

Lebanon's Meltdown: Failed State or Reforms & Transformation?

Olayan School of Business, AUB

Dr. Nasser Saidi

18 November 2021

NASSER SAIDI

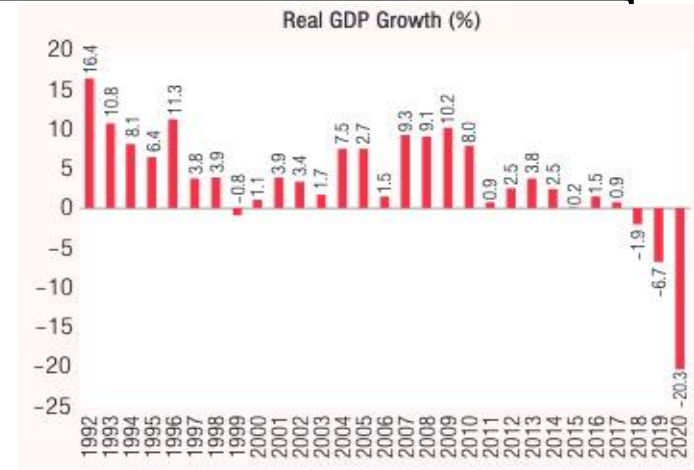
— & ASSOCIATES —

Lebanon's Meltdown: Failed State or Reforms & Transformation?

- **Macro-Fiscal-Monetary, Financial & Socio-Economic Developments**
- **Roots of Lebanon's meltdown**
- **Reforms & Transformation**

The Path to Economic Collapse

- **GDP has declined for the 4th consecutive year, a total fall by 42%** since 2018. This is second to the most severe financial crisis in history in Chile (1926) where real GDP declined 46.6%.
- **4 main pillars of LB economy being destroyed:** trade & tourism, health, education, banking & finance. Massive closures & bankruptcies across all activities.
- **Unemployment > 40%** of the population; **Poverty 77% & Food poverty > 45%** of population
- **Ongoing mass migration of Lebanon's human capital** (doctors, engineers, professionals..) threatens ability of Lebanon to recover in the future. **Long-term scaring.**
- **LBP has lost 90% of its value on the black market in less than 2 years**
- **Inflation stood at 144% as of Nov 2021**, inching closer to a recent peak of 150% => meltdown of salaries, wages
- **Inflation & exchange rate depreciation act as a tax on income reducing real wages and a wealth tax.** The value of \$ deposits has been cut by 85% destroying accumulated financial wealth of several generations of Lebanese (incl. that of Lebanese Diaspora)

