Comments on Lebanon's currency fluctuations in Reuters, Jun 11 2020

Dr. Nasser Saidi's comments on the Lebanese pound and fluctuations appeared as part of the Reuters article titled "Lebanese pound changes hands near 5,000 per dollar, market sources say" published on 11th June 2020. Comments are posted below.

Nasser Saidi, a former economy minister, said the pound's decline had accelerated because of increased demand for dollars in neighbouring Syria, where the local currency has also hit record lows as new U.S. sanctions are set to come into effect. "There is the beginning of panic in Syria over the availability of dollars. This has transferred itself into increased demand in the Beirut market," he said.

"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?

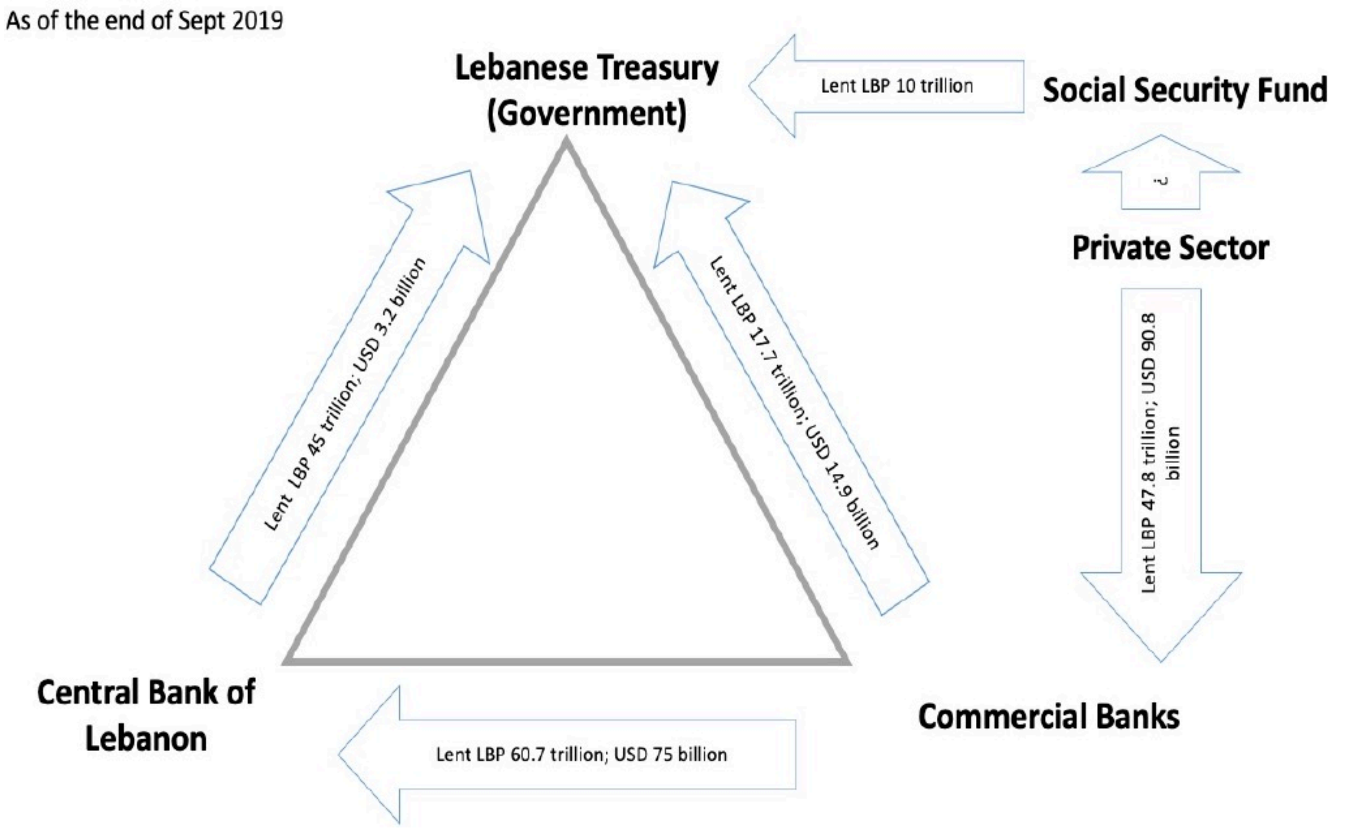
The primary goal of financial sector interventions must be to restore confidence in the banking sector and restart the flow of credit and unrestricted access to deposits. In addition to rebuilding capital buffers and addressing the disastrous state of government finances, we would advocate reforming 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 socalled "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!
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"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 تشريعية). 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 r elated 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 report s 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 n or 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.

