Lebanon's Future in the Balance

Ishac Diwan and Maha Yahya

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Lebanon today is standing at a crossroad as multiple storms are raging and gaining in intensity. The country is in the midst of an economic collapse, compounded by political deadlock, all wrapped in a broader crisis of legitimacy as a significant portion of the Lebanese have lost confidence in their political system. How the economic and political challenges will interact is anyone's guess. Economic collapse may give rise to a Third Republic, or it can allow the current regime to strengthen its hold on a significantly impoverished country.

Current conditions

Since October 17th widespread protests have raged across Lebanon. In major cities and in smaller towns and villages, the Lebanese have demanded an end to the economic and political mismanagement of the country. These protests come on the heels of rapidly deteriorating economic and financial conditions with significant impact on the lives of Lebanese. The priority of the new government of Prime Minister Hassan Diab will be to stop Lebanon's economic and financial free fall. To do so, it must address three simultaneous debilitating crises and their political and socioeconomic repercussions:

The first challenge is the large balance of payments imbalance. The current account gap stood in 2019 at a whopping 25% GDP and Lebanon's small export base is insufficient to even pay for essential imports.[1] In the absence of new external flows, the necessity to drastically lower imports will cause a significant depression in economic growth. The Banque du Liban (BDL) still holds large reserves - some $30 billion. These in fact constitute deposits by the banking sector, and as such, should only be spent sparingly.

The second challenge is that of the fiscal accounts. Public debt stands at over 150 percent of GDP, and its service cost the government in 2019 about 10 percent of GDP, or half its revenues. Government revenues are now collapsing under the weight of the recession and widening the deficit. Over time, the necessity to reduce spending and increase revenue will exert a further depressive effect on the economy.

The third challenge is how to revive the banking sector, and more generally, the private sector. Banks, the main recipients of past capital inflows, are heavily invested in sovereign debt (over 70 percent of their portfolio), and have lost the trust of their depositors. As a result, they are certainly illiquid, and probably insolvent. It is unlikely that the banking sector can be saved without a deep cut in public debt, that in turn would pave the way for "cleaning up" their balance sheets and get them recapitalized anew.

Dealing with these three crises at the same time creates immense challenges for policy-makers. One hundred and fifty one countries have gone through a financial

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[1] See IMF 2019 for the main macroeconomic indicators cited in the article.

crisis of sorts since the 1970s.[2] But, of these a mere 2 percent faced a simultaneous public finance, currency, and banking shocks. In the best of circumstances, it would be extremely difficult for a normal government to put together the type of complex recovery plan needed to deal with these multiple challenges. The array of political actors and vested foreign interests renders the task far more difficult.

Thus far, the policy response has been timid. Inefficient capital and banking controls have been put in place, managed by the banks themselves. The central bank has been unable to provide the liquidity that banks need. As a result, banks have ceased most normal banking functions, and Lebanon is quickly transforming into a cash economy. These developments have brought economic activity to a standstill. Private firms are starving for liquidity, loans, and imports. The recession is rapidly growing in scale to resemble a great depression, with projections of negative growth in the double-digit range if no corrective action is undertaken.[3]

The results are already devastating for the Lebanese people, with worse yet to come. Businesses are going bankrupt, and unemployment is rising rapidly. Rising inflation (running now at a conservative estimate of 25% a year) and currency devaluation on the parallel market have reduced real wages. In a matter of months, poverty has expanded dramatically with the World Bank estimating that it may have reached 40 percent of the population, or 1.5 million people. Shortages in basic goods as well as fuel and medicine are becoming more apparent. Enrollment in public schools is increasing as parents move their children from private educational facilities and there is growing risk that they may eventually remove their children from schools as they try to cope with the crisis. Meanwhile, around a million Syrian refugees and another 250,000 Palestinian refugees continue to live in dire circumstances.

How did we get there?

While economic and political elites cling to the hope that the crisis is temporary, and that it should be possible to revive the Lebanese "miracle economy", a more sober diagnostic is that the ongoing financial difficulties marks the bankruptcy of its post-civil-war economic model.

