

Lebanon: Failed State or Transformation?

*International Forum on Lebanon Revival Plan
University of Balamand*

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Lebanon: Failed State or Transformation?

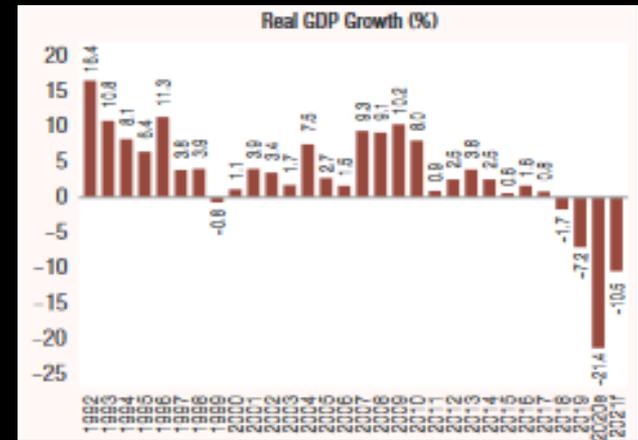
- **Macro-Fiscal-Monetary-Financial & Socio-Economic Developments**
- **Roots of Lebanon's meltdown**
- **Reforms & Transformation**

The Path to Economic Collapse I

- **GDP declined for the 4th consecutive year, a total fall by 58% since 2018**; most severe financial crisis in history in Chile (1926) where real GDP declined 46.6%
- **LBP has lost 85% of its value on the black market**
- **Inflation stood at 240% as of Jan 2022**, with food prices are up 483% => meltdown of salaries, wages
- **Unemployment: 50% of the population; Poverty 80% & Food poverty > 50% of population**; 82% of the population plunged into multi-dimensional poverty
- **Lirafication, Inflation & exchange rate depreciation are a tax on income (reducing real wages) and a massive 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)

Real GDP contracted by a 58% since 2018

(Source: Lebanon Economic Monitor Fall 2021, World Bank)



Average Salaries in Lebanon



Minimum Wage

Salary: LBP 675,000
 Equivalent in USD at LBP 1,500/USD: \$450
 Equivalent in USD at the prevailing rate of LBP 24,000 / USD 28 -> \$1.24 / day



A Lebanese University Professor

Salary: LBP 3.7 million
 Equivalent in USD at LBP 1,500/USD: \$2,466
 Equivalent in USD at the prevailing rate of LBP 24,000 / USD 156.3 -> \$7 / day



Soldier

Salary: LBP 1.30 million
 Equivalent in USD at LBP 1,500/USD: \$864
 Equivalent in USD at the prevailing rate of LBP 24,000 / USD 54.2 -> \$2.4 / day



Judge

Salary: LBP 4.5 million
 Equivalent in USD at LBP 1,500/USD: \$3,000
 Equivalent in USD at the prevailing rate of LBP 24,000 / USD 187.5 -> \$8 / day

The Path to Economic Collapse II

- **Two major external shocks:** Covid pandemic led to a supply shock & **Beirut Port explosion** led to massive losses (\$15bn) and aggravated loss of confidence in overall governance
- **Crisis in Syria had negative spillover effects on Lebanon**, with Caesar Act (Dec 2019) and resulting sanctions resulting in increased demand for forex (US\$) and massive smuggling from Lebanon due to subsidised fuel, medicines and other essentials.
- **Geopolitical tensions with the GCC** resulted lower trade, investment & remittances
- **Ongoing mass migration of Lebanon's human capital** (doctors, engineers, professionals..) threatens ability of Lebanon to recover in the future and its long-term growth prospects. **Long-term scarring effects.**
- **4 main pillars of LB economy are being destroyed:** trade & tourism, health, education, banking & finance

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's financial crisis ranks at top of most severe crisis episodes globally since 1857. Recovery can be long delayed

