoint in The Banker, Oct 2020

This article, titled "Overcoming Lebanon's economic crisis", appeared as a viewpoint in the Oct 2020 edition of The Banker. The article, posted below, can be directly accessed on The Banker's website.

Overcoming Lebanon's economic crisis

Lebanon's financial and economic crises can only be solved with meaningful reform, without which it faces a lost decade of mass migration, social and political unrest and violence.

Violence and crises have shattered Lebanon's pre-1975 Civil War standing as the banking and financial centre of the Middle East. Lebanon is engulfed in overlapping fiscal, debt, banking, currency and balance of payments crises, resulting in an economic depression and humanitarian crisis with poverty and food poverty affecting some 50% and 25% respectively of the population. The Lebanese Pound has depreciated by some 80% over the past year, with inflation running at 120% and heading to hyperinflation. A Covid-19 lockdown and the Port of Beirut horrendous explosion on August 4th created an apocalyptic landscape, aggravating the economic and unprecedented humanitarian crises. The cost of rebuilding is estimated to exceed $10 billion, more than 25% of current GDP, which Lebanon is incapable of financing.

The economic and financial meltdown is a culmination of unsustainable fiscal and monetary policies, combined with an overvalued fixed exchange rate. Persistently large budget deficits (averaging 8.6% of GDP over the past 10 years), structural budget rigidities, an eroding revenue base, wasteful subsidies, government procurement riddled with endemic corruption, all exacerbated fiscal imbalances.

Meanwhile, a monetary policy geared to protecting an increasingly overvalued exchange rate, led to growing trade and current account imbalances and increasingly higher interest rates to attract deposits and capital inflows to shore up dwindling international reserves. Deficits financed current spending, with limited real investment or buildup of real assets, while high real interest rates stifled investment and growth.

The unsustainable twin (current account and fiscal) deficits led to a rapid build-up of public debt. Public debt in 2020 is running at $111 bn, including $20 bn of debt at Banque du Liban (BdL), the country's central bank. This figure represents more than 184% of GDP– the second highest ratio in the world behind Japan, according to the the IMF, Most of this debt is held by domestic banks and BdL, with 13% held by foreigners.

Financing government spend

The BdL's financing of government budget deficits, debt monetisation, large quasi-fiscal operations (such as subsidising real estate investment) and bank bailouts, created an organic link between the balance sheets of the government, the BdL and banks. In effect, depositors' monies were used by the banks and the BdL to finance budget deficits, contravening Basel III rules and prudent risk management.

BdL policies led to a crowding-out of both the private and public sectors, and to disintermediation: the government could no longer tap markets, so BdL acted as financial intermediary i.e. paying high rates to the banking system, while allowing the government to borrow at lower rates. The higher rates increased the cost of servicing the public debt, with debt service representing some 50% of government revenue in 2019 and over one third of spending. Credit worthiness rapidly deteriorated, leading to a 'sudden stop' in 2019, with expatriate remittances and capital inflows moving into reverse.

The crisis Lebanon is now experiencing is the dramatic collapse of what economists describe as a Ponzi-like scheme engineered by the BdL, starting in 2016 with a massive bailout of the banks equivalent to about 12.6% of GDP. Ina bid to protect an overvalued LBP and finance the workings of government, the BdL started borrowing at ever higher interest rates, through so-called “financial engineering” schemes, which evolved into a vicious cycle of additional borrowing to pay maturing debt and debt service, until confidence evaporated and reserves were exhausted.

With the BdL unable to honour its foreign currency obligations, Lebanon defaulted on its March 2020 Eurobond and is seeking to restructure its domestic and foreign debt. The resulting losses of the BDL exceed $50 bn, equivalent to 2019 GDP, a historically unprecedented loss by any central bank.

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. The bubble burst in the last quarter of 2019, with a rapid depreciation of the LBP during 2020. The BDL’s costly attempt to defy the “impossible trinity” by simultaneously pursuing an independent monetary policy, with fixed exchange rates and free capital mobility resulted in growing imbalances, a collapse of the exchange rate and an unprecedented financial meltdown.

