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# country report

Country Office Lebanon



## One crisis too many

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### State bankruptcy and COVID-19 combine to form a toxic catalyst in Lebanon

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For the first time in its history, Lebanon has defaulted - and loses its spotless record of its crisis-resistant solvency. The banking system, a pillar of the Lebanese economy, has begun to totter since the nationwide protests of October 17. The ailing economic system was dragged along for years and kept alive by highly irresponsible fiscal and monetary policies. The COVID-19 outbreak will deal the desolate economy an additional blow, with far reaching consequences that we can only imagine at this point.

### An additional challenge in an overwhelmed health infrastructure

Lebanon is all too familiar with states of emergency. Marked by conflict, occupation and governments in paralysis, the country gained a reputation for being highly resistant to crises. Even when the 15-year civil war was at its height, Beirut's bars kept their doors open. The Lebanese capital was renowned for returning to its lively nightlife after evading bomb explosions during the day. The famous Armenia street, lining up bar after bar and usually packed in the evening, is now deserted.

Early 2020 seems to pile up crises in a way that is taking on a new dimension even by Lebanese standards: The entanglement of problems is perceived differently and triggers a more fatalistic mood in the country. The corona pandemic comes at a key moment: On March 7, 2020, Lebanon declared that it would default on a maturing government bond of 1.2 million USD. The novel virus is going to catalyse the rise in poverty and the contraction of the economy. For the Lebanese, the central question consists of how a state on the verge of total economic collapse can deal with such a sudden, pervasive challenge that is putting even the world's richest economies in dire straits.

The virus began to spread in Lebanon in early March, but the number of people affected still remains comparatively low at the beginning of April (about 500 infected). The Lebanese government reacted quickly overall. Decisive action is necessary in view of the weak health infrastructure in Lebanon: Even before the pandemic, the Lebanese healthcare system was already struggling with considerable financial and supply problems.<sup>1</sup> There is little room for generous measures to support the health sector in combatting the new challenge. While the capacities are not yet fully stretched, equipment for treating corona patients is in short supply.<sup>2</sup> Almost all medical products have to be imported and paid for in dollars - while the scarcity of dollars is exacerbated daily. According to Human Rights Watch, this has led to

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<sup>1</sup> LCPS, The Government Monitor No. 13 (12.03.2020), <https://www.lcps-lebanon.org/agendaArticle.php?id=154>.

<sup>2</sup> Vgl. Anna Hout, Can the Lebanese health system cope with the epidemic?, in Le Commerce (19.03.2020), <https://www.lecommercedulevant.com/article/29696-covid-19-can-the-lebanese-health-system-cope-with-the-epidemic>; Sunniva Rose, Coronavirus stretches Lebanon's ailing healthcare system, in The National (12.03.2020) (<https://www.thenational.ae/world/mena/coronavirus-stretches-lebanon-s-ailing-healthcare-system-1.991827>).

supply shortages of essential medical products and spare parts in both private and public hospitals.<sup>3</sup> The young age of the Lebanese population creates an important advantage in this battle: according to the UN, in 2018 only 12.3% of the population were over 60 years old and thus in the age-related risk group.

### A death blow for the economy?

The spread of the virus will carry severe implications for the already desolate economy. The gross domestic product will continue to shrink, and many observers expect the recession to slide down deeper into double figures (approx. 12%).<sup>4</sup>

Restaurants, bars and hotels which are already struggling to keep their heads above water due to the economic crisis are not going to survive the several weeks of closure. In the period between the outbreak of the protests on October 17, 2019 and the end of February 2020, more than 785 restaurants and cafés have had to shut down and left more than 25,000 employees destitute.<sup>5</sup>

Even without global pandemic, Lebanon's food security is at high risk, as the country imports about 85% of all consumed food. Lebanon's import sources for food products are poorly diversified: for instance, all wheat imports come from Ukraine.<sup>6</sup> This exposes the country to greater vulnerability to supply shortages. The local agricultural sector will also suffer, with supply reductions and price increases that could occur from June or July onwards.<sup>7</sup> Tourism, one of Lebanon's few productive sectors, will not create any revenues for the foreseeable future.

