THE DISORDERLY REMOVAL OF SUBSIDY IS YET ANOTHER CRIMINAL POLICY

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The Disorderly Removal of Subsidy is yet Another Criminal Policy

Remaining foreign exchange holdings to be managed strategically

POSITION SUMMARY

Disconnected from reality, unable and/or unwilling to take effective action to stem the economic meltdown, the political and financial establishment has excelled at shaping policy responses that expose the society to existential risks. In late 2020, Banque du Liban (BdL) officials said that falling foreign exchange (FX) reserves will drive the central bank to halt its support for imports of critical and essential goods—namely, wheat, fuel, medications, medical supplies, and other essential products. A decision that was announced on August 11 concerning fuel imports. Consequently, the issue of the FX subsidy has taken central stage in the crises-ridden country.

Instead of reforming an unsustainable, regressive, inefficient, and corrupt subsidy system and combining it with a well-targeted cash transfer program and, most-importantly, moving to a rights-based approach to social policy, the ongoing "laissez-aller" approach is nothing but criminal.

The inflationary impact of price liberalisation is catastrophic with the absence of a well thought safety net for the Lebanese who are facing shortages of essential needs, namely fuel and medicine.

Despite the belief that Lebanon's subsidy system was unsustainable, Kulluna Irada considers that the issue cannot be taken out of the larger context, namely: the balance of payments crisis and the ability to tackle its implications, including worsening economic activity and declining standards of living, in a way that limits the incidence on the poor and most vulnerable whilst laying the bases for a prosperous economy for all.

The system could not be sustained. Firstly, it is responsible for a FX depletion of around $5 billion per annum. Secondly, it benefits the rich rather than the poor. Thirdly, by offering artificially low prices for imported products, it creates market distortions making locally produced substitutes less competitive and it further encourages hoarding, black-market selling, and cross-border smuggling. Lastly, it benefits a duplicitous system associated with the de facto politico-sectarian establishment. Therefore, protagonists contend that it would be beneficial to abolish the subsidy and limit the outflow of hard currency.

In the absence of any alternative approach, the decision has been taken to remove subsidies, starting with fuel imports. A choice based on an attempt to constrict the problem of melting central bank reserves to the subsidy by inaccurately portraying Lebanon as facing two alternatives: either keep spending with no clear plan for a few more months or extend the system's lifespan by 'rationing' some subsidies and lifting others. This reductionist framing is based on a purely quantitative approach to FX and does not consider the social welfare or general interest of the population at large that is bearing an excessively high cost in any event.

We emphasize the need to lay down the debate terms differently than through the sole lens of maintaining or abolishing the subsidy system. According to the World Bank, lifting the subsidy will increase inflation by 24 percentage points, not accounting for the iterative effect through pressures on the dollar-note market, which will further depreciate the currency, re-enforcing the inflationary-depreciation cycle. The incidence of lifting the subsidy will therefore be significant, especially since 72% of households earn less than LBP 2.4 million a month, equivalent to $200 at today's market rate.

Indeed, the subsidy protected the purchasing power of the Lebanese from deteriorating further due to a depreciating currency. But, more importantly, the subsidy is not the salient factor behind the depletion of FX.

Between October 2019 and October 2020, BdL's foreign currency holdings plummeted $13 billion, while the value of subsidy did not exceed $5 billion. In other words, several billion dollars belonging to well-connected, politically exposed persons were transferred in the months that followed the October 17 uprising, at the expense of the rest of depositors.

Had we had policymakers, they ought to have considered the following questions: Who are the people that will be hit hardest if the subsidy is abolished? How can the impact of higher prices on the lower and middle classes be offset? And to what extent are we ready to dig into the BdL's coffers to do so, while maintaining an adequate amount of FX reserves intact? The answer would have involved trade-offs, the size and impact of which would have hinged on whether the subsidy revamp is a part of a larger reform package consistent with a credible macroeconomic framework in tandem with external funding.

None of the above is being considered.

Kulluna Irada still believes there is an alternative policy which can compensate price liberalisation with a more efficient subsidy approach combined with direct cash transfers in dollars for a total cost of around $2 billion.

It consists of the following:

The remaining FX assets at the Central Bank and the upcoming new SDR allocation should be audited and managed strategically within a comprehensive macro-fiscal plan that stabilizes the economy and places it back on a recovery path.

The most urgent need is to establish a robust social safety net program based on a three-pronged approach:

1) A broad, transparent, **direct cash assistance program disbursed in USD**, given the absence of a unified exchange rate, and the inflationary impact of LBP disbursement at market rates. This cash assistance program should be **managed transparently based on clear vulnerability criteria** to avoid and put an end to the long dated clientelistic capture of state resources by the sectarian power system.

2) The adoption of short-term complementary policies that are fundamental to maximize the impact of a subsidy reform. These include a) stocktaking of usable assets and effective capital control to limit FX drain; b) abolishment of import monopolies and barriers to competition in order to mitigate the impact of subsidy removal on consumers; c) lifting banking secrecy to ensure that cash assistance reaches those who needs it the most. These measures are essential to guarantee an **efficient subsidy system** covering fuel, medicine and wheat.

We estimate the cost of the above two programs at $2 billion.

3) more importantly, shift public policies towards the implementation of a rights-based approach, starting with a **universal health coverage**, but also free education for children.

As the 20 months of inaction that followed the eruption of the most devastating crisis Lebanon has faced since the civil war have showed us, the current political system is no longer able to rule effectively. An interim independent government with extraordinary legislative powers remains, now more than ever, our best chance to pull Lebanon out of the abyss, regain the trust of the Lebanese people and international partners, and set the path for a sustainable and inclusive recovery for all. We urgently need to stop the socio-economic free-fall of Lebanon and adopt a comprehensive macro-fiscal plan in the framework a new social contract.

