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The Interesting Case of Lebanon: Understanding the Ongoing 2019 Crisis, And Proposing a Solution that Distributes Losses Equitably while Allowing for a System Reset

On September 12th, in a meeting with French President Emmanuel Macron at the Residence des Pins in Beirut, the Lebanese class of political elites made a pledge to set aside their political differences over a period of 6 months to move forward with demanded reforms requisite to unlocking essential IMF and CEDRE conference aid money. The French initiative clearly reiterated the demands of the Lebanese people- including explicit economic demands such as issuing a capital controls law to protect depositors, implementing a forensic audit of the BDL, restructuring public debt, and restructuring the banking sector. However, it soon became clear that the Lebanese political factions would renege on their commitments to the French initiative, delaying indefinitely any potential deal with the IMF. Meanwhile, Lebanese people continue to struggle as more and more businesses shut down, people lose their jobs, and purchasing power plummets further via hyperinflation, with no end in sight to Lebanese people's worsening conditions of life. In May 2020, the headcount poverty rate had already reached 55%, up from 28% in 2019; and that was prior to the August 4th explosion that rocked Beirut. As for CPI inflation, it hit 146% by end of December 2020.

The 2019 Lebanese crisis has been in-the-making for decades. The reality is that Lebanon has been living above its means since the start of the post-war era in the early 90's, all while corruption and mismanagement prevented the country from using government overspending and existing resources to develop its ailing infrastructure, its lacking social security system, and under-performing public healthcare and educational sectors.. Simultaneously, Lebanese productive sectors were neglected at the expense of real estate, banking and services- they remained uncompetitive, lacked access to capital, and suffered from a high dependency on raw material imports and global supply chains, as well as a toxic relationship with real estate. To counterbalance this persistent trade balance deficit, Lebanon has relied on remittances from its highly successful diaspora, mainly residing in the GCC, but also present in the US, Europe, Africa and Latin America. This happened through the Lebanese banking sector, long-hailed as a symbol of Lebanese resilience, which continued to lure diaspora money through unrealistically-high interest rates on foreign currency deposits. As long as money poured into the banking system, these incoming funds- through various schemes with BDL and the GoL- would factor into spending on imports, supporting government expenditure, and paying interest on dollar-denominated deposits as well as dollar-denominated debt. The Lebanese people's confidence in the exchange rate peg was unhinged, yet in the meanwhile, the Lira was faltering, the exchange rate shivering. That is, until October 17th, 2019.

Lebanon today is outright insolvent, and the problem is much more complex due to the exposure of both the banking sector and BDL balance sheets to the GoL debt as well as to each other. Nobody can pay anybody, except in rapidly devaluating Lebanese Liras. Without pursuing the path of comprehensive reforms, balancing the budget, issuing a capital controls law, allocating losses justly and sanitizing balance sheets across the financial system, nobody- especially the IMF and foreign creditors- will invest in Lebanon, nor will foreign capital flow into the country. Therefore, it is essential to recognize the losses incurred by the system over the post-war era, as a prerequisite to allocating losses equitably among the various groups that led Lebanon into this mess, all while minimizing the cost borne by poorest depositors as well as the ordinary citizen.

This paper serves to explain the origins of the crisis, followed by presenting the author's proposal for restructuring sovereign debt, allocating losses equitably and sanitizing balance sheets in order to relaunch the banking sector afresh. Lebanon needs a fully-recovered banking sector, one that is fully committed to lending the private sector and that serves a healthy, competitive, economy as well as future generations in Lebanon.

This study does not intend to dismiss the role of politics in any potential resolution of the crisis. In fact, Lebanon has been engaged heavily in the conflicts that have plagued the Middle East, and continues to pay a huge price for the proxy wars that are at play on its territory. Furthermore, domestic politics have been "zero-sum" in nature and counterproductive to the interests of society. While politics may constitute the spirit of the solution, this paper is focused on the financial aspect of the Lebanese crisis. Once there is political will to tackle the financial crisis, this paper advocates for a sovereign debt restructuring process that distributes burdens fairly while pushing for a steep enough restructuring so as to avoid a repeat of the saga, and to build new foundations that serve the Lebanese people and economy going forward.