To transition to a new model, it is important to understand the shortcomings of the past one. Its principle tenets were attracting external capital by maintaining high interest rates and a fixed dollar peg. Capital flowed, largely from the Lebanese Diaspora, into the country's banks, to the tune of 20 percent of GDP on average over the past three decades. These flows in turn allowed the state to maintain a loose fiscal policy. Capital inflows started to weaken around 2015, and eventually, they dried out as depositors lost trust in the country's ability to repay.[4]

The important point is that there was little economic growth to justify such large borrowings. While growth was highly erratic, and subject to a host of political and security shocks, especially after the 2005 assassination of Prime Minister Hariri, the

[2] Laeven and Valencia (2018)
[3] Concerned Citizens, 2020.
[4] For details, see World Bank 2018.

average over long periods was modest (see figure 1). There were two short boom periods, one associated with the beginning of post-war reconstruction in the mid-1990s, and one around the global financial crisis of 2007-08, when deposits flocked to Lebanon. But economic growth was modest until 2010 for a country catching up after a civil war (5.7% between 1995 and 2011), and much too low after the start of the Syrian war (about 1.7% between 2011 and 2019) to sustain the capital inflows for long.

One central reason for the modest growth performance is the loss of competitivity generated by the capital inflow, similar in effect to oil in the rentier state of the Gulf. High interest rates reduced investments in the real economy and job opportunities. And as the exchange rate became over-valued over time (by about 50% between 2000-2015; see IMF 2019), tradable sectors weakened. Corruption and poor infrastructure further increased the cost of doing business. Exports of goods and services, which were between 60 and 80% of GDP in the first part of the 2000s fell steadily to 20-30% GDP by the end of the 2010s.[5]

Until 2011, economic growth was low, but sufficient to allow for a gradual stabilization and a reduction in the country's debt ratio after 2005 (see figure 2), and an accumulation of international reserves. However, the eruption of the Syria conflict reversed this trend triggering a decline in Lebanon's economic growth. Exports were hit by border closures, and inflows started to fall (figure 3). Interest rates differentials rose - from 1-2% over international interest rates until 2015, to 6-7% after 2016 - making it more expensive for the state to refinance its debt (figure 4). By 2015, funding from GCC fell further, as oil prices collapsed, and as Lebanon came to be considered by GCC countries as a Hezbollah stronghold.

Figure 1. Real Economic Growth (GDP%)

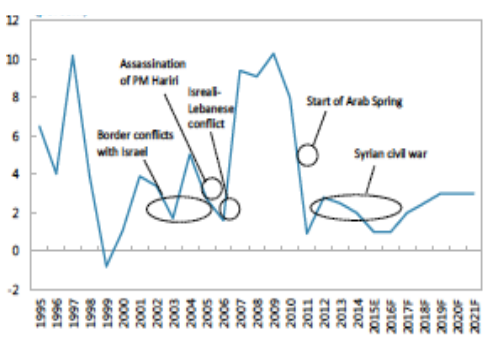
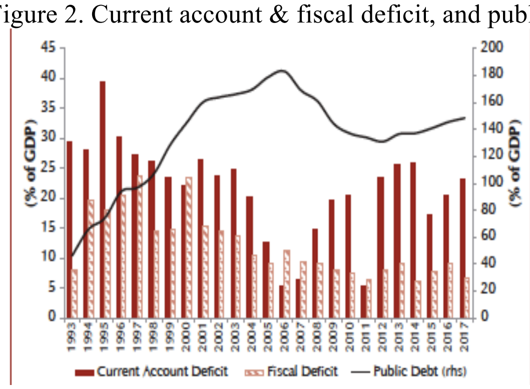


Figure 2. Current account & fiscal deficit, and public debt



Source: World Bank Indicators

By 2011, it was becoming apparent that without proactive measures to address the significant debt overhand and to build a more resilient growth model, the economy was on the road to an inevitable collapse. Such a model would have had to include debt reduction, a floating of the exchange rate, and measures to revive national production - reversing the main tenets of post war reconstruction period, rather than sticking to a doctrine after its foundations had melted away.

[5] World Bank 2018.

