FDL Finance for Development Lab

LEBANON AT RISK

The uncertain road from a debt overhang to a new growth path

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Policy Brief

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Main findings

- The deep reason behind the Lebanese financial crisis is a currency peg maintained for too long. The collapse of the old model of living on the capital account is a rare occasion to rebuild the economy on a firmer more productive and sustainable footing.
- The depth and length of the current crisis is due to the unwillingness of the political elites to distribute losses and clean up the financial system. With no access to loans, firms have been unable to shift production to export. Capital flight has exacerbated the crisis.
- Besides the ongoing financial crisis, the social crisis, and the crisis of the state are equally damaging and require attention. This creates difficult financial trade-offs. But each of these crises can block a recovery if left unattended.
- A big push is the best way to exit the three crises simultaneously. This requires a convincing national program with broad national support and large external funding – a politically challenging task in current circumstances.
- In the meanwhile, a more balanced donor strategy is needed, included an effort to protect basic services, to keep the possibility of a revival of the Lebanese economy alive.

A deep triple crisis

Lebanon's economy, mined with structural faults for decades, has been collapsing since 2019. GDP per capita has seen a significant decline from around $11,000 in 2018 to less than $4,000 in 2022 – one of the harsher economic adjustments ever experienced in a country not at war. By early 2023, the country was mired in: a debt crisis, with debt to GDP exceeding 180%; a banking crisis with depositors unable to access their funds; and a balance of payment crisis with the national currency depreciating by 98%. The pillars of the economy - tourism, education, healthcare - have experienced massive business closures and brain-drain.

Three successive governments have done little to stabilize the situation. The descent continues, now at a slower pace. Even if the economy stabilizes, the current path remains catastrophic for the future. The middle class is disappearing, corporate, human, and financial capital are evaporating, and infrastructure is decaying. The country is at risk of being stuck in a deep poverty trap, despite its rich potential.

In our recent paper, we attempt to advance the policy debate in Lebanon in several directions, with important implications for national and external actors on how to restore stability and initiate a recovery. By focusing on how to maximize the size of the economic pie, we hope that "politics" could become more cooperative for the interest of all. First, because Lebanon's economic problems are complex and not well understood - a necessary condition for solving them is to understand them better. Second, now that it has become clear how costly non-cooperative behavior can be, it becomes even more necessary to advocate cooperative solutions - even as one recognizes that they are difficult to arise in the current fragmented political environment. And finally, to clarify that economic progress is possible, and by so doing, encourage activists to put pressure for a change in the political system itself.

