

Lebanon: Failed State or Transformation?

LIFE presentation

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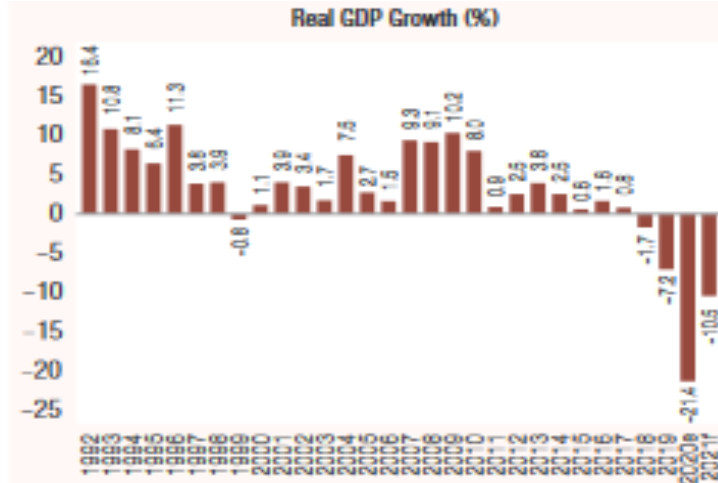
Lebanon: Failed State or Transformation?

- **Lebanon's Path to Economic Collapse**
- **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) real GDP declined 46.6%]
- **LBP has lost 85% of its value on the black market**
- **Inflation stood at 206% as of April 2022**, with food inflation at 375% => 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
- **Inflation & exchange rate depreciation act as 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

Profession	Salary (LBP)	Equivalent in USD at LBP 1,500/USD	Equivalent in USD at the prevailing rate of LBP 24,000 / USD 156.3
Minimum Wage	LBP 675,000	\$450	\$1.24 / day
A Lebanese University Professor	LBP 3.7 million	\$2,466	\$7 / day
Soldier	LBP 1.30 million	\$864	\$2.4 / day
Judge	LBP 4.5 million	\$3,000	\$8 / day

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 the top of most severe crisis episodes globally since 1857

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)