Disclaimer: Unless otherwise stated, the figures used in this study are based on the official exchange rate of 1,500 LBP/USD. Additionally, calculations made are based on official statistics made available by the Banque Du Liban; other sources cited include public institutions and online publications.

A- How Did We Get Here

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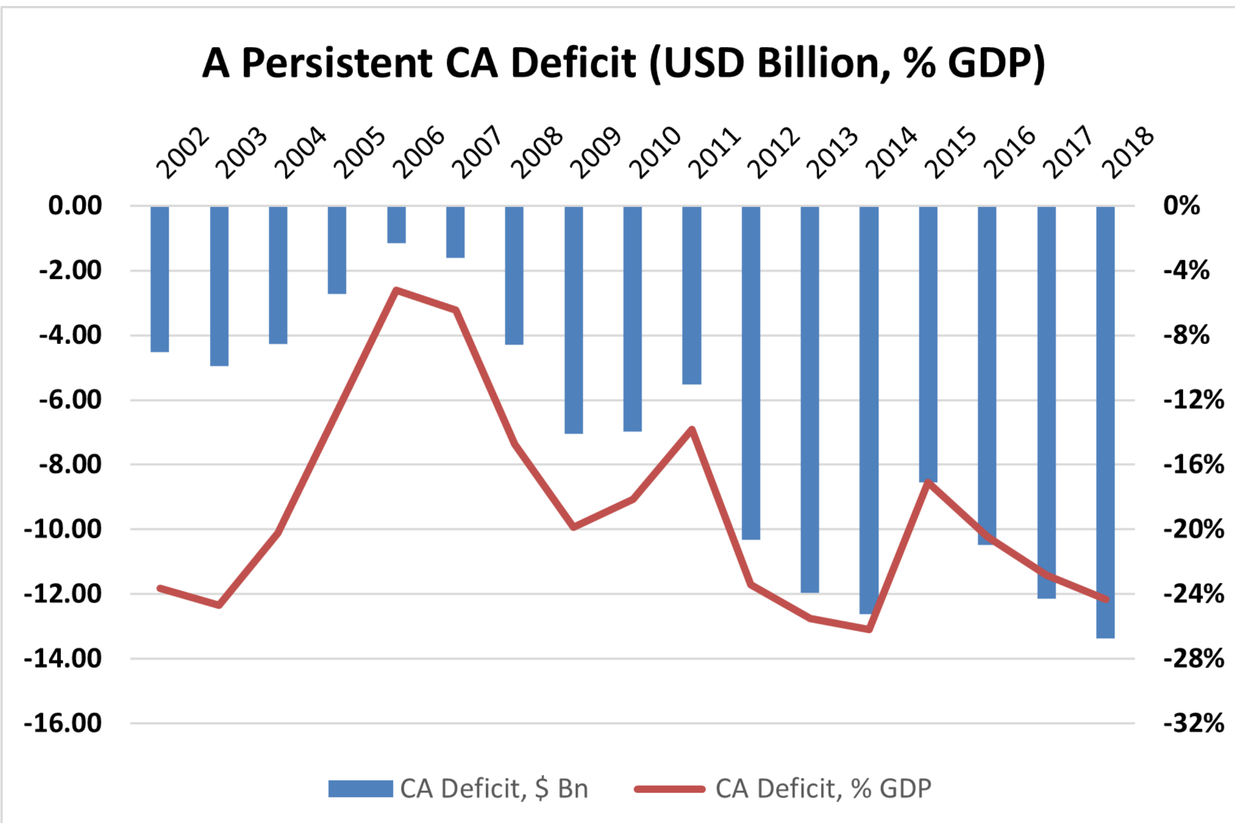
Twin Deficits, Part 1- Current Account Deficit