Economic disaster

A series of policy errors triggered the banking and financial crisis, starting with the closure of banks in October 2019, ostensibly because of anti-government protests decrying government endemic corruption, incompetence and lack of reforms. A predictable run on banks ensued, followed by informal capital controls, foreign exchange licensing, freezing of deposits, inconvertibility of the LBP and payment restrictions to protect the dwindling reserves of the BDL. These errors precipitated the financial crisis, generating a sharp liquidity and credit squeeze, the sudden stop of remittances and the emergence of a system of multiple exchange rates.

The squeeze severely curtailed domestic and international trade and resulted in a loss of confidence in the monetary system and the Lebanese pound. With the outbreak of Covid19 and lockdown measures came a severe drop in tax receipts, resulting in the printing of currency to cover the fiscal deficit, generating a vicious cycle of exchange rate depreciation and inflation. The black market exchange rate touched a high of LBP 9800 in early July, before steadying to around LBP 7400 in early September (versus the official peg at 1507). In turn these policy measures led to a severe economic depression, with GDP forecast to decline by 25% in 2020, with unemployment rising to 50%.

In response to the crisis, the government of Hassan Diab prepared a financial recovery plan that comprised fiscal, banking, and structural reforms as a basis for negotiations with the IMF. In effect, the Diab government and Riad Salameh, governor of the BDL deliberately implemented an inflation tax and an illegal 'lirafication' – a forced conversion, a spoliation, of foreign currency deposits into LBP to achieve internal real deflation. The objective is to impose a 'domestic solution' and preclude an IMF programme and associated reforms.

The apocalyptic Port of Beirut explosion on August 4, compounded by official inertia in responding to the calamity, has led to the resignation of the Diab government and appointment of a new PM, Mustafa Adib. Economic activity, consumption and investment are plummeting, unemployment rates are surging, while inflation is accelerating. Confidence in the banking system and in macroeconomic and monetary stability has collapsed.

Rebuilding the economy

Prospects for an economic recovery are dismal unless there is official recognition of the large fiscal and monetary gaps, and a comprehensive, credible and sustainable reform programme is immediately implemented by a new Adib government. Such a programme needs to include immediate confidence building measures with an appropriate sequencing of reforms. The government must immediately passing a credible capital controls act to help restore confidence and encourage a return flow of remittances and capital inflows. Immediate measures need to be taken to cut the budget deficit, including by removing fuel subsidies and all electricity subsidies (which account for one-third of budget deficits). The removal of these subsidies is necessary to stop smuggling into neighbouring Syria, which has been a major drain on international reserves.

Monetary policy reform is needed to unify the country’s multiple exchange rates, moving to inflation targeting and a flexible exchange rate regime. Multiple rates create market distortions and incentivise more corruption. In addition, the BdL will have to repair and strengthen its balance sheet, stop all quasi-fiscal operations and government lending. Credible reform requires a strong and politically independent regulator and policy-maker.

There is a need to restructure the public domestic and foreign debt (including BdL debt) to reach a sustainable debt to GDP in the range of 80 to 90% over the medium term; this implies a write down of some 60 to 70% of the debt. Given the exposure of the banking system to government and BDL debt, a debt restructuring implies a restructuring of the banking sector whose equity has been wiped out.

A bank recapitalization and restructuring process should top the list of reforms, including a combination of resolving some banks and merging smaller banks into larger banks. Bank recapitalisation requires a bail-in of the banks and their shareholders (through a cash injection, sale of foreign subsidiaries and assets) of some $25 bn to minimise a haircut on deposits. As part of such far-reaching reforms, Lebanon needs a well-targeted social safety net to provide support for the elderly and vulnerable segments of the population

Crucially, the new government needs to rapidly implement an agreement with the IMF. Lebanon desperately needs the equivalent of a Marshall Plan, a “Reconstruction, Stabilisation and Liquidity Fund’ of about $30 to 35bn, along with policy reform conditionality.