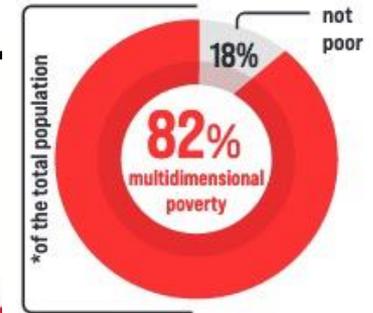
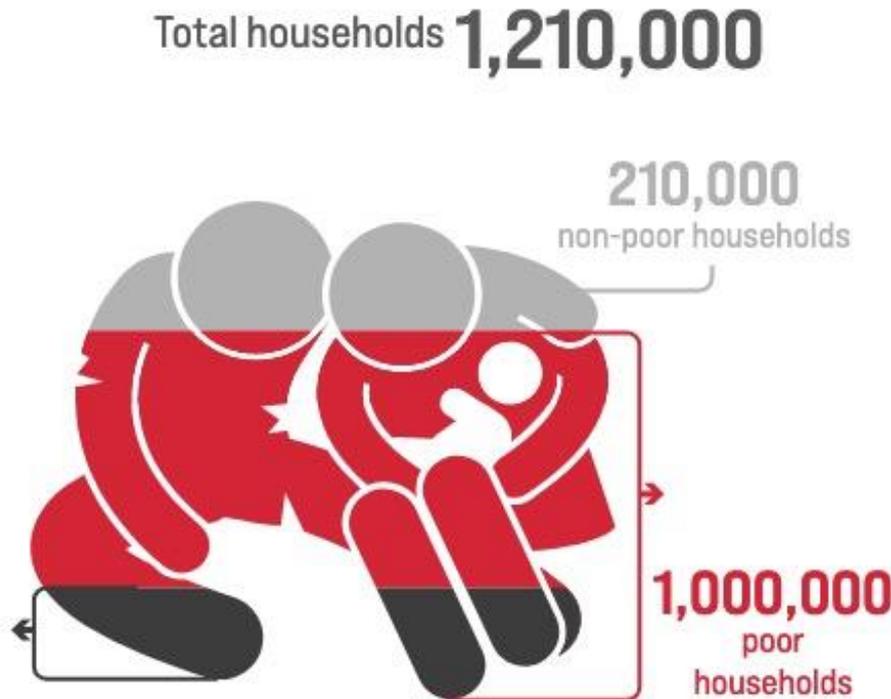
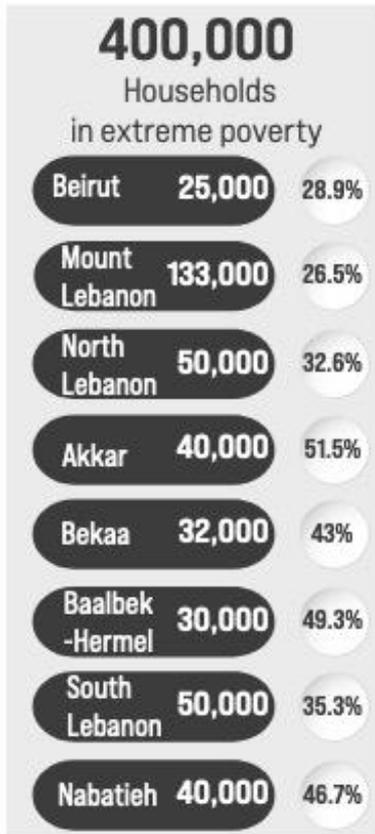
Crisis Severity:
 % Decline in Per Capita GDP,
 Duration of Contraction + Years to Full Recovery in 25 of the Worst Systemic Banking Crises, 1857–2013 (Reinhart and Rogoff, 2014)

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Households experiencing multidimensional poverty and extreme multidimensional poverty

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

Number & share of population by governorate





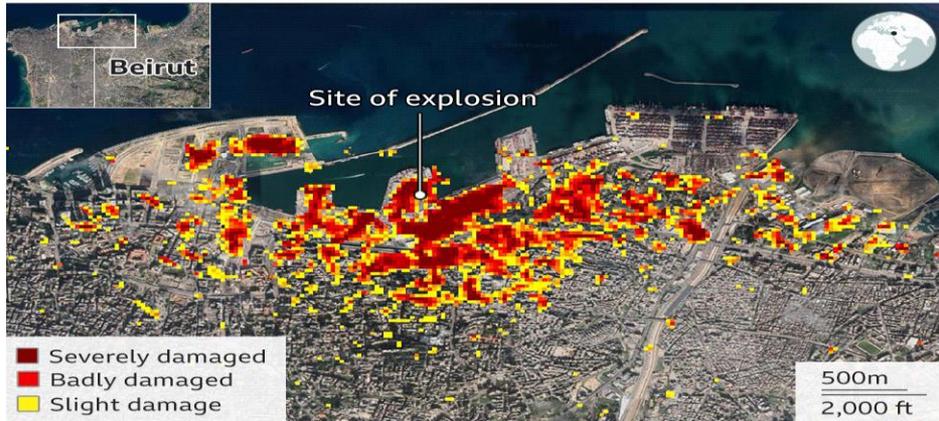
No Political or Economic Accountability for the Port of Beirut explosion, one of the largest non-nuclear blasts in history.