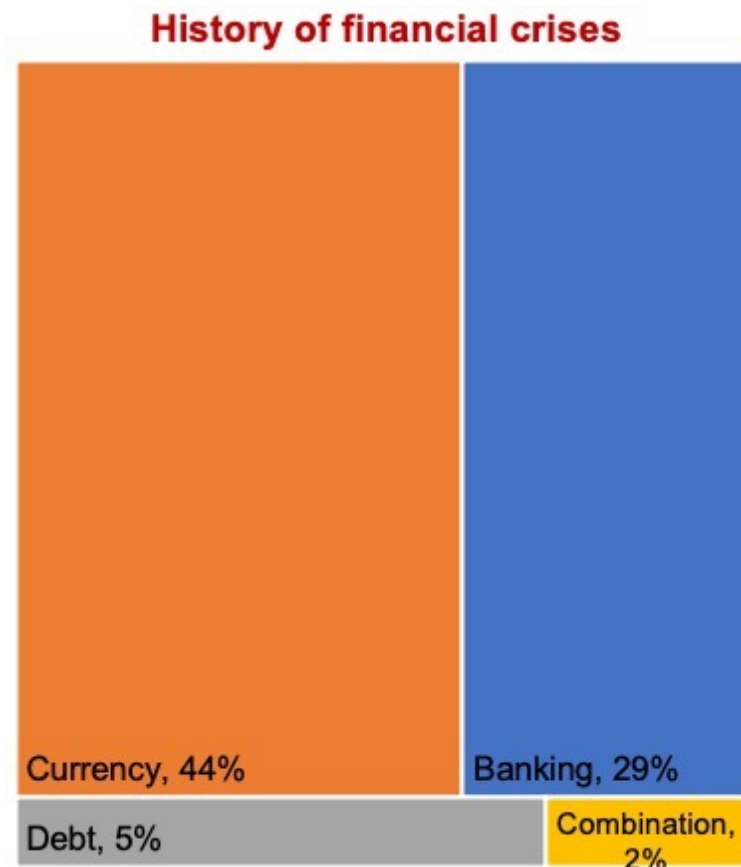
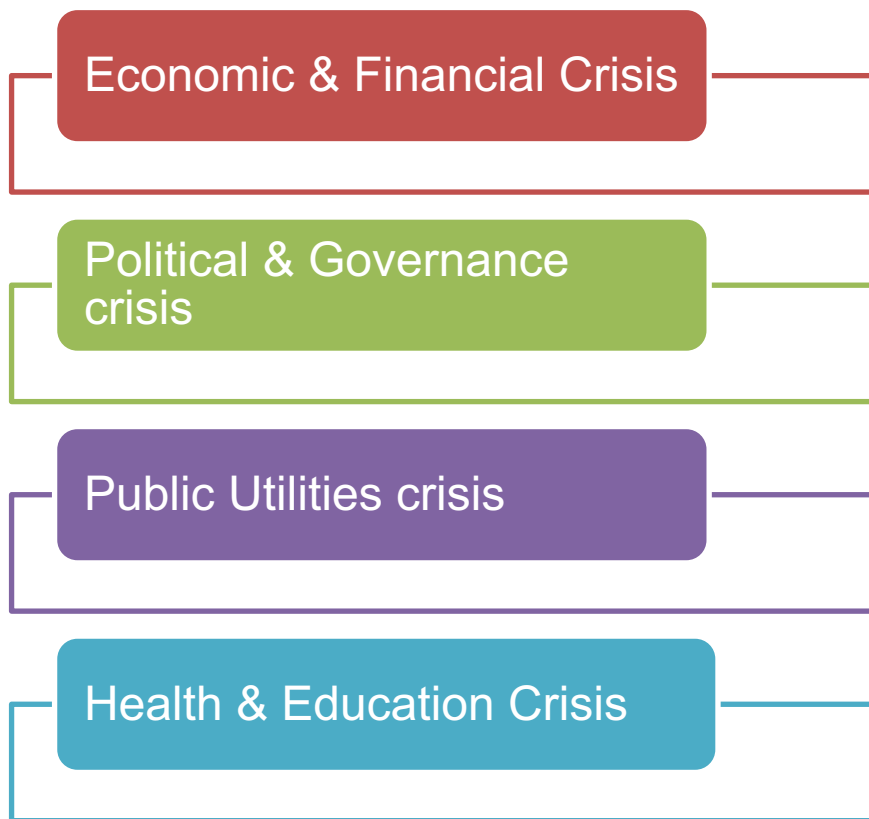
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The Path to Economic Collapse II

- **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
- **Geopolitical tensions with the GCC** resulted in lower trade, direct and portfolio 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

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

Three interlinked balance sheets: a bankrupt gov't that cannot service its debt + banks (75% of assets in gov't & central bank debt) + BDL (borrowing from banks to defend an overvalued currency and to finance gov't).

High Public Debt levels
& Budget Deficits
Large Current Account
Deficits

Functionally bankrupt &
illiquid
banking sector

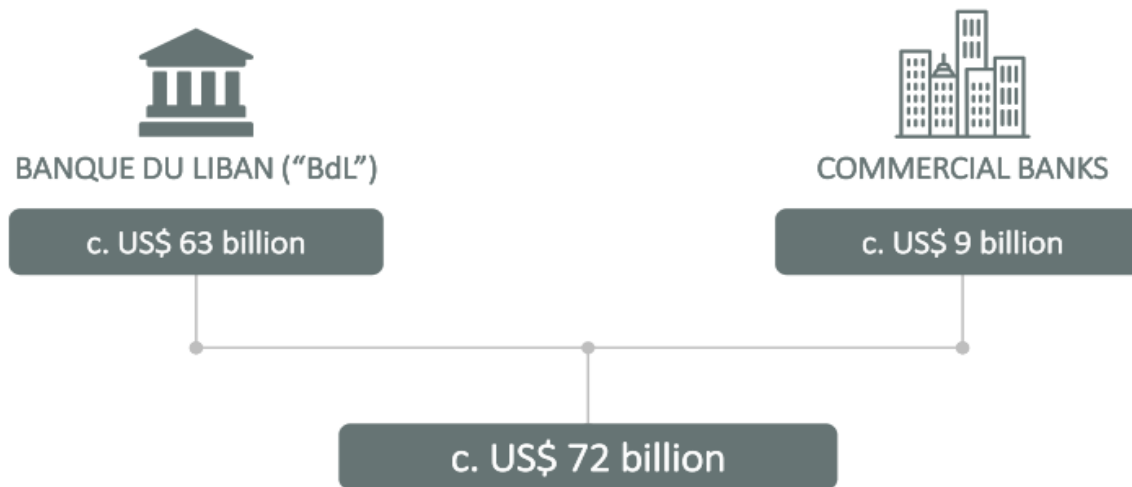
Real economy
experienced no growth
for an entire decade =>
socio-political
implications

