Lebanon's Economic Crisis: A Ten Point Action Plan for Avoiding a Lost Decade

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Beirut, An independent group of development specialists, economists, and finance experts met in Beirut late-December to discuss the ongoing economic crisis and the path forward. This note summarizes the deliberations and puts forth a ten-point action plan meant to arrest the crisis and place the country on a path of sustained recovery.

HOW DID WE GET HERE?

The economic crisis is, at its core, a governance crisis emanating from a dysfunctional sectarian system that hindered rational policymaking and permitted a culture of corruption and waste. The country, led by the public sector, lived beyond its means. Decades of pursuing this model left the economy with high debt and a bloated banking sector.

Inevitably, the dramatic debt increase resulted in an-expanding debt-servicing burden. The large yearly funding needs rendered the country vulnerable to external and regional shocks. As external financial flows into Lebanon slowed, the central bank resorted to desperate and extremely expensive efforts to attract them. Ultimately, this proved unsustainable. Since October, we've had a virtual cessation of capital inflows and a sharp acceleration of outflows.

WHERE ARE WE NOW?

This situation leaves the country with three simultaneous crises.

The first is a balance of payments and currency crises. For 2020, we estimate the gap between USD supply and USD demand at $8 billion. If this gap is not filled, the economy will experience difficulties including the servicing of external debt, imported goods' shortages, currency devaluation, and economic contraction.

The second crisis is that of public finance. Beginning with a 10 percent of GDP deficit in 2019, government revenues are now collapsing under the weight of the recession and the banking crisis described below. Inflation-adjusted spending is also crumbling. We estimate a $3 billion primary budget deficit (excluding interest payments) for 2020. In the current situation, funding this deficit will prove challenging.

The third crisis is that of the banking system. With almost half of banks' assets invested in Lebanese sovereign risk including with the Banque du Liban (BDL) and another quarter representing risky private sector claims, banks are effectively insolvent and illiquid. Despite the loose and inefficient capital and banking controls recently put in place, the sector is experiencing a deposit run. In similar international experiences, the central bank usually steps in and provides the liquidity that banks need. However, the BdL is constrained by its limited USD reserves and by fears that an oversupply of LBP would lead to further currency weakening.

CONSEQUENCES OF CONTINUING ON THE CURRENT PATH

Persisting with the current ad hoc approach to policymaking will lead Lebanon on a path of implosion and political disintegration. We foresee seven consequences:

1. The economy will experience a deep recession. USD shortages will force the economy to adjust to lower imports. Bank and capital controls will hit a private sector that is dependent on liquidity and credit; business closures, salary reductions, and layoffs have already become common. The public sector will retrench given difficult financing conditions. Under this scenario, we forecast the economy will experience a double-digit contraction in 2020—i.e., a recession equivalent to what the US experienced during the Great Depression.

2. The Foreign Exchange (FX) will weaken sharply. The LBP will adjust downwards to bring the supply and demand of USD into balance. Left to its own devices, we estimate the FX could lose up to half its value leading to high inflation. In turn, this will have a massive negative impact on the cost of living, the availability of essential goods, food and healthcare, businesses and unemployment.

3. Capital and bank controls will intensify. Banks will continue rationing deposit withdrawals and external transfers. The private sector's liquidity crunch will deepen and disorderly and un-managed debt defaults (including on Eurobonds) will prove inevitable. BdL will hemorrhage international reserves.

4. Debilitating social conditions will intensify. This kind of economic collapse will cause catastrophic wealth destruction. Poverty rates could rise to more than 40 percent of the Lebanese population with 1.6 million people unable to afford food and basic nonfood items. Unemployment will increase and much of the middle class could be eliminated.

5. A seismic political shift is likely to occur. The current political parties will not emerge unscathed. The security repercussions of social unrest will be significant and difficult to predict.

6. **Without addressing the root causes, the crises will prove long-lasting.** To put it in stark terms, this would become a decade long economic crisis—one from which chances of recovery are significantly dim. A "lost decade" will result from this scenario.

7. Finally, **international financial support is likely to fall far short** of what is needed to relieve the economy.

IS THERE A BETTER APPROACH?

We think there is. Below we outline a three-year program that aims to arrest the crisis, deal with its root causes and set the country back on a path of recovery. The program seeks to ensure equitable burden-sharing of the crisis' fallout while protecting the most vulnerable especially during the period of transition. The ten concrete steps below should be implemented in parallel rather than piecemeal.

1. Establish an empowered economic emergency steering committee to design, negotiate and implement the program. In parallel, create participatory mechanisms to discuss with civil society the policy package, and to empower citizens to monitor its implementation.