At least 220 dead, 7000+ injuries, 300,000 homeless, 70,000 lost jobs, \$15 bn + in losses



Beirut blast damage

Damage assessment carried out 7 Aug



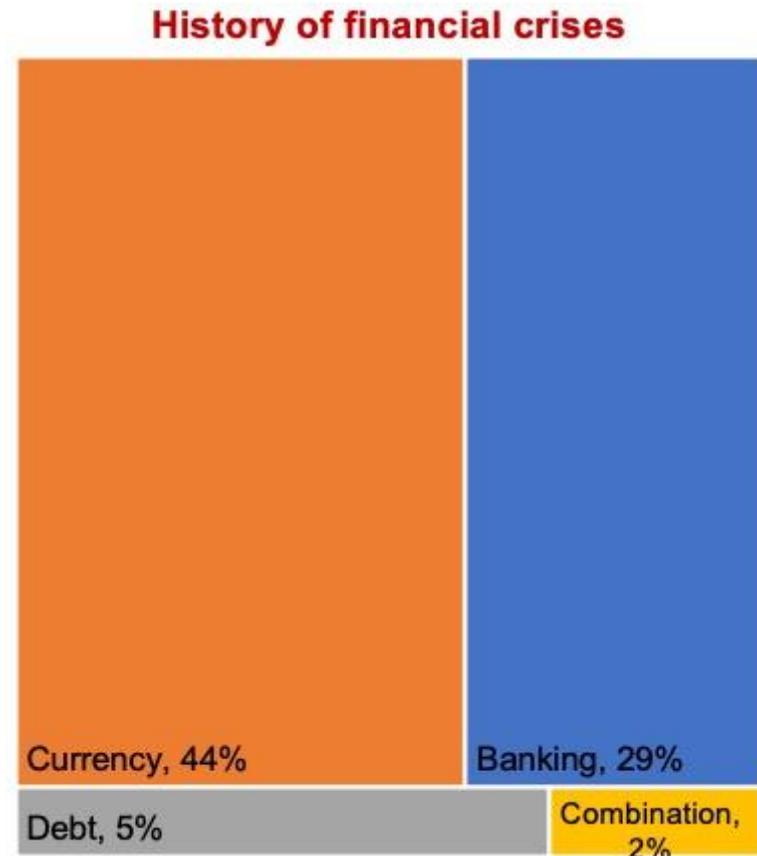
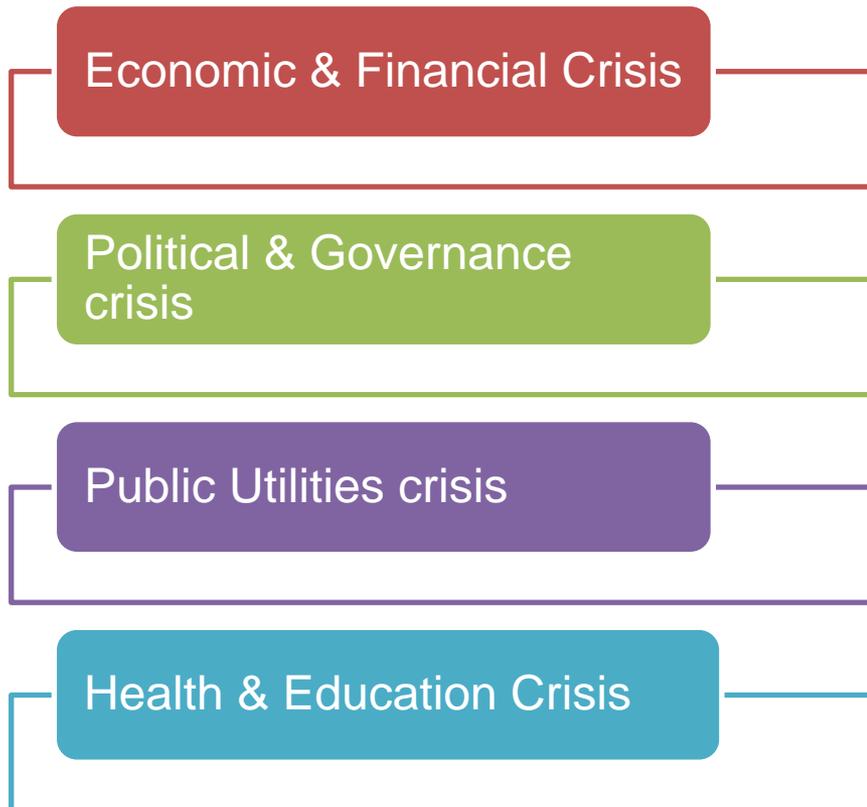
Source: ASA/JPL-Caltech/Earth Observatory of Singapore/ESA

