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# The Eye of the Storm

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## ABSTRACT

Lebanon is in the throes of an unprecedented crisis in its modern history. Starting 17 October 2019, the people of Lebanon have been protesting in the streets in a broad-based uprising. This paper highlights key post-civil war realities and practices that led to the country teetering and proposes a solution package to what ails the country and threatens its future.

Lebanese citizens are now facing arbitrary capital controls and cash withdrawal restrictions imposed by banks. They are witnessing a divergence between the official currency exchange rate, pegged by the Lebanese central bank (Banque du Liban or BDL) since 1997, and the real market exchange rate.

In Lebanon, the political class is often indistinguishable from the government because, unlike most parliamentary democracies, postwar Lebanon is not about the majority governing and the minority opposing. Rather, most parties in parliament are represented in the cabinet, rendering it a microcosm of the assembly. Something that takes precedence over the composition of parliament is the power-sharing between sects, often represented by former warlords. The latter have control over their ministries, which explains why a certain cabinet position is kept with the same party and/or sect when ministers change. Senior public servants wield a lot of power and constitute a serious Deep State that also includes senior employees of government-controlled enterprises. The system that controls Lebanon includes, besides politicians, the central bank and the banking system as well as big money consisting of

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large contractors for the state.

The sectarian system in place is essential to the perpetuation of the dominating oligarchic kleptocracy. Without sectarianism, it would have been virtually impossible for warlords to endure the way they did. Sectarian leaders are indeed very apt at fanning sectarian insecurities among their people. It feels that, when it comes to sects, there is a general abdication of reasoned thinking.

The ill-advised currency peg that is now collapsing has historically created a riskless way of making money. An individual can borrow dollars, exchange them for liras, and deposit the latter at a much higher rate than the borrowing rate. Because of the pegged exchange rate, the currency exchange risk is removed, but the inflated profit kept whole, making wealthy individuals with access, namely the ruling class, wealthier at people's expense.

There are several costs to this peg, the first being the amount of dollars that the BDL needs to sell periodically to defend it. This requires a constant flow of dollars into Lebanon. The second cost is economic. The LBP being highly inflated at its pegged level, imports seem cheap, so the economy relies a lot on the latter, and producers, mainly in the fields of agriculture and industry, find it uneconomical to actually produce. It makes more sense for them to deposit their money rather than invest it given the high deposit rates. Even non-residents, mostly the diaspora who send remittances to Lebanon, prefer to deposit their savings rather than invest in anything.

This policy has crowded out investments and led to an unproductive, rent-seeking economy. The dependency on imports and the fact that most exports would not be economical have led to a current account and balance of payment deficit. Also, due to rampant corruption and the government's inability to effectively collect taxes and duties, the country has run a budget deficit that the BDL has helped fund. The latter therefore needs a constant

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inflow of dollars to defend the peg *and* cover the twin deficits. However, much more significantly, the central bank needs dollars to pay the interest on liabilities, since the money raised from depositors and investors in certificate of deposits and treasury bonds is not invested but rather spent to cover the expenses of the government amidst a spiraling increase in public debt. That is the definition of a Ponzi scheme: design and run a system that depends on enough foreign currency inflows to keep the country from grinding to a halt.

And despite the fact that the scheme engineered to perpetuate the rule of the oligarchs went through hiccups when not enough dollars were flowing, it somehow managed to subsist. The remedy was usually foreign aid from donor countries through international conferences like Paris I (2001), Paris II (2002), Stockholm (2006), Paris III (2007), and more recently, the yet-to-be-implemented Paris IV or CEDRE (2018).

Nevertheless, things took a turn for the worse starting in 2016. A combination of developments constituted the perfect storm that put the whole Ponzi scheme in jeopardy. Remittances from the Lebanese diaspora in Gulf Cooperation Council (GCC) countries started to fall as many Lebanese lost their jobs. Also, many wealthy GCC nationals stopped investing in high-end Lebanese real estate, in part because the relationship between Lebanon and GCC countries soured over Hezbollah's role in the Syrian war and also because the real estate market in Lebanon was stagnant. Furthermore, the presence of about 1.5 million Syrian refugees<sup>1</sup> was seriously straining the Lebanese government's budget. The Syrian war also made it impossible for a lot of Lebanese exports (mostly agricultural) to make their way by land to GCC countries as the border between Syria and Jordan was closed. To make things worse, in 2017, parliament passed a public sector salary raise costing \$917 million.<sup>2</sup> Finally, in 2018, to garner as many votes as possible in the legislative elections, cabinet ministers hired over 5,000 people into

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an already bloated and ineffectual public sector.<sup>3</sup>

As early as 2016, it became obvious to BDL Governor Riad Salame that he needed to find new ways to bring dollars into the system. At the same time, two of the largest banks in Lebanon were in trouble over bad investments they had made outside the country. Salame offered these two banks initially, then any bank that was interested, a convoluted scheme consisting of double swaps, which he dubbed “financial engineering.” The essence of the deal was to purchase from banks their local currency treasury bonds at a huge premium (using a discount rate of 0 percent) in return for fresh dollars that the banks would invest in certificates of deposit with BDL. As dollar interest rates offered were very high, banks offered very tempting deals to customers for fresh dollars, including paying interest on the money in advance. Also, the LBP that banks received from BDL in return for the local currency treasuries were invested at very generous interest rates at BDL. The financial engineering deals unfolded in waves between 2016 and 2018 and have led to riskless profits, or a wealth transfer to participating banks exceeding \$5 billion.