Table 1: Inter-comparison for Year 1 (millions of USD)

Items	Government proposal *Phased approach with BC cash transfer*	Scenario A.1 *Phased approach with BC cash transfer*	Scenario A.2 *Phased approach with BC cash transfer*	Scenario B.1 *Steep approach with BC cash transfer*	Scenario B.2 *Steep approach with augmented BC cash transfer*
Current subsidy	5,238	5,238	5,238	5,238	5,238
Revamped subsidy	2,005	1,871	1,871	-	1,465
Cash transfer	1,536	274	474	465	-
Budget (mainly donations + soft loans)	n.a.	274	474	-	-
FX reserves	n.a.	-	-	465	1,465
Total cost	3,541	2,145	2,345		1,465
Overall FX savings in first year	**1,697**	**3,367**	**3,367**	**4,773**	**3,773**

Phased approach involves gradual removal of the subsidy, while steep approach removes all subsidies.
For scenarios A.1 and A.2, cash transfer is entirely funded by external sources, hence netted out from FX savings.
Scenario B.2 is basically an augmented modality of Scenario B.1 (details in the policy paper).

POLICY PAPER

Ever since the Governor of Lebanon›s central bank, Riad Salame, announced that Banque du Liban (BdL) could no longer subsidize the imports of essential goods, the use of the central bank›s foreign exchange (FX) reserves has taken center stage in the public debate in the crises-ridden country.

On the one hand, the subsidy in place is costly, inefficient, and regressive, and should be revisited to prevent the BdL's foreign position from deteriorating further. On the other hand, any removal of the subsidy will increase inflationary pressures, disproportionally affecting poor and vulnerable households and plunging thousands living on fixed incomes, into poverty, particularly in the absence of a comprehensive stabilization and recovery plan. Despite the firm belief that Lebanon's subsidy system necessitates reform, Kulluna Irada considers the current debate, as important as it is, short-sighted and misleading. The issue of subsidy cannot be separated from the greater context, namely, Lebanon's balance of payments crisis and the ability to tackle its implications, including worsening economic activity and declining standard of living, in a way that limits the incidence on the poor while laying the bases for a better model for all.

Nota Bene: This report was completed in May 2021. Figures have changed since then with the continuous economic and financial deterioration.

A. WHAT IS THE SUBSIDY IN PLACE? AND HOW DOES IT WORK?

The issue of subsidies in Lebanon extends beyond the current crisis and merely represents symptoms of a larger problem: bad macroeconomic policies over the past three decades.

1- THE CURRENT SCHEME IS NOT A PROPER SUBSIDY.

Economists define a subsidy as an incentive given by the government to individuals or businesses, using government funds, that is intended to protect consumers by keeping prices low. It is primarily the jurisdiction of the government and not the central bank. In that sense, the scheme in place in Lebanon is an implicit subsidy and a questionable mechanism that allows the BdL to selectively spend foreign currencies in exchange for offering artificially lower exchange rates to finance certain imports, as part of the BdL's management of its foreign assets.

2- THE SCHEME IS MERELY A FINANCING MECHANISM OF IMPORTS.

In Lebanon, two categories of goods are currently 'subsidized:'

- *Goods directly imported by the government (mainly fuel and wheat)*: Those goods are basically distributed to local intermediaries who, in turn, sell the product at a fixed price and transfer the money back to the treasury. The financial crisis has had two adverse effects. First, having lost access to dollar resources, the government resorted to FX reserves at the BdL to finance said imports. Second, due to the sharp depreciation of the Lebanese Lira, the amounts transferred by local intermediaries to the government, at the official exchange rate of 1,507.5 LBP/USD, are now of much lower worth. This, by definition, generates a fiscal loss that the government must assume.

- *Goods imported by the private sector (medicines, medical equipment, and 'essential' goods)*: in attempt to limit inflationary pressures, the government agreed with the BdL to provide foreign currency at a fixed exchange rate of 3,900 LBP/USD for importers and manufacturers of (initially 300, but de facto much less) goods deemed essential food items and at the official exchange rate for medicines, tapping further into its hard currency holdings.

Hence, the current system is technically a FX subsidy as it is the central bank, beyond its mission, choosing selectively to apply artificial rates to the use of its foreign currency reserves, even if this implies further deterioration of its net position, whereas subsidy cost should be integrated into the budget of the Lebanese State[i]. Typically, BdL ought to be focusing on the following policy issues:

a. The size of usable FX that is left at its disposal (it is perplexing that this information is still not made public to date).
b. A unified exchange rate to import and set prices of goods and services.
c. Measures to curb inflation and preserve the purchasing power of the population.

[i] The Code of Money and Credit does not give the central bank the authority to establish subsidies. Article 70 (as modified by the Law promulgated by Decree No. 6102 of 5 October 1973) defines the overall mission of the central bank as follows:
The overall duty of the Bank shall be the safeguard of currency as a fundamental guarantee for permanent economic and social development, and more specifically:
- Safeguarding a sound Lebanese currency;
- Safeguarding economic stability 13;
- Safeguarding the basic structure of the banking system; and
- Developing the monetary and financial market.
Law n°133/1999 expanded the role of the Central Bank of Lebanon (BDL) defined in article 70 of the Code of Money and Credit to include:
- the development and regulation of the payment systems, especially regarding ATMs and payment cards, the transfer payments, including electronic transfers; and
- the development and regulation of clearing and settlement operations related to payment systems and financial instruments.

3- THE CURRENT 'SUBSIDY' SYSTEM IS UNSUSTAINABLE, REGRESSIVE, INEFFICIENT, AND CORRUPT.

... unsustainable:

- It is estimated that the current subsidy has already led to $5.2 billion of FX reserves depletion in 2020.

- The foreign reserves have been falling by one billion dollars a month on average since June 2020, but less than half of which can be directly attributable to the subsidy. We estimate BdL's 'usable reserves' (i.e., the available liquidity in foreign currency) are between $11 billion (worst-case scenario) and $16.4 billion (best-case scenario), which is self-evidently insufficient to sustain the current subsidy and could at current rates be entirely depleted by end of 2021 or mid-2022.[ii]

- A large fiscal burden is imposed on the State estimated at nearly $3 billion in 2020 due to the selling of (real) dollars at rates lower than the market rate to finance utility services and offset the effective cost of certain imports[iii]. This spending could indeed be put to better use of government services. The fiscal loss from the subsidy is exacerbating an already debilitating government indebtedness and BdL insolvency. Those balance sheet problems will eventually have to be dealt with through a fateful combination of imploding currency, exploding inflation, higher taxes, reduced government spending, or larger haircut on debt and deposits.

