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Lebanon's Multifaceted Economic Crisis of October 2019: Causes, Repercussions- A Diagnosis

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Abstract

The paper analyzes Lebanon's extraordinary economic breakdown of October 17, 2019 when the Central Bank suddenly imposed effectively *de facto* capital controls on Lebanon's prevailing free foreign exchange market since its independence in the late nineteen forties. This action has since led to a major economic and financial crisis: the emergence of a parallel market with a depreciating pound, alongside a few additional official rates designated for particular transactions, rapid inflation, business closures, rising unemployment, deeply declining GDP, and an accelerating rate of emigration of professionals, among others. The paper analyzes the root causes of the crisis, its economic manifestations, and the failure of public and private sector responses during the follow up period through June 2022. It draws attention to three crucial aspects of economic and financial reform that Lebanon would need to implement to assure its sustained recovery.

Keywords: economic breakdown, foreign exchange market, financial crisis, public and private sector, Lebanon

JEL Classification: O1, P1

ملخص

تحلل الورقة الانهيار الاقتصادي غير العادي الذي شهدته لبنان في 17 أكتوبر 2019، عندما فرض المصرف المركزي فجأة ضوابط فعلية لرأس المال على سوق الصرف الأجنبي الحر السائد في لبنان منذ استقلاله في أواخر الأربعينيات، وأدى هذا الإجراء منذ ذلك الحين إلى حدوث أزمة اقتصادية ومالية هائلة، تمثلت في ظهور سوق موازية مع انخفاض قيمة الجنيه اللبناني، فضلًا عن عدد من الأسعار الرسمية الإضافية المخصصة لمعاملات معينة، والتضخم السريع، وإغلاق الأعمال، وارتفاع معدلات البطالة، وانخفاض الناتج المحلي الإجمالي انخفاضًا هائلًا، و تسارع معدل هجرة أصحاب المهن، إلى جانب أمور أخرى. وتحلل الورقة الأسباب الجذرية للأزمة، ومظاهرها الاقتصادية، وإخفاق استجابات القطاعين العام والخاص خلال فترة المتابعة حتى يونيو 2022، وتوجه الانتباه إلى ثلاثة جوانب حاسمة للإصلاح الاقتصادي والمالي يتعين على لبنان تنفيذها، لضمان تحقيق تعافيه المستدام.

Introduction

A few years after the independence of Lebanon in the mid-1940s, its financial authorities moved to establish a free foreign exchange system with a unified exchange rate. This system lasted until 17 October 2019 when the central bank, facing great pressure in defending the Lebanese pound, suddenly decided to impose strict controls on withdrawals from existing foreign exchange deposits, which comprised around 75 percent of total bank deposits. *De facto* capital controls were effectively put in place, leading to a major economic and financial crisis that resulted in the emergence of a parallel market with a depreciating Lebanese pound, alongside additional official rates designated for particular transactions, rapid inflation, business closures, rising unemployment, a deeply declining gross domestic product (GDP), and an accelerating rate of emigration of professionals, among others. In addition, the onslaught of COVID-19 added to the national problems Lebanon had come to face, which were compounded by the huge port of Beirut explosion on 4 August 2020.

From October 2019 to June 2022, governmental plans aiming to address Lebanon's multifaceted economic disaster – in consultation with international organizations – could not be implemented, for various reasons referred to below. It took until 7 April 2022 before the authorities were able to begin charting the first policy steps in the process of recovery with the support of the International Monetary Fund (IMF). However, as of end of June 2022, the process of implementation had not yet begun as the policy steps were yet to be endorsed by the Parliament.

The primary objective of this paper is twofold. Firstly, the paper aims to analyze the extraordinary breakdown of 17 October 2019 by examining its root causes, economic manifestations, and public and private sector responses. Secondly, the paper seeks to draw attention to what we submit are three crucial aspects of any planned economic and financial recovery.

I. Root causes

The factors that ultimately led to the outbreak of the 2019 economic crisis originate in the political/fiscal domain. In other words, the highly wanting political governance in the post-war period since 1993 allowed (if not encouraged) lax and increasingly corrupt economic governance to take hold, with no serious attempts to control an ever-widening fiscal deficit.

Going back to the pre-civil war (1975-1990) period, the Lebanese economy had the following characteristics: relative economic, fiscal, and political stability; low inflation; and large balance of payments surpluses. The latter was mainly due to sizable financial and capital inflows being attracted to Lebanon's free foreign exchange system, along with well-positioned banks that offered relatively attractive interest rates on savings deposits. As long as this situation persisted, the Lebanese exchange rate was in a strong position. In turn, the stability of the rate contributed to the maintenance of relative price stability and encouraged the inflow of capital, especially since a free foreign exchange market was in place. On the other hand, it tended to promote excessive reliance on imports but did not seem to create undue disincentives for the development of a wider national production base. Along with the services sectors, the industrial and agricultural sectors had expanded rapidly up to the outbreak of the civil war.

Since the civil war period led to a great deterioration in the fiscal situation and the depreciation of the Lebanese pound, the post-war governments initially attempted to improve the budgetary situation and bring the fiscal deficit under control when it ended in late 1990. As a ratio of GDP, the overall fiscal deficit (excluding grants) was reduced from about 16 percent in 1991 to 12 percent in 1992, a rapid depreciation of the Lebanese pound fed by adverse speculation notwithstanding.[1] The following year witnessed a consequent further improvement to nine percent (Makdisi, 2004). However, the new government that took over following the 1992 national elections was buoyed by prospects for reconstruction with promises of foreign support (both Arab and international). In 1993, it began putting in place an expansive fiscal policy with little attention paid to the bureaucratic corruption and inefficiency that characterized government operations **(**see Table 1 in the Appendix). This was followed by the 1997 adoption of a fixed exchange rate policy supported by central bank interventions to promote economic stability. However, the hoped-for international assistance in support of expanding governmental operations did not materialize despite international conferences (led by France) that discussed aid to Lebanon.[2] The foreign funding that became available was mostly directed toward covering interest payments on a growing debt to finance government expenditures.

By the end of 2018, these repayments had amounted to 39.35 percent of the total revenue and nine percent of GDP (BLOMInvest Bank, 2019). In contrast, expenditure on education and health comprised only 2.5 percent and 8.67 percent of GDP (2.6 percent and 8.65 percent in 2019), respectively (World Development Indicators).

At no point did the authorities seriously attempt to address the growing fiscal deficits after 1993. Instead, they relied on increasing borrowing from the central bank to finance them. As a result, public debt rose from USD 4.44 billion at the end of 1993 (56 percent of GDP) to around USD 50.21 billion at the end of 2020 (150.43 percent of GDP), with all its negative impact bearing down on the budget and the economy (CAS, Ministry of Finance). During the 1990s, capital inflows led to an overall balance of payment surplus that tended to support the Lebanese

[1] Earlier on 21 February 1992, the central bank decided to stop intervening in the market in support of the Lebanese pound as it had been doing before. As announced by the bank, the reason for its decision was the rapid depletion of its now low level of foreign exchange reserves. Following the cessation of this intervention, the exchange rate began to depreciate with a consequent rise in prices. Huge demonstrations protesting the deterioration of the economic situation, led by the union of labor organizations, finally forced the sitting government to tender its resignation on 6 May 1992. The new government that took over was tasked, among other things, with holding parliamentary elections in the fourth quarter of the year and attempting to bring the fiscal situation under control. This objective was attained despite the continued depreciation of the Lebanese pound, which the central bank could no longer counter or ameliorate (Makdisi, 2004).