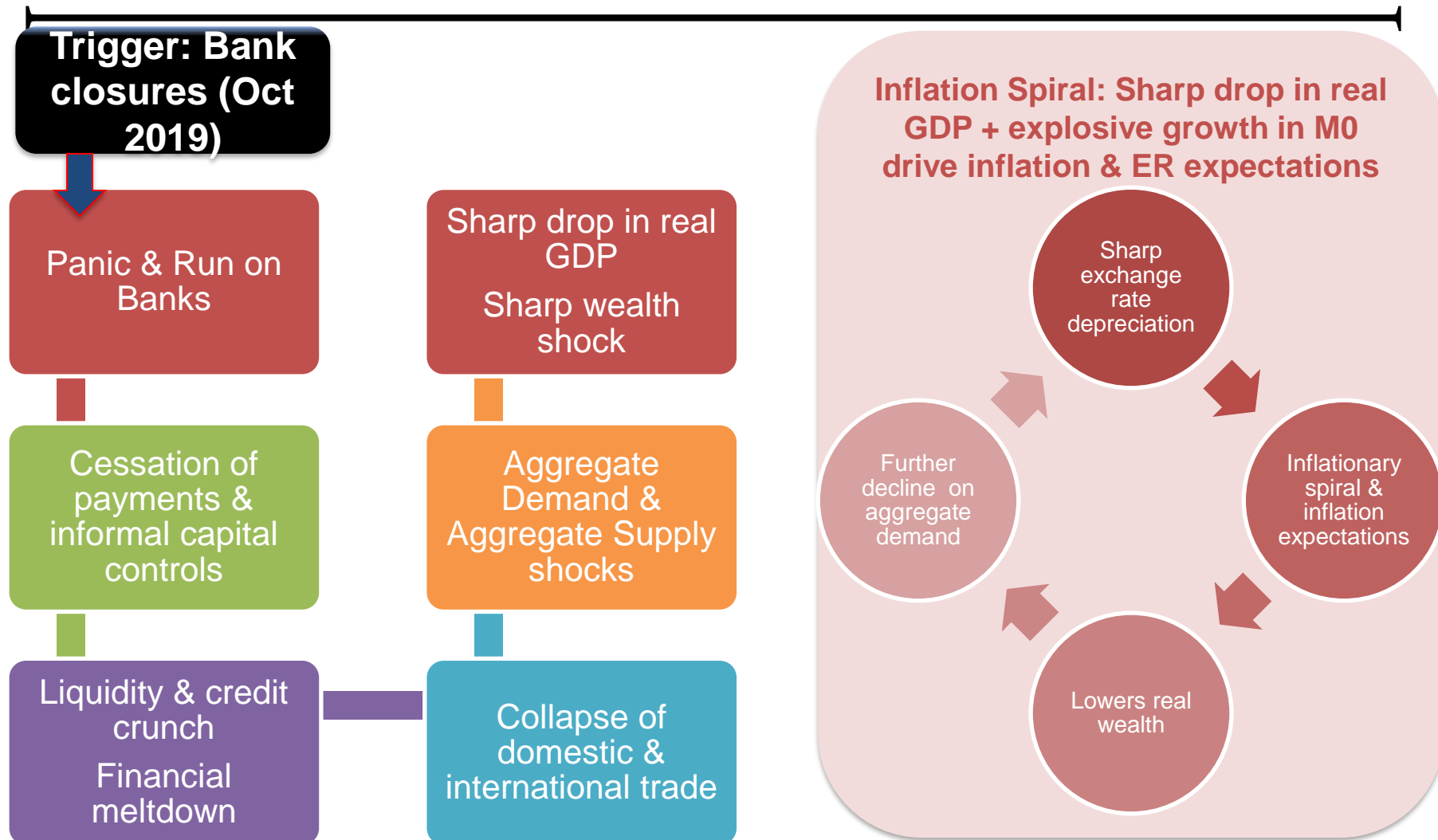


Sources: CAS and WB staff calculations.

Average Salaries in Lebanon

<p>Minimum Wage</p> <p>Salary: LBP 675,000 Equivalent in USD at LBP 1,500/USD: \$450 Equivalent in USD at the prevailing rate of LBP 17,500/USD: \$39 --> \$1.7/day</p>
<p>A Lebanese University Professor</p> <p>Salary: LBP 3.7 million Equivalent in USD at LBP 1,500/USD: \$2,466 Equivalent in USD at the prevailing rate of LBP 17,500/USD: \$211 --> \$9.4/day</p>
<p>Soldier</p> <p>- Salary: LBP 1.30 million - Equivalent in USD at LBP 1,500/USD: \$864 - Equivalent in USD at the prevailing rate of LBP 17,500/USD: \$74 --> \$3.3/day</p>
<p>Judge</p> <p>- Salary: LBP 4.5 million - Equivalent in USD at LBP 1,500/USD: \$3,000 - Equivalent in USD at the prevailing rate of LBP 17,500/USD: \$257 --> \$11.4/day</p>

Financial crisis was triggered by unwarranted Oct 2019 bank closures not by default on Eurobond



New Mikati cabinet: Elections, ST stabilization, ration cards, humanitarian aid, restart IMF talks

The IMF has issued no forecasts for Lebanon from this year onwards

The IIF has two estimates, one based on an optimistic scenario where an IMF agreement is reached by end-2021 & the other extreme of none at all

Main macroeconomic and financial indicators, with two scenarios for 2022

	2019	2020	2021	2022A*	2022B**
Nominal GDP (LP tr)	80.8	93.6	182.3	412.9	463.7
Nominal GDP (\$ bn)	51.6	22.6	23.2	29.7	18.9
Real GDP growth, %	-6.7	-26.2	-8.3	4.1	-4.0
GDP deflator, % ch	4.5	56.9	112.5	117.5	157.4
Inflation, %, ave.	2.9	84.9	140.2	114.0	161.8
Inflation, %, eop	3.2	145.9	204.1	67.4	157.0
Official rate, ave	1,508	1,508	1,508	13,900	24,500
Parallel rate, ave	1,625	5,549	13,569	13,900	24,500
Parallel rate, eop	2,090	8,300	12,000	13,900	28,000
CA balance, % GDP	-22.1	-11.7	-10.3	-8.5	-7.4
Reserves, \$ bn***	29.6	18.6	15.1	18.7	14.5
Fiscal balance, % GDP	-12.8	-6.5	-4.7	-2.2	-4.6
Primary bal., % GDP	-2.0	-3.3	-2.1	2.7	-1.8
Gov't debt, % GDP	170.0	255.3	299.5	125.8	316.4

* 2022A (Optimistic Scenario, 50% probability): Needed reforms are implemented, and agreement is reached with the IMF by end-2021

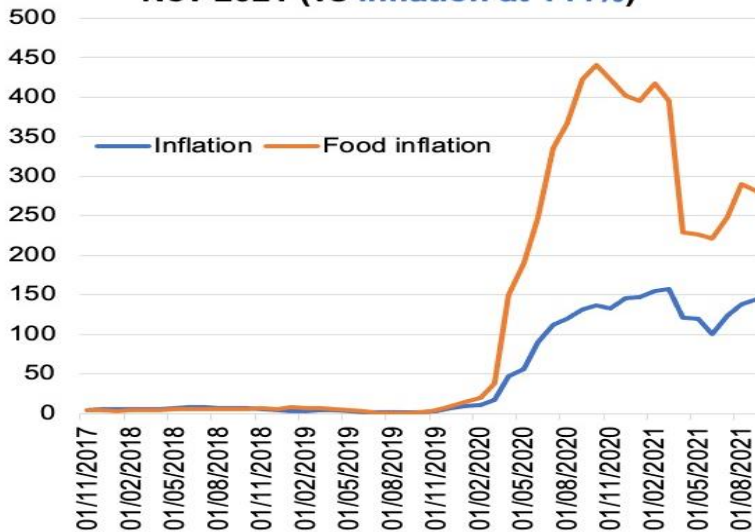
** 2022B (Pessimistic Scenario, 50% probability) assumes partial re-forms or collapse of the new cabinet, and no IMF agreement