Indeed, when the then Prime Minister Rafic Hariri initiated the borrowing binge in the early 1990s, it had at least a clear purpose. The large borrowing that he under-wrote had a possible upside - the reconstruction of the country after a devastating civil war. Moreover, the upside was plausible as the prospect of fast growth in a more peaceful regional environment, with Lebanon acting as a vibrant, pro-western, center of tourism and finance, looked feasible. With the collapse of the peace process, Hariri's bet failed. But some would argue that the risks were well worth taking. In contrast, delays in adjusting the economic model sometime between 2011-2016 had no possible economic justification beyond myopic prevarication, vested political interests, and lack of courage in decision-making. The continuation of the same economic model became an irresponsible bet with no discernable upside.

Fig. 3 Deposit growth, year on year (percent)

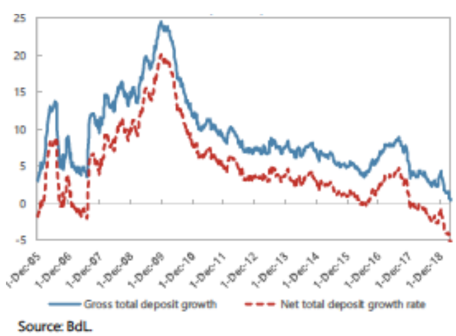
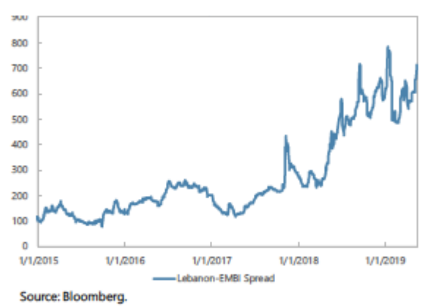


Fig. 4. Lebanon-International interest rate spread (points)



Importantly, policy-makers were not gambling with foreign capital, but with the savings of the Lebanese, at home and in the Diaspora. In many other countries, risky economic expansions are financed by foreign capital, and the cost of failure is shared with foreigners in the form of debt reductions. In Lebanon however, foreign holding of public debt remained below 10%. At the end, it is bank depositors, small and large, that effectively financed the successive government fiscal follies. Depositors usually count on their bank to invest their assets prudently, on their central bank to regulate banks so their deposits remain safe, and on their state to adjust its policies to avert creating a financial crisis. Instead, the state continued to run large deficits, and the central banks continued to accommodate this with ever rising interest rates. Lebanese banks continued to invest massively in sovereign debt, lest they cause the house of cards to collapse. The collapse came at the end from a loss of depositors' trust in the system. Recently leaked data from the National Institute for the Guarantee of Deposits shows that the depositors' run was triggered by the withdrawal of nearly $28 billion of deposits during 2019, 98% of it from the top 1% of depositors - the same economic elite that benefited most from the high interest policy.

How to recover?

A triple crisis is complex to manage, requiring that different policies be implemented in parallel as part of a comprehensive strategy. An independent group of Lebanese development specialists, economists, and finance experts recently outlined such a plan; one that could help Lebanon overcome the crises and move onto a more sustainable path.[6] Based on the principles of justice and equitable burden sharing, the plan calls for deep cuts in public debt to facilitate adjustment, fiscal consolidation and anti-corruption measures to correct internal imbalances, a more flexible exchange rate to adjust external deficits, the reorganization of the banking sector to insure an improved business climate, the creation of a safety net for vulnerable Lebanese and fiscal reform with a view to greater investments in social services.

Yet, the political class still hesitates, refusing to come to terms with the reality of Lebanon's bankruptcy. A conservative estimate puts the losses that need to be distributed nationally at about $60 billion. This represents about 100% GDP, a world record. It is also more than banks total capital base, and will thus likely also impose losses on depositors. Various computations reveal that this implies haircuts in the range of 20% (if imposed on all) to 40% (if losses are allocated to large accounts only).