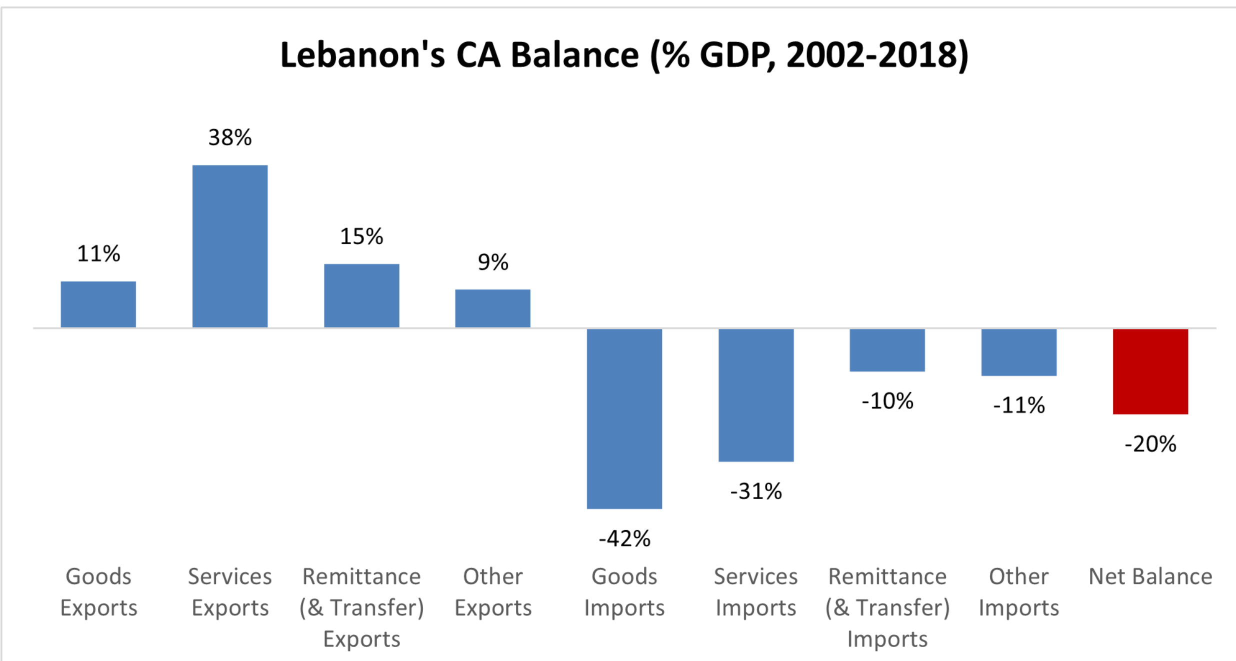
Lebanon has been running a current account (CA) deficit since the 90's. The post-war era (1990- today) is characterized by persistent current account deficits, the deficit averaging around 19% p.a over the 2002-2018 period. Despite the fact that remittances formed a sizable capital inflow to counterbalance the persistent trade imbalance, the deficit persisted, and accelerated starting in 2011 against a highly unfavourable macroeconomic environment and unfortunate regional developments- most notably the eruption of the Syrian crisis. In 2018, the CA deficit reached USD 13.37 Bn, the equivalent of 24.3% of GDP, as shown in the figure below.