Source: "Lebanon: Cautious Optimism but Daunting Challenges", IIF, Sep 2021

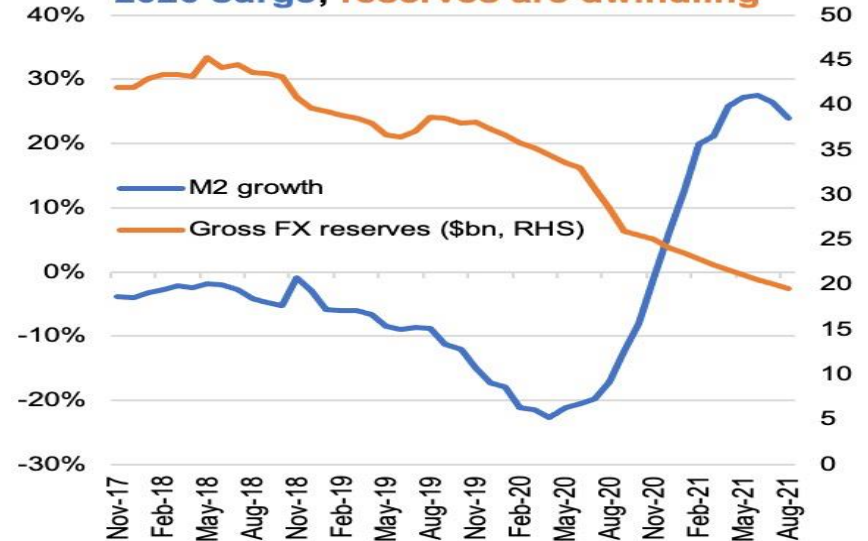
Multiple exchange rates create distortions in the market & encourage rent seeking; Exchange rate depreciation results in surging inflation

Inflation, volatile monetary conditions & exchange rate

Food inflation stands at 280% yoy as of Nov 2021 (vs inflation at 144%)



Currency in circulation eases after 2020 surge; reserves are dwindling



Depreciation of the pound in the black market

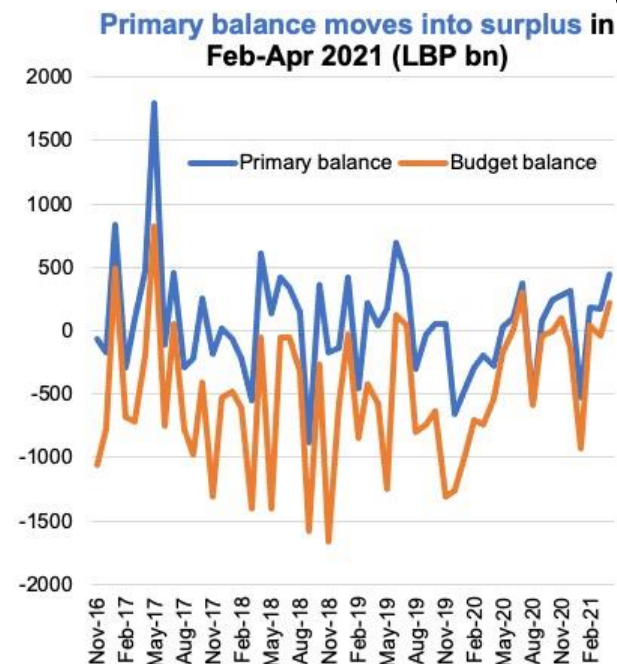
USD to LBP Exchange Rate is at 23,100 (as of 18th Nov 2021)



NS

No fiscal reforms. Monetary financing of fiscal deficits is leading to higher inflation

	2019	2020	2021
Central Government Finance (in percent of GDP)	Actual	WB estimates	
Revenue (including grants)	20.6	11.5	6.9
q/w. tax revenues	15.5	8.1	4.9
Total expenditure and net lending	31.2	16.4	12.2
Current	29.9	15.2	10.9
q/w interest payment	10.0	2.1	1.4
Capital & net lending (excluding foreign financed)	1.3	1.2	1.3
Overall balance (deficit (-))	-10.5	-4.9	-5.3
Primary balance (deficit (-))	-0.5	-2.8	-3.9



High inflation rates drive a sharp fiscal adjustment & reduction in real value of debt

Tax & Non-Tax Revenues fall. Largely due to using over-valued official rate for all tax revenue calculations from imports (customs etc.), and to acquire imports of fuel & other basic products, which were largely smuggled to Syria

Expenditures fall largely because of reduction in interest payments

Debt-to-GDP is estimated to have reached 174% by end-2020, up 3 ppt from 2019

External Sector: LBP depreciation & de facto capital account controls = sharp contraction in imports & sudden stop in capital inflows

Following the introduction of de facto capital controls, the sovereign default, **capital inflows into Lebanon stopped**. A massive contraction of the current account took place in 2020/21 driven by a sharp contraction in imports

