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LEBANON: Financial crisis or national collapse?

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***Lebanon's collapse is of unprecedented magnitude relative to its economy.* The crisis combines a foreign debt default, a currency devaluation and banking sector bankruptcy in a "perfect storm" unseen since the 19th century, according to the World Bank. More than an economic collapse, its consequences are threatening the survival of the country as we know it.**

***Lebanon's crisis is no accident.* Many date the start of the collapse to October 2019 and the popular uprisings in the country. Most citizens are in denial, unable to grasp the depth of the economic and financial losses they face. But the sources of the collapse can be found earlier, at the end of the 1990s. The currency peg fixed in 1997 allowed deficits to accumulate that have been unsustainable since 2016. More than a financial crisis, it is the end of the economic and social contract established in 1989 to end the civil war.**

***Lebanon's debt is unrecoverable.* At the center of the power structure we find a dominant banking sector. Structural changes are the condition for the country's chances to recover and for the society to survive. They seem possible, but are they likely?**

Lebanon is experiencing an economic and financial crisis that seems to have begun with the outbreak of major demonstrations in October 2019. During those three to four months, a population usually divided along religious and sectarian lines appeared united against the whole reigning political elite, calling for them to step down with slogans such as "all of you means all of you". The popular and united uprising soon faded as the Lebanese people came under pressure from the fast deterioration of the national currency.

The uprisings were unable to produce any party or formation capable of offering a political alternative on its own, and all attempts to form coalitions failed, as activists couldn't agree on the real causes of the crises unfolding, on the priorities and the type of political reforms they would fight for. This essay aims to analyse the very secular economic and financial mechanisms underlying the crisis in Lebanon. It will attempt to show that it is not a chance event and should not be considered surprising. The paper will focus on the context behind the economic changes and the transforming financial flows used by the governing political groups to fund their sources of power. This will show that they all became functionally unable to solve or alter the course of the unfolding collapse.

Based on this, the paper will suggest a few priorities and possible outcomes for the country.

Human aspects of an unprecedented national collapse

The spectacular fall of the Lebanese pound (LBP) has been ongoing for almost two years. The official exchange rate on the eve of the October 2019 uprisings was 1507 LBP to $1. In the first days of 2022, it rose above 30,000 LBP for $1 on the so-called "black market" where the true level of supply and demand is reflected imperfectly. Galloping inflation accompanies this fall. Prices grew at a rate close to 200% at the end of 2021, while the national currency has lost more than 95% of its pre-crisis value. The latest estimate of food prices shows inflation that exceeds 500% on many products.

The poverty rate went from 30%–35% in 2019 to 85%–90% at the end of 2021, a clear indication of the extent of destruction of the middle class.

The economy has collapsed to the point that GDP fell from almost $55 billion in 2018 to around $35 billion in 2020 and the various estimates for the year 2021 place it between $22 and $24 billion. It continues to fall rapidly in 2022. The spectacular drop in GDP per capita reflects the very rapid impoverishment of the population and of the middle class. Indeed, while the GDP per capita was around $8,000 in 2018, putting Lebanon among the middle income countries, it was estimated at less than $3,000 at the end of 2021, leaving Lebanon in the poor or lower income category in a mere 18-month period. The poverty rate went from 30%–35% in 2019 to 85%–90% at the end of 2021, a clear indication of the extent of destruction of the middle class.

While these statistics are dramatically explicit, they fail to reflect the human reality: mass emigration, power cuts, lack of medicine, endless queues at gas stations – all are factors linked to this context, not to mention the massive forest fires which occurred during the summer of 2021, the inability of hospitals to provide adequate health services and the refusal of many of them to accept patients unless they are able to provide advance cash payments, and the inability of the state power company to provide more than two hours of electricity a day.