A comprehensive IMF macroeconomic-fiscal-financial reform programme that includes structural reforms, debt, and banking sector restructuring would help restore faith in the economy in the eyes of the Lebanese diaspora, foreign investors/aid providers and help attract multilateral funding from international financial institutions and Cedre conference participants, including the EU and the Gulf Cooperation Council. This would translate into financing for reconstruction, access to liquidity, stabilise and revive private sector economic activity.

Without such deep and immediate policy reforms, Lebanon is heading for a lost decade, with mass migration, social and political unrest and violence. If the new government fails to act, Lebanon may turn into "Libazuela"!

"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

Source: 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?

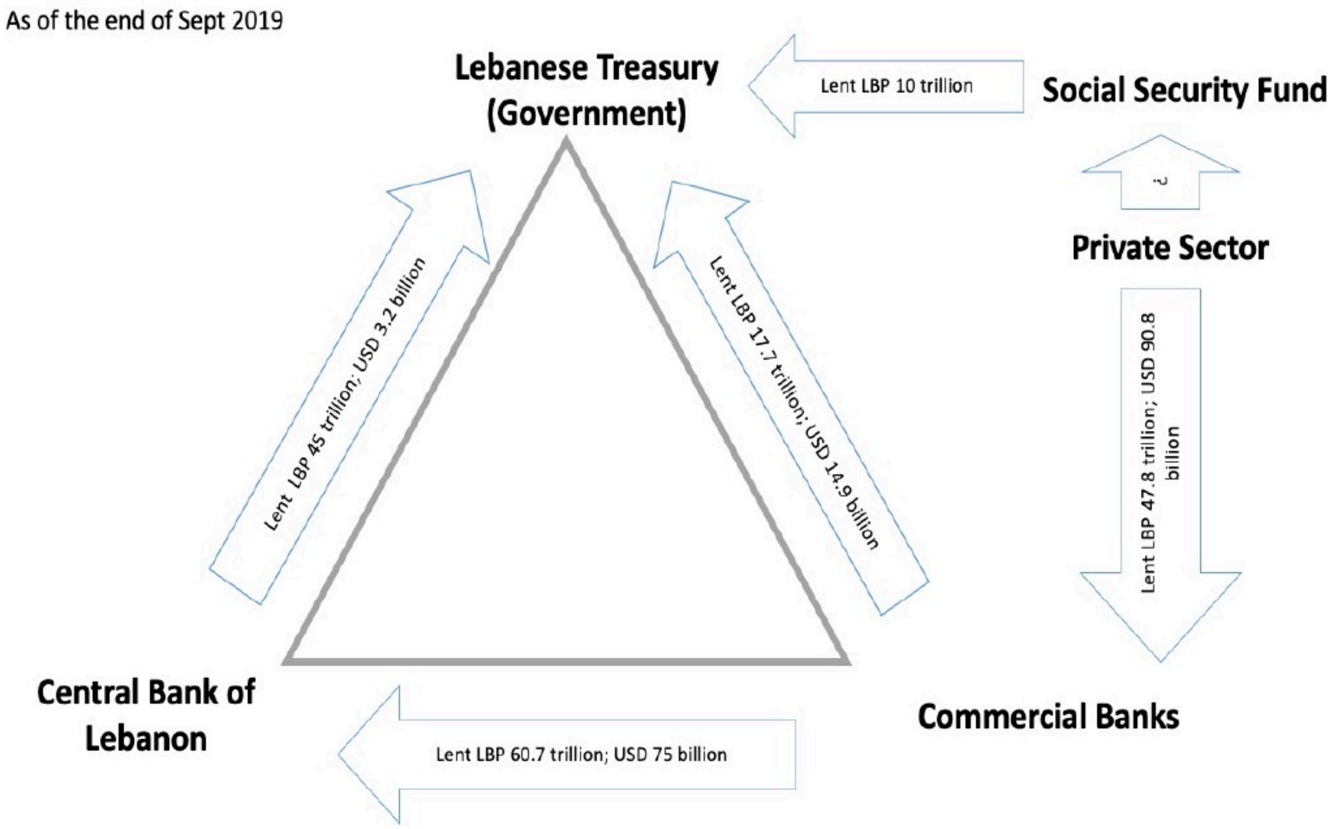
The primary goal of financial sector interventions must be to restore confidence in the banking sector and restart the flow of credit and unrestricted access to deposits. In addition to rebuilding capital buffers and addressing the disastrous state of government finances, we would advocate reforming 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).