A serious recovery plan that tackles the imbalances of the past would be able to garner foreign support, which would greatly increase its chances of success. Support is crucially needed to smooth the effects of the massive shock on Lebanese society and economy, minimize wealth destruction, and thus contribute to the maintenance of social solidarity and to the survival of good firms during this difficult transition period. In normal circumstances, the reform program would adopt an IMF-led umbrella to gain international credibility. Unfortunately, there are strong forces in Lebanon, including Hezbollah and parts of the progressive camp among of the revolutionaries, who oppose IMF involvement, fearing US influence would politicize its action, and that its conditionality will hurt the working class disproportionally. The financial and political oligarchy are also opposed for fear that this would weaken their hold on power and that the requested reforms would diminish their vested economic interests.

In the absence of external support, the country risks descending into chaos, making predictions about political change much more uncertain. The current path has no good landing in sight - just the hope for an unlikely miracle. It counts on capital controls and low real interest rates to tax the deposit base over time. This scenario could last a year or two, causing significant destruction. Without access to banking services, more firms would go bankrupt than necessary. The fiscal deficit will have to be financed by printing money, further destabilizing the macro situation. In all likelihood, big capital will continue to exit the country, further bleeding the deposit base. There will be a sharp rise in poverty, a wiping out of the middle class, and an acceleration of migration of skilled Lebanese. In such a scenario, the country risks being stuck in a low-growth Venezuela-like trap.

The end of a political model

The roots of sectarianism lie in the political model that has characterized Lebanon since its independence in 1943, when a national accord enshrined a power-sharing model based on sectarian identity.[7] The 1989 political settlement that ended the fifteen-year civil war further institutionalized the sectarian based power-sharing model. Haririsim

[6] Concerned Citizens, 2020.
[7] Salibi 1990.

brought the Sunni bourgeoisie at the center of the new settlement, as it took charge of the reconstruction effort. The dominant role of wartime sectarian politicians was secured, putting them in a position to plunder national wealth in order to finance their patronage networks and entrench their legitimacy.[8] Access to rents was important to influence elections results, and to hinder the rise of alternative political forces within their group.[9] Clientelist networks came to dominate social life - for example, three quarters of university students thought that political connections were needed to find jobs.[10]

Later developments broadened the ruling coalition to include Hizbollah as a first among equals. The prominent role given to Hezbollah by Syria, the leading power in Lebanon between 1990 and 2005, transformed the country into a hub for the party's "resistance" against Israel and its allies. Its expanding regional role including its defense of the Syrian after 2012, increased its powers. Today the party is a key defender of the corrupt sectarian order, because the system effectively protects the party and its weapons. This period reaffirmed Lebanon's schizophrenic character —a merchant republic alongside a militarized entity pursuing an agenda of resistance—and reflected the uneasy regional balance that marked Lebanon's post war period between the interests of Saudi Arabia, and those of Iran and Syria.

The progressive expansion of the size and diversity of the governing coalition meant that fiscal spending rose in response to demands for larger rents. The key political groups engaged in allocating jobs to their constituents, leading to bloated civil and security services. Their control of various ministries allowed them to provide preferential treatment in the procurement of government contracts to their client contractors.[11] A notorious illustration is provided by the national electricity utility, which became a milking cow for various political parties: its cost over the past two decades averaged 11 percent of expenditures, and added up to about a third of public debt, at a time where the Lebanese paid twice the regional price.

Meanwhile, insistence on successive national unity governments in the period following the assassination of Prime Minister Rafic Hariri in 2005 created political paralysis. The presence of all political parties in government with their diverse and often conflicting interests allowed Lebanon to remain relatively stable in the midst of an otherwise chaotic regional environment. However, it also created political deadlock, which was most evident when Lebanon remained for two years without an elected president in 2015.

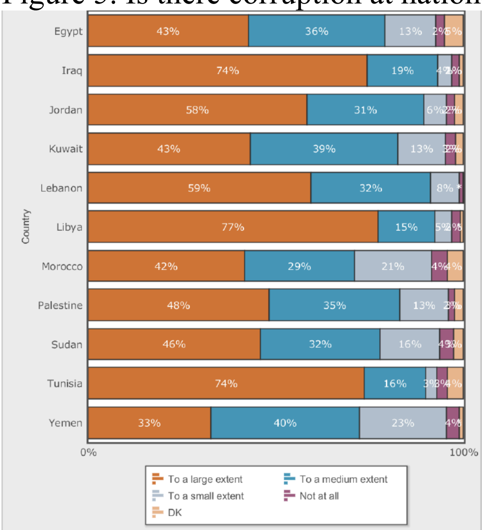
Over time, and as the fiscal space closed down, especially with the deterioration of debt ratio after 2011, Lebanon's politicians engaged increasingly in the extraction of regulatory rents from the domestic private sector. A recent study identifies several hundred politically connected private firms. These firms turn out to be concentrated in the banking, media, energy (including oil and gas distribution), health (i.e. hospitals, drug import and distribution), real-estate construction, road paving, water extraction and