BBC



Lebanon's multiple crises result from mal-governance, endemic corruption, incompetence, failed policies, dysfunctional politics & have tipped Lebanon from being a fragile 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)



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 support LBP compounded fiscal deficits and Gov't & BDL debt growth

Three interlinked balance sheets: a bankrupt gov't that cannot service its debt + banks (80% of assets in gov't & 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

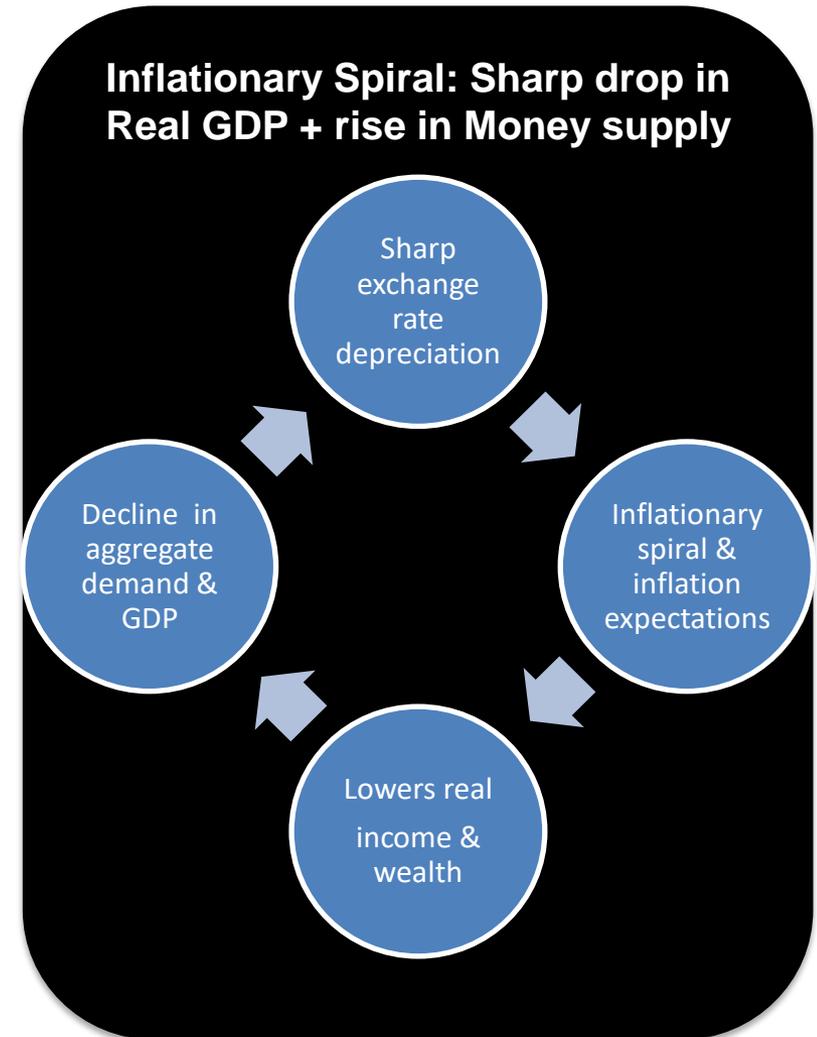
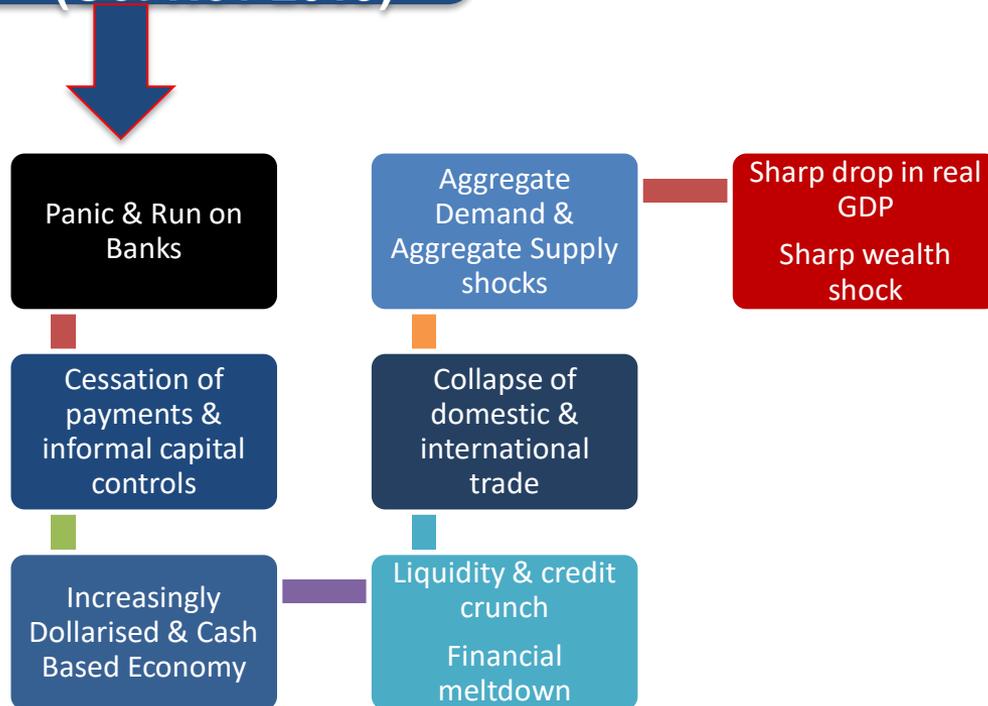
Functionally bankrupt &
increasingly illiquid
banking sector