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

Bulk of Financial Sector Losses Lie in the BDL: needs radical restructuring

Losses in the Lebanese financial sector have reached c. US\$72 billion

Estimated losses resulting from the devaluation, the expected sovereign debt restructuring and the restatement of selected BdL and banking sector assets



Lebanon's intertwined and oversized financial sector – faced with massive losses resulting mainly from years of financial engineering operations aimed at defending the peg – needs to be recapitalized.

Source(s): Lebanese authorities
Note(s): BdL data as of 31 December 2021; Commercial banks consolidated data as of 31 October 2021

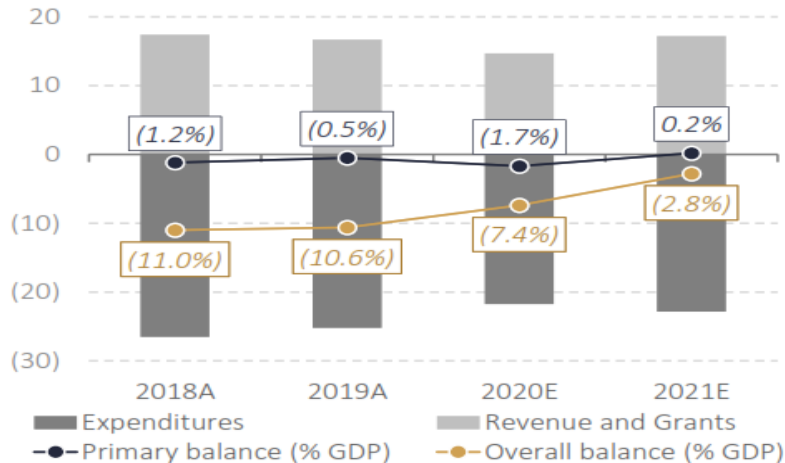
Multiple crises since 2019 are not due to natural causes, war or external intervention: deliberate policy choices

- The Diab government plan of **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 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 by **BDL & banks refusing to recognize losses on B/S & need to restructure**. At the core are **BDL losses likely exceeding \$63 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...) **NS**

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

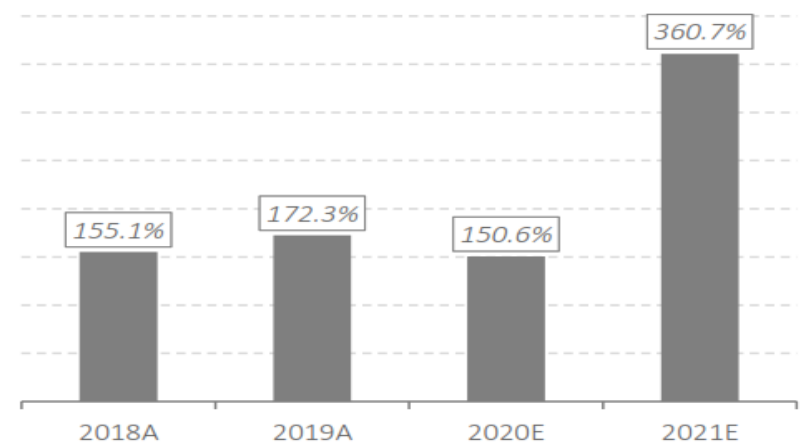
1 Primary and overall budget balance

in LBP trillion



2 Lebanon outstanding central government debt¹

As of 31 December 2021



High inflation rates drive a sharp fiscal adjustment, reduction in real value of debt & budget expenditures in real terms

