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Three Lost Years

Overdue Solutions to Lebanon's Monetary Crisis

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ABOUT THE AUTHOR

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Executive Summary

Since 2019, Lebanon has descended into the worst economic crisis in its history. A hit-hard population has suffered greatly, while political leaders have only continued to take advantage of the crisis to further their own interests. This policy brief seeks to illuminate the politicization of money and explains how the country's elite political class has manipulated the money supply to prevent and delay badly needed reforms that could put Lebanon on a path to stability and recovery. Policy recommendations are included to regain control of the country's money supply, halt spiraling hyperinflation, and reform the banking sector. It is absolutely essential that all relevant stakeholders, including the government of Lebanon, the Central Bank, and private sector banks, collaborate on the implementation of the reforms listed below. Absent these critical reforms, full dollarization of the economy is the only remaining path. The third quarter of 2022 has added a turbulent twist to the crisis in Lebanon. The Lira has been tumbling as its effective market rate saw a depreciation from LBP29,000 at the beginning of July to LBP40,000 at the end of September. Even its quasi-official Sayrafa rate weakened from LBP25,3000 to LBP29,800 over the same period. Although the Lebanese Parliament adopted a budget at the end of September and also announced a departure from the long-time currency peg at the level of 1,500 lira to the dollar, the urgently needed balancing of fiscal expenditures and incomes and the consolidation of the currency regime into a unified exchange rate are far from being achieved. At the same time, political battles have been raging over the future leadership of the government throughout the summer, while the previously repressed ire of depositors has erupted in a series of popularly applauded incidents of "withdrawals by force."

Introduction

The third quarter of 2022 has added a turbulent twist to Lebanon's crisis. The Lira has been tumbling as its effective market rate saw a depreciation from LBP29,000 at the beginning of July to LBP40,000 at the end of September. Even its quasi-official Sayrafa rate weakened from LBP25,3000 to LBP29,800 over the same period. Although the Lebanese Parliament adopted a budget at the end of September and announced a departure from the long-time currency peg at the level of 1,500 lira to the dollar, the urgently needed balancing of fiscal expenditures and incomes and the consolidation of the currency regime into a unified exchange rate are far from being achieved. At the same time, political battles have been raging over the future leadership of the government throughout the summer, while the previously repressed ire of depositors has erupted in a series of popularly applauded incidents of "withdrawals by force."

These developments reinforce what I have pointed out in two previous papers on the Lebanese disease of crony capitalism (After the Crony, published November 2021) and the need for a real resolution of the banking crisis (Addressing the Lebanese Banking Crisis, published April 2022). To update the observation made at the beginning of those papers, it can only be said that the collapse brought on by the crony system of the past 30 years, has in no meaningful way been resolved. In the minds of the informed public, the immense work of dealing with the crisis through decisive reforms and meaningful policy measures has not even begun.

Thus, the baseline of any discussion over a solution for the national situation remains unchanged, namely that Lebanon has descended in 2019 into the worst economic crisis in its history, marked by staggering inflation, the collapse of the local currency, and enormous public debt. This devastating diagnosis has worsened in recent weeks. In a prominent example, the World Bank has termed the situation a "deliberate depression", arguing that intentional inaction at the highest levels of government after the start of the crisis has prevented stabilization and recovery.

It has also been reconfirmed that the primary bearers of the losses are Lebanon's population and depositors. According to UNESCWA, 82% of the country's population is now living in multidimensional poverty.[1] Lebanon has also experienced the world's largest increase in the price of its food basket, making it among the top three most food insecure countries after Venezuela and Zimbabwe.[2]

By all indications, those least affected by the crisis have been among the ranks of the elite political class that caused this crisis and continues to rule the country. While Lebanon's recent elections presented an important opportunity to alter the country's drastic course, electoral outcomes failed to displace the country's ruling political leaders, and the status quo remains intact. The same actors that caused the current situation continue to hemorrhage sparse state resources to provide for their clientele networks rather than address any of the country's staggering crises. Lebanon's curse of crony capitalism remains deeply entrenched.

This tragic baseline prevails three years after the fall of Lebanon's unsustainable scheme to finance debt and twin deficits with more debt and continued deficits. This paper seeks to illuminate one particular facet of Lebanon's current crisis: the politicization of money. For the purposes of this paper, I define politicization of money as the elite entrapment and seizure of the economy's economic lifeblood to such an extent that it is withheld from the entire system of productive economic activities, whether these are services or manufacturing.