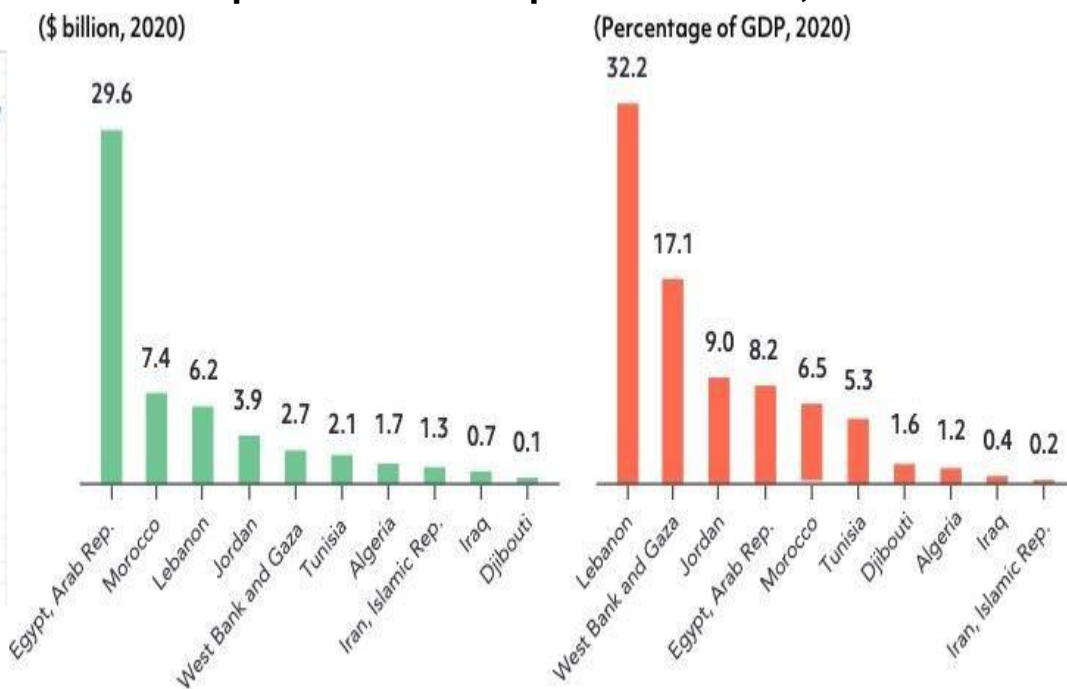
Lebanon continued to be among the top remittance recipients in MENA last year, but no longer intermediated by the banking sector.

Current Account deficit stood at \$259mn as of Dec 2020



Source: BDL

Top remittance recipients in MENA, 2020



Source: Migration & Development Brief 34, May 2021, World Bank.

Roots of Lebanon's meltdown: Unsustainable Twin Fiscal & Current Account deficits. Unsustainable fiscal policies + overvalued LBP generated CA, debt, banking & currency crises; BDL Ponzi scheme generated biggest financial collapse in history

High interest rates + 'financial engineering'/borrowing by BDL to protect LBP compounded fiscal deficits & debt growth (Gov't & BDL)

Three interlinked balance sheets: a bankrupt gov't that cannot service its debt + banks (75% of assets in govt & central bank debt) + BDL (borrowing from banks to defend an overvalued currency and to finance gov't). **BDL & banks refusing to recognize losses on B/S & need to restructure**

High Public Debt levels
& Budget Deficits
Large Current Account
Deficits

Functionally bankrupt &
increasingly illiquid
banking sector

Real economy
experienced no growth
for an entire decade =>
socio-political
implications

Politically rudderless:
delays in Parliamentary
elections, Presidential
election, cabinet
formation, absence of
reforms etc.

Multiple crises since 2019 are not due to natural causes, war or external intervention: avoidable

- The **comprehensive reforms** (including government and BDL debt restructuring, gradual exchange rate depreciation, electricity and other structural reforms, the establishment of a Social Safety Net to protect the poor and needy, fiscal reform, and capital controls) that were presented in April/May 2020 as part of the Diab government plan could have led to an agreement with IMF, WB, EU, donors, GCC, Int. community.
- Reforms were **deliberately sabotaged by politicians** unwilling to undertake fiscal & structural reforms, and **BDL and banks** unwilling to recognize losses on their balance sheets. **BDL losses likely exceed \$70 billion due to supporting overvalued LBP through ‘financial engineering’/bank bailout & high interest rates.**
- BDL is responsible for the biggest transfer of wealth in history in favour of the rich, the bankers and bank shareholders. **BDL created the biggest Ponzi scheme in history, greater than Madoff’s.**
- What Lebanon is going through is a **deliberate policy of adjustment through deflation, immiseration** through inflation tax on income and wealth, the freezing and Lirafication of deposits. This is a deliberate haircut -the biggest in financial history (greater than in Cyprus, Greece, Iceland, Argentina, Venezuela...)