As per its website, BDL’s dollar assets today are worth \$30 billion. When compared to the \$70 billion that BDL borrowed from banks, we see a deficit of \$40 billion in hard currency. By this arithmetic, \$40 billion of depositors’ money is gone, ill spent. I am not including local currency losses because BDL can always print liras. It is increasingly clear that the ad hoc capital controls and the haircuts in disguise applied by banks as well as the loss of value in the local currency are here to stay.

As we look ahead, several steps are required to address the decaying financial, monetary, and fiscal situation that has resulted from decades of mismanagement and incompetence.

\* **Capital controls:** Capital controls should be made official and for a

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- predetermined period of time (18 months) that may be extended if needed.
- \* **Financial statements auditing for BDL and all banks according to IFRS9 standards:** Before losses of depositors' money can be distributed, these need to be assessed.
  - \* **Bank insolvency:** Banks that are found insolvent will be required to be recapitalized by current shareholders or put in receivership.
  - \* **Profits from "financial engineering":** Banks will be required to disgorge the profits from the financial engineering deals they struck with BDL, failing which, the state will get a stake in banks in proportion to the profits they made.
  - \* **Interest rates:** BDL has lowered interest rates on deposits but has not matched them with a reduction of rates on consumer or business loans. This step only served to beef up banks' profits by reducing the amount of interest they paid. Rates on deposits and loans should be lowered dramatically. That includes interest paid by BDL to banks on their deposits.
  - \* **Haircuts:** Haircuts should be applied to bank accounts above a certain threshold (say, \$1 million), in proportion to the interest earned on these accounts over a certain period (say, the last five years). Depositors subject to haircuts will be compensated with shares (new shares, post-recapitalization) in proportion to the amount cut from their deposits.
  - \* **The peg:** The peg should be ended gradually. In a first stage, the exchange rate could be set to 2,250 LBP to the dollar. A gradual floating thereafter will limit the social ramifications of an immediate float.
  - \* **Sovereign debt:** The state should hold off on servicing existing sovereign debt or retiring maturing debt, at least to internal debtholders. A restructuring of the debt should include a drastic reduction of both the coupon payments and the principal as well as the lengthening of Eurobonds' maturities.
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- \* **Audit of bank accounts of politically exposed people:** recuperating the ill-gotten wealth of politicians, public servants, and major providers of services to the state starts with an audit of their bank accounts before and after 17 October 2019.
  - \* **Independent judiciary:** The successful prosecution of corruption cases (among others) requires a strong judiciary that is not susceptible to political pressure.
  - \* **Electricity:** The IMF would require the immediate end of EDL (national electricity company) subsidies as one of the conditions to aiding Lebanon. This will lead to either an increase in outages—leading citizens to buy more power from operators of generators—or an increase in electricity tariffs. Buyers will be put under financial pressure either way. Instead, it makes more sense to contract out the building of two new power plants via BOT contracts.
  - \* **Balance of payment (BOP):** To reduce the BOP deficit, it is important to import less and export more. An adjustment in the exchange rate of the lira will help as would increases in tariffs on imports of luxuries. However, it is important that the government provides help, land grants, and tax incentives to the agricultural and industrial sectors.
  - \* **Fiscal deficit reduction:** The public sector is bloated, but laying off public employees at this stage will only lead to further unrest, as would increasing the value-added tax (VAT) from 11 to 15 percent. Headcounts should instead go down by attrition. The same applies to public sector retirement packages. The latter are generous but cannot be curtailed for retirees. Instead, they could be for public sector employees who will retire starting several years from now.
  - \* **Privatization:** Although state-owned assets are very poorly managed, selling them off now at rock-bottom valuations is both unwise and

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immoral. Nevertheless, that should not preclude taking the national airline public (priority to domestic shareholders) or exploring public-private partnerships for the other assets.

- \* **Oil and gas resources:** Most importantly, the government should avoid selling Lebanon's oil and gas production forward as it is unfair to deprive future generations from revenues to pay for the theft and mismanagement of the current leadership.

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## Endnotes

- 1 World Report 2019: *Events of 2018* (USA: Human Rights Watch, 2019), [PDF file].
- 2 Ellen Francis, "Lebanon president signs tax, wage increase laws," *Reuters*, 21 August 2017, <https://www.reuters.com/article/us-lebanon-wages/lebanese-president-signs-tax-wage-increase-laws-idUSKCN1B10XR>.
- 3 Sunniva Rose, "Lebanese MPs: 15,000 government employees hired illegally," *The National*, 28 February 2019, <https://www.thenational.ae/world/mena/lebanese-mps-15-000-government-employees-hired-illegally-1.831701>.