Source: BDL

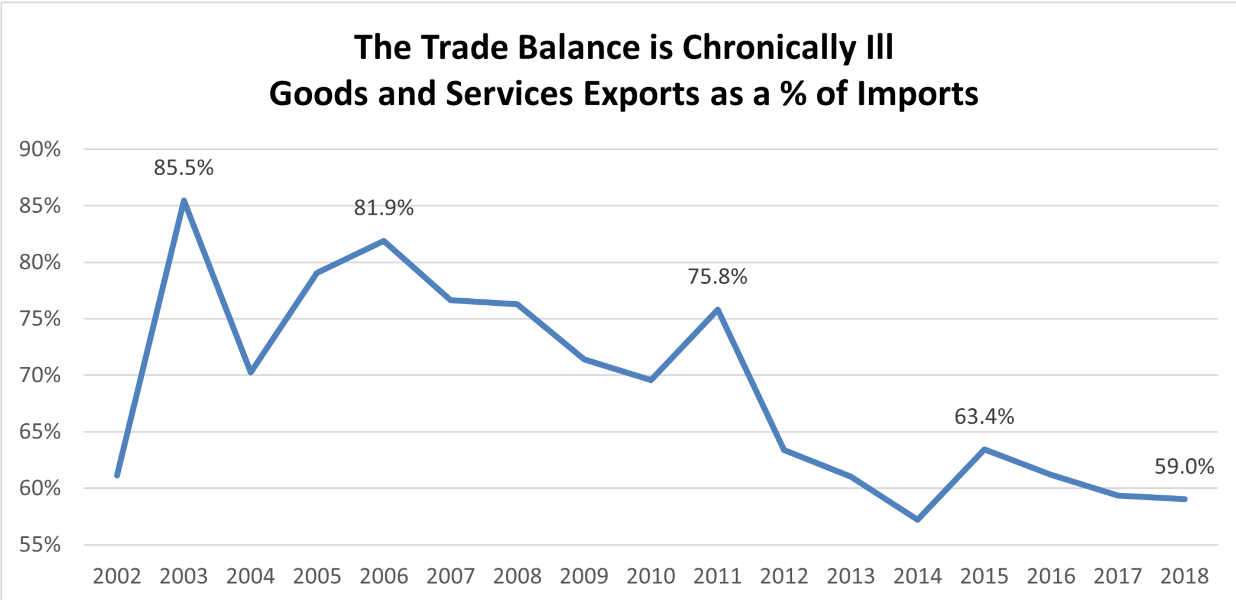
In 2018, exports of goods constituted USD 3.8 Bn, the equivalent of around 7% of GDP (a cumulative 11% of GDP over the 2002-2018 period). As for goods imports, they constituted USD 18.9 Bn, the equivalent of around 34% of GDP (and a cumulative 42% of GDP over the 2002-2018 period). Services exports in 2018 constituted USD 15.8 Bn, the equivalent of around 29% of GDP (and a cumulative 38% of GDP over the 2002-2018 period). As for services imports, they constituted USD 14.3 Bn, the equivalent of around 26% of GDP (a cumulative

31% of GDP over the 2002-2018 period). Netting the aforementioned numbers yields a Goods and Services net balance of negative 24% of GDP in 2018, and also a negative 24% of GDP net balance over the 2002-2018 period. If we introduce remittances (including other transfers) as a counter-balance to this systemic imbalance, the picture is only slightly better. Remittance inflows constituted USD 6.4 Bn in 2018, the equivalent of around 12% of GDP (and a cumulative 15% of GDP over the 2002-2018 period). As for remittance outflows, they constituted USD 4.1 Bn in 2018, the equivalent of around 8% of GDP (a cumulative 10% of GDP over the 2002-2018 period). Netting the remittances balance yields a net position of positive 4% of GDP in 2018 (and a cumulative net position of positive 5% over the 2002-2018 period). In current account terms, the net position after accounting for remittances is a serious net negative position of around 20% in 2018 (a cumulative negative 19% of GDP over the 2002-2018).