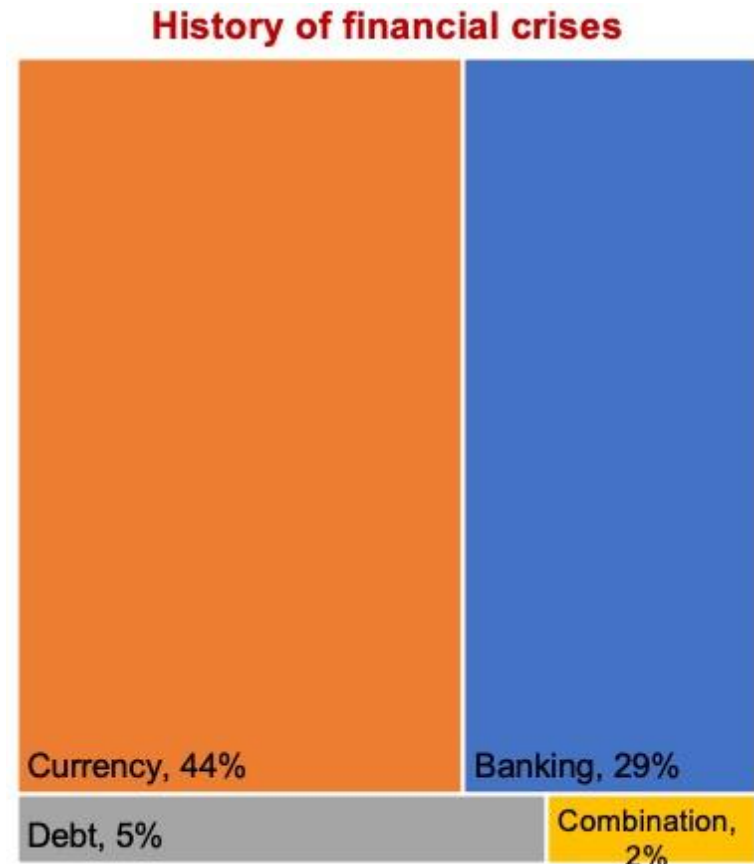
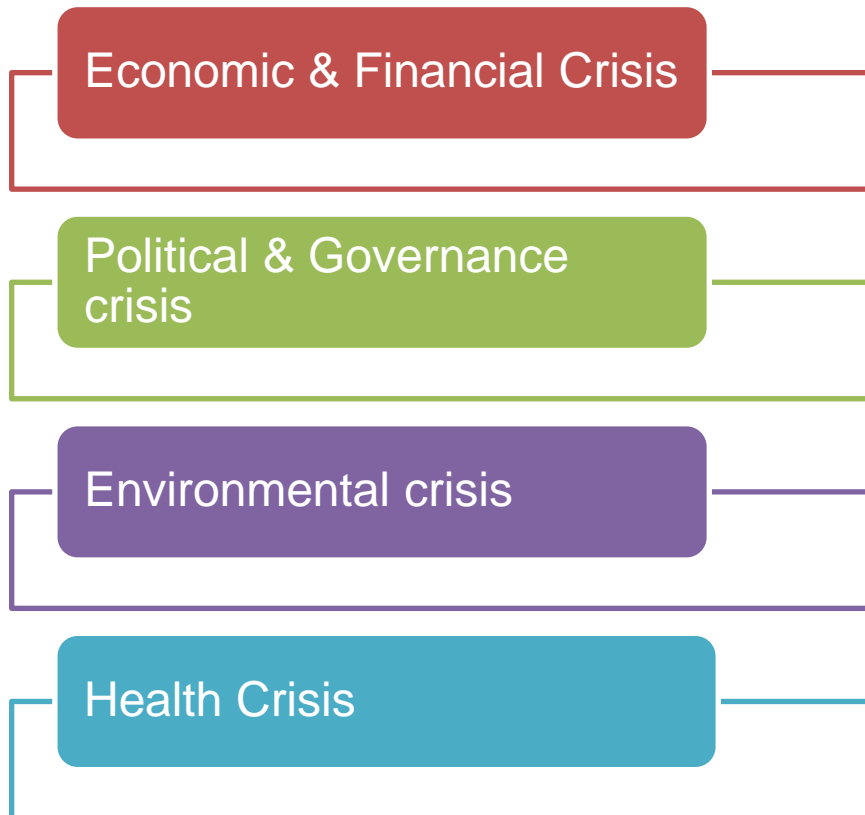
Rank	Year	Country	Peak to Trough	Peak to Trough	Peak to Recovery	CSI	Double Dip
			% change	# years	# years		Yes or No
1	1926	Chile	-46.6	3	16	62.6	Y
2	1931	Spain (civil war)	-34.6	9	26	60.6	Y
3	1983	Peru	-32	11	25	57	Y
4	1931	Uruguay	-36.1	3	17	53.1	Y
5	1893	Australia	-28	8	20	48	Y
6	1929	Mexico	-31.1	6	16	47.1	Y
7	1921	Italy	-25.5	3	21	46.5	Y
8	1890	Brazil	-21.7	4	21	42.7	Y
9	1923	Canada	-30.1	4	10	40.1	N
10	1890	Uruguay	-21	2	19	40	Y
11	1981	Philippines	-18.8	3	21	39.8	Y
12	1980/1985	Argentina	-21.8	11	18	39.8	Y
13	1929	India	-8.2	9	31	39.2	Y
14	1929/1933	US	-28.6	4	10	38.6	Y
15	1994	Venezuela	-24.2	11	14	38.2	Y
16	1939	Netherlands	-16	6	21	37	Y
17	2009	Greece	-24	6	12	36	Y*
18	1931/1934	Argentina	-19.4	3	15	34.4	Y
19	1931	Poland	-24.9	4	9	33.9	N
20	1929/1931	Austria	-23.4	4	10	33.4	N
21	1981	Mexico	-14.1	7	17	31.1	Y
22	1920	UK	-18.7	3	11	29.7	Y
23	2001	Argentina	-20.9	4	8	28.9	N
24	1980	Chile	-18.9	2	8	26.9	N
25	2002	Uruguay	-18.9	4	8	26.9	N
	<i>Average</i>		<i>-24.3</i>	<i>5</i>	<i>16</i>	<i>40.5</i>	