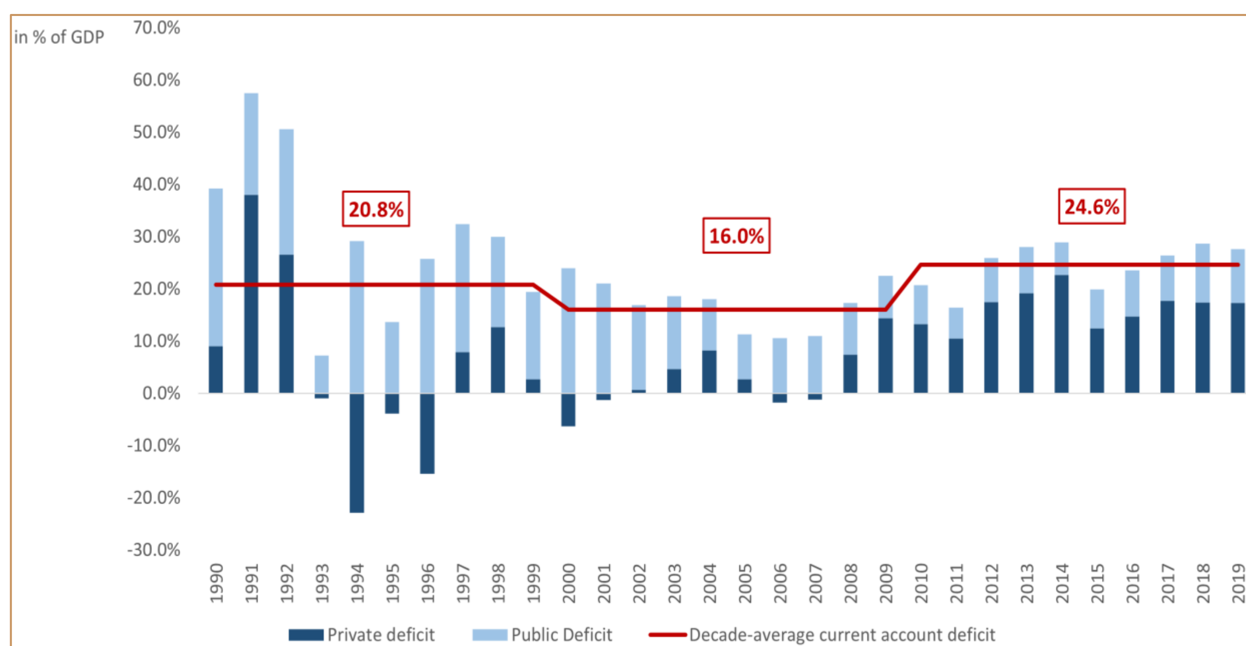
Causes of the crisis

While there are many narratives about the cause of the crisis, to us, the most convincing one is the least understood. In our analysis, the root cause for the current crisis lies in the rising over-valuation of the

national currency, propped up by a costly defense of a peg for far too long. The post-civil war economic model overstayed its usefulness by two decades, because of a lack of decisive policy-making. An early devaluation would have encouraged investment and deflated government debt – allowing for a more productive use of foreign capital inflows, and an early search for a more sustainable growth path, based on productivity and export, rather than on over-consumption and unsustainable credit.

Figure 1 shows the evolution of the current account and the public deficit over time. Enough financing came in to finance a current account deficit that *averaged* more than 20% GDP over three decades – this must be a global record. Until around 2007, the fiscal deficit absorbed most of the inflows, but after 2000, the fiscal deficit was reduced, and capital flows started financing mainly a private deficit. It should be also noted that the debt service was mainly remitted to the domestic private sector, boosting its expenditures even more. For example, in 2018, the current account deficit stood at 25.5% GDP, and it was divided about equally between a public sector deficit (11.1% GDP) and a private sector deficit (14.3% GDP). The private sector deficit itself is made of the difference between a modest investment rate (20.4%), and a dismally low private saving rate, at 6.1% GDP. This term also includes imports destined to Syria but not included in re-export data – a recurring problem in Lebanese statistics given a long and porous border.

