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Political paralysis at the brink of an economic collapse

The immense challenges for Lebanon grow with its political inability to act

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The killing of the Iranian General Qassem Soleimani complicates the already stagnating formation of a government in Lebanon that has been pending for months. Hassan Diab is struggling with considerable domestic hurdles, but seems nevertheless determined not to step down. Political leadership is urgently needed: not only to implement economic reforms, but also in view of regional tensions. At the same time Lebanon is sliding further into an economic crisis, the sheer scale of which politicians are only now beginning to understand. The failure of the central bank and politicians to mitigate the pervasive uncertainty by clear communication has severely damaged confidence in the currency, banks and financial system.

Hurdles for government formation

Soleimani's death has increased uncertainties across the region, and no shortage of attention has focused on Lebanon: how is the nation, in which Hezbollah commands a prominent political place, going to shield itself from potential destabilization? It undoubtedly constitutes a challenge for a country that remains without a government for the past three months. Lebanon is no stranger to leadership vacuums – but the sheer scale of the different crises it is facing simultaneously makes decisive political leadership more urgent than ever.

Following the resignation of Prime Minister Saad Hariri in the face of mass protests across the country, Hassan Diab, a professor at the American University of Beirut, was designated as the

new Prime Minister by the Parliament on the 19th of December. The parliamentary consultations took place after numerous postponements and months of political bargaining during which several potential candidates were proposed, only to be rejected shortly after. Senior officials have been claiming for some time now that the formation of the government is on the verge of a breakthrough, yet the expected date for the announcement of a new cabinet has been continuously postponed due to squabbles over ministerial posts. If Diab completes this first step, the new prime minister will then be faced with steering Lebanon through an impending economic collapse, one of the largest protest movements since the civil war and escalating regional tensions between Iran and the US.

Diab's nomination came as a surprise, announced a night before parliamentary consultations. Hezbollah backed his candidacy along with its political partners. Important established parties, however, did not endorse him. Amongst these, the Sunni Future Movement and the Christian parties Lebanese Forces and Kataeb have furthermore announced that they will not participate in the new government and work in opposition.

This division of the parliament would have important implications. Until now, Lebanon was governed by a national unity government representing not only, as required by the constitution, all confessional groups. The practice of this national unity government has been carried to an extreme in which all parties represented in parliament participate in government. As a consequence, the government turned into an inflated consensus apparatus, constantly resisting meaningful reforms and lacking all parliamentary checks-and-balances. The state has not known any opposition in parliament since the end of the Syrian occupation - apart from a short interval with the Mikati government (2011-2013) and three Kataeb MPs since early 2018. Opponents of such a scenario, in which major parties do not participate in government, criticise it as a unilateral "confrontational government". It could, however, open new opportunities for the development of better parliamentary control mechanisms.

It is not only the aforementioned parties who refuse to support Hassan Diab. The highest Lebanese Sunni court, the Dar al Fatwa, has backed the resigned Hariri and not yet expressed its opinion on the designated Prime Minister. Diab has failed to win the support of the majority of the Sunni populations. What is more, the parties which initially voted for the designated Prime Minister (amongst them the Free Patriotic Movement) signaled the withdrawal of their support. Should Hassan Diab succeed in forming a government despite all obstacles, the question remains whether such a government will be able to survive.

First of all, the reaction of the people towards the new government will play a role. Demonstrations are still taking place, albeit with smaller crowds – but with new violent outbursts. The protests are a remarkable politicization in a general apolitical atmosphere of frustration. One of the main demands of the demonstrators is the formation of a new, politically untainted "technocratic" government, i.e. a government made up of ministers who are appointed by merit rather than sect, and who, more importantly, are not members of the "Sulta", the constantly recycled Lebanese ruling class. In the eyes of many protesters, Hassan Diab, a former Education Minister, does not meet the criteria of an independent technocrat.

It is foreseeable that the new cabinet will consist largely of ministers who are politically and economically linked to the traditional parties, even without official party affiliation. The demand of a genuinely independent government is not realistic in the current political landscape. It remains to be seen whether the pressing economic situation will increase the people's acceptance for a compromise.

International acceptance for new government

The new government will have to struggle with hurdles on both a domestic and international level: The relationship with the USA is a key question in this regard, even more so with the developments after Soleimani's death. The maximum pressure campaign of the United States encompasses a decisive position towards Hezbollah. The Trump Administration gradually increased sanctions on Hezbollah's politicians, but also on organizations and banks linked to them. They furthermore threatened to sanction its political partners, which could hit large parts of the government.

Secretary of State Mike Pompeo's visit to Lebanon in summer 2019 made it clear once again: Hezbollah is a thorn in the side for US regional interests. The United States would hardly cooperate with a government dominated by Hezbollah if pro-Western parties are absent from it – rather they would attempt to destabilize the government by targeting it with sanctions.

After Soleimani's killing, this scenario has become all the more evident to the Shiite parties. In order to maintain stability and to protect themselves from international isolation, the Shiite speaker of parliament, Nabih Berri, and Hezbollah, were demanding that all parties should be included in the cabinet, despite the aforementioned parties' refusal to do so. This traditional government format reduces Hezbollah's position as a target, offers a shield behind a party equilibrium and guarantees the continuity of its political influence. Yet it seems unlikely that parties such as the Lebanese Forces or the Future Movement (without Hariri as PM) will be persuaded to join this government whilst the economy is collapsing and the masses uprising. An alleged technocratic government, however, might provide a similar cover and allow Hezbollah to reduce its political visibility in the new cabinet.