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)
Amer Bisat, Henri Chaoul, Ishac Diwan, Saeb El Zein, Sami Nader, Jean Riachi, Nasser Saidi, Nisrine Salti, Kamal Shehadi, Maha Yahya, Gérard Zouein

Institutional Endorsements
LIFE
Kulluna Irada

"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 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

Firas Abi-Nassif, Amer Bisat, Henri Chaoul, Ishac Diwan, Nabil Fahed, Philippe Jabre, Sami Nader, May Nasrallah, Paul Raphael, Jean Riachi, Nasser Saidi, Kamal Shehadi, Maha Yahya.

Lebanon at a Turning Point, Article in Al Arabiya, 23 Jan

2020

The article titled "Lebanon at a Turning Point" appeared in Al Arabiya on 23rd January, 2020 and is posted below. Click here to access the original article.

Lebanon at a Turning Point

Endemic and persistent corruption, mismanagement, gross mal-governance, and failure to address Lebanon's economic, social, and environmental challenges have driven protestors to throng the streets amidst bank closures, payment restrictions, and foreign exchange controls. Protesters had called for a cabinet of professionals, "technocrats," politically independent, experienced persons, divorced from sectarian politics. The new government formed under duress is a mix of professionals and politically affiliated members. Significantly, it is comprised of 20 non-parliamentarians promising better accountability and has six female members (including the Middle East's first female defense minister). However, the stark reality, as Prime Minister Hassan Diab clearly identified, is that the country is at a "financial, economic, and social dead end." Indeed, Lebanon has become a failed state. Will the new government have the political courage to undertake deep and unpopular reforms? Will it be willing to commit political suicide?

The new government has a gargantuan task ahead: It must immediately address the interlinked economic, banking and financial, and currency crises, not to mention a deadly environmental crisis. The accumulated difficulties have ballooned over the past three months due to a series of policy mistakes and inaction including the panic-inducing closure of the banks, informal capital controls, restrictions on domestic and external payments, a rapid depreciation of over 40 percent of the Lebanese pound in the parallel market and effective inconvertibility of deposits. In turn, the pound's depreciation and the liquidity crunch have led to a sharp acceleration of inflation (some 30 percent), a sharp drop in economic activity (e.g. car registrations dropped by 79 percent year-on-year in November), leading to growing layoffs and unemployment, business closures/bankruptcies, and falling incomes, resulting in a collapse of investment, a sharp curtailment of household consumption, and more than a 50 percent fall in government revenue. The forecast is that real gross domestic product could decline by 10 percent, a great depression, not a recession.

Time is running out for Lebanon. Sovereign debt has risen to 160 percent of GDP, with a projected debt service of $10 billion, equivalent to 22 percent of GDP and over 60 percent of government revenue. The fiscal deficit jumped to about 15 percent of GDP last year (from a budgeted 7.5 percent) and is likely to rise again this year. The debt dynamics and fiscal deficit are on an unsustainable path, with central bank monetary financing of the deficit heralding rapidly increasing inflation and accompanying depreciation of the Lebanese pound. Lebanon’s external accounts are also in crisis, with the current account deficit (some 26 percent of GDP), aggravated by falling remittances and a surge in capital outflows, despite the illegal and unofficial capital controls.

What should the policy imperatives be of the new government? Fundamentally, the Diab government needs to develop and implement a series of economic and structural reforms that aim to restore trust in the government and its institutions, notably through an anti-corruption strategy and stolen assets recovery program, and addressing the fiscal, banking, financial, monetary, and currency crises to avoid a lost decade of economic depression, poverty, deep social unrest, and political chaos. The immediate priorities include the following reforms.

Establish an emergency cabinet committee for immediately implementing economic and financial policy reform measures.