Figure 1. Internal and external deficits

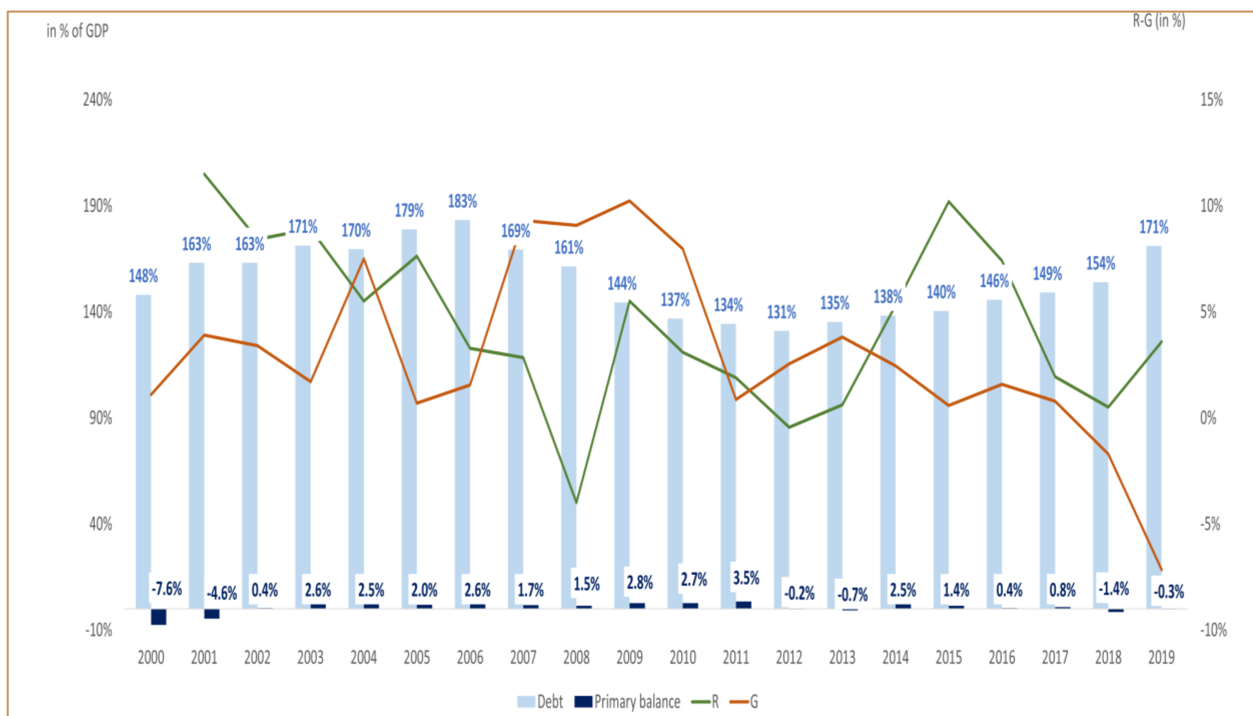


Sources: World Bank. The annual current account deficit is the sum of the public and private deficits. The red lines represent decadal averages of the current account deficits.

Since public debt still is an essential part of the problem, and so it is useful to understand its dynamics. Public debt has been "too high" in Lebanon since the early 2000s, a result of the big infrastructure push of Rafik Hariri. By the time of his assassination in 2005, public debt to GDP stood at 200%. The political bet done in 1993 was to fuel a recovery through a reconstruction program financed by debt, gaging on a regional peace that would bring to Lebanon a generous peace dividend. The bet was lost when the peace process died by the mid-1990s. From that point on, the economic strategy has remained on auto-drive.

The following five years saw rapid GDP growth rates. Tight budgets and rising fiscal revenues led to several years with primary surpluses -- even though fiscal expenditures were badly allocated, focused on the payment of interest on debt, overstaffing of civil servants, and a large subsidy to the power sector, at the expense of public investment in human capital and infrastructure. Primary surpluses and high growth rates led to declines in the debt ratio, which fell to a low of 130% GDP in 2012 – still a dangerously high level by international standards. Figure 2 illustrates the dynamics of the public debt ratio. After 2011, the continuous rise of the debt ratio, reaching 170% GDP in 2018, was entirely driven by a combination of high interest rates and low GDP growth. This occurred even as the primary deficit had a (small) surplus in the 2010s (+1% GDP on average). The overall deficit kept growing – the debt ratio grew because of its rising refinancing cost, and the low GDP growth.

Figure 2. Public debt dynamics



Sources: World Bank and WEO. Red line: GDP growth rate, Green line: average interest rate on public debt. Light blue bars: public debt to GDP; deep blue bar: primary deficit to GDP. The LHS measures the debt and deficit to GDP ratio, the RHS axis measures percent change for R and G.

The implication is simple, even if it is still hard to accept by a polity and population deeply traumatized by the economic implosion: now that the bubble has been plucked, it is time high to accept reality and start the difficult task of rebuilding the country – better late than never! While the destruction of the old rent-based economy is painful, it also represents a historical opportunity to reconstruct the economy on firmer grounds.

Why is the crisis so deep?

The second main conclusion of the paper is about the causes that explain how deep the current crisis is. Rarely has GDP fallen by as much – between 40 and 60% - during peace times. The main reason for this is to be found in the complete closure of the financial system. Cut-off completely from credit, firms were unable to shift their production from the collapsing domestic demand to export markets – in spite of a massive devaluation that had improved their competitivity. In fact, exports were cut in half after 2019!