A few examples of dramatic and tragic events serve to summarise this context of mass and rapid impoverishment. On December 13th 2021, Mohsen Halim Suleiman, a retired member of the Lebanese Armed Forces (FAL), unable to face the collapse of his living conditions, attempted to commit suicide by setting himself on fire. The average salaries of public and private sector employees saw a 6 to 8-fold decrease in their purchasing power. A significant proportion of the salaries are below $50 per month. For many it no longer makes sense to spend money on transportation to work. Meanwhile, a recent incident linked to a widespread power outage, following a failure in a regional electricity generation plant, revealed the extent of the state's downfall. Television journalists entered a deserted plant, as the site's security personnel had not come to work. The camera crew showed live pictures of a dark site with no visible presence of any technical or administrative staff. This is one of the main technical sites within the country's network.

In a January 2022 interview, the Minister of Telecommunications sounded the alarm regarding the ability of the two main internet and mobile telecom providers to continue their services in the coming months. The revenues of these companies, which have been taken over by the government, are still labelled in Lebanese pounds (LBPs) at the official rate of 1507 LBP. The revenues of the company called Touch reached $850 million in 2018 compared to a dismal $5 million in 2021. To align the consumption tariffs of these services, a government decree is needed. Mr Mikati's government has thus far failed to deliver one. With a caretaker government in place since May 16th following the parliamentary elections, there are no expectations for any action to be taken on this seemingly pressing issue for so many. Even if rates were adjusted only partially to reflect the reality of costs, the vast majority of subscribers would be unable to afford the prices. As a reminder and one explanation of the reluctance to deal with this problem in particular, the uprising of October 2019 was triggered by a decree from the Minister of Telecoms setting a tax on the use of free encrypted messaging on the internet, particularly WhatsApp. In his interview, the Minister recalled with a nostalgic tone the time when "corruption was everywhere and then there was money… today, there is no money left…".

At the end of April 2022, a boat fleeing Lebanon for Cyprus carrying over 60 people, including many children, capsized. At least seven died, children among them. As poverty levels skyrocket, Lebanese families, like Syrians, see the risks of crossing the sea towards the EU as a better alternative than the prospects of their living conditions at home. Most of the people on board were residents of Tripoli in the north of Lebanon, the poorest city in the country and one of the poorest cities in the Mediterranean. It has also produced many Lebanese billionaires.

How did we get here?

A society living beyond its means

Lebanon's trade balance has had a structural deficit since the end of the civil war in the late 1980s.

The negative balance oscillated between $3.5 billion and $6.5 billion a year from 1990 to the eve of the global financial crisis in 2007. From 2008, annual deficits increased to approximately $10 billion a year until 2011. The trade deficit increased further, reaching $15 billion in 2014 and varied at around $13 billion until 2019. These are very large deficits relative to the size of the economy at 25% to 35% of GDP consistently since 2010. The "improvements" observed at the end of 2019 with a deficit of 20% of GDP is merely the result of a dramatic fall in consumption as imports fell against the background of the economic crisis. Since the end of the civil war in 1989, the average deficit has been almost 32% of GDP according to various estimates, compared to world averages closer to 5% or 6% of GDP. This underlines the magnitude of the trade gap and the extent of the accumulated deficits, which have become a central feature of the Lebanese economy.

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A comfortably financed deficit

The reserves of the central bank – Banque du Liban (BDL) – seem stable over the same period of deficit accumulation since 2010, averaging around $31 billion until 2019, when the crisis began. There was even a short period when reserves increased, between 2015 and 2017, reaching a peak of more than $35 billion at the end of 2017. Note that we consider currency reserves in the strict sense. The gold reserves of the BDL are not included in this number. This is justified by the fact that the gold reserves were purchased a long time ago, before the beginning of the civil war in the 1970s and have been subject to legal and constitutional constraints since the mid-1980s. For the BDL to dispose of the gold reserves it must propose and pass a specific law in parliament.

The stability of the foreign exchange reserves imply that the high level of structural trade deficit in the economy is financed by substantial inflows that compensate for the gap and ensure the preservation of the reserves, whose importance can be assessed effectively by their size relative to the country's economy and in this particular case to the dependency on imports. Thus, the $35 billion of BDL reserves in 2018 represented 17 months of imports. This should be compared with an average of just over eight months among OECD countries, and almost 30 months for Saudi Arabia, which has among the highest foreign exchange reserves in the world. By contrast, the foreign exchange reserves held by the central bank of Tunisia represented barely 2.6 months of imports in the same year. These ratios clearly show the BDL's substantial reserves on the eve of the crisis in 2019.