Unlike other countries, the private sector in Lebanon cannot expect any significant rescue packages from the government. One should rather expect tax increases to ease the budget deficit in light of the default. Additionally, attention to Lebanon's plight continues to wane as every country is primarily concerned with mitigating the economic impact at the national level. Coupled with crashing oil prices and shrinking revenues for the Middle East, it seems less likely that more international aid will flow into Lebanon.

The gradually growing poverty will continue to rise due to the toxic mix of state bankruptcy, price increases and pandemic. The unsustainable fiscal and monetary policies, and the visible wealth of Lebanon's 1% have concealed this trend to some external observers and cemented the image of Lebanon as a wealthy country. In 2018, around 27% of the population was below the poverty rate, but this is likely to have risen substantially in the course of the economic crisis in 2019. The World Bank already warned in November that ceteris paribus more than half of all Lebanese could slip into poverty.<sup>8</sup> The corona virus will further accelerate this development. A similar trend can be expected for the unemployment rate, which according to estimates for the period prior to the economic crisis was at 25%,

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<sup>3</sup> Human Rights Watch, Hospital Crisis Endangering Health (10.12.2019), <https://www.hrw.org/news/2019/12/10/lebanon-hospital-crisis-endangering-health>.

<sup>4</sup> Firas Abi Nassif i.a., Lebanon's Economic Crisis, Carnegie Middle East Centre (06.01.2020), <https://carnegie-mec.org/2020/01/06/lebanon-s-economic-crisis-ten-point-action-plan-for-avoiding-lost-decade-pub-80704>.

<sup>5</sup> Lebanon: 785 Restaurants, Cafes Closed, in Asharq al Aswat (20.02.2020), <https://aawsat.com/english/home/article/2140916/lebanon-785-restaurants-cafes-closed-25000-employees-laid>.

<sup>6</sup> Nabila Rahhal, Economic and coronavirus crises threaten Lebanon's already fragile food security, in Executive Magazine (01.04.2020), <https://www.executive-magazine.com/agriculture/economic-and-coronavirus-crises-threaten-lebanons-already-fragile-food-security>.

<sup>7</sup> Nabila Rahhal, Q&A with Nadine Khoury, in Executive Magazine (26.03.2020), <https://www.executive-magazine.com/agriculture/qa-with-nadine-khoury-coo-of-robinson-agri-on-how-covid-19-has-impacted-agriculture>.

<sup>8</sup> World Bank Press Release (06.11.2019), <https://www.worldbank.org/en/news/press-release/2019/11/06/world-bank-lebanon-is-in-the-midst-of-economic-financial-and-social-hardship-situation-could-get-worse>.

with youth unemployment even reaching 37%.<sup>9</sup> The hopelessness for even highly educated young Lebanese leads to an increasing talent drain.

## Lebanon's colossal debt

Through a mixture of mismanagement and corruption, the country was run down to bankruptcy. The state is the third most indebted country in the world, with a debt rate of 170% of gross domestic product (GDP). The negative balance sheets of the government, the central bank and the local banks create a Molotov cocktail of challenges.

Since 2000, about half of the government revenues have had to be spent annually only to pay the interest of held debts. By 1996, interest rates had reached such a high level that the two thirds of all new debts had to be taken on by the government in order to finance existing interest liabilities.<sup>10</sup>

In order to maintain the house of debt cards and the pegging of the Lebanese pound to the US dollar, fresh dollars have to flow into the country from abroad. Yet as foreign remittances are declining since the Syrian civil war, Lebanon's US dollar reserves are also shrinking. This has shaken the Lebanese pound: since summer 2016, the Lebanese currency has lost an estimated 60% of its value. The government is trying to combat unofficial exchange rates by setting the ceiling for exchange offices at LBP 2000 for one USD. But this measure will not be sustainable as long as dollar reserves needed for essential imports continue to dwindle.