[2] Three Paris international conferences were held: Paris I in 2001 pledged EUR 500 million in aid, Paris II in 2002 pledged USD 4.4 billion in aid, and Paris III in 2007 pledged USD 7.6 billion in aid (Bifani, 2021). The conditions governing aid disbursement were not completely met by the Lebanese authorities. In practice, less than 50 percent of the available funds were utilized.

pound despite growing budget deficits after 1993 (Eken and Helbing, 1999). In subsequent years, the picture changed. Available data (figures 1, 2, and 3 in the Appendix) reveal an overall trend of growing balance of payment deficits for the period 2002-20 due to declining financial inflows. The causes of this decline are attributable to adverse political events that shackled the country's stability, including, the assassination of Prime Minister Rafic Hariri in 2005, the Israeli war on Lebanon in 2006, and an ever-increasing political schism among Lebanese political parties – some of which have close connections with outside countries.

With an overall decline in these inflows in the following years and the emergence of overall balance of payments deficits (Figures 1a and 1b in the Appendix) alongside the growing budgetary deficits, the pressure on the Lebanese pound continued to mount with a consequent fall in the foreign exchange reserves of the central bank that continued to support it until 17 October 2019. Wishing to maintain the official rate while protecting its own remaining reserves, the bank imposed the strict capital control discussed in section II. In the years leading up to the crisis, the central bank attempted to shore up its declining reserves by tempting commercial banks with relatively high interest rates to lend the bank sizable amounts of their own foreign exchange reserves – a mistaken policy of overcommitment to the central bank on the part of banks motivated by profit greed.[3] Once dissipated by the central bank in financing the fiscal deficit, the commercial banks, in turn, saw their own foreign exchange reserves effectively depleted in that the central bank could no longer afford to return what it had borrowed.

Briefly, the root causes of the crisis may be traced to three major interrelated factors: the first (and most important) is poor governance that permitted and encouraged wasteful fiscal operations marred with extensive corruption. The second, in consequence, is the growing fiscal deficit (and hence public debt) that the central bank willingly or unwillingly financed by resorting to indirect commercial bank accommodation of the deficit in later years instead of attempting to resist continuous accommodation. The third is the growing domestic political instability that led to decreased confidence in the Lebanese economy and hence a reduced inflow of foreign capital. All these factors contributed to the growing balance of payments deficits (mainly due to the deteriorating net financial and current accounts) that eventually could no longer be accommodated and led to the unprecedented 2019 crisis.

II. National protests and their manifestations

The breakdown of 17 October 2019 came on the heels of large national protests. These protests initially erupted against planned economic measures by the government but then turned into large political demonstrations against the governing class, who were accused of corruption and

[3] Some bankers claim that the increased lending to the central bank was initiated by the Intra Bank, which had overcome difficulties with the help of the central bank. In turn, with the objective of widening its deposit base, Intra Bank raised its interest rate on savings deposits. Other commercial banks were forced to follow suit by lending to the central bank to stay in good standing while raising the rate on savings deposits to avoid being moved to competing banks that had raised their rates.

held responsible for a deteriorating economic situation. Under pressure, the banks closed that day, and the government resigned on 29 October. The banks reopened on 1 November, but, with the "unofficial" sanctioning of the central bank, they imposed strict *de facto* controls on withdrawals from foreign exchange deposits that, as of end of October 2019, had stood at USD 9.2 billion (69 percent of total private deposits) (Bank Du Liban), whereby none were allowed except for commercial transactions. This, in turn, led to the emergence of a black market for the US dollar[4] alongside a few varying official rates which the central bank later introduced. They are noted below.

The formation of a new government on 21 January 2020 did not lead to an amelioration of the bank/depositor situation. It was accompanied by political tensions (including street demonstrations) that added further pressure on the Lebanese pound, thereby driving the black market rate to about LL 2,800 per USD by the end of March from about LL 1,800 on 17 October 2019.[5] It should be noted that the government had prepared a plan for financial recovery, but its official approval was thwarted following the Beirut port explosion on 4 August 2020, and the government resigned a few days later. The explosion caused huge damage not only to the port but also to neighboring business and residential areas, thereby adding further pressure on an already deteriorating economy as indicated below. A new government was formed on 21 January 2021 and called on IMF assistance to help restore recovery. Due to emerging national political disruptions, it took over a year and a quarter before Lebanon could negotiate a preliminary understanding that required the country to take certain initial steps before IMF financial assistance could be approved (see section IV below).[6]

In the meantime, alongside the artificial official rates introduced by the central bank for specific purposes explained below, a depreciating black market rate increasingly came to cover private sector foreign exchange transactions which came to value on the basis of this rate. On its part, and with the objective of lessening the severe restrictions on withdrawals from foreign exchange deposits, the central bank issued circular 151 on 21 April 2020, which allowed depositors a monthly withdrawal of USD 3,000 to be converted into Lebanese pounds at the rate of LL 8,000 per USD. Later, on 6 June 2021, circular 158 permitted the alternative withdrawal of USD 400 per month, in addition to the equivalent of USD 400 divided into USD 200 converted to Lebanese pounds at the rate of LL 12,000 per US dollar in cash and the rest via credit cards.

Given the substantially higher exchange rate on the black market (it had reached LL 31,000 per USD on 10 January 2022, see Figure 2 in the Appendix), the allowed withdrawals from

[4] In fact, limited deviations from the official rate began to appear a few months earlier.

[5] On 7 March, Prime Minister Hassan Diab declared that Lebanon would default on a due Eurobond repayment and pursue the restructuring of its debt, and on 23 March, the Lebanese government decided to stop paying back all debts in foreign currencies. This was the first time Lebanon defaulted on due repayments of its foreign debt.

[6] An official document titled "Restoring the Lebanese Financial Sector" (2020) detailing the proposed measures for dealing with the outstanding public debt had been prepared for discussion with the IMF. The government, however, resigned in August 2020 before it could submit this document for parliamentary approval.

bank deposits in Lebanese pound equivalent amounted to a substantial "haircut" on these deposits, small as they may be. This prompted the central bank to intervene in the market by issuing circular 161 on 16 December 2021, which permitted banks to purchase dollars at the prevailing "Sayrafa" rate[7] of LL 20,000 per USD maintained by the central bank. The rate was then increased to LL 22,700 per USD in May 2022 (see Figure 2b in the Appendix). Consequently, the black market rate dropped; as of end of April 2022, it was above but close to the Sayrafa rate, though it later rose again.

It has been contended that the main objective of circular 161 was political. Parliamentary elections had been set for 15 May 2022, and those in power were concerned that a rising black market rate would negatively impact their election prospects. In this context, on 15 January 2022, the central bank's intervention coincided with the decision of Hezbollah and Amal to end their ongoing boycott of cabinet meetings.[8] Finally, with the objective of attracting new foreign exchange inflows after 17 October 2019, the central bank set a new policy directive whereby all such inflows were exempt from the restrictions applied to outstanding foreign exchange deposits with the banking system before that date.[9] Briefly, Lebanon's historic free foreign exchange system was suddenly transformed during the period under consideration into a system of strict exchange controls, multiple exchange rates, and severe quantitative restrictions. Section IV touches on what we consider the desired post-crisis foreign exchange system.