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

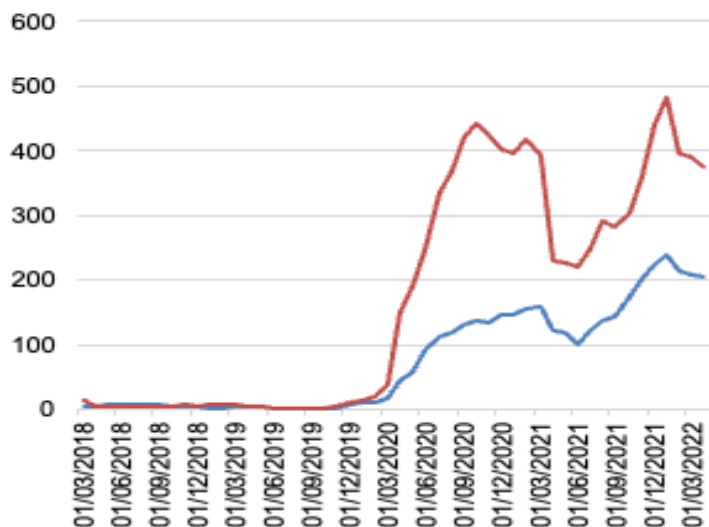
Nominal expenditures fall largely because of reduction in interest payments

Debt-to-GDP is estimated to have reached 360% by end-2021 (2020: 151%)

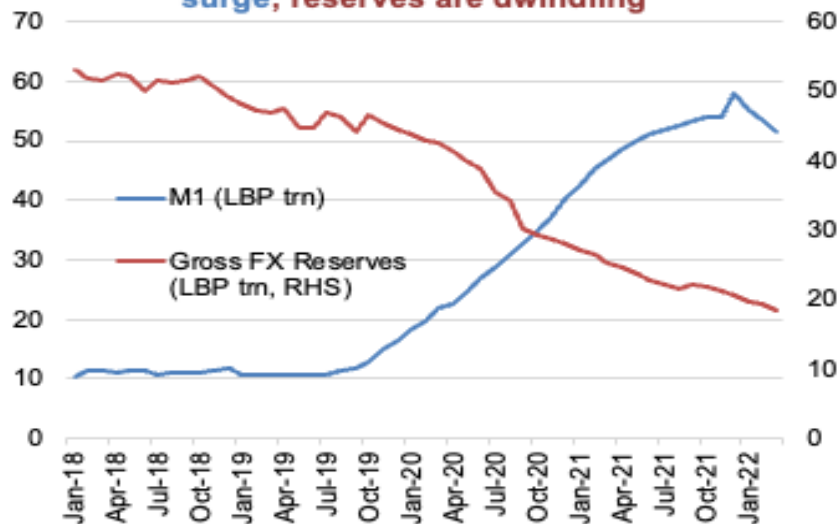
Multiple exchange rates create distortions in the market, encourage smuggling & rent seeking; Exchange rate depreciation results in surging inflation

Inflation, volatile monetary conditions & exchange rate

Food inflation stands at 374% yoy as of Apr 2022 (vs inflation at 206%)