A context of persistently weak economic growth

In 2011 the war began in neighbouring Syria. From that moment on, Lebanon's economic growth slowed and became anaemic compared to the growth standards of emerging countries. After two or three exceptional years at the end of the Lebanese civil war in the early 1990s, which saw exceptional growth rates of around 30% and 40%, economic activity fluctuated at relatively sustained levels between 3% and 6%. That, despite two or three very weak years due to violent political events in 2005 following the assassination of Prime Minister Rafic Hariri and the 33-day war with Israel in 2006. These were compensated by years of very high growth in 2008 and 2009 with rates of nearly 10%.

However, 2011 marked the beginning of a period of very weak growth, with a rate of less than 1% that year against the backdrop of the start of the war in Syria. Since 2014, economic activity has never exceeded 2%. Long-term economic weakness is a source of additional stress on the country's financial stability. The level of foreign exchange reserves and the ability of the BDL to maintain a fixed rate for the Lebanese pound against the US$ at 1507 LBP is even more surprising.

An unconventional rentier economy

Annual financial inflows of foreign currency are therefore independent of the performance of the underlying domestic economy, with the diaspora, one of the country's most valuable assets, a key source.

Lebanon has experienced multiple migration waves, starting in the mid-19th century under the Ottoman empire. Particularly important was the migration throughout the civil war between 1975 and 1990, which scholars have called "the Fourth wave", when an estimated 1 million Lebanese left the country. A new wave of migration is currently occurring as the unfolding crisis depreciates purchasing power, destroys savings and pensions and deteriorates wealth. While it remains difficult to measure precisely, estimates of new departures vary between 220,000 and 250,000 in the last two to three years. Lebanon is country that exports its human capital, with its diaspora of between 5 and 10 million one of the largest in the world relative to number of resident citizens.

For decades, remittances have been the dominant source of the hard currency inflows that financed the trade gaps. These transfers have experienced very strong growth since the beginning of the 2000s. Starting from annual levels of about $2.5 bn in the year 2000, they reach annual over $7 billion by 2005. In terms of percentage of GDP, these transfers amounted to nearly 25% of GDP in the early 2000s and remained above 17%–18% of GDP in recent years. The contribution of migrant remittances to financing deficits appears all the more essential when compared to the global average of remittances, which represents no more than 0.8% of global GNP. Even in countries known to be major sources of migrant workers that are significantly dependent on remittances, like Morocco, Egypt and the Philippines, remittances only contribute between 6% and 9%, far below the Lebanese level. In fact, Lebanon is the country in which GDP depends most on remittances by some distance. Remittances play a crucial role in the functioning of the Lebanese economy and financial balances. The intensity of this dependence means Lebanon could be labelled a rentier country, and its entire economic and social stability is hostage to any change in the conditions of their availability and continuous inflow. The disruption of the economic and financial model began long before 2019. The financial catastrophe is the result of an accumulation of imbalances generating pressures on the system that were never properly managed.

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The Syrian refugee crisis and its economic impact

Lebanon's ratio of refugees to total population is one of the highest in the world. The massive influx of Syrian refugees since the beginning of the war in 2011 have generated extreme pressures on the social system, including healthcare and schools, but above all on energy and food consumption. Even if the level of consumption of goods and services per individual is very low, the very high number of refugees is an extreme shock. The UN and World Bank calculations put the ratio of refugees at 35% of the population in 2014, second only to the island of Aruba, with its 110,000 residents and the flows of refugees coming from Venezuela.

The impact on external balances is extremely negative. The sudden increase in demand generates inflationary pressure which impacts the fixed parity of the Lebanese pound, which is guaranteed by the BDL at 1507. While the UN compensates for part of these costs, the assistance has come several months late and for amounts lower than the actual costs to the country's economy. The UN compensation mechanisms are calculated based on registered refugees of about 1 million whereas many institutions put the number of refugees in Lebanon closer to 1.5 million. Thus, the Syrian refugee crisis had a clear and significant impact on GDP and is one of the main sources of the fall that began in 2011.