Since Lebanon is greatly dependent on imports, the continuous depreciation of the Lebanese pound has led to a historic rise in consumer prices across the board. By 2021, the consumer price index reached a peak of 612.4 points compared to a low of 95 in 2008 (see Figure 3 in the Appendix). At the same time, real GDP growth is estimated by the IMF to have declined by 6.9 percent in 2019, 25.9 percent in 2020, and another five percent in 2021, along with shrinking work opportunities and mounting unemployment (see the document presented by the Lebanese government for parliamentary approval, 2022). The headcount poverty rate[10] increased from 28 percent in 2019 to 55 percent in 2020, while the multidimensional poverty rate[11] almost doubled from 42 percent to 82 percent between 2019 and 2021 (ESCWA, 2021).

[7] The Sayrafa rate is an exchange rate for the US dollar set by the central bank to be close to the actual market rate, by injecting dollars into the market through the "Sayrafa Platform." On 1 February 2022, the central bank announced that the Sayrafa rate will be used for all fresh payments and all international card payments, including POS, e-commerce, and ATM withdrawals.

[8] The boycott was prompted by the ongoing official investigation of the explosion in the port, which they claimed was not following proper administrative procedures, i.e., politically motivated.

[9] It remains to be seen what course the rate will take if the central bank ceases to intervene in the market after the Parliamentary elections end while the agreement with the IMF is finalized.

[10] The national poverty headcount ratio is defined by the World Bank as the percentage of the population living below the national poverty line(s).

[11] The Multidimensional Poverty Index (MPI) is an international measure that goes beyond the traditional monetary poverty measures to capture more dimensions of poverty, including acute deprivations in health, education, and living standards faced simultaneously by a person. This index covers more than 100 developing countries (Oxford Poverty and Human Development Initiative (OPHI)).

As of May 2022, the crisis continued unabated due to responsible authorities' failure to deal with it.

On the other hand, it is important to note the lack (at least up to the scheduled national elections of mid-May 2022) of any substantial protests against the governing authorities (including the monetary authorities) accused of being responsible for the country's dramatic economic downfall. A few factors that helped cushion the effects of the crises may help explain this phenomenon. One is the increase in emigrant remittances. As shown in Figure 4 in the Appendix, the crisis prompted an upward reversal in their trend after its outbreak, helping reduce the overall balance of payment deficit. As a percentage of GDP, remittances rose from 12.62 percent in 2018 to 20.9 percent in 2020 (World Bank data). This greatly helped support consumption expenditure despite the fall in GDP. Indeed, World Bank estimates indicate that, as a percentage of GDP, consumption increased from 101.544 percent (86.331 trillion current LCU) in 2016 to 107.937 percent (128.097 current LCU) in 2020 (World Bank data, 2020).

The drawings on US dollar accounts held by Lebanese citizens abroad are a second supporting factor. No data are available, but they are likely to be significant. The rise in the rate of the US dollar outpaced the rise in domestic prices, which translated into additional purchasing power for consumers with dollar balances. As Figure 5 in the Appendix shows, the Purchasing Power Parity Conversion Factor for GDP[12] increased from 775.811 in 2019 to 1414.979 in 2020 (World Bank data, 2020). A third factor that helped cushion the effects of the crisis is increased immigration since the outbreak of the crisis. Available data show that in 2020, the net migration rate[13] was at -9.5 per thousand population (International Organization of Migration, 2021).

The decision of 17 October was intended to drastically slow down the drain of foreign exchange more significantly by suddenly doing away with Lebanon's established free foreign exchange system that has been in place since the late 1940s. However, it represented a grave policy reversal that gave rise to very adverse economic consequences, including a great blow to the confidence of national and foreign savers in the country's banking system. Lebanon had never even remotely faced a similar crisis before, not even during the 15-year civil war. Restoring a free foreign exchange system poses a major challenge (among others) that Lebanon will face in its now delayed planned recovery (see section IV).

[12] The purchasing power parity (PPP) conversion factor is a spatial price deflator and currency converter that controls for price level differences between countries, thereby allowing volume comparisons of gross domestic product (GDP) and its expenditure components. This conversion factor is for GDP (World Bank Group data). GDP is measured in *LCU per international USD*, where LCU refers to Local Currency Unit. LCU per international USD is the unit used to measure GDP.

[13] The net migration rate is defined as "the number of immigrants minus the number of emigrants over a period, divided by the person-years lived by the population of the receiving country over that period. It is expressed as net number of migrants per 1,000 population."

III. Adaptations/responses to the crisis, 2020-22

A. Public sector: Political turmoil, thwarted measures

Given Lebanon's low level of political governance and continuous political instability, it is perhaps not surprising that as of end of June 2022 (more than two years after the outbreak of the crisis), the responsible authorities had yet to begin implementing major reforms that would address the crisis.

Following the resignation of the government on 30 October 2019 after the pressure of popular demonstrations, the new government that took over on 21 January 2020 undertook the task of preparing a reform plan in consultation with the World Bank, the IMF, and private consultants such as Lazard.[14] The plan focused on various familiar aspects of fiscal and monetary reforms, including (among others) restructuring foreign debt banking reforms, improved fiscal governance, and the creation of safety nets, all of which in the end meet the familiar conditions for international assistance.

The plan was approved by the government. However, the government was forced to resign shortly after the Beirut port explosion that destroyed the port area and neighboring districts, in addition to causing more than 200 casualties. Consequently, its intended plan could not be acted upon. It took more than nine months to agree on another government on 10 September 2021, which, in turn, became paralyzed later for three months due to internal political frictions.[15] Resuming its meetings in mid-January 2022, a new budget was prepared and negotiations with the IMF were resumed to implement long-awaited reforms.[16] On 7 April 2022, an IMF staff mission visiting Beirut reached a staff agreement that was endorsed by the government. It mandated the implementation of several policy reform measures prior to seeking IMF financial assistance (see section IV below). Their translation as actual policy measures was formulated in a government-proposed law shortly afterward. While it was submitted for approval by the parliamentary committees concerned, they did not act on it and left matters to the new parliament to be elected on 15 May 2022 (see footnote 26 below).

B. Private sector: The market rules

The inability of national authorities to cope with the crisis shifted the burden of adjustment to a severely impacted private sector and to market rule. Alongside declining real incomes (compounded by the freeze on deposit withdrawals), citizens have been forced to adapt to rapidly rising prices, coupled with emerging shortages of goods and shrinking work

[14] For plan details, see Bifani (2021) and IMF press release no. 22/108. Earlier in November 2020, the World Bank Group prepared a "Reform, Recovery and Reconstruction Framework" focusing on four main pillars: governance and accountability, employment, social protection, and infrastructure. Potential financing sources included international grants as well as the unlocking of private sector financing.

[15] On 14 October, clashes took place between supporters of Amal and Hizbollah on the one hand and the Lebanese Forces on the other hand. This led the former two parties to boycott cabinet meetings until their specific demands were met. Although they were not met, they decided to end their boycott in early January 2022.