Currency in circulation eases after 2020 surge; reserves are dwindling



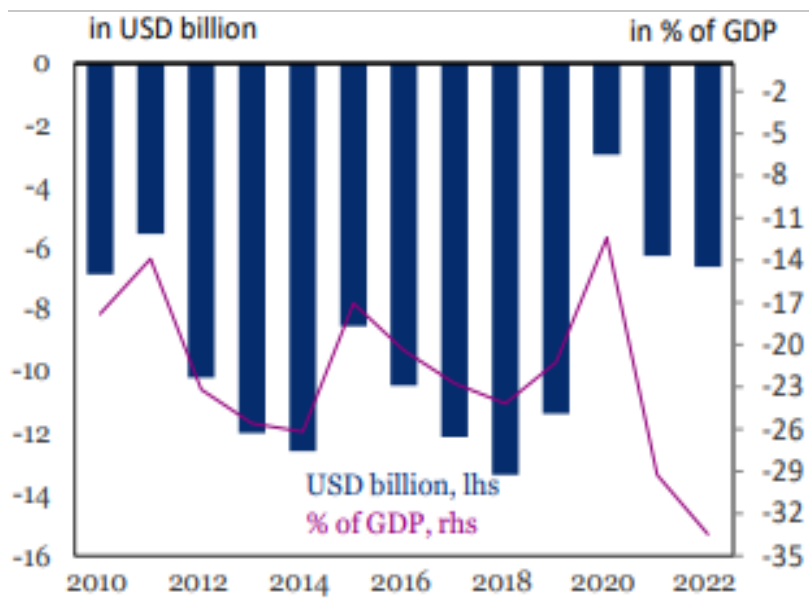
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External Sector: LBP depreciation & de facto capital account controls = sharp contraction in imports & sudden stop in capital inflows

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 continues to be among the top remittance recipients in MENA

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

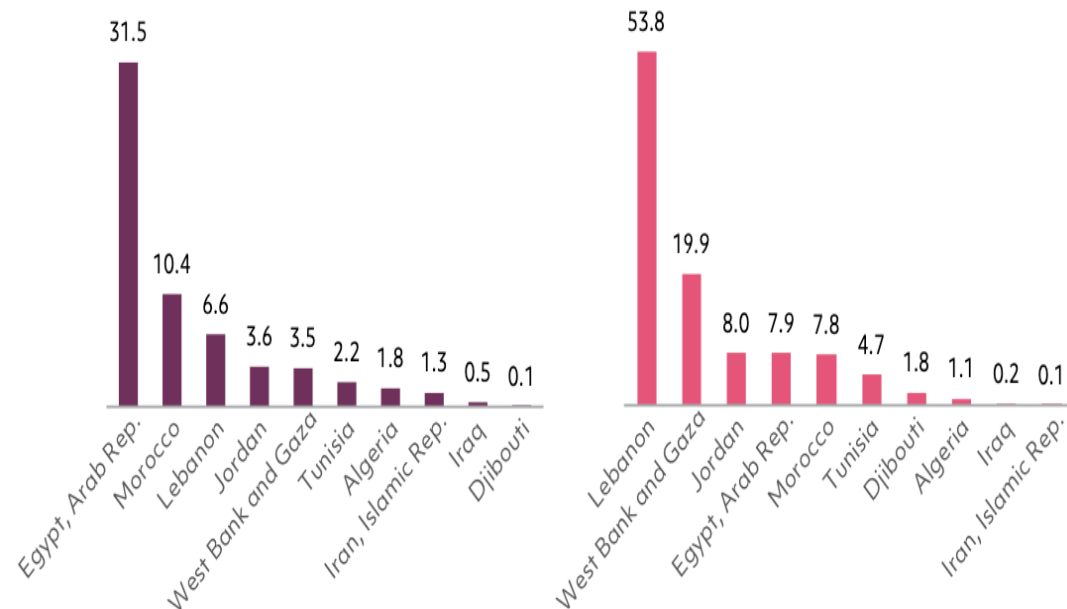


Source: IIF, March 2022

Top remittance recipients in MENA, 2021

(\$ billion, 2021)

(Percentage of GDP, 2021)



Source: Migration & Development Brief 36, May 2022, World Bank.