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

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

Bank closures & the dynamics of inflation and exchange rate depreciation

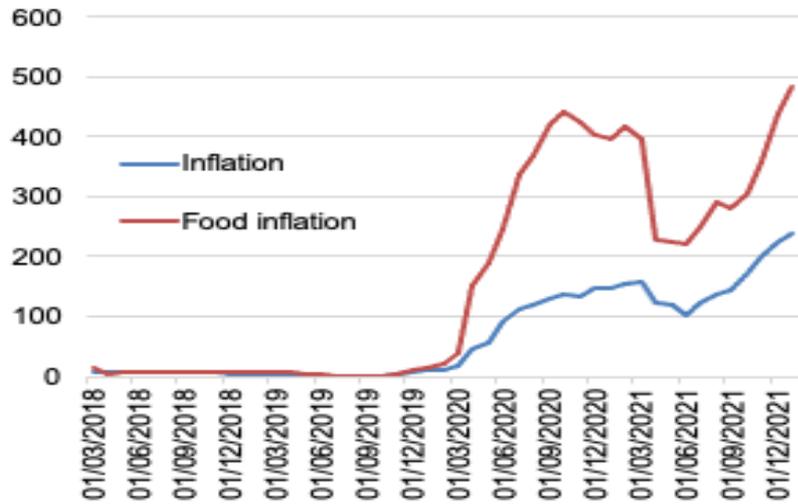
**Crisis Trigger:
Bank closures
(Oct-Nov 2019)**