## Entering default with a poor negotiation basis

The country debated intensively whether the accumulated debts should be paid. The announced default and restructuring affect not only the bond maturing on 9th of March, but the entire Eurobond debt of about 30 billion US dollars. Opponents of this decision fear that Lebanon will lose its spotless borrowing record and therefore the access to the international credit market.

At the beginning of the year, both central bank chairman Riyadh Salameh and Prime Minister Hassan Diab still signaled their intentions to meet the commitments in 2020. Just two days before the maturing of the USD 1.2 billion March bond, the government decided unanimously to default; the dwindling US dollar currency reserves being a central reason for this decision. Public opinion was also against the payment of debt. "How can we pay creditors abroad while the Lebanese cannot get their money from their bank accounts," Diab justified the government's decision.<sup>11</sup>

Lebanese banks hold about 50% of government bonds and are therefore particularly exposed. Debt restructuring will be messy and complex and might result in the closure or merger of many local banks, as a large part of their capital is at risk. In order to avoid bank insolvency, many experts recommend a bail-in of investors, i.e. that they participate in the bank's losses if their investments exceed a certain amount.<sup>12</sup> Restructuring will carry drastic consequences for the banking sector, which despite public mistrust is essential for the Lebanese economy.

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<sup>9</sup> Sami Zoughaib i.a., Growing Pessimism and Concern over the State of Lebanon's Economy, LCPS Policy Brief February 2019, [https://www.lcps-lebanon.org/publications/1551273344-policy\\_brief\\_40\\_eng.pdf](https://www.lcps-lebanon.org/publications/1551273344-policy_brief_40_eng.pdf).

<sup>10</sup> Nisreen Salti, No Country for Poor Men, Carnegie MEC (17.09.2019), <https://carnegie-mec.org/2019/09/17/no-country-for-poor-men-how-lebanon-s-debt-has-exacerbated-inequality-pub-79852>.

<sup>11</sup> Diab quoted in Aljazeera (7.03.2020), <https://www.aljazeera.com/ajimpact/lebanon-default-debt-time-200307182500108.html>.

<sup>12</sup> Virginia Furness, Depositor bail-in 'may be the only way', in Euromoney (20.03.2020): <https://www.euromoney.com/article/b1kwbrjj7pcrz/lebanon-depositor-bailin-39may-be-the-only-way39-to-save-the-banking-sector?copyrightinfo=true>.

About one third of lenders are international creditors. They are expected to confront Lebanon with tough litigations which could result in high costs for the state. Lebanon's bonds are lacking the so-called "Collective Action Clause", which would have allowed the government to negotiate changes of bond's conditions with the creditors in a few large steps applying the majority rule. Now, Lebanon might have to renegotiate the terms with each creditor individually.

Local banks were opposed to the default and, expecting a default shortly before maturity, attempted to sell their bonds to foreign buyers in recent weeks - especially to the London-based Ashmore Group. This, in turn, has weakened the government's negotiating position. With these purchases, Ashmore has acquired approximately 1 billion USD, or more than 25% of the government bonds maturing this year - enough to be able to reject and thus block negotiations and the government's conditions for debt restructuring.<sup>13</sup> President Michel Aoun condemned the fire sale of government bonds to foreign buyers. He announced a local investigation to inspect whether these sales were against Lebanese law, made potential debt rescheduling more difficult and thus exacerbated the crisis.

## The way forward

The country's financial gap continues to widen. Economic experts estimate that a sum of around 20-25 billion US dollars in financial aid is needed to prevent the economy from collapsing.<sup>14</sup> Loans from the International Monetary Fund (IMF) remain the most likely option to plug these holes. Until now Lebanon has only requested IMF's technical assistance.