The central reason why policymakers were unable - or unwilling - to clean up the banking sector rapidly is the huge size of the losses that need to be distributed. To see this, it is useful to look at the balance sheet of "Lebanon-Inc" - a consolidate picture of the balance sheets of the central bank, the state, and the banking system (Table 1). To make it simple, only dollar denominated assets and liabilities are record3ed here since hyperinflation has debased all LBP denominated instruments.. On the asset side, there is gold and the FX reserves held by the BdL, the banks (remaining) private sector loan portfolio, and their holding of FX, and public debt. Here we assume that state det is reduced to $20b – we do not assume that other national assets are pledged to bail-out the financials sector. On the liability side, there are the deposits in the banking system, and the government's external debt (which we estimate is settled at a discount of 80%). Netting out the balance, we reach an estimate for total loss of around -$50b - this represents about 2.5 times current GDP! The table assumes that all the equity of banks (on paper, this represents around $22b) is wiped out. In this conservative scenario, deposits would need to receive a haircut of a bit less than 50%, on average (i.e possibly less for small deposits and more for large deposits, as is usually done for motives of social fairness).

Table 1. Balance sheet of Lebanon Inc – end 2022

Assets		Liabilities	
BdL: FX Reserves	10	Government Eurobond outside country	4
BDL: Gold	15	FX deposits in banks and other liabilities	111
Banks: Private sector loans	10	Total liabilities	115
Banks FX	10	**LEBANON INC. EQUITY**	**-50**
Public debt	20		
Total assets	*65*		

Source: Authors computation based on CB figures

How to attribute guilt? The accumulated financial losses at the end relate not just to the public debt overhang, but also to the central bank defense of the peg. Exchange rate policy in Lebanon is the responsibility of the government. But the central bank should have stopped the bleeding earlier - by refusing to defend the peg when its own reserves run-out, and before it had to start using depositors' money to do so. The BdL pushed banks to place most of their FX liquidity with it by offering abnormally high interest rates, while it only earned low rates on reserves abroad. It built a large currency mismatch by defending the peg when capital flows where insufficient to finance the current account, and by lending to the state (in LBP). The latest Mikati plan estimates BdL losses at $60b, with nearly $50b in FX losses.

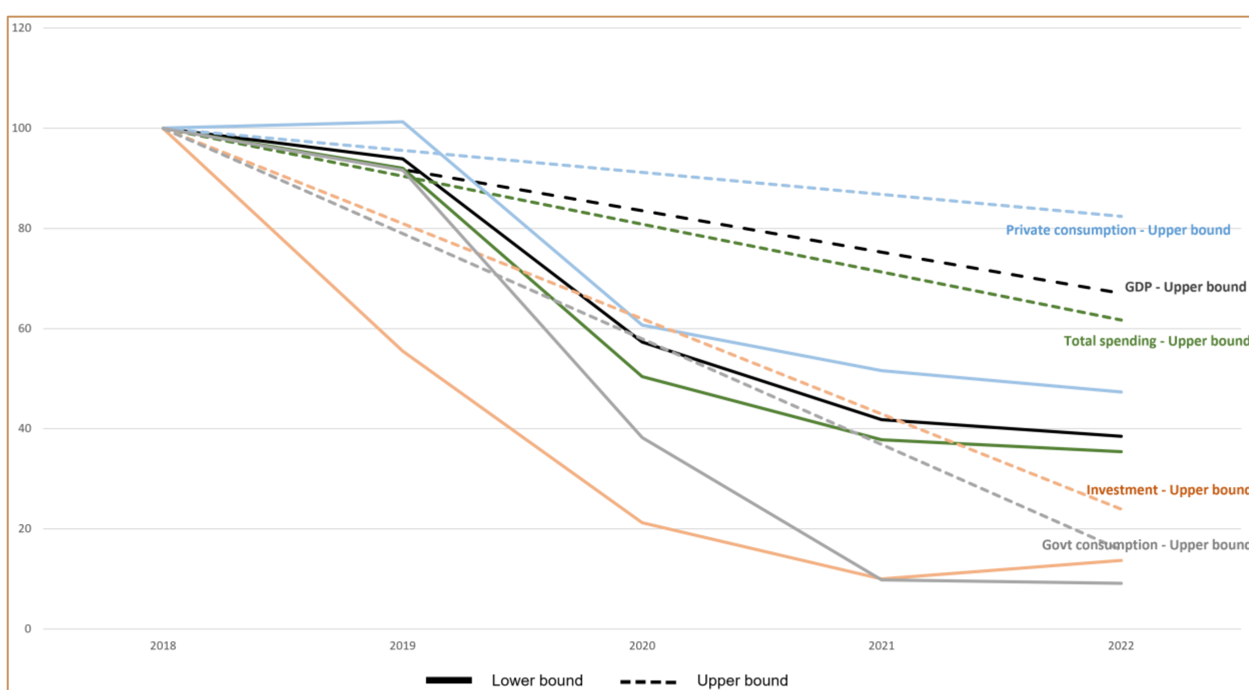
The passage of time is not helping find a financial resolution, quite the opposite. The main benefit of "doing nothing" is related to the justly decried "lirafication" process, whereby depositors take part of the loss when they withdraw dollar deposits at exchange rates way lower than market rates. However, we estimate such withdrawals at only around $3b. What is noteworthy instead is that over time, the BdL has spent around $30b of its reserves financing capital flight and subsidizing imports. In addition, there was a huge fall in the banking sector's loan portfolio, by around $30b, benefiting borrowers at the expense of depositors (dollar loans were repaid at the official exchange rate). In retrospect, the "policy-freeze" seems to have been due not to a psychological rejection of a harsh reality, but instead, to active rent-seeking by parties that use the situation to improve their own interest at the expense of that of the nation.