High interest rates and economic weakness, a destructive combination

Due to the dependency on currency inflows, the BDL's monetary policy did not seem to acknowledge the change in economic activity. Interest rates remained high at about 6% between 2011 and 2015 and reached close to 10% in 2016. GDP remained anaemic, approaching 0% growth, according to official figures, and dove into recession from 2017 on. This high interest rates policy seems to have been the opposite of what the economy required. It reflects the BDL's choice to protect the attractiveness of private banks rather than the domestic economy and local employment by lowering interest rates to relaunch GDP growth. The BDL's priority was to promote the strategically important gathering of deposits in foreign currencies for the sake of the stability of its own foreign reserves and balance sheet.

From 2016 onwards, income from interest received by all members of the Association des Banques Libanaises (ABL), a banking owners' syndicate, rose exponentially from an already high level of $3.5 billion in 2014 to nearly $8.5 billion in 2018. These revenues represented more than 15% of GDP in 2018. By way of comparison, in the same year in France, where the banking sector has significant weight in the economy, revenues represented 6% of GDP. Dividends followed the same trend. They increased from a level of $600 million to more than $1.1 billion, a rise of almost 100% in a short two-to-three-year space while the economy was slowing.

At the same time, the central bank pursued an aggressive policy of lending to the state through the underwriting of debt instruments, some in US$ but mostly in Lebanese pounds. That nearly 40% of the banks' shares belong to dominant political figures from the successive governments since 1990 shows the interconnected interests of the various actors and the central role played by the ABL and the BDL in this context. However, the difficulty maintaining external inflows is largely due to deep changes in the global oil markets.

The fall in oil prices and their impact on remittances

Oil prices began falling rapidly in the summer of 2014. From around $120 a barrel in July 2014 prices reached $45 by the beginning of 2015. Prices fell below $30 a barrel in February 2016 in a context of very high volatility. This resulted in a sharp decline in economic activity and sudden fiscal and balance of payments deficits in most oil-exporting countries, particularly the Gulf states. Remittances to the Lebanese economy are mainly sent by Lebanese people working in the Gulf states, the origin of 50%–60% of total transfers to Lebanon. The dramatic fall in oil prices negatively impacted the capacity of the diaspora to maintain the same level of transfers. They started declining in the summer of 2016 and many institutional depositors and clients from the Gulf states faced urgent liquidity needs and started withdrawing some of their deposits.

The economic and financial collapse is neither a mere accident, nor caused by any short-term mismanagement. It is the collapse of a way of life based on a consumption-based society through very high imports and very large trade gaps.

Lebanese banks saw zero growth of their deposit base in 2016. This triggered an immediate response from the BDL, which sharply raised interest rates to help the banks protect and grow the much-needed deposit base. After a brief recovery in the last quarter of 2016 and early 2017, net deposits moved into negative territory by the end of that same year and decreased by 5% at the end of 2018. All banks put stringent restrictions on deposit withdrawals as the uprisings began in the last quarter of 2019.

The economic and financial collapse is neither a mere accident, nor caused by any short-term mismanagement. It is the collapse of a way of life based on a consumption-based society through very high imports and very large trade gaps, financed by one of the highest levels of remittances in the world and high interest rates.

A national system's total collapse

Electricité du Liban (EDL): An impossible burden

EDL's operating deficit accumulated over the last 30 years alone represents 46% of the total public debt of nearly $95 billion at the end of 2020. The main source of this problem lies in the unit kilowatt/hour (kWh) pricing to the consumers on the one hand and a rate of unpaid bills which remains high. The price per kWh was set in December 1997 based on the oil prices at the time of $22 per barrel. As oil prices rose to levels of $140 per barrel EDL's losses ballooned. No government was willing to change EDL's reference prices for more than 20 years. EDL ended up bankrupt and unable to provide electricity.