This entrapment of money, I contend, has been orchestrated over many years through fiscal decisions, or rather fiscal indecision, misallocation of available resources, and lack of reform. The seizure of money to the advantage and exclusionary benefit of the involved actors has been implemented at the level of monetary policy decisions and through actions related to the money supply. This paper will analyze how the country's elite actors have manipulated the money supply to achieve their self-interest while using short-term political maneuvers to conceal their illicit gains and continuously push off badly needed reforms. This deliberate avoidance of reforms includes, but is not limited to, reforms in the judicial system, public sector, state institutions, and the financial sector.

To delineate the politicization of money in the crony capitalist reality of modern Lebanon, it deserves to be noted that money generally is a tool and motivation of politics. Sociologists have described how money is sacralized in market-capitalist societies, assuming a role that transcends technical functions such as serving as a unit of account. In a market capitalist setting, especially one that incorporates vibrant capital markets, money is the symbol of belonging and the livelihood of the economy. It is, however, protected from the extreme politicization seen in Lebanon. This protection is achieved by institutional and legal safeguards that govern the relationship between fiscal and monetary policy making and policy implementations. But when those safeguards are violated, manipulating money for political ends has ramifications that go far beyond what we see.

In short, what has unfolded in Lebanon is a man-made monetary collapse driven by political elites. It has had devastating financial outcomes that are borne by an unwilling and increasingly vulnerable population of unbanked and banked citizens, among whom are hundreds of thousands of middle and upper-middle class depositors who are left with no access to their savings and unable to pay for critical necessities such as food and medicine.

Standing against three years of economic collapse and widespread suffering in which Lebanon's leaders have failed to act, this brief presents a path to action to improve Lebanon's monetary situation. In simple terms, the continuous printing of money to delay reforms and finance the state budget has vastly inflated the currency. This paper thus argues that the government of Lebanon should urgently enact reforms to plug hemorrhaging resources - or else dispense with the Lira entirely and fully dollarize the economy.

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[1] UN Economic and Social Commission for Western Asia (UNESCWA), Beirut, 2021, Multidimensional Poverty in Lebanon (2019-2021): Painful Reality and Uncertain Prospects.
https://www.unescwa.org/publications/multidimensional-poverty-lebanon-2019-2021

[2] The World Bank, Washington D.C., October 2022, Food Security Update.
https://www.worldbank.org/en/topic/agriculture/brief/food-security-update?cid=ECR_TT_worldbank_EN_EXT&s=08

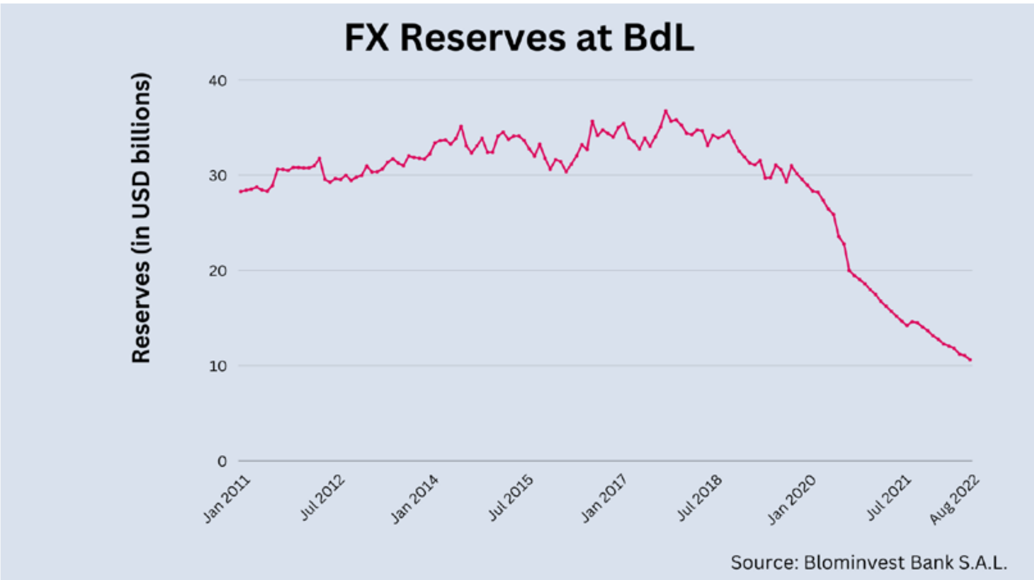
Banque du Liban's ongoing unsustainable monetary policy