2. Replace the ad hoc and self-administered capital and banking controls. Controls are likely needed for an extended period even in the best of scenarios. They need to be run in a centralized and transparent fashion backed by proper legislation.

3. Decisively deal with public sector debt. Immediately announce a moratorium on debt payments (external and domestic), hire legal counsel, and convene a creditor's committee. Our view is that Lebanon's fundamentals justify a debt load ranging between 60 and 80 percent of GDP over the medium term. To reach this target, creditors should be offered a menu of concessions including lower principal, reduced interest rates, and extended maturities.

4. Embark on a credible fiscal reform. Public spending, currently inefficient, wasteful, and vulnerable to corruption, must be transformed. The electricity sector is but one example. A wholesale governance and regulatory reform program are needed to curb the rent-seeking culture. These reforms, along with savings accruing from lower debt servicing, should allow for increased spending on social sectors and infrastructure. Second, a broad revenue reform is needed that focuses less on raising tax rates and more on addressing weak collection and overt reliance on specific sectors. Third, we recommend the adoption of a binding and credible "fiscal rule" that caps the size of future budget deficits.

5. Deal with private-sector debt. The private sector is facing a severe crisis. Convene a creditor/debtor roundtable to agree on a standardized menu of financial relief actions aiming to safeguard viable firms while orderly liquidating those that aren't. The existing draft Bankruptcy and Restructuring law should be promptly passed.

6. Repair BdL's balance sheet. BDL is a large lender to the government and has an estimated USD30 billion negative net FX position rendering it vulnerable to devaluations. Until this is dealt with, it is tough to see the confidence in the LBP returning.

7. Bring the banking sector back to health as a prerequisite to reinvigorating the economy. Public debt restructuring and mounting Non-Performing Loans (NPLs) will render many banks insolvent. Complicating matters, banks are highly exposed to the BdL who's own balance sheet is impaired. Current bank equity is far from sufficient to cover these hits. Our estimates suggest $20-25 billion of fresh capital is urgently needed. Current shareholders need to assume the losses and be required to bring in fresh capital. This may also necessitate a reduction in the number of banks. In parallel, foreign loans and State assets could conceivably be used to recapitalize the sector (see below). As the above is not likely to be enough, there is a near-certain need for reducing portions of large deposits and swapping them into bank equity.

8. Preserve social peace through a focus on social justice. This involves the distribution of losses that are concentrated on the richest in society while sparing small bank depositors. Foreign funding should be used to blunt the pain of adjustment. A safety net must be put in place to fight poverty and support health and education. And workers should be helped to transition out of decaying sectors into those that benefit from the devaluation.

9. Re-think the FX/monetary policy mix. The fixed (and overvalued) exchange rate regime has contributed to large current account deficits, hurt export-oriented sectors, and forced BdL to maintain elevated interest rates. Looking forward, we recommend a more flexible exchange rate arrangement centered around a weaker LBP. However, until confidence in the LBP returns, it will be dangerous to allow the currency to freely float. Some form of currency management will have to maintain for the medium term.

10. Secure a multi-year Stabilization and Structural Reform Facility. We estimate that a three-year $25 billion fund is needed. This facility should be used to shore up BDL's net reserves, help fund the immediate government budgetary needs, finance badly needed social spending, and contribute to bank recapitalization. The economic program recommended above can garner this kind of support, including from the World Bank, the EU, and the GCC. However, it will realistically require an IMF program as an umbrella. We also think there is scope to partly fund this facility with state assets and possibly hoped-for oil and gas revenues. We cannot overstate the importance of good governance, transparency, and accountability in this regard.

CONCLUSION

The consequences of the current path are catastrophic. Delays will only increase dislocation, exponentially magnify the needed adjustment, and place the burden on those least able to shoulder it. A better option is available. It won't be easy, may at times prove painful and will certainly require a new social contract. But we sincerely believe this approach will pave the way for a better and prosperous future.

SIGNATORIES (IN THEIR PERSONAL CAPACITIES)

Firas Abi Nasif, Edward Asseily, Bilal Bazzy, Amer Bisat, Henri Chaoul, Ishac Diwan, Hanine el Sayed, Ali El Reda Youssef, Saeb el Zein, Nabil Fahed, Philippe Jabr, May Nasrallah, Paul Raphael, Jean Riachi, Nisreen Salti, Nasser Saidi, Sami Nader, Kamal Shehadi, Maha Yahya, Bassam Yammine, Gerard Zouein