Lebanon financial crisis ranks at top among most severe crises episodes globally since 1900

Crisis Severity:
 % Decline in Per Capita GDP,
 Duration of Contraction +
 Years to Full Recovery in 25 of
 the Worst Systemic Banking
 Crises, 1857–2013
(Reinhart and Rogoff, 2014)

Lebanon's multiple crises, a result of incompetence, mal-governance, failed policies, endemic corruption and dysfunctional politics, have tipped Lebanon from being a fragile, failing state into a Failed State

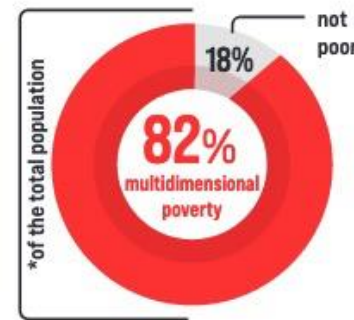
“Failed State: a country whose government is considered to have failed at some of its basic responsibilities, for example keeping the legal system working correctly, and providing public services (= electricity, water, education, hospitals, etc.)” (Cambridge dictionary)



Households experiencing multidimensional poverty and extreme multidimensional poverty

by governorate (number & share of the population)

In some Lebanese regions, extreme multidimensional poverty rates are high, approaching or exceeding 50% among households



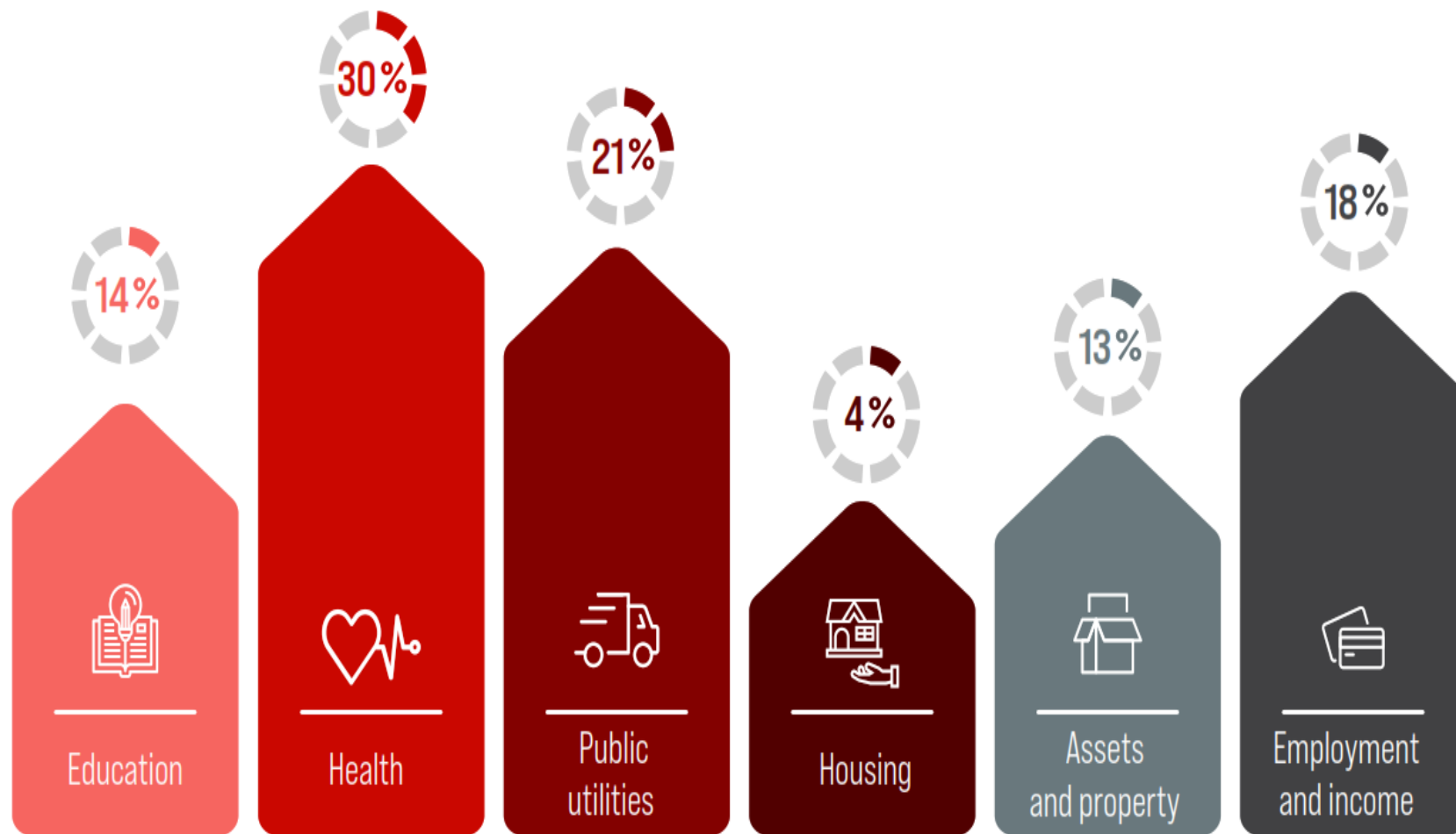
400,000	Households in extreme poverty
Beirut	25,000 (28.9%)
Mount Lebanon	133,000 (26.5%)
North Lebanon	50,000 (32.6%)
Akkar	40,000 (51.5%)
Bekaa	32,000 (43%)
Baalbek-Hermel	30,000 (49.3%)
South Lebanon	50,000 (35.3%)
Nabatieh	40,000 (46.7%)