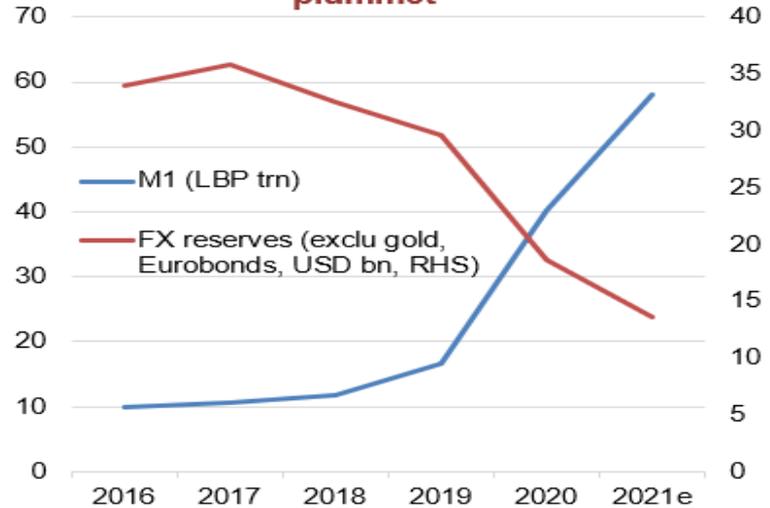
Multiple exchange rates create distortions in the market & encourage rent seeking; Monetary financing results in exchange rate collapse and near hyperinflation

Inflation, volatile monetary conditions & exchange rate

Food inflation stands at 483% yoy as of Jan 2022 (vs inflation at 240%)

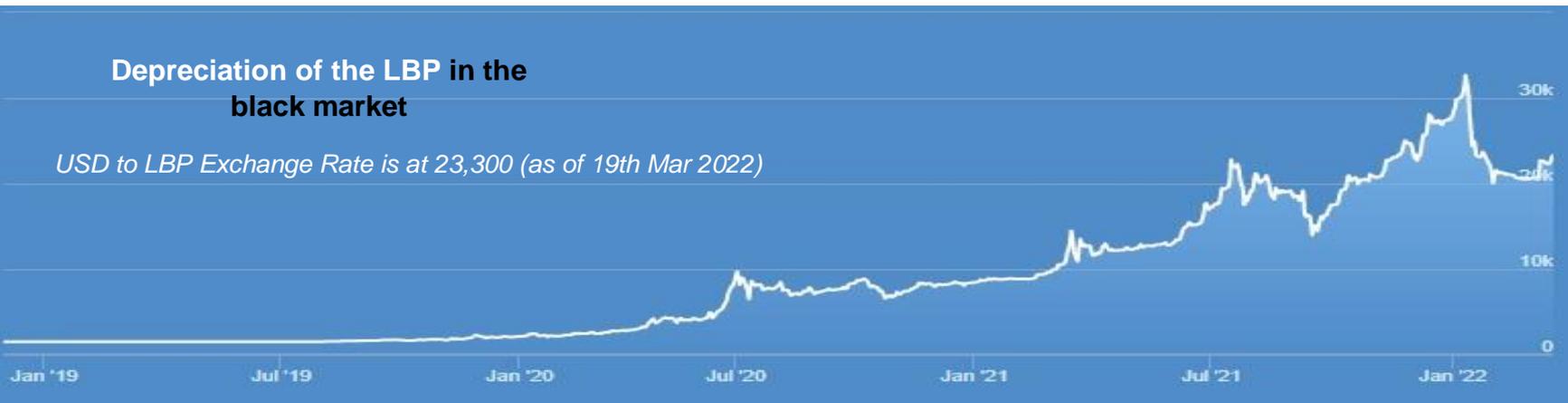


M1 explodes; international reserves plummet



Depreciation of the LBP in the black market

USD to LBP Exchange Rate is at 23,300 (as of 19th Mar 2022)



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

- 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. At the core are **BDL losses likely exceeding \$70 billion** due to supporting overvalued LBP through 'financial engineering'/bank bailout & high interest rates.
- **BDL created the biggest Ponzi scheme in history, greater than Madoff's**. BDL is responsible for the biggest transfer of wealth in history in favour of the rich, bankers and bank shareholders.
- 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, illegal, deposit haircut** -the biggest in financial history (greater than in Cyprus, Greece, Iceland, Argentina, Venezuela...)