[16] The government had prepared a financial plan for the settlement of the public debt (see the next footnote); however, in the absence of an overall recovery plan, it did not take off in the discussions.

opportunities with two major consequences: rising unemployment and an increasing rate of emigration. The measures taken by the central bank – alongside the government's failure to take the required policy action – implied that the private sector was to be a major determinant of market developments. What was initially and officially referred to as the black market became the major market with a freely fluctuating exchange rate (reaching LL 33,000 per USD at the end of 2021) that determined the prices of both commodities and services and forced private sector transactions to adapt to the new market rules. Indeed, for many transactions, the dollar, rather than the Lebanese pound, became the currency of transaction. This market shift served the central bank's objective of no longer being responsible for maintaining a unified exchange rate or choosing to support designated official and other transactions, either at the official rate or some other artificially designated rate. The result of this market shift is the multiplicity of rates that has come to emerge during the period under consideration.

It is estimated that in 2020 alone, the private sector shrank by around 45 percent (ESCWA, 2021). Similarly, the BLOM Lebanon PMI Index, which measures the strength of the private sector, whereby a measure below 50 implies contraction in the private sector as opposed to expansion, stood for 2020 and 2021 below this number. It is estimated that GDP declined by around 58 percent since 2019, estimated at USD 21.8 billion in 2021 (World Bank, 2022), and employment rose by 23 percent. The sector most affected has been the construction sector, which laid off most of its employees, followed by the hotel and restaurants sector and the manufacturing sector.

At the level of firms, those engaged in production for the national market were the hardest hit in terms of employment losses, reaching 30 percent of their total employment, compared to a loss of 14 percent for firms engaged in export-oriented production (ESCWA, 2021).

This can be explained by the greater decline in local demand compared to international demand, partly cushioned by the deprecation of the Lebanese pound. In addition, non-exporting firms suffered from a bigger debt burden than exporting firms (the former receive the larger part of their sales in Lebanese pounds but pay for most of their inputs in dollars), with a significant portion of their debt being denominated in dollars.[17]

The measures taken by the banking system further exacerbated the drop in local demand due to the imposition of sharp withdrawal limits and pressure for the closure of dollar deposits. The usage of debit and credit cards became rarely accepted as a formal way of payment, slowly transforming the economy from dependence on e-payments to being a primarily cash economy.

It may be noted that in response to both the pandemic as well as the port explosion, a number of non-governmental organizations (NGOs) and initiatives have been making efforts to revive

[17] More generally, more than 50 percent of the debt of the private sector is denominated in dollars (ESCWA, 2021).

the destroyed parts of Beirut. To illustrate, the International Medical Corps designed an emergency response plan to support people's physical and mental health (Makkieh and Abdelbaki, 2020). "Offre Joie," an NGO founded in 1985, established a rehabilitation program to renovate buildings impacted by the explosion. The organization "Taydal Al Amal" contributed to renovations, with a long-term goal of reviving all damaged infrastructure. "Food Blessed" launched a relief community kitchen program delivering thousands of meals to people in need. In addition, "Achrafieh Social Association" focused on supporting the elderly and catering to their medical, psychological, and physiological needs.

However, the support extended by various NGOs could hardly substitute for needed governmental action and policy. As of end of June 2022, Lebanon's deep economic and financial entrapment had yet to be addressed by the responsible authorities.

IV. After the fall: What recovery?

Two vexing issues have been facing the design of Lebanon's recovery plans. The first has centered on the required measures to grow out of the deep depression of its national economy with the accompanying imposition of sudden and unprecedented strict exchange restrictions on the withdrawal of foreign exchange deposits. The second is how to determine and assign the costs of recovery between four parties: (1) the government in its capacity as the major borrower from commercial banks to finance its growing public debt; (2) the central bank, a lender to the government to finance this debt from the reserves of commercial banks placed with it at relatively attractive rates; (3) the commercial banks that directed a large portion of their own deposits as loans to the central bank; and (4) the depositors who are on the receiving end of any agreed resolution that will determine how, and to what extent, they may recover their locked-in savings – notwithstanding the interim measures by the central bank that permit very limited uses of existing deposits.[18]

Aiming to initiate the process of recovery, the government that took over on 10 September 2021 turned to the IMF for assistance. A visiting IMF mission in April 2022 mandated, as a prior condition for IMF assistance, that the Lebanese authorities elaborate and begin implementing far-reaching reforms pertaining to the banking and fiscal sectors as well as the exchange rate policy. These include bank restructuring (not specified); externally assisted bank-by-bank evaluation for the 14 largest banks; reforming the bank secrecy law; audit of the central bank's foreign asset position; approval of a medium-term fiscal and debt restructuring strategy; approval of the 2022 budget; and the central bank's unification of the exchange rates

[18] In February 2022, the governmental committee responsible for negotiations with the IMF prepared a first plan of how to address the huge foreign debt burden facing Lebanon (see committee's unpublished document, *Restoring the Lebanese Financial sector*). As reported, it essentially comprised haircuts and the freezing of deposits for 15 years to arrive at the elimination of public debt in foreign exchange. It rendered the depositors (the creditors) the bearers of the major cost for the recovery of the public debt instead of the borrowers, i.e. the government and the central bank. Out of USD 104 billion outstanding public debt, it proposed an effective deposit haircut of about USD 60 billion (58 percent of the total), assuming an exchange rate of LL 20,000 per USD. The remaining amount was to be converted into shares and bonds and the rest to be reimbursed over 15 years. After an initial discussion with the IMF team, a revised plan was supposed to be prepared (see section III).

for authorized current account transactions. As noted above, the government followed through with a proposed law, including various reform measures that were not acted upon prior to the scheduled elections of 15 May. The press published its details.[19]

The settlement of the public debt was opposed by a number of Lebanese experts and professional associations, among others. We submit it fell short at two key levels, which we believe should be addressed in any proposed recovery plan to be adopted by the post-election government. The first is its failure to emphasize the question of urgently needed governance reform, particularly the control of corruption. The second is its failure to assure the recovery of national confidence by: (1) not explicitly referring to an intended restoration of a fully free foreign exchange system with a unified exchange rate; and (2) proposing a settlement of the public debt, which appears to discourage the inflow of new capital. Both matters, briefly discussed below, are of specific concern to national and foreign savers whose savings ultimately influence the rate and stability of national growth. Furthermore, the implementation of some of the proposed measures is left uncertain, leaving its determination, as it is, to the evolving situation (see Section 2 A) below.