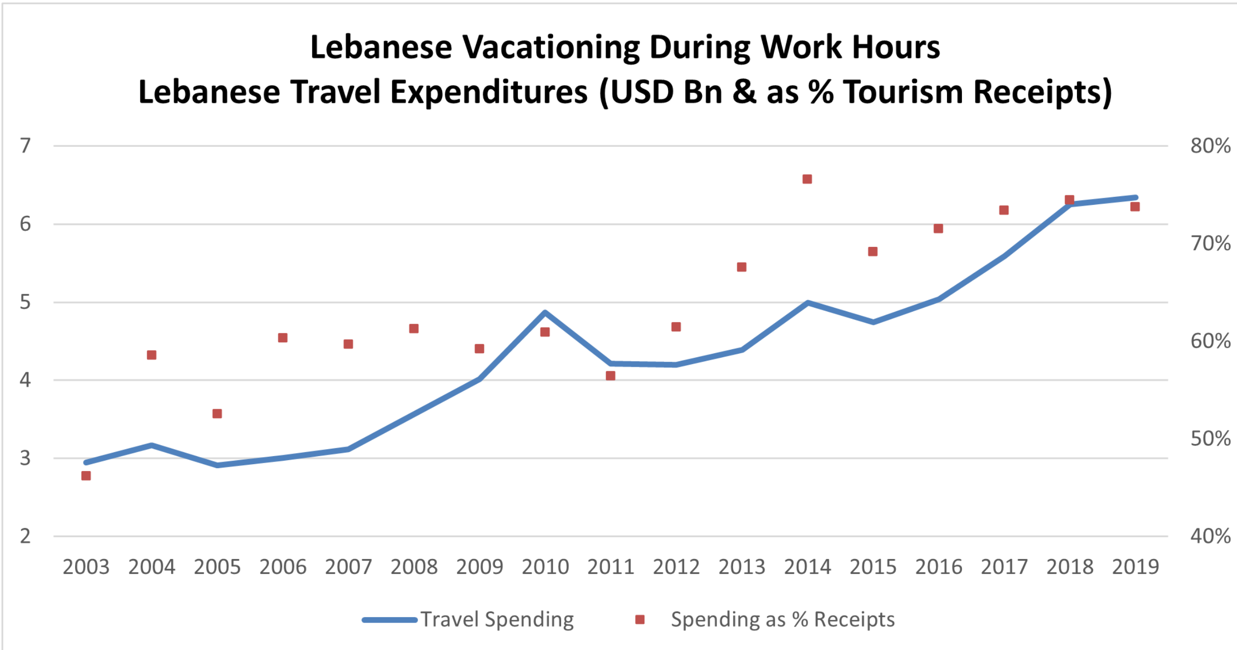
Source: BDL

It is noteworthy that there was a time when the Lebanese trade balance was not in the state of deformity that it is in today. In 2003, exports covered 85.5% of imports. By 2011, the ratio dropped to 75.8%, and to 59% in 2018.