But since reserves are down to a minimum, and there is not much left to steal, it is now high time for a big (political) push to clean up the financial system. The reduction of public debt, and the cleaning up of banking balance sheets are a necessary condition for stabilization and recovery. To make it easier (politically) to absorb the huge losses, there should be more creativity in "dressing up" these losses – by devising a Lebanon specific bond with a small haircut in face value, low interest, and a long maturity, and including warrants on various upsides – such as growth, and the discovery of oil and gas. These would also provide incentives for the economic and political elites to improve economic performance.

Three crises, not one!

A third conclusion is that while most of the policy focus has been on the banking crisis, the other two ongoing crises are even harsher: these is an acute social crisis, and there is a collapse of the state. Poverty is estimated to have risen to 50% population. The state budget has fallen ten-fold. Basic services such as health, education, electricity, or clean water are no longer delivered. While there can be no dynamic economy without a banking sector, there can be no country without a state. In the short term, the three crises compete for financial resources and for political attention. But they are also complementary: lack of progress on any one of them would preclude progress on the recovery goal. As such, the risk of falling into a poverty trap is high unless they are all properly addressed.

Figure 3. National account - as % shares of 2018 levels



Source: Authors computations based on WB data. The upper bound is calculated in real LBP term, using inflation data to derive real values. The lower bound uses the market exchange rate to compute a real dollar value.