Lebanon has long maintained chronic twin deficits draining its FX, reserves: one in its budget and another in its current account. This deficit was consistently and, especially before 2002, expensively. financed by borrowing from domestic and international markets. Additionally, the central bank has over the years, and most heavily during the past three years, spent billions of dollars in FX reserves on maintaining Lebanon's currency peg. In hindsight, it has been proven that this peg strategy was increasingly detrimental in the three to four years prior to 2019, as the strategy resulted in a heavily overvalued currency. In 2019, the IMF found that the Lebanese Lira was overvalued by as much as 66%[3] compared to the real market rate, a disequilibrium that was suffocating the real economy and making it more difficult for Lebanese businesses to compete on international markets.

Both deficits remain in place today. And while the peg has largely collapsed, what has taken its place is an inherently unstable array of multiple exchange rates. For an even more damaging imposition, decision makers during the crisis, resorted to an extremely expensive and poorly designed system of subsidies, which drained the country's hard currency reserves with no benefit for state finances or the impoverished people of Lebanon.

Subsidies have long been a tool of Lebanese politics, as they were a powerful tool used by political masters to curry favors with constituents. Despite being repeatedly proven as ill-designed and unable to serve the needs of those in need of social safety support, a reduced program of subsidies is in force until today. Specificities in the provision of subsidies have, however, changed over the years and have produced their most devastating outcomes in the context of the economic crisis. One can argue that the government sought, beginning in December 2019 and increasingly beginning in February 2020, to avoid reform pressures. It resorted to a subsidy mechanism that was heavily damaging to reserves between the onset of the financial crisis and the phasing out of support for imports of fuel, medications, and wheat, which led to spikes in the smuggling of those goods in the second half of 2021.

While Banque du Liban's (BdL) FX reserves decreased by more than $20bn since October 2019 to $10bn in August 2022 (see graph below), institutional behaviors on the fiscal and monetary sides continued to delay meaningful reforms while relying on the same longstanding monetary policies that caused the country's present economic collapse. In short, despite three years of devastating economic crisis, nothing has fundamentally changed.



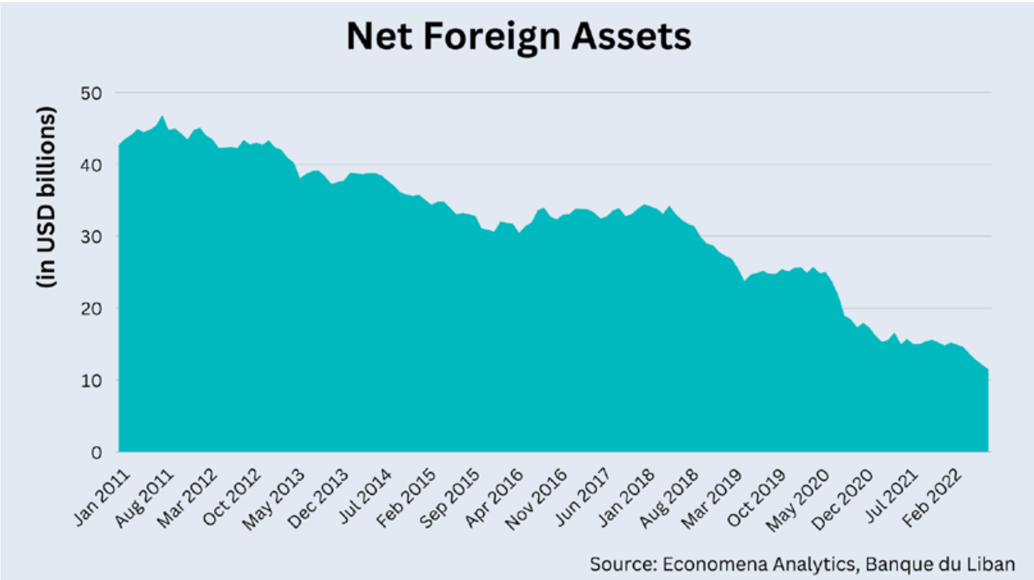
[3] International Monetary Fund, Washington D.C., October 2019, Lebanon: 2019 Article IV Consultation -- Press Release; Staff Report; Informational Annes; And Statement by the Executive Director for Lebanon. https://www.imf.org/-/media/Files/Publications/CR/2019/1LBNEA2019001.ashx

Before addressing policy options, it is important to understand how monetary policy at Lebanon's central bank has enabled and perpetuated this collapse.