... regressive:

- Subsidies in Lebanon are not well-targeted and benefit mainly higher income groups. The benefits of selling goods below real import costs largely profits the affluent whose consumption patterns (e.g., higher fuel and power consumption) disproportionately rely on subsidized goods. According to the United Nations Development Programme (UNDP), only 6% of the transport subsidy in Lebanon ends up in the pockets of the poorest 25% of the population, while the richest quartile receives 55%[iv].

... inefficient:

- Artificially low domestic prices keep the volume of imports higher than it should be, which wastes reserves and hinders much needed import-substitution. This is most evident in fuel imports for instance (the mirror image of which is cross-border smuggling).

- The implicit subsidy has created multiple exchange rates to import and sell goods in Lebanon causing further uncertainty in the market and impeding growth potential. This has caused market distortions and encouraged hoarding, black-market selling, and cross-border smuggling, further fueling the very inflationary pressures the subsidy was established to avoid.

- The current system serves to a large extent the private interests of a network of importers, shady smugglers, and hoarders whose raison d'être is to squeeze rent from the system and ensure the benefits never reach those in need.

[ii] The BdL does not publish its net foreign position, unlike other central banks. BdL's gross foreign assets excluding gold reached $21.9 billion as of April 15, 2021. BdL's gross position includes $5.5 billion in securities (mostly Lebanese Eurobonds) and mandatory reserves on commercial bank's customer deposits in foreign currencies. In addition, various sources estimate that the BdL had lent out around $6 billion to banks since October 2019, although this exact amount was never published; this sum is not immediate liquidity and, hence, cannot be considered part of the BdL's usable reserves. Thus, the value of usable reserves will depend on whether these loans to banks are hidden in BdL's gross position (the worst-case scenario $11 billion) or netted (the best-case scenario $16.4 billion). To our luck, very recently, the Governor of the Banque du Liban, Riad Salame, announced, in an interview with the French daily, Le Figaro, that usable reserves are at $16.35 billion.

[iii] This is a conservative estimate using the following assumption: an average exchange rate of 6,705 LBP/USD in 2020; assuming the $5 billion in subsidy for both types of subsidized goods combined (as described in the text above) in 2020 were sold at an average rate of 2,300 LBP/USD, the subsidy would have reduced the effective cost for consumers by 67%.

[iv] UNDP, 2015, "Fossil Fuel Subsidies in Lebanon: Fiscal, Equity, Economic and Environmental Impacts."

... and corrupt:

- Predictably, the shady network has entrenched itself in Lebanon's sectarian system with the political establishment providing cover and itself accruing the subsidies' financial and political benefits. In addition to the classic beneficiaries of the system (e.g., fuel, medicines, and wheat flour importers' cartels), several items in the subsidized consumption basket set by the current government are controversial, pointing to involvement of special interests with the choices made at the expense of the collective welfare.

B. GOVERNMENT'S INACTION AND PIECEMEAL APPROACH

The Ministry of Economy and Trade (MOET), in collaboration with the World Bank Group (WBG), drafted a plan to replace the FX subsidies with direct fund transfers (bank accounts, alimony cards, or cash) to Lebanese resident households.[v] The proposed plan aimed at lifting subsidies on imports except those related to the production of electricity and medicines, the latter two being subject of specific programs later. To offset the devastating effects of inflation resulting from price liberalization, it offers direct transfers to the population in foreign currency to support their basic consumption needs. Unlike traditional approaches to direct aid to the poorest, the proposed compensation scheme targets the lower 80% of the population by providing a monthly support of $50 per adult and $25 per child in the first year. The financial support as well as the coverage are both set to decline progressively for the following four years. The stated objective of this proposal is to extend the time-till-exhaustion of remaining BdL reserves, thus delaying a forced and disorderly exchange rate adjustment.

Since its inception, the government proposal suffered from a major lack of credibility and legitimacy. First, it merely comes from a caretaker government that was not able to actuate any effective measures to curb the economic free fall.

Second, it requires the adoption of a set of laws by Parliament, including a budget, before it can even be implemented, which is a time-intensive and politically unfeasible task in the current political context.

Third, the proposal's advanced timeline was unrealistic.In all cases, months have passed since the subsidy reform proposal was first developed and inaction has been the name of the game since then.

Last but not least, even though the estimated cost is significantly lower than the current system, by covering 80% of an economy's population, the plan is extremely large by regional and international standards. According to the WBG, the plan costs $3.9 billion over five years—to which around $3 billion for medicines and electricity production must be added. The budgetary outlays will start at $1.5 billion in year 1 and decline to $311 million in year 5, equivalent to an average annual expenditure of around $780 million. These are significant government expenditures, provided that funding is secured, which is not the case thus far, making the proposal unaffordable.

[v] World Bank Group, 2020, "Lebanon Subsidy Reform: Short-term Patch Pending More Comprehensive Macroeconomic Reform."

A plan to replace the current subsidy system by a ration card has since been adopted by Parliament. It is also based on a piece-meal approach without any comprehensive framework for a stabilization and recovery plan, which is still due to this day. The plan involves a one-year $556m ration card for half a million families with an average amount per family per month of $93. But neither funding source nor qualifying criteria have been decided.

Unimpeded, authorities will most probably tap into the unexpected new SDR allocation to fund this program with their usual short-sighted kick-the-can approach.

As designed, both schemes raise serious concerns regarding the identification and beneficiary selection, especially that Lebanon does not have the required institutional structures that can select the disadvantaged in a fair, transparent way, away from clientelism.

In the absence of a census of residents or a reliable social register that would allow the government to know the characteristics of the target demographic (e.g., the composition of households, whether they permanently reside in the country, etc.), the selection would necessarily be relayed by community leaders and their networks, thus strengthening their grip on an impoverished, frightened, and desperate society.