Pillars of the government's contemplated economic reform program (May 2022)



Lebanese
authorities



International
Monetary Fund



International
partners



Prior actions required for IMF Executive Board approval of an Extended Fund Facility are all Pending

Actions	Responsibility
Cabinet approval of a bank restructuring strategy	Government
Parliament approval of an appropriate emergency bank resolution legislation	Parliament
Initiation of a bank-by-bank assessment of the banking sector by reputable international firms	BCCL/ BdL
Parliament approval of a reformed bank secrecy law	Parliament
Completion of the audit of the BdL's foreign asset position, based on TOR approved by the IMF	BdL
Cabinet approval of a medium-term fiscal and debt restructuring strategy	Government
Parliament approval of the 2022 budget	Parliament
Unification of exchange rates for authorized transactions	BdL/ Government
Parliament approval of a capital control and deposit withdrawal legislation	Parliament

Financial sector

Fiscal & debt

Monetary

Two scenarios: Reform, No Reform

Holistic Macro-Fiscal-Financial-Structural Transformation is required as part of an IMF programme

Reforms	No Reforms = Failed State
New Monetary policy framework	Hyperinflation & LBP depreciation
Deep Fiscal/Public sector reform	Cash economy
Exchange rate unification & flexible rates	Zombie banking system
Structural reforms (SoEs, power, water, telecom)	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

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 public sector. 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

Credible Monetary reform requires a strong & politically independent BDL, Special Investigation Committee, BCC & Capital Market Authority

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

A Three-Part Banking & Financial Restructuring Plan for Lebanon

BDL is converted into a special statute joint-stock company governed by the provisions of a New Money & Credit Act. Its shares are registered & listed on the Beirut Stock Exchange and part owned by the State (55%) and public, like the Swiss National Bank.

Bank Resolution Authority: banks restructured (liquidations, M&A) & recapitalised by existing & new shareholders and a bail-in of depositors

SOEs, GREs, public commercial assets (including land and future Oil & Gas revenues) transferred into an independent, professionally managed National Wealth Fund (e.g Temasek). Bonds could be issued to compensate depositors.

Reforms? Political landscape remains polarized & fragmented despite recent elections

	2022	2018	2009		
Groupings	Seats	Seats	Seats	Difference 22-18 (+/-)	Difference 22-09 (+/-)
March 8 alliance	58	70	58	-12	0
Hezbollah & affiliates	13	14	13	-1	0
Amal & affiliates	15	17	13	-2	2
Free Patriotic Movement (FPM) & affiliates	17	24	20	-7	-3
Tachnag	3	3	2	0	1
Marada	2	3	3	-1	-1
Candidates or parties linked to March 8 alliance	8	9	7	-1	1
March 14 alliance	33	42	58	-9	-25
Future Movement (FM) & affiliates	8	19	32	-11	-24
Lebanese Forces (LF) & affiliates	19	16	8	3	11
Kataeb	4	3	5	1	-1
Candidates or parties linked to March 14 alliance	2	4	13	-2	-11
Centrists	8	9	11	-1	-3
Progressive Socialist Party (PSP) & affiliates	8	9	11	-1	-3
Civil society and independents	29	7	1	22	28
Civil society groups	13	1	0	12	13
Independents	16	6	1	10	15
Memo					
Turnout (%)	49	49	55	-8	-14
Total number of Members of Parliament (MPs)	128	128	128	-	-
Parliamentary majority	65	65	65	-	-
Potential opposition alliance (traditional opposition, civil, society, all independents.)	35	14	19	21	16
Potential opposition alliance + Lebanese Forces (LF) & affiliates	54	30	27	24	27
Maximum anti-Hezbollah alliance	70	58	70	12	0

Source: L'Orient-Le Jour, Wikipedia, National Democratic Institute, BofA Global Research. The potential opposition alliance arithmetic in the table assumes for simplicity all independents join the alliance. However, a number of independents

BofA GLOBAL RESEARCH

Expect delays in formation of a Cabinet & election of a President => risk of institutional vacuum with no or partial reforms and delay in IMF agreement and its implementation

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Coda: Failed State or Transformation?

- Lebanon is paying the price of **unsustainable, fixed exchange rate, fiscal and debt policies and underlying corruption, mal-governance & no accountability**
- 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**
- **Transformation is required** to avoid a failed state and lost decade(s)
- Lebanon's needs a **financial package of about US\$85bn for stabilization & reconstruction**: *Banks \$20bn + Infrastructure \$15bn + Fiscal transition \$10bn + BDL restructuring \$20bn + 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.**
- **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"