There is no other lender apart from the IMF who would or could provide such a sum (or even a fraction of it) under the current circumstances. The Lebanese government's repetitive promises of reform have lost their credibility: years of CEDRE negotiations have shown the international community how little Lebanon is able to reform and meet the conditions for loans. In the words of Lebanese economist Sami Nader, "Lebanon's ruling class has never missed an opportunity to miss an opportunity and engage in real economic reform".<sup>15</sup>

An intervention by the IMF is rejected by a large part of the population as it is associated with a harsh austerity dictate and mass poverty. Hezbollah was initially also strongly opposed to this option. The paramilitary party sees the organisation as an instrument of American interests. More importantly, the Shiite paramilitary group fears that externally imposed IMF conditions will reduce its own influence. Yet facing the accumulation of crises, Hezbollah's Secretary General, Hassan Nasrallah, had to retract this stance - as there are hardly any alternatives.

Interventions by the IMF also entail high risks when credit programmes are poorly negotiated. The indicators the IMF focuses on relate to budgeting, economic growth and macroeconomic stability. Significant progress can be made in all these areas, while other indicators such as inequality, social security and poverty can be neglected.

The problem of Lebanon remains primarily a political one. A functioning Lebanese economy requires necessary political reforms that fight corruption, and strengthen transparency as well as the rule of law. Without these prerequisites, conventional IMF interventions may even strengthen the grip of the political elite on the economy. If IMF-typical goals such as market liberalization are applied without politically independent supervision and regulation,

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<sup>13</sup> Cloe Cornish, Lebanon's sovereign default, in Financial Times (10.03.2020) <https://www.ft.com/content/75990a94-62c7-11ea-a6cd-df28cc3c6a68>.

<sup>14</sup> Nasser Saidi, Time is running out, in Carnegie MEC (08.12.2019), <https://carnegie-mec.org/diwan/80524>.

<sup>15</sup> Sami Nader, in Carnegie Middle East Expert Survey February 2020, <https://carnegie-mec.org/diwan/81091>.

they might exacerbate corruption. Privatizing state-owned enterprises might just translate into handing them over to members of the political elite.<sup>16</sup>

### The lack of social policies

Social safety nets must be provided in the face of the acute crisis, as the financially weak are particularly vulnerable in times of austerity. Further cuts in the public budget usually affect the salaries of public sector employees (approx. 13% of employment), lead to a reduction in the welfare state and also reduce investment in key infrastructure projects - thus programs that disproportionately affect low-income earners at a time when they're financially vulnerable.

There are hardly any social safety nets for the Lebanese. Citizens cannot rely on unemployment insurance or benefits. The informal sector is estimated to be about two-thirds of Lebanon's GDP - leaving workers in the gastronomic, agricultural, construction and seasonal sectors often without health insurance or other social protection.<sup>17</sup> The National Poverty Targeting Programme (NPTP) is one of the few instruments available to the population. The NPTP provides e-cards to buy food (in February 2020 for 15,000 households) and distributes now in light of the Corona crisis aid packages with food and hygiene articles for poor households. The existing mechanisms provide only short-term financial remedies.

The impoverishment of Lebanese society could reverse the small successes in the fighting of sectarianism that the country has experienced since October 17. Lebanon is a country where clientelism and identity politics step in when the government fails to provide basic social services. The rise in poverty could also become a major challenge to public order, as crime and violence could increase. Lebanon touches on uncharted margins of hunger and misery. Images from Tunisia show how potential reactions to accumulations of crises in combination with a lack of income can look like.

The short- and long-term effects of the economic crisis coupled with the virus will reach far and exacerbate Lebanon's struggles in every respect. The Lebanese crisis mentality will have to prove itself again in the times ahead.

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<sup>16</sup> Mounir Mahmalat, Why a Traditional Austerity Plan Would Exacerbate Lebanon's Woes, in LCPS <https://www.lcps-lebanon.org/featuredArticle.php?id=262>.

<sup>17</sup> Lea Bou Khater, Poverty Targeting is not the Solution for Much Needed Social Policy, in LCPS, <https://www.lcps-lebanon.org/featuredArticle.php?id=280>.

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