Moreover, even if the removal of subsidies on imports of critical goods and essential items can lead to certain BoP relief, the effect is merely temporary. The plan is yet another ineffective piecemeal approach to the BoP crisis while a comprehensive plan is urgently needed. The subsidy is not the sole factor behind the deterioration in the BoP; eliminating it will not end the crisis. Lebanon requires a wide-ranging vision to build a better-targeted, affordable, and more sustainable policy response to support the poor and the most vulnerable, while limiting the impact on the BoP by putting the country's foreign assets to strategic use.

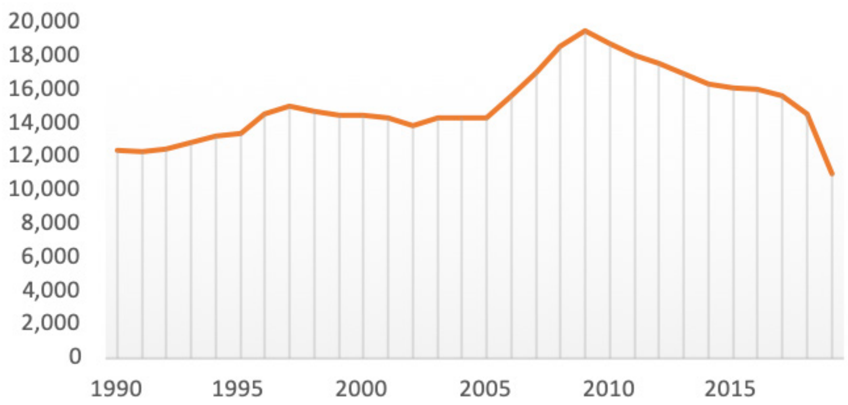
C. RETHINKING THE DEBATE ON THE SUBSIDY AND DECLARING BDL'S FOREIGN ASSETS 'NATIONAL STRATEGIC RESERVES'

The ongoing approach for the subsidy issue paints a narrow and misleading picture. It limits the problem of melting foreign currency reserves to the subsidy, inaccurately portraying Lebanon as facing two choices only: either keep spending without a plan for a few more months or extend the system›s lifespan by 'rationing' or removing the subsidy altogether. This reductionist framing of the policy is based on a purely quantitative approach to central bank reserves and does not serve the general interest of the population who will sooner or later bear the cost in either event.

There is a fundamental need to lay down the debate terms differently than through the sole lens of maintaining or abolishing the subsidy system. The subsidy issue is one element of a larger problem: the BoP crisis that led to the Lira losing 88% of its value in almost two years, significantly decreasing the purchasing power and standards of living of citizens (Chart 1). Today, lifting the subsidy will inflate these negative sequels as prices will surge even more.

Thus, the questions policymakers ought to consider are: i) how can the impact of higher prices on the poor be offset? And to what extent are we ready to dig into the BdL's coffers to do so, considering the need to maintain an adequate amount of FX reserves intact?

Chart 1: Real GDP per capita (in PPP 2017 USD)



SOURCE: INTERNATIONAL MONETARY FUND. ESTIMATES AFTER 2012

1- BDL'S REMAINING FX ARE NATIONAL STRATEGIC RESERVES.

The function of any central bank reserves is basically monetary that also aims to protect the financial sector. In the case of Lebanon, spending the remaining $11 billion (or $16.4 billion in the best-case scenario) in foreign currency holdings would have to be far more strategic than mere current consumption needs. This takes on greater importance in the context of the severest crisis Lebanon has faced since the civil war and when the savings and incomes of millions of people have effectively been wiped out and the very foundations of the society are now at risk.

The current depletion of foreign assets is happening without any conception of fair and targeted distribution of losses, legal restrictions on the movement of capital, adequate social protection, and national investment projects to lift the country out of the crisis. To this end, whatever is left in FX must not be subject to the discretion of the central bank and should be proclaimed 'Strategic National Reserves' envisaged to serve the following main objectives:

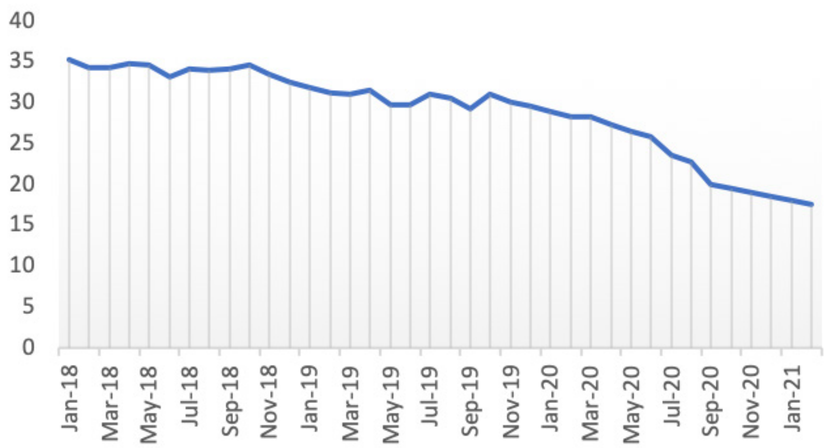
1. Pay back small-scale depositors up to a certain threshold.
2. Protect the poor and the most vulnerable; and
3. Lay the foundations for a productive economy capable of generating future returns for all.
4. Safeguard the national currency (i.e., avoid Armageddon scenario).

Had this approach prevailed at the start of the crisis, those strategic assets would have been significantly greater today, but the absence of capital controls led to their depletion at a faster pace than what economic fundamentals suggest, further exacerbating Lebanon's external vulnerabilities.

To put things into perspective, between October 2019 and October 2020, BdL's foreign currency holdings decreased $13 billion, while the value of subsidy did not exceed $5 billion (chart 2)[vi]. In other words, several billion dollars belonging to well-connected and politically exposed persons were transferred in the months that followed the October 17 uprising, at the expense of the rest of depositors, which makes the irresponsibility and complicity of successive governments criminal. Access to strategic foreign currency reserves has not been managed in the nation's best interest.