73%	Beirut	63,000
75%	Mount Lebanon	382,000
85%	North Lebanon	137,000
92%	Akkar	76,000
91%	Bekaa	69,000
92%	Baalbek-Hermel	57,000
87%	South Lebanon	128,000
92%	Nabatieh	88,000

Figure 3 shows the contribution of each of the six dimensions to the overall value of the Index. In Lebanon, the contribution of the housing dimension, for example, is the lowest compared with other dimensions such as health.

Figure 3. Contribution of the six dimensions to the total value of the Multidimensional Poverty Index in Lebanon, 2021

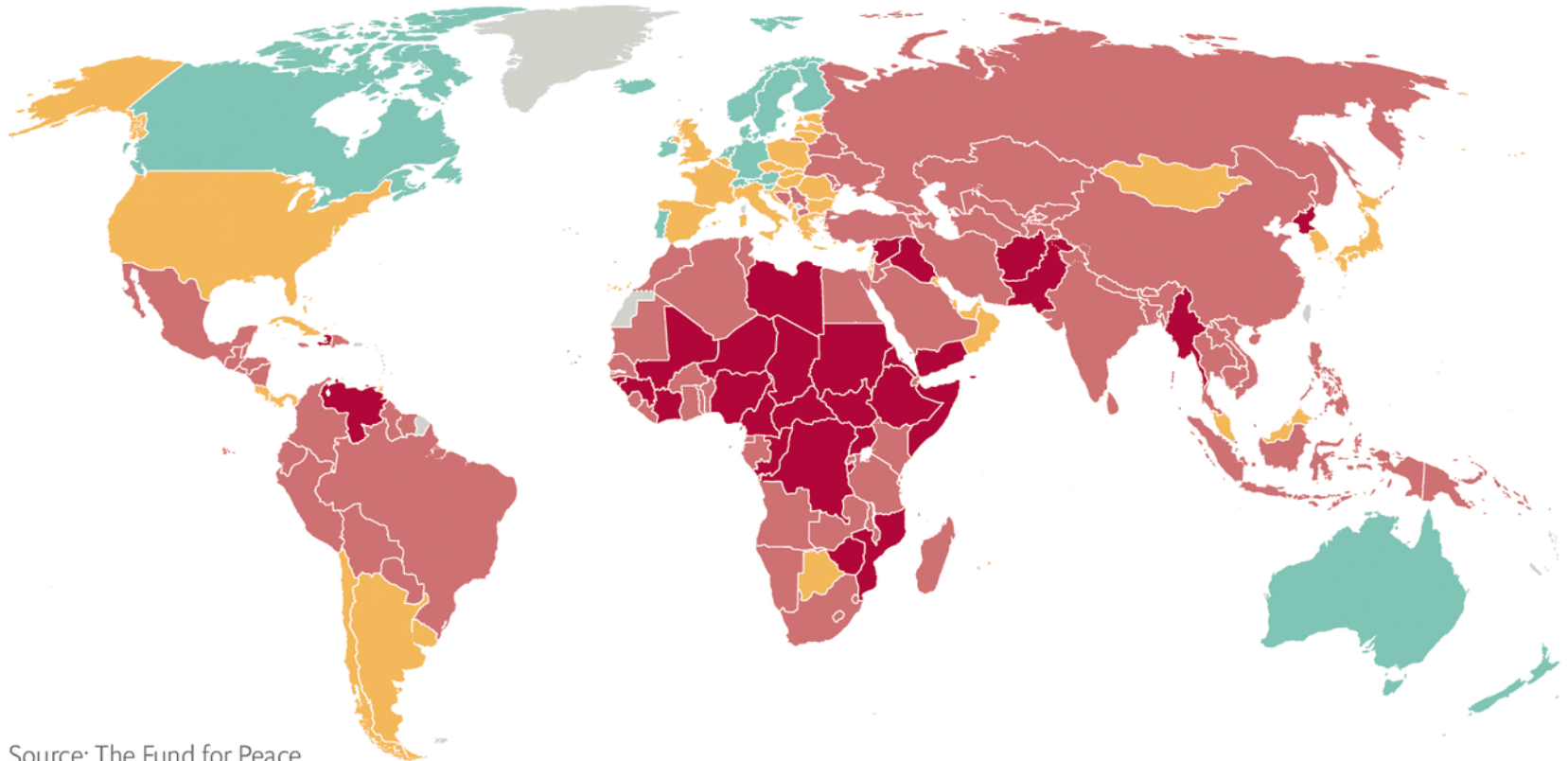
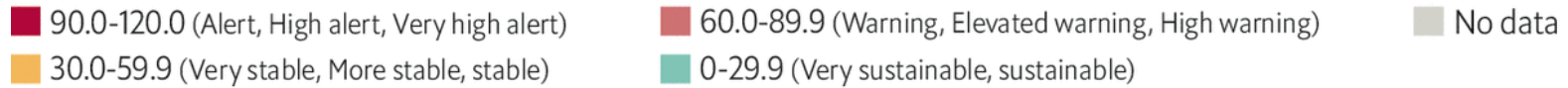