[8] Traboulsi 2007.
[9] Corstange 2016.
[10] LCPS, 2013.
[11] Leenders 2012.

sale, mining (including quarries), telecommunication, soft-drinks, and pharmaceutical production sectors.[12] They monopolize their sector of activity, sometimes in the form of inter-sectarian cartels, profiting from regulatory favors that include juicy public contracts, favorable tax and custom treatment, monopoly rents, access to public land, and preferential access to finance. The study estimates that this unfair competition lowered job creation by 25%, as compared to more competitive conditions.

This period also saw a great expansion of income inequality. The proceed of large construction contracts, monopolization of markets, and high interest rates enriched a 1% of the population disproportionately. It is now estimated that this 1% controls 25% of income, and 50% of wealth of the country.[13] Moreover, as state deficits rose, its services decayed, and pervasive inequalities in access to fundamental services such as health and education rose, and became evident across the country.[14] This rise in inequality is connected to a rise in the perception of corruption, which is now among the highest in the region (figure 5).

Figure 5. Is there corruption at national level?



Source: Arab Barometer, 2018

The ongoing revolt

Since October 17th Lebanon's protestors have focused on the need to change the country's power-sharing system and reverse the rapid deterioration in the quality of daily life. For the political elite, the breadth of discontent was startling. No political leader or party was spared. What has become apparent to the Lebanese is that their economic woes are at heart the consequences of a governance crisis. The dysfunctional sectarian system allowed a narrow group of leaders to usurp communal representation, propagate a siege mentality, and generate an environment of abuse among all communities. Amidst Lebanon's historically most painful crisis, politicians have remained focused on scoring

[12] Diwan and Haidar 2019.
[13] World Bank 2016, Asouad, 2016.
[14] Salti and Chaaban, 2010.

political points as the country sinks into the abyss, keen to protect their interests in a system that can no longer sustain such behavior.

Beyond declining economic conditions, a profound crisis of legitimacy is driving people into the streets to denounce their ruling class and the system of governance. Along with an expanding sense of national solidarity has come rising popular narrative that "us versus them" is no longer about ethnicity or even class, but about a corrupt political class against the population.[15] The revolutionaries in the streets are now making their voices heard loudly. The have called for early parliamentary elections and a new president. They want to build up their country rather than be forced to leave it. They believe that it is way below its potential, and that they can do much better with their collective energy and skills. They want performance to replace corruption, and meritocracy to replace connections. They want social justice, not rising inequality. The current moment is also about upturning social norms.[16] It is an uprising against a patriarchal system, with many women at the forefront of the movement. For the youth, it is a fight for their future. Not only are there no job prospects, but moreover, they are not vote until they are 21. Marginalized populations are also increasingly more active in demanding rights to a dignified life.

A financial crisis as profound as the one that Lebanon is facing today requires long-term solutions supported by a political process that reestablishes trust in the system. Opinion polls in 2018 showed an abysmal trust gap whereby 77 percent of Lebanese did not trust their government, and 80–85 percent did not trust parliament and political parties.[17] Closing this trust gap begins with elections, based on a credible electoral law that reestablishes parliamentary legitimacy. In parallel, a national process to rethink Lebanon's political framework has to be launched. This must be one in which all Lebanese, especially those that have taken to the streets and those that see themselves as politically marginalized, feel they are involved and that addresses their concerns. Without this, the Lebanese will simply not be willing to bear the pain of the necessary economic adjustments while their political leaders continue to reap the benefits of a delegitimized political system. In short, unless a new social contract is formed between citizens and their state, it will not be possible to put the country on a road towards sustainable recovery.

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