[vi] The decrease was $2.8 only over the same period one year earlier. Calculated using published Foreign Assets of Banque du Liban. Database checked on March 30, 2021.

Chart 2: Foreign currencies at BDL (in billions of USD)



SOURCE: BANQUE DU LIBAN. EXCLUDING SECURITIES.

The national strategic reserves must serve the interests of the largest number of stakeholders and help build a vibrant society where people can live, work, and thrive. A responsible government would have to make difficult trade-offs to serve the vast majority of the population, while policy is currently conducted in favor of a smaller group of privileged persons.

The management of BdL's foreign reserves ought to balance the following interests to maximize collective welfare:

a. The interest of depositors, representing half of the Lebanese population, dictates that reserves remain intact to protect the real sums remaining in their bank accounts, especially for small-scale deposits.

It is time the Lebanese came out of denial and abandoned the rhetoric that falsely claims that there is a possibility to 'unfreeze' or 'recreate' the deposits in the banking sector. Lebanon's banking sector has collapsed, and banks are technically bankrupt. The entirety of the remaining FX would barely recover 10% of the deposits if the money were to be returned to depositors today, let alone the fact that those FX are highly needed reserves for a country that defaulted on its sovereign debt and whose population depends on imports for basic needs.

Tangibly, however, it is still possible to adopt a policy framework where small-scale depositors can be reimbursed up to a threshold to be determined, as a part of a banking sector restructuring. The returned funds can then be used by those depositors to cushion the blow from subsidy removal, as this category of depositors are unlikely to transfer the money abroad and will basically use it to mitigate the subsidy removal impact on their consumption. In this sense, it is a sincere way of 'supporting' a large segment of the population with its own money instead of inefficient subsidy scheme.

The same goes for pensioners who were legally obliged to contribute in LBP to finance their retirement programs, which lost 90% in value at today's exchange rate, should be guaranteed as a part of the comprehensive plan.

b. The interest of the poor and most vulnerable might require the use of foreign currencies, given the urgency of the situation, to support their purchasing power and protect their basic rights.

However, the crisis should be an opportunity to shift away from a humanitarian approach to an economic approach based on the universality of certain services. Policy priorities should focus on the creation of social safety nets that are more about ensuring the provision of basic social rights such as healthcare and education. Furthermore, ensuring universal access to healthcare and basic education would be equivalent to a significant boost for the purchasing power of the Lebanese—what the subsidy system was admittedly put in place to do—because it would reduce household spending on two key consumption categories.

Even though these policies might seem costly at first glance, the associated social benefit outweighs the cost. Indeed, Lebanon's total expenditure on healthcare and education is already one of the highest in the world as share of GDP; therefore, policy can start by reprioritization and reallocation of budgetary resources and other spending towards healthcare and education to improve the efficiency and the productivity of these two sectors. Moreover, given the current crisis context, the two sectors are vital to protect one of the country's last comparative advantages. When families can no longer have access to health services or no longer afford good schooling, an entire generation will be lost, with serious implications for medium- and long-term growth[vii].

c. The national economic interest entails the deployment of significant resources to finance the structural transformation needed to lay the foundations for a productive and inclusive economy.

One argument for lifting subsidies is that by increasing prices of imported goods, the drop in the external bill will create an import substitution industrialization to reduce the country's dependence on foreign markets. While this makes sense economically, the problem is that the transformation process can be long and costly in a situation of crunching credit, price uncertainty, as well as in the absence of an enabling environment as it is the case in Lebanon today.

Lebanon could make partial use of its assets to build a competitive, sustainable, and inclusive economy capable of generating new capital inflows from abroad. The country also must leverage resources at its disposal, including through public-private partnerships, to finance investment in strategic economic sectors with the best comparative advantage and the greatest export

[vii] Innovative financing solutions are possible if a credible reform plan is implemented, including leveraging the support of multilateral development banks (MDBs). For instance, the World Bank can be asked to reallocate part of the Bisri Dam loan that has been canceled to finance the early stage of universal healthcare of education systems.

potential, which can eventually become a sustainable source of much-needed hard currency.

Moreover, even though the Lebanese government suspended payments on sovereign debt, it will eventually have to pay part of what it owes in foreign currency following negotiations with creditors, which would allow Lebanon to go back to international debt markets. Prior to debt negotiations, the International Monetary Fund (IMF) is likely to consider the level of FX insufficient and will ask the monetary authorities not only to maintain but consolidate them. In fact, FX reserves also have an essential monetary function: higher levels of reserves increase confidence in the country's abilities to finance its economy and stabilize its currency.

This analytical framework applies, all things being equal, in the event the remaining FX is all Lebanon is left with. Of course, FX reserves can be preserved to the extent that other issues are solved. A trustworthy government would be able to revive external financing channels and, when this is the case, the funds for the objectives listed above will consist of maximum donations and soft loans and a minimal use of BdL's foreign currency holdings. Lebanon can take advantage of the boost given to the global financial safety net and emergency financing through multilateral development banks (MDBs) to respond to the needs of low- and middle-income countries to tackle the COVID-19 pandemic and its intertwined impacts. In addition to the exceptional allocation of almost a billion dollars in Special Drawing Rights (SDR) from the International Monetary Fund within a global post-Covid response Lebanon could also access new facilities that are currently being discussed by the IMF's high-income member countries who have pledged to convert part of their own SDR allocations to help countries in need.

2- POLICY ACTIONS ARE REQUIRED BEFORE ANY SUBSIDY REMOVAL.

We caution that any subsidy revamp or removal must be preceded by prerequisite policy measures to maximize the positive social impact, otherwise the potential subsidy reform will lose in effectiveness. These include the following:

Policy 1- Stocktaking and capital controls

The BdL no longer has reserves in net terms (i.e., its liabilities in foreign currency far exceed its assets), but it continues to hide information regarding its usable foreign reserves even though the livelihoods of millions of Lebanese depend on it. This lack of transparency is a major hurdle to any sound policy planning and therefore must come to an end.