With the departure of Saad Hariri, Lebanon will lose a prime minister who was extremely well connected with the West and the Gulf, especially Saudi Arabia. These countries were and remain the most important potential donors for Lebanon. The fact that Hariri, who had already stepped down from his official functions as PM, travelled to Paris on the 11 December to meet with international donors in order to discuss financial support options, illustrates not only Hariri's expectation to stay in the game. He is also signaling his key role in obtaining funds (though how central he really is open to question). Hariri remains a realistic consensus candidate for Prime Minister. A government in which Hezbollah's weight is considered to be too dominant will in comparison face difficulties with its traditional donors.

Steering towards an economic collapse

The failure of the political class to implement reforms in recent decades and the three-month anti-government protests have pushed the country's economy to the brink of collapse. While the Christmas period gave a further boost to consumption and slowed down the crash, the downfall of the unsustainable economy is now to be perceived everywhere.

The expectation of a financial collapse is heightened by the daily tightening of banking restrictions and a rapid devaluation of the national currency, which lost approximately 60% of its value in early January. Dollars are becoming tight to pay for essential, import-dependent goods: these include medicines, petrol and wheat. The Syndicate of restaurants, nightclubs and bakeries estimates that up to 500 restaurants, cafés and other catering establishments closed in the last three months of 2019. Salaries are not being paid, and in small

supermarkets, shelves are gradually emptying. The much cited miserable electricity supply is worsening further: The length of daily power cuts in the capital has doubled from three to six hours, while citizens in some rural areas only have a few hours of electricity supply a day. Three suicides linked to the economic situation, reminiscent of the self-immolations in Tunisia, have spread strong concern in the Lebanese public.

The International Monetary Fund corrected its previous forecast of 1.3 percent to 0.2 percent for 2019, while the Lebanese Central Bank expects zero growth for the year. Other economists are warning that government paralysis and ongoing protests could bring GDP growth below zero percent. If expectations of GDP growth of -1 or -2 percent became reality, it would be one of the worst economic performances for the country since the end of the 15 year long civil war in 1990.

What is astonishing in light of this desolate economic situation, however, is that crisis communication is almost completely absent - by both the central bank and by politicians. Instead of aiming to stabilize the currency and economic crisis with official statements, silence aggravates the unclear financial situation. In many ways, this has severely damaged public confidence in the banking and financial system. The head of the central bank, Riyadh Salame, has so far only appealed to the public with one conference in November and one decree addressing interest rates.

Banks are imposing arbitrary and increasing capital controls since the outbreak of the protests. In the absence of clear and transparent guidelines, banks have favored some - especially wealthier - depositors over others. Such practices arouse deep mistrust and have a simple, predictable consequence: customers try to get their savings out of the banks or invest in real estate. Since September, customers of commercial banks have withdrawn at least over \$4 billion in deposits, although experts fear that the number is much higher. It will take years to re-establish the trust lost.

For Lebanon, which has maintained its unsustainable economy through foreign investment and remittances, international creditworthiness is essential. But in the face of political paralysis and dwindling economic performance, rating agencies have downgraded the solvency of the nation and its commercial banks: Moody's did so from Caa1 to Caa2, Fitch from CC to CCC. Lebanon repaid a USD 1.5 billion Eurobond in December at maturity, which further strained its foreign exchange reserves. In order to be able to pay the maturing bond at all, Lebanon issued two new bonds of USD 1.5 billion on 27 November. Lebanon expects a further bond maturity in March.

Attempts to obtain financial support from allies in the Gulf, the country's usual go-to solution, have so far been unsuccessful. The donors' conference in Paris on 11 December, which was convened in response to the economic emergency, has likewise produced no concrete commitments of cash. The international signal is clear: no money will flow into Lebanese coffers until there is a government that is willing to reform.

The structural background to the financial crisis has been widely discussed in public in recent months. In order to keep public finances afloat, the central bank borrowed money from local banks at exorbitant interest rates to buy public debt in return. The high interest rates led to a neglect of the private sector - as banks, instead of granting domestic loans to the private sector, preferred to tap into the lucrative interest profits of the central bank.

At the same time, the central bank raised US dollar interest rates in order to attract deposits from the Lebanese diaspora and foreign investors, thereby financing the double deficit - the current account deficit and the budget deficit. However, the rising interest rates also increased the overall cost of government borrowing. Rising government deficits, which were increasingly financed by the central bank, left little room for the public sector. Riyadh Salame is now trying to reverse this interest rate policy: in one of his rare public decrees since the mass protests, Salame ordered the lowering of interest rates for foreign currency deposits to a maximum of 5 percent and for the Lebanese pound to 8.5 percent.

Outlook

Prime Minister-designate Hassan Diab faces major challenges in forming a government. The killing of Soleimani has further complicated the political consensus. Hezbollah and Amal will very likely try to downplay their role in the new government in order to reduce their area of attack.

The formation of a government is urgently needed for economic reforms and as a signal of stability and reassurance to investors by implementing reforms. Hassan Diab seems to be on the verge of forming a new cabinet, but is confronted with new hurdles time and again. Yet even if he were to succeed, there is all the more reason to doubt whether such a government would survive for long. Debt restructuring and far-reaching reforms are unavoidably necessary. The populist argument that the funds looted by the corrupt political class could be recovered and used to finance deficits falls far short of the mark. The necessary reforms will hit the population drastically. The future government implementing them will need a high degree of political legitimacy.

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