(1) Governance: Endemic corruption

In order to become successful and sustainable, national recovery must go way beyond its familiar aspects of economic planning. Economic plans alone, no matter how sophisticated, would not serve their major purposes should the political context in which they are implemented remain wanting – and Lebanon's political governance has been hugely wanting. Its long prevailing confessional system at the levels of the Parliament, the government, and public sector appointments helped nourish (among other factors) the spread of corrupt practices across the public sector that parliaments elected on a confessional basis failed (and did not wish) to tackle.[20]

Table 1 in the Appendix depicts the growing level of corruption, as measured by the Corruption Perceptions Index[21] for the period 2012-2021 for which data are available. In the index, the greater the score, the higher the level of corruption. At the beginning of the period, Lebanon

[19] Specific fiscal, banking, and exchange rate measures apart, at the financial recovery, the proposed law addresses the outstanding central bank obligations of USD 72 billion, which were accumulated as a result of accommodating continuous budgetary deficits by eliminating the USD 60 billion owed to commercial banks. The rest (USD 12 billion) is set to be gradually eliminated over five years. In turn, this loss is to be compensated firstly by forcing viable banks to eliminate their capital and subordinated debt securities and to recapitalize anew, and secondly by obliging shareholders and creditors of the bank as well as their big depositors to contribute substantially. Coming to depositors, the law treats them harshly as the seemingly ultimate creditors of the outstanding foreign exchange debt. It permits maintaining a *minimum* of USD 100,000 for each depositor with the excess deposits: (1) being converted into shares (not specified); and/or (2) made to sustain a certain loss; and/ or (3) converting part of the debt to LL at an arbitrary rate. How these three alternative measures, individually or together, are to be implemented is not addressed

[20] International reports on Lebanon's economic recovery may allude to the need for improved political governance, but, as expected, they do not delve into this question.

[21]The Corruption Perception Index is an index that refers to the perception of government corruption, and it ranges between 0-100, where the lower the number, the worse the perceived government corruption.

ranked midway among the countries included in the index. By 2019, its rank rose to 149 out of a total of 180 countries (or a score of 28 over 100). In 2021, it climbed to 154 out of a total of 180 countries (a score of 24 over 100), thereby joining the top quarter of the most corrupt countries in the world. Concurrently, an increasing level of openly confessionalist political behavior has been manifesting itself – not only with regard to the long-entrenched confessional distribution of administrative appointments in the public sector, but increasingly in open political discourse.[22] The negative impact of corruption on economic growth (as shown in the Lebanese case in Table 1) is supported by research work on this relationship (see Mauro, 1995; Aidt, 2009). More recent work includes that of Gründler and Potrafke (2019), who use a large dataset of 175 countries between 2012-18 and find that as the Corruption Perception Index increased by one standard deviation, the GDP decreased by about 17 percent. They explain that a higher CPI contributes to a lower GDP through decreasing foreign direct investment and increasing inflation, thereby highlighting the strength of the relationship, especially in autocracies.

Lebanon's growing level of corruption in 2019-21 is perhaps not surprising given this period's highly unsettled political situation along with a general decline in public sector operations. As of mid-2022, Lebanon had yet to settle on a path of recovery. We submit that, once this path is agreed on and the country begins its long journey of rehabilitation, the pre-2019 conditions that permitted the coexistence of corruption and growth are unlikely to endure in the post-2021-22 period, at least not with equal effect. One reason is that national tolerance of governmental corruption has been diminishing and opposition to it has become more vocal; this renders corrupt practices more difficult to carry out. The conditions of sought-after international assistance that imposes outside oversight of governmental economic reforms are a supporting factor. Admittedly, whatever their positive influence, the efficacy of these two factors is yet to be tested in the period following the May 2022 parliamentary elections. As mentioned before, it is important to keep in mind that, short of drastic political reform, a complete eradication of corruption remains wanting.

Another reason is the changed regional environment over the past decades that reinforces the need for drastically improved political governance.[23] When the Gulf countries were yet to develop economically and financially, Lebanon's open market economy and available national expertise helped cement the position of Beirut as a major regional financial center and attract financial resources from the Gulf. With the subsequent economic and financial development of the Gulf region attracting a growing residency of Arab and other professionals, Beirut's regional financial position was becoming relatively less prominent due to the severe blows resulting from developments occurring throughout 2019-21 – the Beirut port explosion in

[22] A striking example is the emerging public reference to the alliance between the Hezbollah and Amal parties as the "Shiite Doe," and another is the emerging confessional reference to the electoral districts, e.g., as mainly being Christian, Sunni, or Shiite districts. In previous decades, such political discourse hardly surfaced at the public level, if at all.

[23] Improved political governance implies implementing policies and measures that foster long-term sustainable development by promoting economic growth and well-being for citizens.

particular. Recovering its financial position as part of its overall national recovery is similarly dependent on the emerging quality of political and economic governance that could help rebuild trust in Lebanon's financial system.

Thus, in contrast with past domestic (and even foreign) tolerance of prevailing corruption in the public sector, good governance has now emerged as a major requisite for successful, rather than distorted, economic and financial recovery. The details of this matter lie outside the purview of this paper, except to note that it might require setting up an independent body (outside the public sector) that would be charged with the task of monitoring the implementation of the recovery plan.

(2) On regaining confidence in the national economy

(a) The foreign exchange system

As noted above, the ad hoc measures taken by the central bank since the outbreak of the crisis that led to the freezing of bank deposits in foreign exchange (dollar deposits in particular) and the creation of multiple exchange markets (including two separate markets for the dollar)[24] all contributed greatly to further weakening confidence in the Lebanese economy and the Lebanese pound. These measures suddenly changed the nature of the pre-2019 free foreign exchange system, thereby creating legitimate concerns, if not fears, about its future course; especially since the law allows for forced conversions of foreign exchange deposits into Lebanese pound deposits as one of the intended measures.[25]

We submit that a declared objective of restoring a well-governed free foreign exchange system with a unified exchange rate would help rebuild the confidence of foreign and national depositors in the planned recovery. Otherwise, uncertainty about this planned restoration would greatly diminish the confidence of savers, both national and foreign, in the Lebanese banking system, even if reformed. While new deposits (post-October 2019) are free to move, unless the reestablishment of a free foreign exchange market is highlighted as a primary objective, there would always be doubt that controls may return. Precedents are not readily forgotten. At the same time, the US dollar needs to stop being allowed to serve as a currency in circulation along with the Lebanese pound.

The willingness to hold savings in Lebanese pounds is dependent on its unrestricted convertibility into foreign exchange. The reasoning here is that, though weakened by the crisis of 2019-22, Lebanon's comparative advantage remains embedded in the fields of services (educational, technological, and trade). The country's tradition of education, economic, cultural, and commercial openness, coupled with its entrepreneurial spirit, continues to reinforce this advantage. Reinvigorating the role of the foreign exchange sector should support

[24] A free market rate for dollar inflows after 2019 that were exempted from any restrictions and a highly discounted rate for any possible withdrawals from the pre-2019 dollar deposits

[25] As noted above, this intended measure has been met with strong opposition from various professional syndicates and other groups.

rather than compete with the development of the industrial and agricultural sectors, keeping in mind that Lebanon’s limited natural resources would not allow these sectors to be the dominant bedrock for national recovery. However, it remains that the mutual development of all economic sectors, along with the technological sector, should be the objective of any recovery plan.

(b) Settlement of the public debt

The proposed immediate elimination of USD 60 billion of the central bank’s obligations vis-à-vis commercial banks is unsettling. Its ultimate burden is shifted to the depositors or savers by practically eliminating the bulk of the foreign debt obligations owed to them. The sanctity of maintaining foreign exchange deposits as per existing laws is thus violated by resorting to a policy of “liralization,” i.e., forced conversion of foreign exchange deposits into Lebanese pound deposits. Apart from any legal implications such a policy might carry, the adverse impact of such forced conversions would go beyond making national and foreign savings in banks (the source of lending and economic activity) bear the brunt of addressing the public debt burden. Such an act would prompt national and foreign savers to avoid placing their future savings in the Lebanese banking system (even in a reformed system). It would thereby cripple national economic recovery by disincentivizing capital inflows despite any international assistance Lebanon may yet be able to negotiate, or despite any official policy declaration intended to assure national and foreign savers and investors of the sanctity of their post-October 2019 foreign exchange holdings, even if a free foreign exchange system is restored. Once a policy precedent is set, it will always be remembered.