Source: ESCWA calculation.



Fragile states index 2021 illustrates Lebanon's rapid meltdown

Fragile States Index score 2021



Source: The Fund for Peace

The Economist

NS

Lebanon's Meltdown: Failed State or Reforms & Transformation?

- Macro-Fiscal-Monetary, Financial & Socio-Economic Developments
- Roots of Lebanon's meltdown
- **Reforms & Transformation**



Two scenarios: Reform, No Reform

Reforms	No Reforms = Failed State
Monetary policy	Hyperinflation & LBP depreciation
Deep Fiscal reforms	Cash economy
Exchange rate unification & flexible rates	Zombie banking system
Structural reforms (power, water, SoEs)	Long-term economic depression
Restructure banking sector	Migration & loss of human capital
Restructure BDL & its debt	Collapse of basic public utilities
Restructure public debt	Collapse of law & order
Social Protection	Collapse of social services
Anti-Corruption programme	Poverty & famine
Abolish banking secrecy	No external financing

Monetary & Exchange Rate Reforms

Gradual move to flexible rates and inflation targeting, with appropriate policy sequencing. Multiple rates create market distortions and incentivise more corruption.

Stop all BDL quasi-fiscal operations and public sector financing. Credible reform requires a strong & politically independent banking regulator & monetary policymaker.

Monetary reforms to include:

- *Currency reform: new currency to be issued (“New Lira”)*
- *New Money & Credit Code*
- *Abolish Banking Secrecy Law*
- *Unify exchange rates and move to Flexible ER regime & Inflation Targeting*
- *Independent Special Investigation Commission*
- *Accountability, transparency & disclosure: audited & published accounts; publish MoM of Central Council; report on policy to CoM and Parliament;*
- *Governance reforms: limit Governor & VG terms to 4 years, only once renewable; no cumulating of functions (CMA, SIC) etc.*
- *Independence of Banking Control Commission, including budget & funding*
- *Develop financial markets; independent CMA*
- *Establish an independent Special Banking & Financial Court*

Fiscal Reform, Public Sector Restructuring & Structural Reforms

- Address **tax evasion** and ‘underground economy’
- Institute a **Fiscal Rule**. Achieve a sizeable primary fiscal surplus to put public debt on downward & sustainable path
- **Structural reforms**: EdL, Telecom, State-Owned-Enterprises
- Establish a **National Wealth Fund** to manage all SOEs and GREs ...& future Oil & Gas revenues. Privatisation is not a viable option without reform and good governance of SOEs & GREs
- **Move to Digital Government**
- **Government procurement reform** (law passed; needs implementation)
- **Subsidies reform**: Smart, targeted cash subsidies / direct transfers to households
- **Pension system+ Social Protection Reform** (inc. Social Safety Net)
- **Review size of government**. Address ‘ghost workers’ problem
- Anti-Corruption program and **Stolen Asset Recovery Initiative** (StAR)
- Establish an **Independent public debt office**

Coda

-
- Lebanon is paying the price of **unsustainable, fixed exchange rate & fiscal and debt policies**
 - **Deep depression & financial meltdown were avoidable**
 - Lebanon's financial meltdown and deep depression result from **deliberate policies** by politicians, BDL, & government to impose real deflation through an **Inflation Tax & Lirafication**
 - Lebanon is experiencing the bursting of the **BDL's biggest Ponzi scheme and largest deposit haircut in history & resulting transfer of wealth**
 - Immediate reforms are required to avoid mounting losses and lost decade(s)
 - Lebanon's needs a **financial rescue package of about US\$75bn for stabilization & reconstruction**: *Banks \$20bn + Infrastructure \$15bn + Fiscal transition \$10bn + BDL restructuring \$10bn + BOP support \$5bn + Private sector financing \$15bn*
 - **IMF & international support is imperative but conditional on undertaking a comprehensive set of deep governance, economic, monetary, fiscal and structural reforms**



Bruno Catalano: "The Immigrants Void"

Lebanon's Meltdown: Failed State or Reforms & Transformation?

Dr. Nasser Saidi

nsaidi@nassersaidi.com

NASSER SAIDI

— & ASSOCIATES —