The essence of BdL's monetary policy has consisted of accumulating FX reserves to support a fixed exchange rate regime. Yet, for this policy to be sustainable, the inflow of foreign currencies into the economy should exceed the outflows, thus allowing the accumulation of FX reserves.

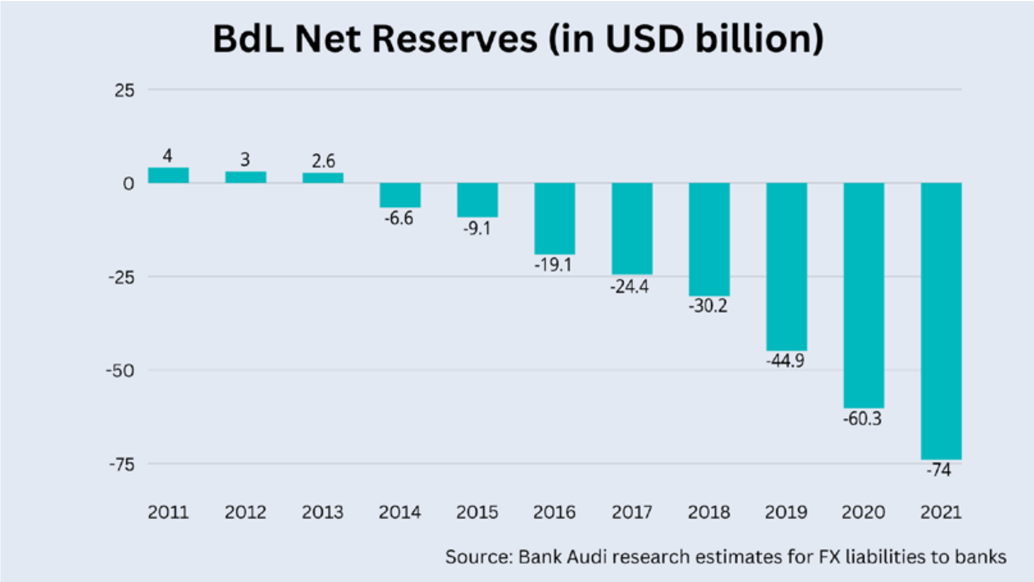
When the Balance of Payments (BoP) shifted into the negative, the depletion of FX reserves was completely unprecedented. Between the country's declaration of independence in 1943 and 2010, Lebanon had never witnessed more than two consecutive years of BOP deficits. As indicated by the graph below, the BoP, which summarizes all the economic transactions between Lebanon and the rest of the world, was positive until 2011, achieving a surplus that peaked at $46.85 bn in August 2011.

The BoP began to decline in 2011, indicating that more FX funds were continuously exiting the country than entering it. Lebanon recorded its first annual BOP deficit in a decade in December 2011, reaching a shortfall of $1.99 bn. With the continual outflow of FX, the underlying imbalances in the political-economic system could no longer be concealed. Thus, the worsening of Lebanon's external position from 2011 onward can be attributed to its chronic and high twin deficits, which were financed using those same FX reserves.