Instead, a different approach to settling the debt issue should be envisaged; one that would preserve Lebanon’s comparative advantage as an open economy and help encourage the reflow of capital as the reform measures take effect. The details of this alternative approach cannot be detailed here except to note that it would uphold the principle of repaying debt obligations in foreign exchange, whereby, instead of forced “liralization” and cuts, a policy of extended debt repayment may be envisaged. Accordingly, the central bank could elaborate a schedule of payments of its debt obligations in foreign exchange to commercial banks over a clearly specified number of years. An annual review of the repayment schedule would take place in light of the evolving financial situation of the central bank. In turn, the banks would be required to schedule the payment of their debt obligations to the depositors over the same number of years, again subject to an annual review of their evolving financial situation. The authorities may also consider supplementary policies, such as imposing (as a one-time measure) a progressive income tax on accumulated interest income during the period 2016-19 when central bank action led to markedly higher levels of interest rates on savings deposits that benefited depositors. Alternatively, they may consider establishing a sovereign or rehabilitation fund to manage (not sell) state assets, provided it would be, as part of its setup, an independent public institution managed by highly-qualified and independent professionals. Its returns would contribute to the settlement of the outstanding debt over a scheduled period of time. Potential supplementary sources of financing, including grants, may also contribute to this fund.

This alternative approach would assure depositors that their foreign exchange savings are in safe custody, though they would have access to them only over time and may possibly have to cede to the government part of their interest income earnings after 2016. Along with the reform measures intended to preserve the sanctity of the foreign exchange system, it would also encourage the inflow of new capital as well as the planned recapitalization of existing viable banks as part of the proposed banking restructuring and reform.[26]

Concluding remarks

Following its economic breakdown in October 2019, Lebanon was yet to initiate a major recovery program despite official recourse to international organizations as of end of June 2022. However, even when plans are finally agreed on, Lebanon would continue to face the major dilemma of implementing economic reforms in the context of non-reformed political governance, in which case implementing recovery measures would, at best, help initiate a distorted development in the shorter run with an uncertain outcome in the longer run. However, should the changing of these conditions force a major improvement in political governance, Lebanon would be well-equipped to traverse the path of sound national recovery.

[26] On 15 May 2022, a new parliament was elected and, constitutionally, the sitting government became a caretaker government. This parliament then voted (by less than 50 percent of the total vote) to reappoint sitting Prime Minister Najib Mikati as Prime Minister-designate. Shortly afterward, in response to parliamentary groups' growing opposition to the governmental plan that had been submitted to the outgoing Parliament, he announced that, once confirmed, the new government would revise it, whereby deposits would not be eliminated as proposed earlier. Instead, a rehabilitation fund shall be established to address how depositors may regain their savings. The setup of this Fund, as the Prime Minister put it, was to be detailed later.

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Appendix

Table 1.a: Lebanon: Correlation between corruption perception index and the growth rate, 2012-2021

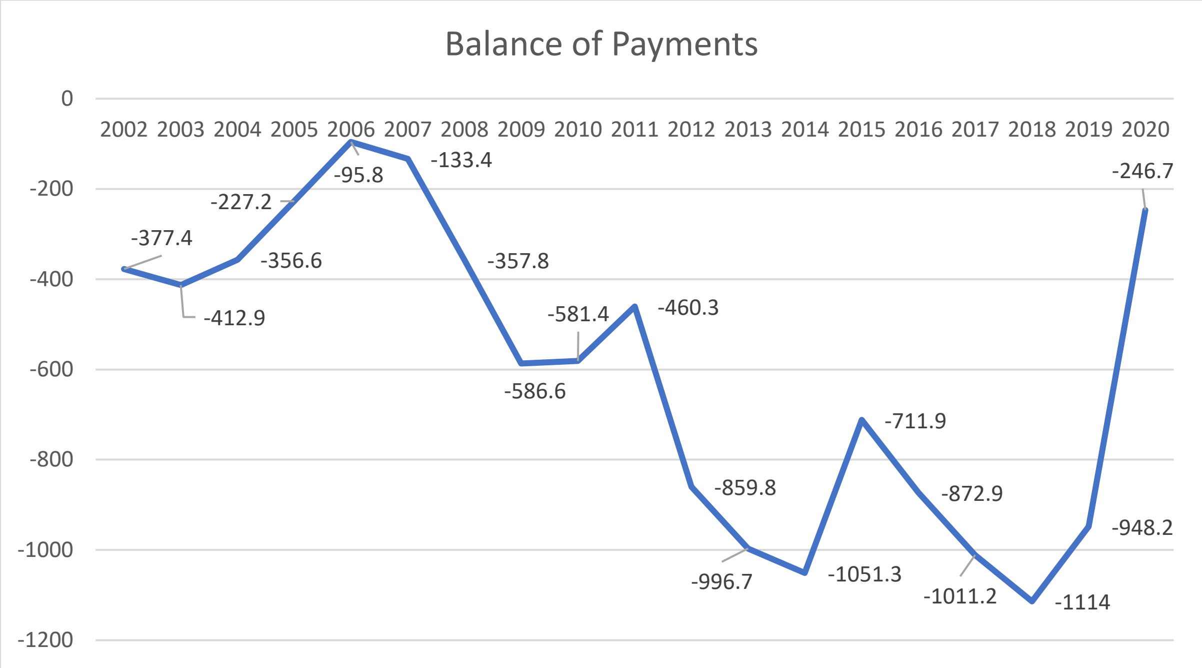
Year	Corruption Perception Index	Growth Rate (in percentage)
2012	30	2.541
2013	28	3.811
2014	27	2.454
2015	28	0.582
2016	28	1.582
2017	28	0.782
2018	28	-1.702
2019	28	-7.157
2020	25	-21.464
2021	24	

Sources: Transparency International, Corruption Index, 2021; World Bank Group data, 2020.
Note: The Corruption Perception Index refers to the perception of government corruption. It ranges between 0-100; the lower the index, the worse perceived government corruption.