Debt monetization & monetary financing of fiscal deficits is leading to higher inflation

Central government finance				
	2018	2019	2020	2021e
Total revenue (in % of GDP)	20.9	20.7	15.9	9.4
o/w Tax revenue (in % of GDP)	15.3	15.5	10.9	7.2
Total expenditures (in % of GDP)	32.2	31.6	20.5	10.7
Wages & pensions (% of spending)	38.2	42	53.1	53.2
Interest payments (% of spending)	30.4	31.7	14.8	13.1
Capital spending (% of spending)	5.2	4.0	2.1	3.0
Overall balance (in % of GDP)	-11.3	-10.9	-4.6	-1.3
Primary balance (in % of GDP)	-1.5	-0.9	-1.5	0.1

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 183% by end-2021 (2020: 179.1%)

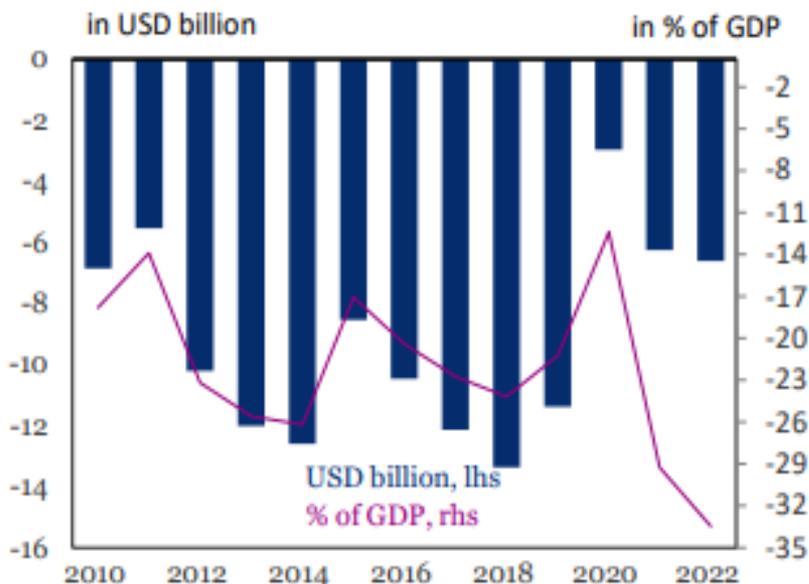
External Sector: LBP depreciation & de facto capital account controls = sharp contraction in imports & sudden stop in capital inflows

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.

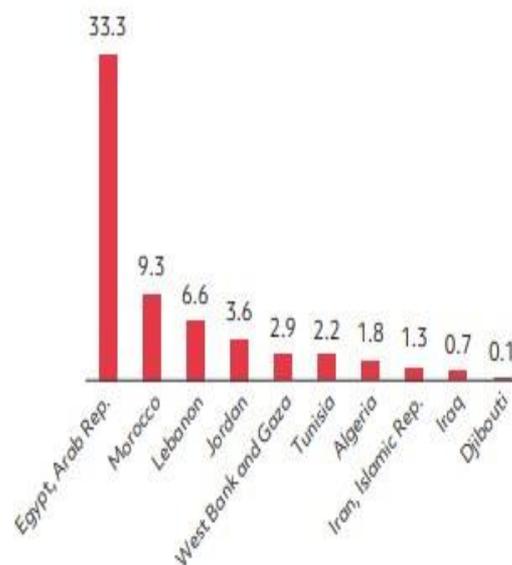
Lebanon continued to be among the top remittance recipients in MENA last year

Current Account deficit is estimated at **28.8% of GDP in 2021 (2020: 12.4%)**

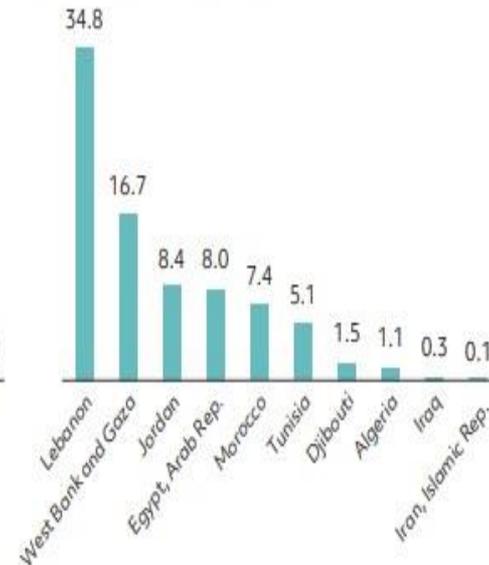
Top remittance recipients in MENA, 2021



(\$billion, 2021e)



(Percentage of GDP, 2021e)



Source: IIF, March 2022

Source: Migration & Development Brief 35, Nov 2021, World Bank. **NS**

Lebanon: Failed State or Transformation?