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[1] We will use the term capital controls to refer to formal capital and banking controls in the rest of this paper
[2] Hereafter referred to as BDL, the acronym for Banque du Liban
[3] Paul Krugman, "Free Advice: A Letter to Malaysia's Prime Minister," Fortune September 28, 1998.
[4] IMF, The Liberalization and Management of Capital Flows: An Institutional View November 14, 2012
[5] Article XIV, Section 2, of the IMF Articles of Agreement makes an exception for transitional arrangements: "A member that has notified the Fund that it intends to avail itself of transitional arrangements under this provision may, notwithstanding the provisions of any other articles of this Agreement, maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on

which it became a member (…) In particular, members shall withdraw restrictions maintained under this Section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the general resources of the Fund."

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

The article titled "The Trouble with the Creeping Expropriation of Depositors", written by A Citizens' Initiative for Lebanon was published on 24th January, 2020 and is posted below. Click here to access the original article.
This note is the second in a series of analysis by an independent group of citizens who met in their personal capacity in December 2019 to discuss the broad contours of Lebanon's financial crisis and ways forward.

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

A Toxic Policy-Mix

The first element of this mix is the steep depreciation of the LBP. The LBP market rate is in free fall, now heading to nearly twice the official rate. While depreciation is necessary to reduce the current account deficit, it has been made much larger than necessary by inaction on the fiscal front. Deteriorating tax collection (down by 40 percent percent already) is generating an additional deficit in the primary balance of about $4 billion. With no other choices available, this will be increasingly financed by the Banque du Liban (BdL) injecting LBP liquidity, thus accelerating inflation and depreciation in the future.

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

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

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

Why this Policy?

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

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

Costs of this Policy

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

- It is unfair and discriminatory. Lebanon’s lower and middle classes will be decimated not only by lower real wages and pensions, but also by a liquidation of the wealth and lifetime savings accumulated by generations of expatriate and resident Lebanese. It is completely unprecedented to put the burden of loss on the depositors while shielding banks’ shareholders from such pain.

- It is inefficient. It will lead to a sharper contraction of the economy than necessary and a reduction in its growth prospects, for four reasons. Wealth destruction will push down demand. Many private firms will go bankrupt because their borrowings are mainly in foreign currency while their income is in LBP. Confidence in banks will collapse leading to severe financial disintermediation. And inflation will accelerate further because of “too much” Liras in the system.

In the second half of 2001, Argentina went through a similar experience. A sudden stop of inflows led to a bank run. Soon after, deposit withdrawals were sharply curtailed (the “corralito”) and the ARS1/1$ currency peg was abandoned. A law was passed to convert all dollar deposits (which were predominant, as in Lebanon) into pesos at ARS1.4 for $1. The market rate collapsed however to ARS3.9 for $1, reducing the value of dollar deposits by 64 percent. A deep recession followed, with GDP collapsing by 12 percent. But there were two major differences with Lebanon: the banks held little public debt, and the exports improved rapidly. The resulting recession in Lebanon can be expected to be far more destructive, especially that Lebanon’s exports are unlikely to rebound as fast as in Argentina.

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

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

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

Signatories

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