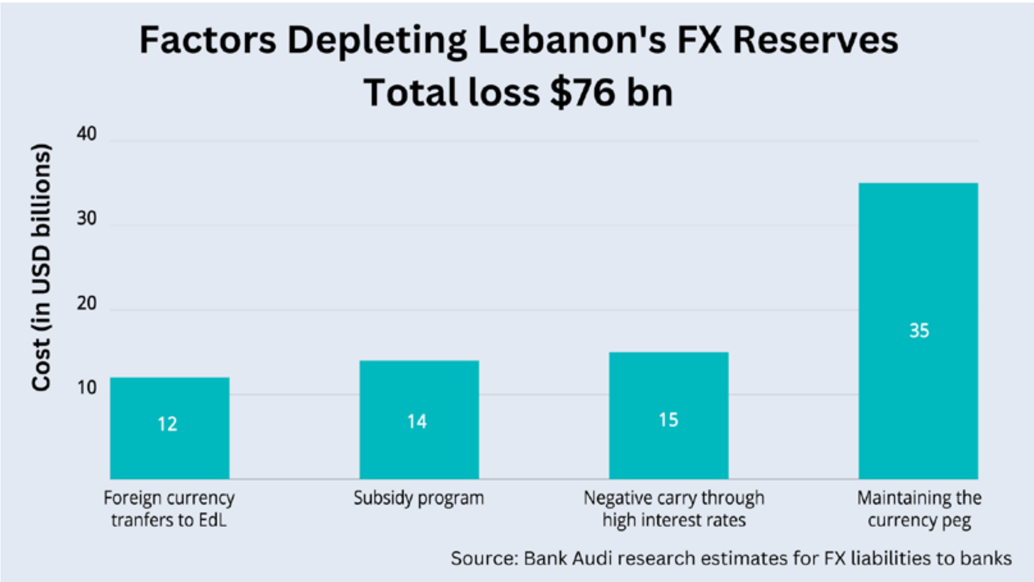


The result has been an alarmingly deteriorating situation, with the Central Bank's net reserves estimated to have turned negative in 2014 (see graph below).[4] Since then, BdL has been tapping into depositors' money to pursue its monetary policy despite various warnings by the IMF (through its Article IV consultations) and experts. Instead of implementing any meaningful reforms, the government permitted the Central Bank to pursue "financial engineering," a term referring to a range of strategies that offered lavish returns for new dollars. Attempts to engineer dollar inflows have only served to obscure the Central Bank's increasingly dire situation and postpone much-needed reforms. Lebanon's twin deficits effectively became a powder keg, building up pressure until the economy melted down entirely in 2019. Confidence in the Lebanese financial sector was lost in the late summer of 2019, leading to the collapse of the peg in August of that year.

[4] Net reserves defined as Gross FX reserves (excluding Eurobonds) less FX Liabilities (Bank deposit in FX at BdL)



As analyses of the crisis years before and during the collapse show, between 2014 and 2021, more than $76bn was spent from depositors' money to maintain the peg, which has primarily benefited the government. The factors contributed to this immense fund drainage can be identified as follows: Transfers in foreign currencies from the government to Électricité du Liban (EdL), Lebanon's state-owned electricity provider, amounted to $12 bn between 2014 and 2021. An additional $14 bn has gone to a poorly designed subsidy program that has given way to an informal but entrenched array of lucrative smuggling networks across the border with Syria. Furthermore, BdL has sustained negative carry, due to the high interest rates paid to banks on their deposits at BdL compared to the interest earned by BdL on its foreign currency reserves. This has amounted to an interest loss of approximately $15 bn between 2014 and 2021. The remaining $35 bn was the cost of maintaining the peg at LBP 1,500 when BdL could not afford to due to its negative net reserves.