An economic recovery and liquidity reform program is required and must be prepared and agreed upon with the International Monetary Fund and the World Bank. Lebanon needs a multilaterally funded package of some $20-25 billion for economic and social stabilization, budgetary and balance of payments support, and a redesigned CEDRE program. In 2018, more than $11 billion was pledged in soft loans at the CEDRE conference in Paris, funding from which being unlocked is dependent on reforms made in the country. Prime Minister Diab’s announcement of potential visits to Saudi Arabia and other Gulf nations would be a propitious opportunity to discuss participation in the reform program.

A credible fiscal reform should top the list of policy priorities.

Starting with the 2020 budget, the aim should be to achieve a 5-6 percent primary budget surplus over the next two years through expenditure and revenue measures. These would include the removal of subsidies on electricity and fuel, which are major drains on the budget, revisiting public sector salaries and pensions, in addition to public procurement laws and procedures, and improved tax compliance. But medium- and long-term fiscal sustainability requires imposing permanent constraints on fiscal policy through two fiscal rules: a budget balance rule (e.g. budget deficits not to exceed 2 percent of GDP) and a debt rule (e.g. debt-to-GDP should not exceed 80 percent of GDP).

Public debt restructuring is key.

Given the Eurobond maturing in March 2020, another initial pain point is initiating negotiations on restructuring and re-profiling Lebanon’s public debt, including the debt of Lebanon’s central bank. So far, the absence of an empowered government haa constrained any negotiations on restructuring its debt. Lebanon’s crisis-hit bonds have been flashing warning signs of a sovereign debt distress if not default ahead. Yields on the government’s $1.2 billion of notes maturing in March were close to 200 percent on January 22 (versus at 13 percent just before the start of protests), while the price of other Lebanese Eurobonds plummeted to historic lows. The new government should immediately initiate debt restructuring negotiations within the comprehensive economic stabilization and liquidity program. A successful restructuring could reduce the net present value of debt by some 50 percent, substantially lowering the debt burden and its servicing.

The banking sector must be restructured.

Given that 70 percent of Lebanese banks’ assets are invested in sovereign debt and central bank paper, a restructuring of public debt will necessitate an extensive reform of the banking system, including a bail-in of the banks through a $20-25 billion recapitalization by existing and new shareholders, a capitalization of reserves, a sale of assets, — such as real estate, investments, and foreign subsidiaries — and a consolidation of banks to downsize the sector.

Lebanon needs to change its monetary policy and move to a managed flexible exchange rate regime.

The high interest rates required to maintain the overvalued official dollar peg generated structural current account deficits, created a domestic liquidity squeeze, crowded out the private sector, and increased the cost of public borrowing. Reform starts with admitting the failure of the pegged regime, recognizing the de facto depreciated parallel market rate, and instituting formal capital controls through legislation during the economic transition period.

A social safety net must be implemented to protect the vulnerable.

Importantly, given the need for painful reform measures and rising extreme poverty levels, a targeted and well-funded social safety net, to the tune of some $800 million, needs to be put in place to protect the poor and vulnerable.

This is a historical turning point. Either Lebanon will choose a path that leads to the economy's stabilization and a gradual recovery over a three- to five-year transition period, or it will avoid necessary reforms, confirming the country as a failed nation and dooming it to a decade of desolation.

"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

*Firas Abi Nassif, Henri Chaoul, Ishac Diwan, Saeb el Zein, Nabil Fahed, Philippe Jaber, Sami Nader, May Nasrallah, Paul Raphael, Jean Riachi, **Nasser Saidi**, Kamal Shehadi, Maha Yahya*

"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, andforced 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.

Signatories (in their personal capacities)

Firas Abi Nassif, Edward Asseily, Bilal Bazzy, Hala Bejani, Amer Bisat, Henri Chaoul, Ishac Diwan, Haneen El Sayed, Ali El Reda Youssef, Saeb el Zein, Nabil Fahed, Philippe Jabr, Sami Nader, May Nasrallah, Paul Raphael, Jean Riachi, Nisreen Salti, Nasser Saidi, Kamal Shehadi, Maha Yahya, Baasam Yammine, Gerard Zouein