A destructive exchange rate policy

The fixing of the conversion rate of the Lebanese pound against the dollar at the rate of 1507 was also decided in December 1997. This decision was the result of long efforts to stabilise the national currency since 1992. At the end of the civil war following the Taif peace accords the Lebanese pound experienced a period of great instability and devaluation. From a level of 500 to $1 at the beginning of 1990, the Lebanese currency dropped to nearly 3,000 to $1 in the last quarter of 1992. The same year, Rafic Hariri became Prime Minister and Nabih Berri became speaker of the parliament. Riad Salameh was appointed governor of the central bank in 1993.

Hariri's reconstruction strategy for the country was built on the ability to attract foreign direct investment, particularly from the Gulf countries. But the general instability and depreciation of the local currency was a very significant obstacle. Mr. Salameh implemented a gradual stabilisation strategy of the LBP that lasted four years and resulted in the level being fixed at 1507 to 1$ in December 1997. This was only possible by raising foreign currency reserves. The choice to start borrowing in US$ was made and the level of debt started rising in 1993. From 1997 on, the level of foreign debt increased exponentially. This proved to be a destructive strategy in the longer run. It imposed restrictive monetary and high interest rates and impeded the capacity of the economy to adjust to changing circumstances, a very big risk for a small and international trade dependent economy. The events of 2011 and the changes to the global oil markets in 2014 were two missed opportunities where the fixed exchange rate should have been adjusted to reflect the deterioration of the international liquidity situation.

Unproductive budget spending and irresponsible tax policies

The main items of state expenditure reflect the underlying rentier nature of Lebanon's economy, which was based on a pure consumption model. Over a third of spending goes to interest payments to service the ballooning debt. Nearly 25% goes to public sector payroll and nearly 40% is spent on subsidies.

Subsidies weigh very heavily on the country's deficit. They contribute $5.2 billion of the total of $12 to $15 billion annual gap over the recent period. Subsidies on energy products account for almost 60% of total subsidies. Energy and fuel subsidies are regressive in nature, benefiting consumers with the highest spending capacities. This promotes overconsumption and constant widening of the already unsustainable inequality gap, one of the world's highest, worse than Brazil and close to South Africa's levels. Current functioning and state employee payroll expenditure amounts to 95% of total spending. This leaves no room for any serious infrastructure investments.

Against this backdrop, the taxation revenues in Lebanon are amongst the lowest in the world, with the total contribution to GDP of all taxes never exceeding 14%–15% of GDP and corporate and income taxation never exceeding 5%. This compares to tax contributions to GDP of 32% in Tunisia, 25% in Turkey and the US and 47% in France. Lebanon is closer to Singapore, with a 13% tax contribution but, unlike Lebanon, Singapore runs a very high balance of payment and trade balance surpluses. These policies generated a non-repayable government debt and a total collapse of the financial system with a bankrupt banking sector and depleted foreign exchange reserves.

An unrecoverable debt

The debt burden in 2019 was 170% of GDP. The debt continues to grow because of the prohibitive cost of interest paid on the existing inventory. In 2020, GDP was only $34 billion, while the stock of debt continued to rise. The weight of the debt thus exceeds 250% of GDP. And yet this is probably a low estimate. GDP projections for 2021 are such that the debt ratio will be significantly higher, reaching levels closer to 350% of GDP. This level of debt cannot be repaid. Indeed, the Lebanese government announced a default on a debt repayment in 2020, because it simply had no other option.

A bankrupt banking system

Faced with a snowballing trend of deposit withdrawals and in anticipation of a full-blown bank-run Lebanese banks took unilateral measures at the end of 2019, severely restricting access to customers' deposits in US dollars at the official rate of 1507, establishing de facto capital control and effectively breaking the fixed exchange rate. All these actions were imposed outside of any legal framework.

The BDL refused to officially acknowledge the effective collapse of the fixed exchange rate but introduced multiple exchange rates "specific to types of transactions". The resulting effect was a total collapse of trust in the financial system and the disruption of the payment systems, with many international banks in Europe and the US restricting money transfers to and from Lebanon. The latest official figure for these deposits was published in 2018 by the BDL. The latest review of these estimates after two years of financial turmoil show about $110 bn of deposits left with 70% denominated in foreign currencies. The banks' aggregate assets show 70% of total loans were granted to the government and the central bank through a combination of subscriptions to treasury bonds and loans to the central bank in the context of what has been described as "financial engineering" in the last few years. In its latest published balance sheet, the central bank recognises $85 bn debt to the banking sector while holding only $12 bn in reserves.