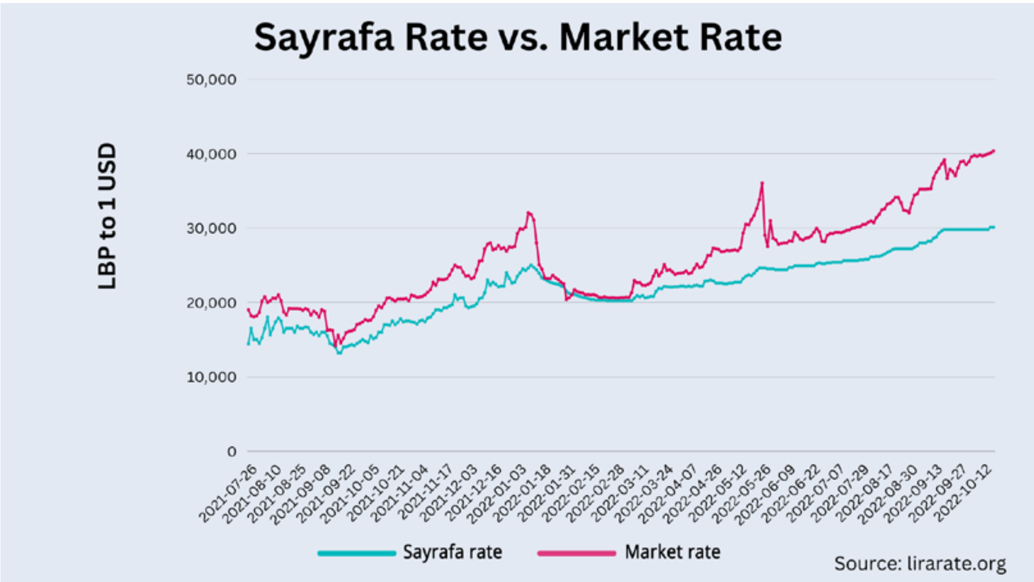


Formal and informal currency markets

BdL's failed policies have had many harmful effects on the Lebanese public; however, the state of the foreign currency market is among the most severe. Since 1997, the Lebanese state has relied on a currency peg that has stabilized the FX value of the Lira at 1,500 to the dollar for over twenty years. The peg succeeded in providing the Lebanese economy with a veneer of stability. The ruling elites consistently exploited this veneer to justify their flawed economic model and prevent any meaningful reforms, resulting in a high twin deficit incompatible with a fixed-exchange rate regime. As the economic collapse began in 2019, the currency quickly fell with it. The volatile parallel, or "black market," exchange rate has fluctuated, reaching an all-time low of LBP 40,000 to the dollar at the end of September 2022. The Lira has lost 96% of its market value since the financial collapse began in Summer 2019.

The central bank of Lebanon continues to display the official rate of LBP 1,500; however, in practice, it has been replaced by an exchange platform called "Sayrafa." Sayrafa was launched in May 2021, following a first failed attempt to do so in June 2020. The stated purpose of this platform has, since its inception, been to eliminate parallel market currency exchanges by becoming the official reference point for the market value of the Lira. However, the platform's calculation for producing a single rate has not been made clear, leading to criticism over its transparency and usefulness.[5] Moreover, two adjustments of the rate that banks used for internal conversion of depositors' pre-crisis dollar (colloquially called "lollar") funds to Lebanese lira that were undertaken in 2020 and 2021, can be described as attempts to appease depositors that did not contribute to stabilizing the currency situation but which only added uncertainty to the market through the introduction of a further new exchange rate. A third, massive adjustment has been announced for November 2022, officially devaluing the lira by a factor of ten. However, this adjustment to the exchange regime has also been undermined by unclear exceptions that cast serious doubt on its ability to be more than a temporary fix.

The rates listed on Sayrafa are rarely used in the end because banks and money exchangers – the institutions on which Sayrafa's calculations are supposedly based – continue to use their own estimates when processing real transactions. The ambiguity surrounding the platform subverts its purpose of clarification and permits a small community of speculators to benefit from a market weakness. This deficiency, which is caused by BdL's monetary policy, allows these speculators to buy dollars at the Sayrafa rate and then sell them at the parallel market rate, thus increasing Lebanon's widespread currency arbitrage rather than decreasing it.



[5] Gemayel, Fouad. "BDL's Sayrafa Platform: Inside a Black Box." L'Orient Today, 13 Dec. 2021, https://today.lorientlejour.com/article/1284596/bdls-sayrafa-platform-inside-a-black-box.html

Finally, Sayrafa enables the Central Bank to purchase money from citizens and companies by buying dollars and selling them back at lower rates. The fact that BdL profits from these exchanges alludes to another policy-level deficiency in the existing political economy system, which is the non-performance of the tax regime and absence of tax fairness. With the Sayrafa platform, the burden of funding the state is once again placed upon the private sector in a less than transparent and accountable manner. The imposition of a haphazard platform is thus another symptom of a state that cannot fund itself through a healthy or robust system of taxation and thus stymies reforms in financial sector. It also enables BdL to continue burning through its reserves in the support of extremely expensive subsidies.

Financial Repression in Lebanon

The mandate of adopting a timely and responsible state budget is inherent to the concept of an accountable democracy. It has been neglected in the past, and many words have been uttered and studies conducted toward addressing the need for legislating a budget that can support the country's reemergence from its crisis.

Against this background, a look at Lebanon's 2022 budget reveals some surprises. Since 2019, the fiscal deficit has shrunk to less than 3% of GDP, total expenditures are less than $1.3 bn, and the government debt-to-GDP ratio in real value is around $6 bn – just below 40% of GDP. Those figures may appear acceptable at first glance, but they are mainly the result of the huge devaluation of the Lebanese Lira. The numbers continue to mask immense problems and inefficiencies stemming from the government's failed fiscal policies.