Table 1.b: Lebanon: The Pearson correlation matrix between corruption perception index and the growth rate

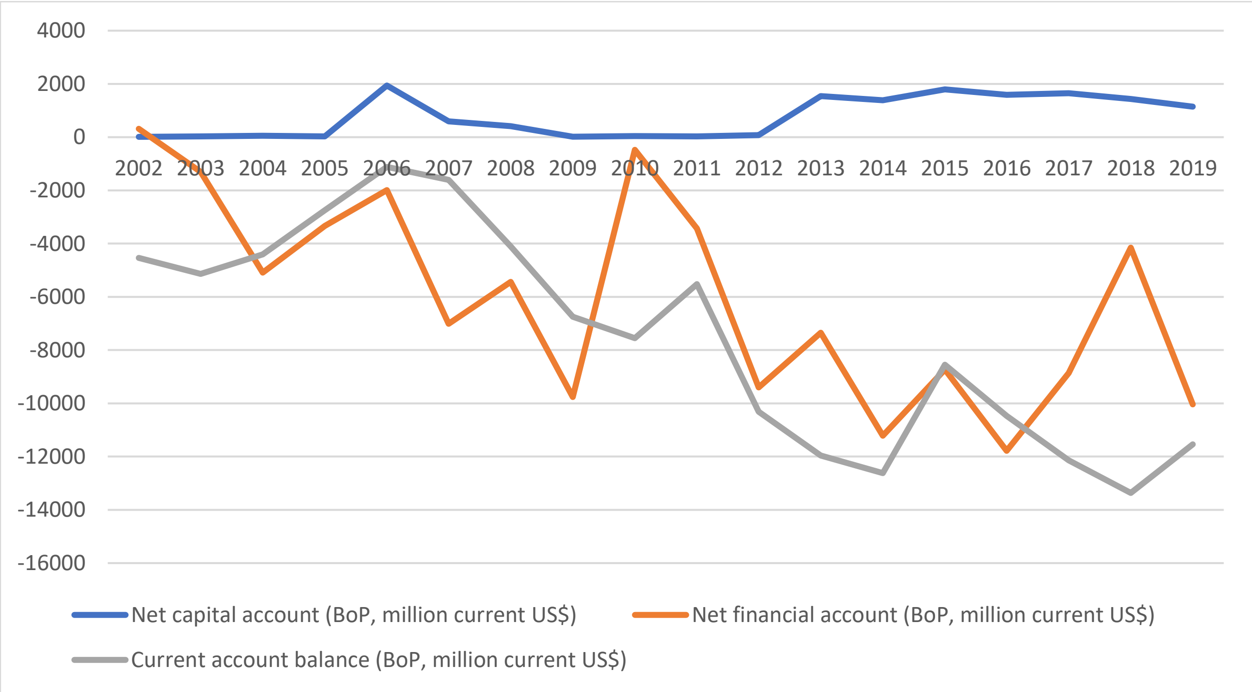
Pearson Correlation Matrix	Corruption Perception Index	Growth Rate
Corruption Perception Index	1.000	
Growth Rate	0.7587	1.000

Figure 1.a: Lebanon: Balance of payments, 2002-2020 (USD million, annual)



Source: Bank Du Liban.

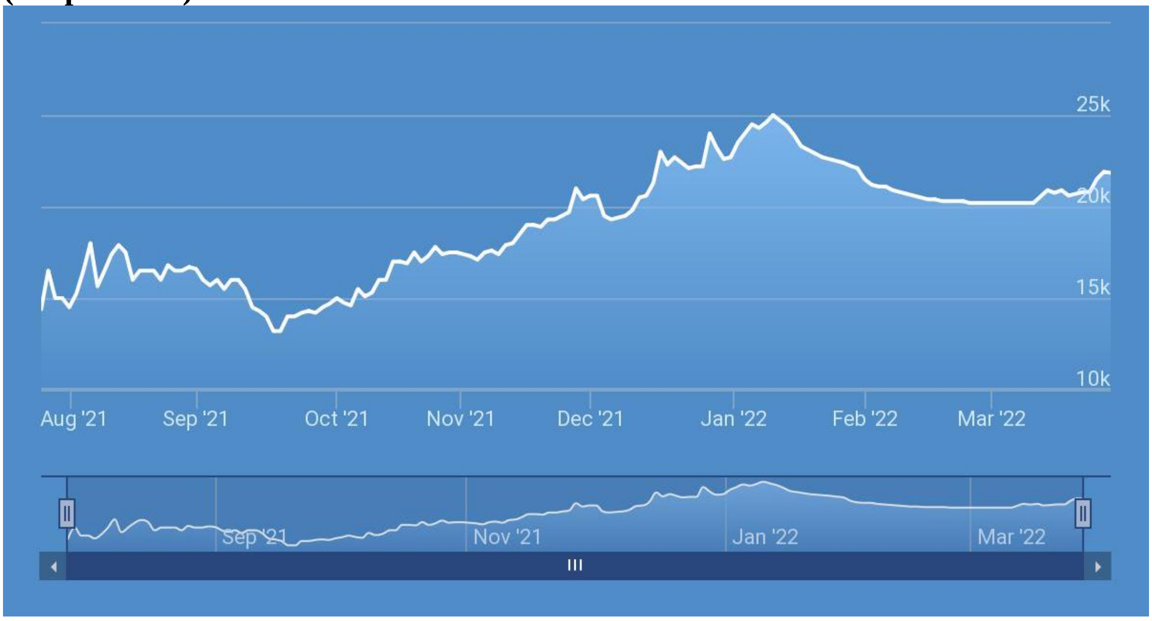
Figure 1.b: Lebanon: Balance of payments, 2002-2019
Capital account, financial account, current account



Source: Bank Du Liban.

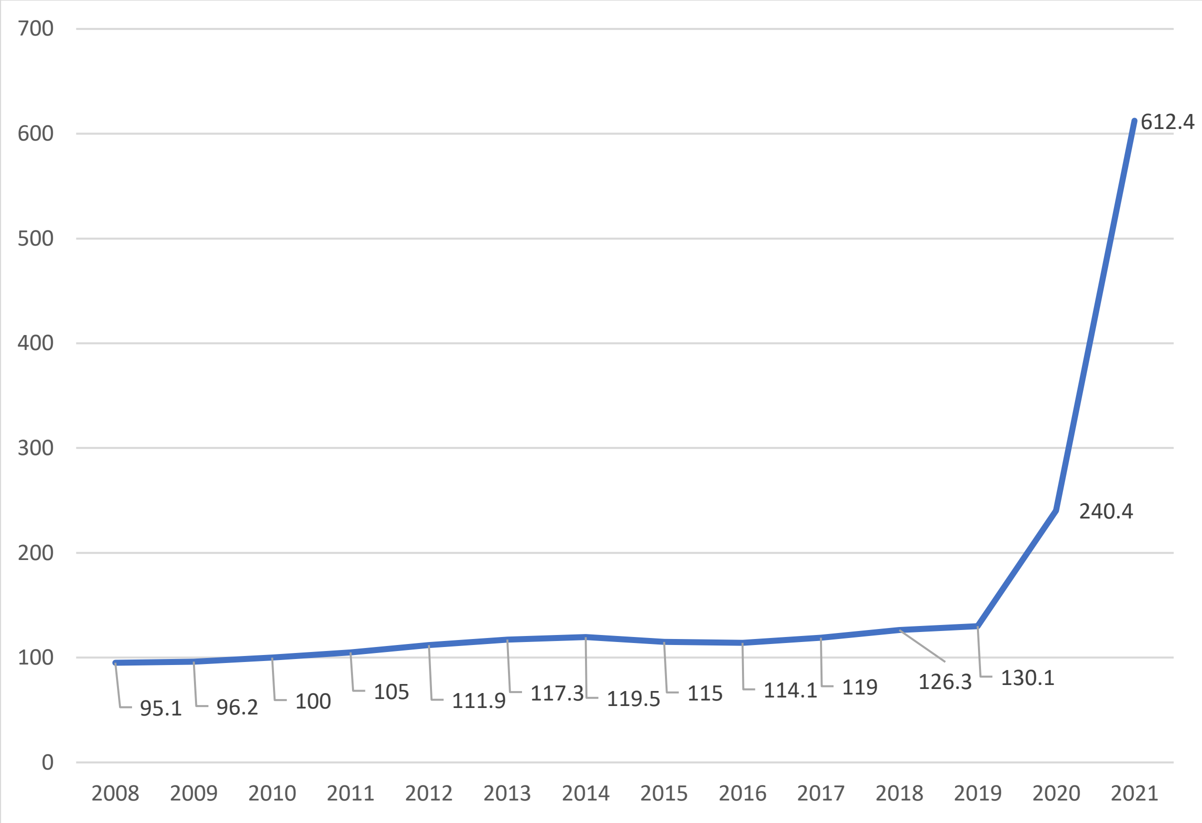
Figure 2.a: Lebanon: Unofficial market rate, January 2019- January 2022 (LL per USD)

Figure 2.b: Lebanon: The Sayrafa rate, August 2021-March 2022 (LL per USD)



Source: Bank Du Liban, the Sayrafa Rate.