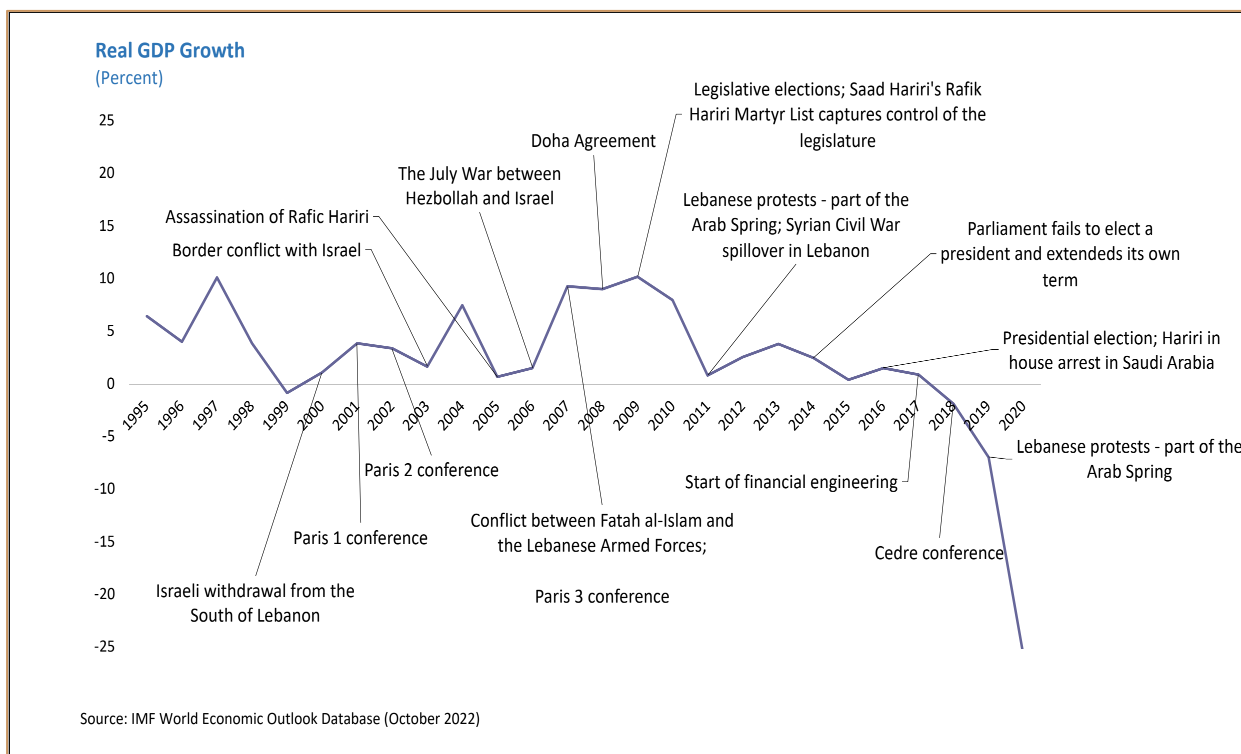
The implication is that existing (but scarce) national assets and external support should not be all devoted to the resolution of the financial crisis. Instead, they need to be distributed in a judicious way to support a balanced stabilization, in ways that provide the best chances for a rapid recovery.

A big push is needed, but is politically very challenging

A fourth conclusion is that a rapid initial economic recovery is highly desirable to get state, market, and society to start moving rapidly away from their present wounded state. This requires to generate a confidence boost. Future growth does not require massive state investments, or complicated regulation. Lebanon has many comparative advantages – from a skilled population, to a connected diaspora, and to a brand-name that is still valuable globally. We believe that if it takes place at all, growth could only come by bubbling up though SME innovation across the territory. The old model of a rentier economy is dead, and a new model is needed. The new model moreover needs to be resilient to the type of shock that have, and will continue to rock the country, given its geographical situation and its history (Figure 4).

Such a big push might be created by the initiation of the reform of the financial sector, together with sizable external support, allowing inflation to come under control, and social tensions to be minimized during the transition to a new growth path. Such a plan might generate a confidence push that leads to a large appreciation of the national currency – the billions of dollars circulating in the economy being used for investment and imports rather than as a precautionary store of value. Such a scenario may sound fanciful in the current depressed environment. But Rafik Hariri managed to rebuild downtown Beirut under more difficult circumstances, when militias where still roaming the streets, and the country was utterly divided. Ambitious reforms were also implemented in Lebanon during two historical moments: the post 1958 civil war presidency of Fouad Chehab, the post 1975 civil war of Amine Gemayel. In each of these episodes, the cabinets managed to obtain broad legislative power from parliament to implement the deeded reforms. To do so again would require a at minima a new political dispensation, if not a new political settlement, willing to bet on reforms and development.