For example, nearly 50% of the budget expenditures go towards public sector salaries, 10% cover debt servicing in local currencies, and 17% of expenditures act as a contingency, signaling poor allocation of resources.[6] A 2022 paper found that most public expenditures are skewed heavily towards beneficiaries in the public sector, who received nearly 6.5 trillion Liras (69% of all social protection expenditures in 2019-2022), despite making up only one fifth of Lebanon's labor force.[7]

The state, using the central bank as the only authority with the right to print money, has chosen to monetize its remaining budget deficit by printing more of the local currency. The near-constant production of new money (see graph below) has only fueled Lebanon's raging hyperinflation, which has triggered the Olivera-Tanzi effect. In short, because there is a delay between taxable events – such as the movement of goods across borders – and the moment that the tax is actually collected, inflation quickly eats away at the real value of that tax. This creates a downward spiral in which the government continues printing money to finance its deficit, which then further aggravates inflation. Thus, while Lebanon's tax revenues seem to have increased substantially since the onset of the crisis,[8] they have only done so in LBP. The real value of those additional tax dollars has decreased due to spiraling hyperinflation. The Olivera-Tanzi effect has made it all but impossible to establish any fiscal discipline in Lebanon and fund the budget through a healthy system of taxation.

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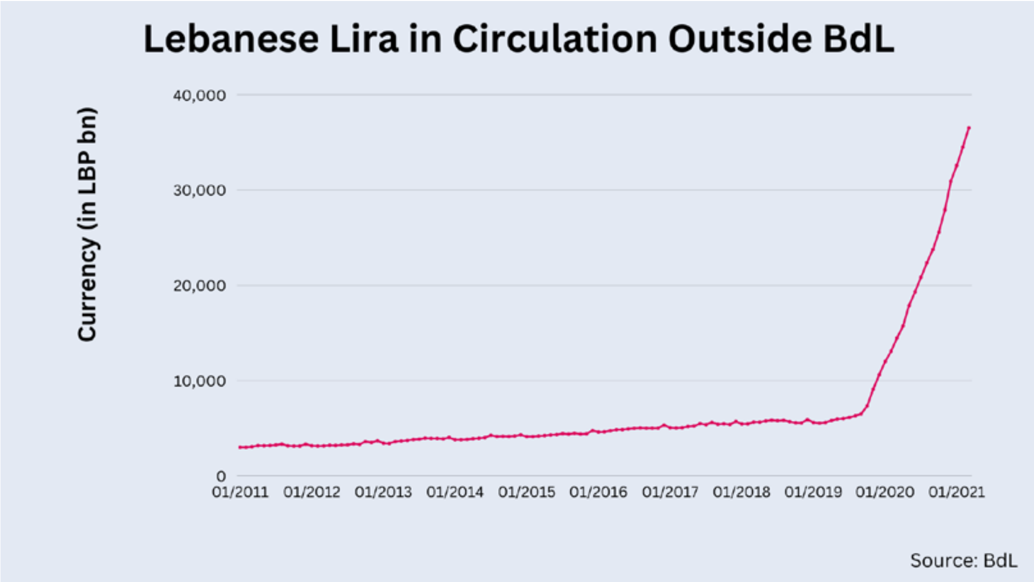
[6] Atallah, Sami, and Sami Zoughaib. The Policy Initiative, 2022, Lebanon's Rigged Budget, https://www.thepolicyinitiative.org/article/details/205/lebanon%E2%80%99s-rigged-budget

[7] Saghir, Cynthia, and Wassim Maktabi. The Policy Initative, 2022, Lebanon's Discretionary Spending Favors Public Sector Employees, https://www.thepolicyinitiative.org/article/details/193/lebanon%E2%80%99s-discretionary-spending-favors-public-sector-employees.

[8] "Lebanon Tax Revenue." *CEIC Data*, CEIC, https://www.ceicdata.com/en/indicator/lebanon/tax-revenue.



Lebanon's policymakers have continuously opted to manipulate and politicize money in order to achieve short-term political wins and delay productive reforms. As a result, egregious inefficiencies continue to lie behind Lebanon's deceptive macroeconomic indicators. The government and Banque du Liban have forced the Lebanese public to bear the weight of fixing these numbers without doing anything to alleviate their suffering or address the root causes of the collapse.

The path to monetary stabilization

The best available option is for Lebanon's policymakers to immediately regain the trust of its economic agents, an anchor to stabilize the economy, by implementing critical reforms related to the state budget, the public sector, and the banking/financial sector. Given the continuously deteriorating situation, the following policy recommendations should be implemented by Lebanon's leaders as quickly as possible:

› **End the politicization of money and regain swift control of the money supply**
Do not finance future state budgets by printing more money, as this only contributes to devastatingly high inflation. Additionally, decisions to adopt predictably imbalanced budgets have to be reversed. Responding to the crisis solely by raising public sector wages without addressing any of the root causes of the monetary collapse will only prolong the public's suffering.