The first step of capturing the depth of the situation would entail making a careful inventory of the remaining assets, which will allow deciding on their allocation through a multi-year strategy based on which additional funding from international financial institutions or other entities might be requested.

If it is true that the current account deficit is a key structural cause of the crisis, one should not forget, however, that hard currency outflows are not only due to the import bill. Several billion dollars were transferred abroad at the height of the liquidity crisis in October 2019 and in the following months, which would have enough to finance the subsidy system for at least another year and, perhaps, avoided a disorderly default on sovereign debt[viii]. Therefore, an effective and transparent law on capital controls must be put in place as soon as possible prior to any subsidy revamping.

Policy 2- Abolishment of import monopolies and barriers to competition

In addressing governance problems associated with the subsidy system, one cannot overlook the legal protection of import monopolies that have long plagued Lebanon's retail sector due to lack of competition, constantly keeping domestic prices artificially high and killing the economy's competitiveness. In the absence of an overall strategy, the incidence of the broad-coverage subsidy reform compensation scheme for the 2.7 million Lebanese living under the upper poverty line could be less significant if higher-than-estimated inflationary pressures materialized via direct and iterative effects as a result of subsidy removal.

In the current non-competitive oligopolistic structure of the Lebanese economy, inflation could well soar higher than the currency depreciation rate, as it had been the case in the past, making the extra purchasing power brought by any dollar aid all the less important. Therefore, enacting necessary economic governance reforms to limit rent-seeking activities and, particularly through the adoption of a competition law and abolishment of import monopolies ("exclusive agencies"), will go a long way in helping mitigate the impact of subsidy lifting on consumers.

Policy 3- Lifting banking secrecy

Lebanon is one of the few countries in the world with a quasi-absolute banking secrecy law. In the so-called 'era of tax transparency,' major advanced economies now require their citizens to report their financial accounts held overseas and require foreign financial institutions to report information about clients from these countries to relevant tax authorities. From this perspective, it is hard to believe that banking secrecy in Lebanon still serves any useful purpose except for protecting private interests or hiding information related to tax evasion, corruption, and crime.

For any effective cash transfer to achieve its pre-defined purpose, transparency on the socio-economic and financial situation of potential recipients is key to ensuring that aid goes to those in need and limit nepotism. Lifting the banking secrecy is a major tool to verify whether the beneficiaries correspond to the desired target of any dollar aid scheme.

Policy 4- Condicio sine qua non: social safety net

The incidence of lifting the subsidy will be significant. According to the Central Administration of Statistics, 72% of households earned less than LBP 2.4 million a month in 2018-2019—equivalent to $200 at today's market rate—so the current situation already means a significant deterioration of their standards of living. Following the subsidy removal, inflationary pressures will materialize via direct and iterative effects. According to the WBG, removing the subsidy will increase inflation by 24 percentage points, not accounting for the iterative effect through pressures on the dollar-note market, which will further depreciate the currency, re-enforcing the inflationary-depreciation cycle.

[viii] These hard currency outflows are significant. Associated estimates range from $4 billion to $7 billion according to various sources.

For this reason, a social safety net should be in place prior to subsidy removal in the form of a cash transfer program. With regards to beneficiary targeting and selection, it is essential that a transparent mechanism be used to identify recipients. Clear and objective criteria should be deployed, based on easily identified vulnerability characteristics (e.g., female-headed households, persons with disability, large families, etc.) This allows beneficiaries and the public a better understanding over aid eligibility criteria and limits the ability of political groups to manipulate the selection process. The pool of beneficiaries can then be refined by the exclusion of the non-poor through objective disqualifying variables (e.g., area of main dwelling, number of registered cars per household, etc.).

Importantly, any disbursement of humanitarian and development assistance must be done in foreign currency to ease pressure on the exchange rate and improve the social well-being[ix]. Simply put, printing Lira (monetization) to finance cash-transfers will add extra pressure to the exchange rate and reduce the value of our national currency, eventually hurting the poor through elevated prices.

D. POLICY SCENARIOS

In the absence of international aid that can be mobilized within a solid macroeconomic strategy (concretely, IMF program), drawing directly in BdL's foreign currency holdings, or indirectly through monetization, has been the sole tool to finance basic import needs with no forward-looking strategy.

This policy choice is harmful for it increases the losses over time, but nonetheless can be avoided. Much of the removal of the subsidy will hurt the people that the subsidy tries to help in the first place. However, if the goal is to protect their purchasing power from further deterioration due to currency depreciation, we present plausible modalities that would serve this noble objective in a more efficient way beyond the current unsustainable subsidy scheme ($5 billion yearly) and the unaffordable proposal by the government ($3.9 billion over five years + $3 billion for EdL and medications in year 1 and year 2).

The scenarios presented in Table 2 are based on a cost-benefit analysis, taking into consideration unavoidable trade-offs that typically benefit some groups at the expense of others, so the advantages associated with the proposed actions outweigh their drawbacks. These scenarios are realistic, politically viable options to replace the current FX subsidy. Any subsidy revamp must be accompanied by a compensation program and must be passed into law through the appropriate constitutional channels, including a transparent budget and a clear timeline, hence the need for an effective government independent of the current establishment with sweeping legislative powers.

[ix] Providing relief in hard currency to an impoverished family means we are taking something away from BdL, basically, preventing the BdL from acquiring this hard currency in case of assistance from a foreign entity. While simple logic might indicate that the recipients are being supported at the expense of the BdL, economics tells us that this is not a zero-sum game. Amid a recession like ours, preventing someone in need from having an additional dollar takes away one dollar from their total spending, because this person is not going to save it—while if she spends it, she will increase the supply of hard currency, easing the pressures on the Lebanese pound. But giving the same dollar to BdL does not add this dollar back into total spending because the central bank is not going to spend it, and even if the BdL spends it to finance imports, it will have a far less important impact due to deficiencies in the subsidy system (e.g., hoarding, cross-border smuggling). Thus, disbursement of aid in local currency in the current context is not a zero-sum game, it is a negative sum game, because it would exacerbate inflationary pressures by increasing money supply, making everybody worse off.