Figure 4. Growth and political instability



Source: World Bank data and authors computations

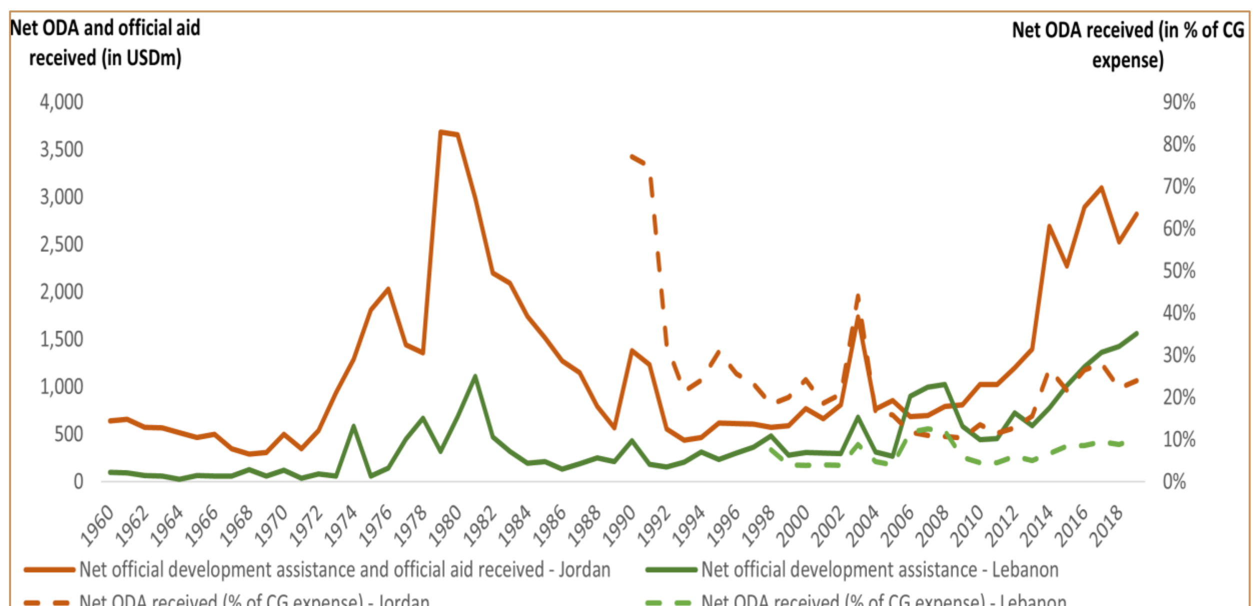
The implication is that the stabilization package should be part of a more ambitious platform for national renewal. Signals about the direction of policy will be key. The necessary ingredients include basic security, the rule of law, policies that foster social mobility, and the rehabilitation of basic infrastructure. The goal should be to allow municipalities to compete for attracting SMEs away from places like Dubai, substituting high wages by lower costs and a good life amidst an enchanting nature and a vibrant culture.

Can donors walk on two legs?

Finally, the last innovation of the paper is to propose a new donor strategy. Donor's support will be crucial to generate a big push, when the "politics" finally line up to allow this. So far, over the years, donors have been generous (Figure 5), although Lebanon is as much a donor darling as Jordan. But repeated bailouts have generated moral hazard, and explain why the country had to fall from very high. We recommend like many in Lebanon that donors now stick to their conditionality – there should be no more blank check that helps an ineffective regime survive by kicking the can down the road. The IMF has reached a staff level agreement in April 2022, which includes a list of prior actions that need to be met before a program can go to its board, and these should become tightly enmeshed with the donors' offer of a conditional big push.

The list of prior actions represents however a minimal platform on which to build a stabilization and recovery national strategy. When the time comes, a 3-year typical IMF program would be too short to support a comprehensive national program, given the magnitude of the challenges. A longer, more structured, and more generous program, would be needed. In such a program, the focus needs to be to move away for the current extraordinary level of austerity to a measured expansion of the state, ahead of the recovery of the economy. This would require a much closer cooperation between the IMF and the World Bank than occurs typically.

Figure 5. Official Development Assistance for Lebanon



Source: World Bank data

But for this conditional big push to be useful, it must be complemented with efforts to keep society from become too deeply wounded during the interim. The implication is an important recommendation for donors to develop a more balanced two-legs strategy. To support a first leg heavily leveraged on conditionality, a second leg is needed that organizes humanitarian support more comprehensively around a support for basic services. This second leg is required until the (uncertain) time where political progress will allow for a deeper reform program to be initiated. Supporting basic services also allows for a quicker macro recovery and reduction of inflation; and it gives some space for the state to rebuild its capacity more rapidly, a sine-qua-non for a revival of the country when the time comes.

In conclusion

The political situation remains dynamic and uncertain. But one could also afford some guarded optimism, at least for the longer term. The political/societal evolution that has been triggered by the crisis is still ongoing, and it won't be as easy for the establishment to continue to escape their responsibilities and impose their choices in the future. What used to be accepted misbehavior in the past, such as state procurement with no competition, now moves public opinion and elicits strong opposition by civil society.

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