To solve this gap, the BDL is forcing its creditors to accept the LBPs it is printing at an accelerated rate. This is fuelling hyperinflation and causing further devaluation of the national currency. The black-market value of the LBP has gone from 2,000 at the beginning of 2020 to 34,000 today. There is nothing to stop the continuation of this trend towards 50,000 and beyond. The financial system is broken and bankrupt. The Lebanese economy cannot rebound.

Any prospects for an exit of the crisis?

The short answer is yes. However, any exit path requires structural issues to be solved and recognition that the economic model sustaining a prevailing social contract is broken and cannot be mended. A sustainable and credible exit strategy would be predicated on a few priorities.

The financial sector requires a complete overhaul, calling for very difficult choices. The ability to restructure the banking sector implies a detailed audit and full access to all accounts and payment flows. One of the most stringent bank secrecy laws in the world was introduced in the 1960s. This protective shield must be removed, and the law repealed if any serious restructuring process is to take place. A policy of distribution of losses aimed at protecting segments of the society that are unable to cope with losses of revenues or assets must be declared. Deposit accounts below an amount to be determined and retirement and health insurance fund accounts would be the primary beneficiaries of such plans.

Meanwhile, the weight of the EDL's accumulated losses in the total debt of the country is close to 50%. There is no possible exit path without tackling this central problem. The production cost for the EDL is almost double international standards. It must urgently be lowered to closer to standard levels. In parallel, fuel subsidies must be replaced by a more targeted system aimed at benefiting lower income users while introducing higher taxation through progressive VAT on higher income and corporate and government sector users.

The BDL's gold inventory is one of the largest in the world. The physical size of the reserves is estimated at 9.2 million ounces. The current value is $17 billion. Other similar assets such as Middle East Airlines, Casino du Liban, Intra Bank and a very large land portfolio are similar subjects of concern. State-owned assets must be preserved as much as possible and be used as guarantees for funding new infrastructure and social programmes for the purpose of relaunching economic activity. They should not be used exclusively to compensate for the incurred losses and outstanding debt.

The way Lebanon emerges from this crisis will impact not only the Lebanese but will have wider effects on the region. Lebanon can prove that it is possible to use this crisis as an opportunity to build a modern state with rights for all citizens.

Conclusion

Lebanon's financial crisis is of such magnitude that it has destroyed the very foundations of the state and the social and cultural pact that has prevailed since the 1990s. The population seems too shocked to grasp this reality and many common reactions and attitudes reveal a state of denial in the society. Exit strategies require a strict and disciplined reallocation of resources and a transition away from a strict consumption-based economy. Lebanon can no longer run large trade gaps with unstable funding models.

The governance and political framework which resulted from the Taif agreement in 1989 are unable to operate the decision-making processes required to manage the crisis. The political class in its present form is effectively obsolete. Yet, the national elections which took place in May confirmed the prevalence of the traditional leaderships, even as a number of new MPs emerged from the new opposition groups. At the time of writing, the new assembly has just voted Nabih Berri speaker of the parliament. He has occupied the post since 1992.

Deep reforms are thus unlikely. The most probable outcome is minimal acceptable agreement with the IMF as a first step. This would hopefully trigger additional support from other financial institutions and the EU. On this limited basis, one can imagine a drive towards a "reconstruction plan" where specific deals can be struck on a public–private partnership model with the support of international financial institutions. While this will undoubtedly have a positive impact, it will not address the fundamental needs for deep economic, social and constitutional change and allow the emergence of a viable economy and a long-term stabilised Lebanese society on the borders of Syria, which is seeking its own strategy of "reconstruction".

The way Lebanon emerges from this crisis will impact not only the Lebanese but will have wider effects on the region. Lebanon can prove that it is possible to use a crisis of profound magnitude as an opportunity to build a modern state with rights for all citizens. Alternatively, it can show that the prospect for stable, prosperous, social democratic constitutions is not yet within the reach of the present and next generations.

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