Table 2: Subsidy Value (in millions of USD)

Items	Current	Government proposal *Phased approach with BC cash transfer*	Scenario A.1 *Phased approach with BC cash transfer*	Scenario A.2 *Phased approach with BC cash transfer*	Scenario B.1 *Steep approach with BC cash transfer*	Scenario B.2 *Steep approach with augmented BC cash transfer*
Fuel EDL	900	900	-	-	-	-
Gaz (LPG)	99	-	-	-	-	-
Disel	1,076	-	1,076	1,076	-	-
Other fuel	963	-	-	-	-	-
Medicines & med supplies	1,105	1,105	660	660	-	-
Wheat	135	-	135	135	-	-
Essential items	960	-	-	-	-	-
Total	**5,238**	**2,005**	**1,871**	**1,871**	**-**	**-**

There are four options to finance a cash transfer program, namely:
(i) Monetary creation by the BdL (i.e., monetization);
(ii) Budgetary allocations;
(iii) International assistance; and
(iv) FX holdings.

Monetization risks exacerbating in significant ways current macroeconomic conditions and will lead to further deterioration in the currency value. Government funding is similar since budget deficits have de facto been monetized for years. Therefore, we exclude these two options in the scenarios below and we solely consider the last two options.

While no large-scale international financial assistance is expected anytime soon without a trustworthy government in place, the possibility to fund small-scale short-term cash transfer programs through (reallocation of) low-interest long-term maturity loans or grants should be examined (Scenarios A.1 and A.2). Moreover Scenarios B.1 and B.2 recognize that the usage of FX reserves might end up being if not the only option, the better policy choice—compared to current system or subsidy removal without social safety net—but this should be done in a more strategic way that respects the considerations discussed in Section C. Table 3 summarizes the associated cost of each scenario.

Table 3: Compensation Program, Cash Transfer (in million of USD)

Period	Government proposal *Phased approach with BC cash transfer*	Scenario A.1 *Phased approach with BC cash transfer*	Scenario A.2 *Phased approach with BC cash transfer*	Scenario B.1 *Steep approach with BC cash transfer*	Scenario B.2 *Steep approach with augmented BC cash transfer*
Year 1	1,536	274	474	465	1,465
Year 2	964	274	474	465	1,465
Year 3	620	-	-	-	-
Year 4	465	-	-	-	-
Year 5	311	-	-	-	-
Total cost	**3,896**	**548**	**948**	**930**	**2,930**

Phased approach involves gradual removal of the subsidy, while steep approach removes all subsidies.
The government proposal aims to cover 80% of the population in year 1.
Scenario A.1 targets the poorest 27% of the population. Scenarios A.2 and B.2 the lower 45%. Scenario B.2 the lower 45% in addition to partial compensation of small-scale depositors.

Before discussing the policy scenarios suggested to reform and/or replace the current subsidy, it would be beneficial to state two limitations to our approach. First, we do not pretend to suggest a comprehensive roadmap for stabilization and recovery here beyond the pre-requisite policies stated in the previous section prior to any subsidy removal. Second, the cost associated with each policy scenario is an approximation based on conservative calculations[x]. The cost of each scenario will eventually depend on demand effects resulting from the removal of subsidies on certain goods, but there is uncertainty regarding the elasticities for these consumption goods in the Lebanese economy, which this paper does not treat.

[x] Calculations are based on 2020 consumption figures provided by the Ministry of Economy and Trade to the WBG team. Reference: World Bank Group, 2020, p. 3.

Scenario A - Phased Approach

This first scenario supposes that some targeted FX subsidy should stay in place in the short run. A national committee on imports will be formed to set the import needs for each item, and supervise and ensure the purchasing process is transparent, fair, and generates economies of scale to maximize the gain for the consumer, not the intermediaries.

Under this scenario, all subsidies for fuel, gas, and the MOET essential items will be lifted. Financial support to Electricité du Liban (EdL) also must cease to reduce hard currency outflows, regardless of the long-needed sectoral reform. EdL will need to immediately revisit the tariffs, while supporting the consumption of small households.

The FX subsidy amounts $1,870 million the first year and $330 million the second year. It will cover the following items only:

- Wheat flour ($135 million), beyond its symbolic meaning with bread being the top food item for the average Lebanese household, particularly lower income ones, it is relatively inexpensive.

- Diesel ($1,075 million), lifting the subsidy for this item will generally be reflected on energy-intensive sectors (manufacturing, transport, tourism), with the single highest impact in the productive sectors needed to increase economy's competitiveness and attract hard currency.

- Chronic disease medication, representing 60% of medication import bill ($660 million), the lives of thousands of people depend on their accessibility.

The subsidy for wheat and diesel will be in place for another year, while the subsidy for chronic disease medication will cease after 18 months subject to broad healthcare coverage for Lebanese citizens to take place no later than January 2023.

This policy would save $3.3 billion of the subsidy value in the first year and $4.8 billion in the second year. The largest incidence of this phased approach to subsidy removal will be seen in the richest quartile due to the consumption patterns or activities (e.g., smugglers) of this category of high earners who have the resources to take the hit anyway. The remaining 75% of the population will also feel the impact to a lesser degree. To mitigate the expected rise in poverty rate following partial subsidy removal, financial assistance to poor and most vulnerable households will have to be delivered. However, this scenario precludes the use of BdL's FX holdings to finance cash transfer programs, given that they will essentially provide hard currency to import wheat, diesel, and chronic diseases medications. The policy should then examine how much of the latter it can afford to help.

Scenario A.1 - Narrow-Coverage Cash Transfer (27% of population)
This scenario suggests establishing a national social safety net with a progressive selection methodology based on clear, transparent, and easily identified vulnerability characteristics (e.g., female-headed households, persons with disability, large families, etc.) and accessible technology to limit political interference.

The $246-million loan (ESSN) financed by the WBG should be mobilized shortly to provide urgent cash transfer to 147,000 households (approximately 20% of the population) under the food poverty line for one year, among other things such as the development of a National Social Registry[xi]. Funding from donor partners will support another 50,000 households ($70 million) increasing the total coverage to 27% of the population.