Two scenarios: Reform, No Reform

Holistic Macro-Fiscal-Financial-Structural Transformation is required as part of a comprehensive IMF/WB programme

Reforms

No Reforms = Failed State

New Monetary policy framework

Hyperinflation & LBP depreciation

Deep Fiscal reforms

Cash economy

Exchange rate unification & flexible rates

Zombie banking system

Structural reforms (SoEs, power, water)

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/Stolen Asset Recovery

Poverty & famine

Abolish banking secrecy

No external financing

Credible Monetary reform requires a New Monetary & Credit Code with a strong & politically independent BDL, BCC, SIC & CMA

<i>Monetary Policy: Target Inflation. Move to flexible exchange rate regime</i>	<i>Stop all BDL quasi-fiscal operations and public sector financing</i>
<i>Restructure BDL: forensic audit & governance; restructure BDL debt.</i>	<i>Governance reforms: limit Governor & VG terms to 4 years, only once renewable; no cumulating of functions (CMA, SIC) etc.</i>
<i>Restructure banking sector: recapitalisation + bail in => Independent Bank Resolution Authority</i>	<i>Establish an independent Special Banking & Financial Court</i>
<i>Abolish Banking Secrecy Law: anti-corruption + higher tax revenues</i>	<i>Develop financial markets; independent CMA</i>
<i>Enact Capital Control Law applicable to all transactions</i>	<i>Money & Credit Code Reform</i>
<i>Currency reform: new currency to be issued ("New Lira")</i>	<i>Accountability, transparency & disclosure: audited, published accounts; publish MoM of Central Council; report on policy to CoM & Parliament;</i>
<i>Unify exchange rates Multiple rates create market distortions and incentivise more corruption.</i>	<i>Independent Special Investigation Commission</i>
<i>Consumer Protection Law</i>	<i>Independent Banking Control Commission</i>

Fiscal Reform, Public Sector Restructuring & Structural Reforms

- **Institute a Fiscal Rule**, a permanent constraint on fiscal policy through numerical limits on budgetary aggregates. A Budget Balance or Debt Rule.
- Address **tax evasion** and ‘underground economy’
- **Review size of government. Address ‘ghost workers’** problem
- **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)
- **Structural reforms**: EdL, Telecom, State-Owned-Enterprises
- Establish a **National Wealth Fund** to manage all SOEs and GREs and future Oil & Gas revenues. **Privatisation is not a viable option** absent reform and good governance of SOEs & GREs

A Three-Part Banking & Financial Restructuring Plan for Lebanon

1. BDL to be converted into a special statute joint-stock company governed by the provisions of a **New Money & Credit Act**. Its shares are registered, listed and publicly traded. BDL would be majority owned by the State (55%), Depositors and Banks, like the Swiss National Bank.

2. **Bank Resolution Authority**: banks restructured (liquidations, M&A) & recapitalised by existing & new shareholders along with a bail-in of Depositors as shareholders

3. SOEs & GREs transferred into a **National Wealth Fund** majority owned by the State, with depositors becoming shareholders

Plan ensures contribution of State/BDL, bank shareholders & depositors

Coda: Transformation or Failed State

- Lebanon is paying the price of **unsustainable, fixed exchange rate, fiscal and debt policies**
- Lebanon's financial meltdown and deep depression result from **deliberate policies** by politicians, BDL, & government to impose real deflation through an **Inflation Tax & Lirafication. Deep depression & financial meltdown were avoidable.**
- Lebanon is experiencing the bursting of the **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**
- **IMF & international support is imperative but conditional on undertaking a comprehensive set of deep governance, economic, monetary, fiscal and structural reforms.**
- **Lebanon will not recover if there is no political reform to address corruption, institute rule of law, justice & accountability and undertake deep reforms.**



Bruno Catalano: "The Immigrants Void"