› **Implement a debt ceiling**
It will be quasi-impossible to regain economic stability if the state continues to burden itself with debts that it cannot pay back, leading inevitably to further defaults and credit devaluations. A debt ceiling will fix the maximum amount of money that the government can borrow. It will also help to improve Lebanon's creditworthiness and decrease the burden on the private sector to finance the state's interest payments, thus supporting debt sustainability in the future.

› **Reform inefficient public sector institutions**
In order to return the central bank to a position of solvency, rapid outflows of money must be addressed. This primarily requires regaining control over outflows to state-owned enterprises and public sector institutions such as EdL that offer poor services and require constant additional funding from the government to stay afloat. Payrolls should be reassessed, ghost jobs should be eliminated, employees should be hired solely by necessity, and the challenges of the public procurement reform road map must be overcome.

- **Reform the electricity sector**
  Lebanon is currently consuming electricity at exorbitant rates, reaching $1/kwh. It has moreover neglected for the past decade to shift its energy mix toward renewable sources, which damages the country's position vis-à-vis climate risk mitigation needs. Both, the high cost of electricity production and the failure to implement the transition to renewable energy, have been putting tremendous pressure on economic activity. Tapping into easily accessible renewable energy sources, such as wind and solar photovoltaic, and reducing the cost of electricity will have wide ranging positive impacts. It will lead to an improvement in the country's productivity, compliance with climate targets, an increase in purchasing power per capita an amelioration of the Gini index ranking, and an increase in the state's income.

- **Reform the banking sector**
  Restructuring the banking sector is a thorny and painful process, and there is no magic solution able to fully save deposits and the sector. Most estimates indicate that losses represent five times Lebanon's current GDP – a completely unprecedented scale. There is an immediate need for a plan that frees banks of troubled assets without overburdening taxpayers or engaging in high moral hazard. In line with existing international methodologies, Lebanon should allow banks to offload their troubled assets to a separate legal entity – a "bad bank"[9] – thereby allowing them to draw a line under the errors of the past and focus on rebuilding the future.

- **The government, BdL and banks must agree on a fair distribution of losses**
  No progress can be made on returning Lebanese banks to solvency if relevant actors remain unwilling to agree on the extent of Lebanon's losses. Accountability and meaningful reforms should be based on compromise and aim to protect depositors as much as possible.

- **Unification of foreign exchange rates**
  The ambiguity over Sayrafa's platform needs to be solved, primarily by eliminating regulations and barriers to foreign exchange market operations. It is also necessary to establish a transparent platform that is liquid and efficient enough to allow the rate to respond to market forces. The market-making role of BdL should be reduced and limited to managing volatility.

- **Pass a capital control law that protects depositors' rights.**
  Most Lebanese remain locked out of their savings accounts as banks introduce widely varying restrictions. A capital control law is necessary to protect financial sector liquidity while giving people access to their money.

- **Engage with the IMF in all matters of Lebanon's economic recovery.**
  International financial institutions are an essential ally on the path to recovery. Lebanon must enter into an IMF program in order to introduce foreign currency liquidity, restore confidence, and create the necessary conditions for economic revival.

[9] See my paper "Addressing the Lebanese banking crisis", April 2022, for further reading.

Conclusion

The politicization of money, the weakening of institutional monetary prudence, and the descent into a system of crony capitalism are problems at the heart of the Lebanese economic crisis. They perhaps explain how the country fell so quickly and so far. However, the reversal of this deep fall of Lebanon needs more than negotiations with the international community and technical adjustments to the fiscal and monetary regime. It is not the ambition of this paper to reverse patterns of crony capitalism and politicization of money and blaze a trail to a new social formula and sense of community in Lebanon.

This paper recognizes, however, that immediate and practical policy steps are needed and that Lebanon's leaders have now had three years to implement the reforms listed above and have still failed to do so. Leaders in the parliament and Central Bank have failed to show the interest, courage, and determination needed to resolve the country's compounding crises, preferring instead to point fingers while profiting economically and politically from the vulnerability of the population. It will be difficult to enact these reforms amid a lack of political will to address root issues.

The path laid out above is the best among available options amid a devastating climate of political impunity and economic instability. Many citizens, NGOs, businesses, foreign governments, and international organizations have called for the Lebanese government to take serious action to address ongoing crises. Its unwillingness to do so portends difficult years ahead for Lebanon. Going forward, stakeholders should be realistic about their options and move forward with a path of reform. Should Lebanese leaders fail to enact these reforms, full dollarization of the economy is the only remaining option.

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