Scenario A.2 - Broad-coverage (BC) cash transfer (45% of population)
The cash transfer scheme will be broad-based covering a larger number of beneficiaries compared to Scenario A.1, but not to the extent of what the government plan suggests (being too expensive) and will run over a shorter period (two years instead of five years). As in A.1, this scenario bases the cash transfer on the ESSN and its donors (27% of the population).

Additionally, financing options through loans and/or grants will also be explored with various multilateral development banks (MDBs) as part of their commitment to support emerging and low-income countries in response to the COVID-19 pandemic[xii]. Furthermore, a national solidarity fund could also be created to provide more funds and help reduce the impact to the poor and the vulnerable[xiii]. These last two measures will aim for $200 million to support additional 150,000 households in the first year, bringing the total number of households eligible for cash transfer to 350,000 or 45% which corresponds to the overall poverty rate for 2020 as calculated by the WBG. Donations and concessional loans for the amount of $474 million will be required to finance the poorest 350,000 households in the second year.

Scenario B - Full-Scale Subsidy Removal
Under this scenario, the FX subsidy will be lifted on all goods—including subsidy to EdL—and services once a compensation scheme is put in place. In addition, it is optional to partially or fully fund the program through BdL's foreign currency holdings.

The motif for this scenario is the following: In the current political deadlock, and ahead of an election campaign, the risk of using FX reserves to pay for an expensive cash transfer program is real, especially that the current government has not secured any tangible funding for its larger-than-necessary plan. That would obviously be a poor policy given the size of the latter. Therefore, given the likelihood of such an event, FX financing as per Scenarios B.1 and B.2 below represents a strategically smaller loss compared to the government's proposal, despite the significant drain on BdL's coffers.

[xi] $204 million aims to arrest the increase in extreme poverty by providing cash transfers to poor households.

[xii] The World Bank Group and Regional Development Banks adopted emergency response packages amounted to $230 billion to support emerging and low-income countries following the COVID-19 outbreak. For more information check the G20 Finance Ministers and Central Bank Governors statements.

[xiii] The UN ESCWA suggested a solidarity fund to tackle the impact on poverty due to the COVID-19 pandemic, and other natural or man-made disasters such as the Beirut Port explosion, based on shared responsibility and societal solidarity in place, especially between the wealthiest top decile and the poor. Increased transparency on income and wealth would allow the Lebanese authorities to improve poverty-targeting practices through a whole-of-government approach.

Obviously, this policy choice would save $5.2 billion a year, i.e., the entire value of the current subsidy, but its incidence will be extremely large on the poorest half of the population, which justifies the use of FX to fund a broad-based cash transfer to partially compensate this hit[xiv].

Scenario B.1 - Broad-coverage (BC) cash transfer (45% of population)
The compensation program under this scenario will target 45% of the population or approximately 1.7 million people over two years. Adults will receive $30 per month each and children $15.

By covering 45% of the population, which is consistent with the overall poverty rate advanced by the World Bank, the outlays equal $465 million per year yielding, all things equal, in net savings of $4.7 billion compared to the current subsidy.

Scenario B.2 - Augmented BC cash transfer (45% of population + small-scale depositors)
The modalities of this scenario are the same as in Scenario B.1: Abolish the $5.2 subsidy and reinject $465 million per year in compensation over the same period. Additionally, the cash assistance scheme will be augmented by a framework where small-scale depositors can be partially reimbursed according to certain modalities to be determined, up to $2 billion in total over two years.

The reimbursed funds will play the role of cash assistance and help small-scale depositors cushion the blow from subsidy removal, using their own money. Unlike big-scale depositors, this category of depositors is very unlikely to have accounts in foreign countries. Thus, the money will basically be spent domestically, which will ease the pressures on the BoP and the exchange rate in the short run benefiting a larger share of the population.

We propose the four scenarios above as realistic, financially affordable, and politically viable options to replace the current FX subsidy and establish cash transfer programs to support the poor and the most vulnerable. The scenarios in question i) consider the social aspect and the economic incidence on the population; ii) they respect the principles of simplicity, transparency, and affordability; and iii) they prioritize grants and donations as financing tool.

We caution that, in the current Lebanese crisis, any policy by itself is meaningless and has to be associated with other set policies. All of this must be conceptualized as a part of a larger macroeconomic stabilization framework that takes into account the compromises and policy trade-offs the Lebanese society has to undertake.

Concrete measures must be put in place prior to any subsidy revamp, including stocktaking of foreign assets, laws for capital controls and competition, the creation of social safety net, and lifting the banking secrecy to ensure cash assistance reaches those who really require it. Furthermore, these policies should eventually be consistent with a credible macroeconomic package that includes exchange unification, minimum wage adjustment, among other steps, to prevent the country from running out of FX and being forced into a disorderly exchange rate adjustment.

[xiv] This scenario does not address the complementarity between the suggested compensation scheme and ESSN.

Such a harmonized package should be flexible so it can be adjusted over time to respond to the evolution of the economy. Without it, however, there will be no real solution to the current crisis, which emphasizes the necessity of an independent government with extraordinary legislative powers to pull Lebanon out of the abyss, regain the trust of the Lebanese people and our international partners, and set the path for a sustainable and inclusive recovery for all.

Kulluna Irada is an advocacy group committed to political reform in Lebanon. It is engaged in defining the foundations of a modern, sustainable and just state, and in coalescing local and international actors around this vision to create momentum for change. The organization pairs extensive policy expertise with civil society engagement and advocacy tools in order to raise awareness on public issues and implement sustainable solutions. Kulluna Irada is funded exclusively by Lebanese citizens in Lebanon and abroad. The organization's internal governance is based on collegial decision making and strict rules on conflict of interest: board members have vowed not to run for elections or participate in any public auction.

Kulluna Irada
Beirut Digital District
BDD 1281, Ground Floor
Syriac Patriarchate Street
Bachoura – Beirut, Lebanon
+961 1 640 020
info@kulluna-irada.org