Figure 3: Lebanon: Consumer price index, 2008-2020
(Base year=2010)



Source: World Bank.
Note: CPI is an index that measures inflation relative to a base year of the price of a market basket.

Figure 4: Lebanon: Personal remittances, 2002-2020
(Percentage of GDP)

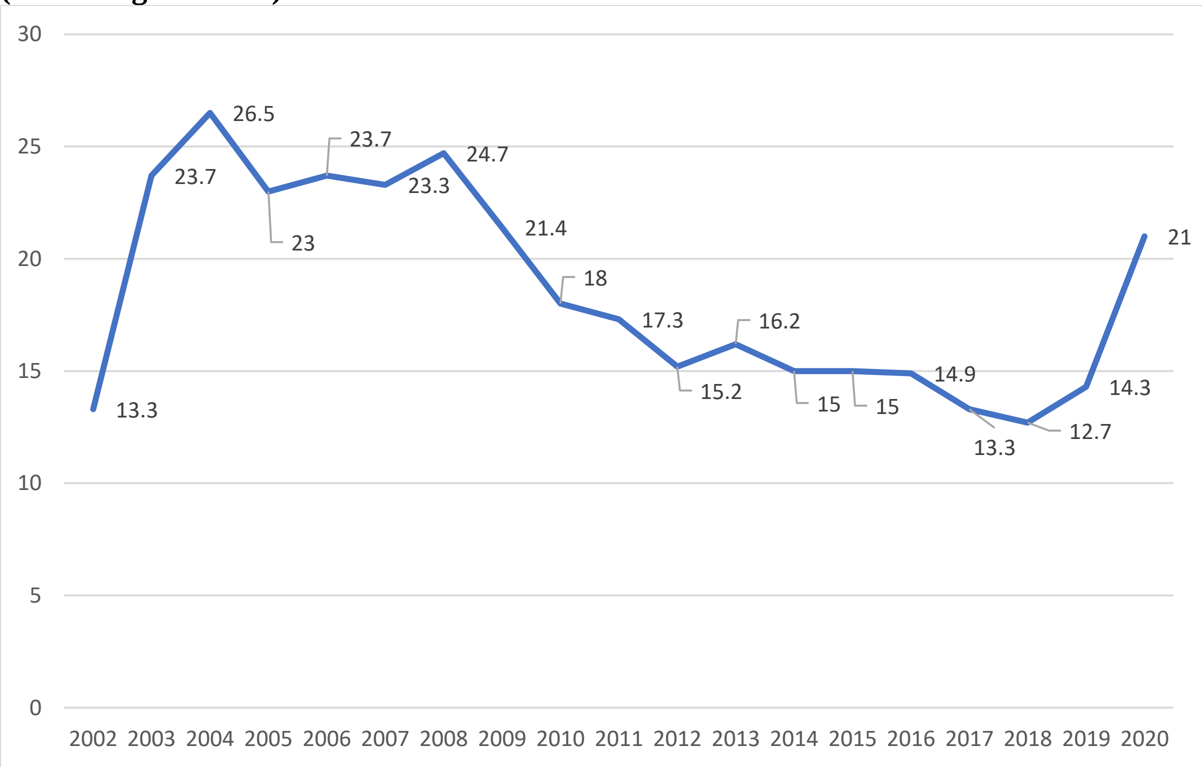
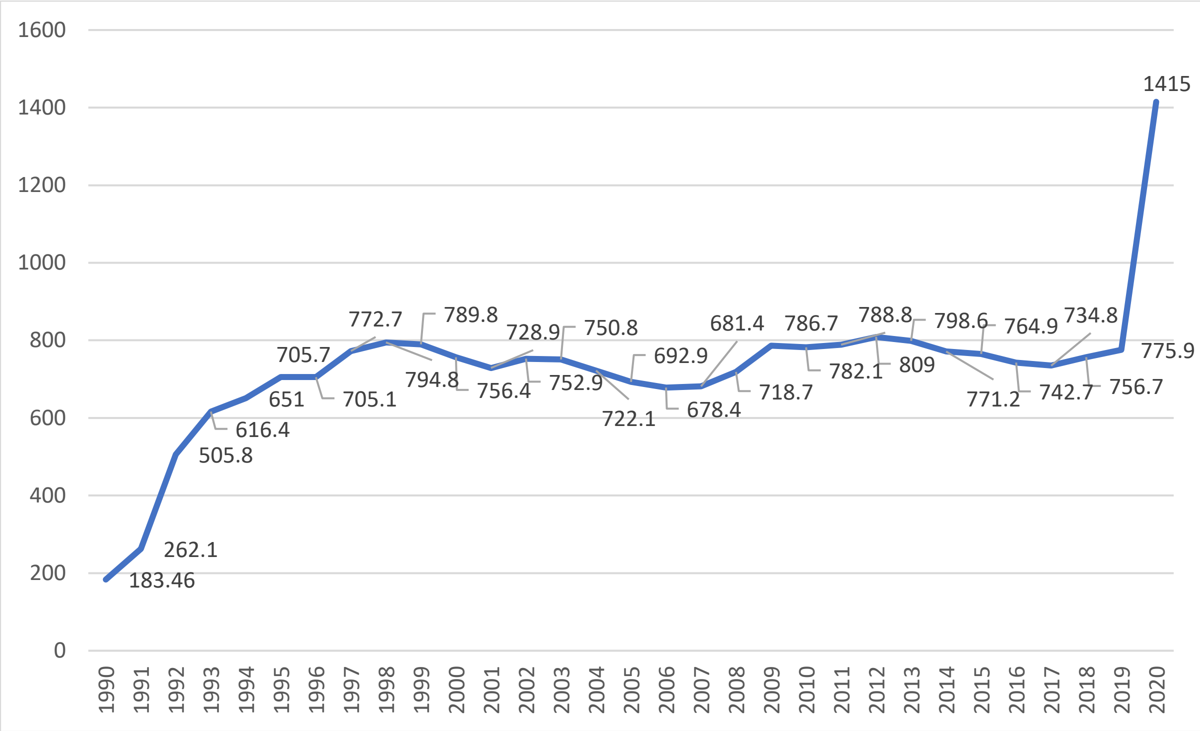


Figure 5: Lebanon: Purchasing power parity conversion factor, 1990-2020



Source: World Bank.