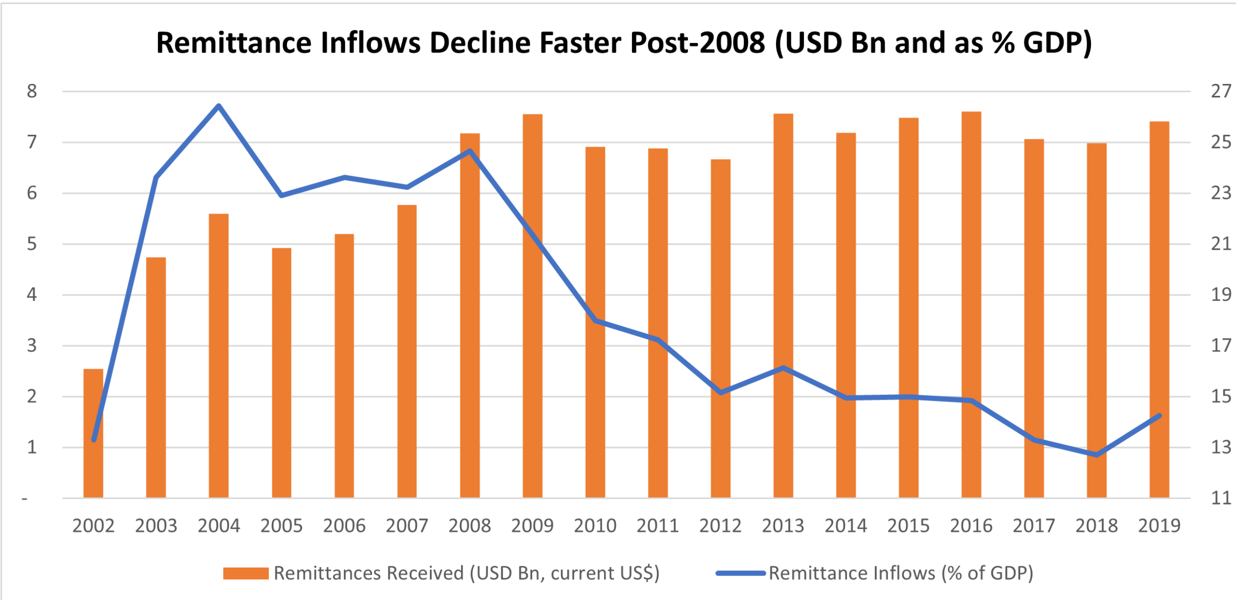
Source: BDL

Moreover, standards of living rose largely, and with no basis rooted in the economy. The system supported a consumption-based model that placed the wrong set of economic incentives for people making decisions in an economy. Lebanon has been a deficit country throughout the post-war era, despite misleading growth figures and sporadic episodes of currency inflows. While the Lebanese people enjoyed a higher standard of living, the lavish lifestyles and fancy dinners on holiday in Europe concealed the fact that there was a drainage in the system that would eventually burst and take down everybody with it. Take tourism inflows and outflows for instance. By end of 2018, tourism inflows totaled USD 8.59 Bn, an increase of 34% from USD 6.37 Bn in 2003- a meager increase since no real plan was put in place to transform the sector beyond “sun and beach” tourism. Still, incoming tourism spending is a significant source of inflows. Yet instead of funding the economy, the trend since the post-war era was mainly supporting a rapidly increasing standard of living- lavish lifestyles, new cars, dinner parties in Europe etc. In the case of tourism flows specifically, tourism spending by Lebanese abroad formed 46% of tourist inflow receipts in 2003. By the end of 2018, the ratio grew to 74%.



Source: BDL

Additionally, it is worth noting that the current account deficit situation has been accumulating over a long period of time, and gradually grew unsustainably in the red. The warning signs were there early on. By the late-2000s, fresh remittance inflows had clearly slowed down. In 2011, amidst a crisis in neighboring Syria and changing international economic dynamics, Lebanon faced a race against time to build a roadmap based on reforms and an economic vision. In 2014, economic challenges in the Gulf Cooperation Council (GCC) due to falling energy prices signalled the beginning of the unravelling of the Lebanese model. Given the reliance on remittances to counterbalance the goods and services account deficit, external imbalances began to accentuate, and intensified post-2008.

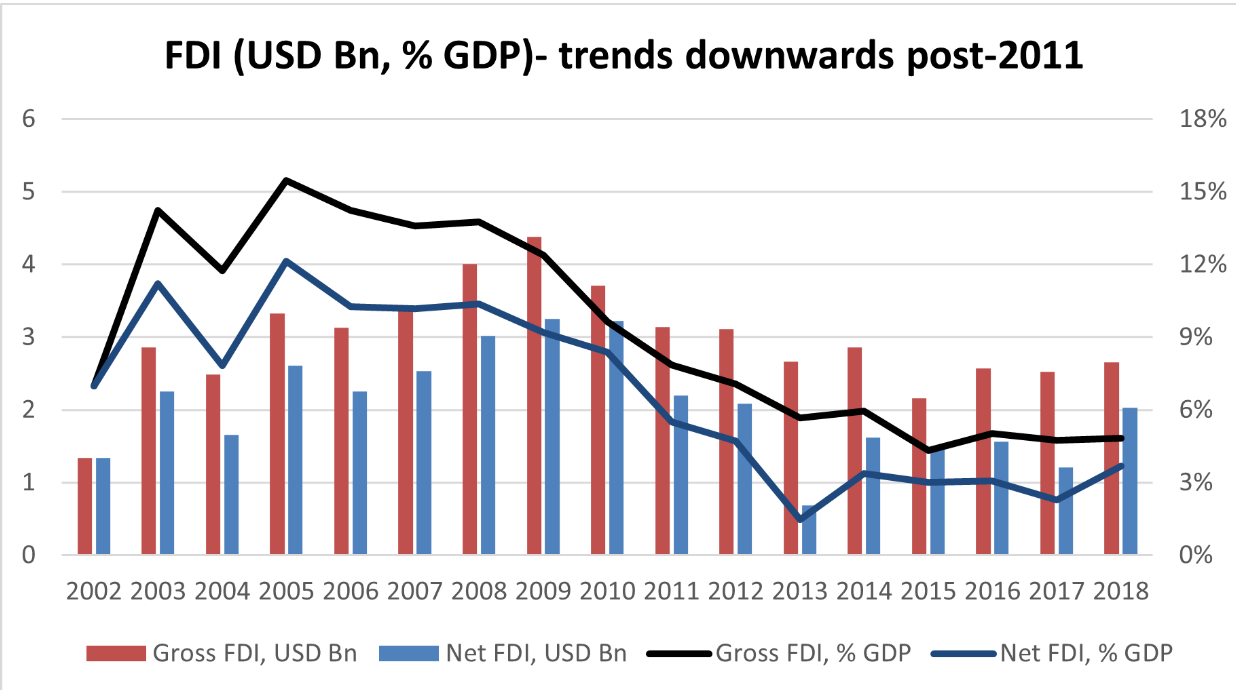


Source: World Bank

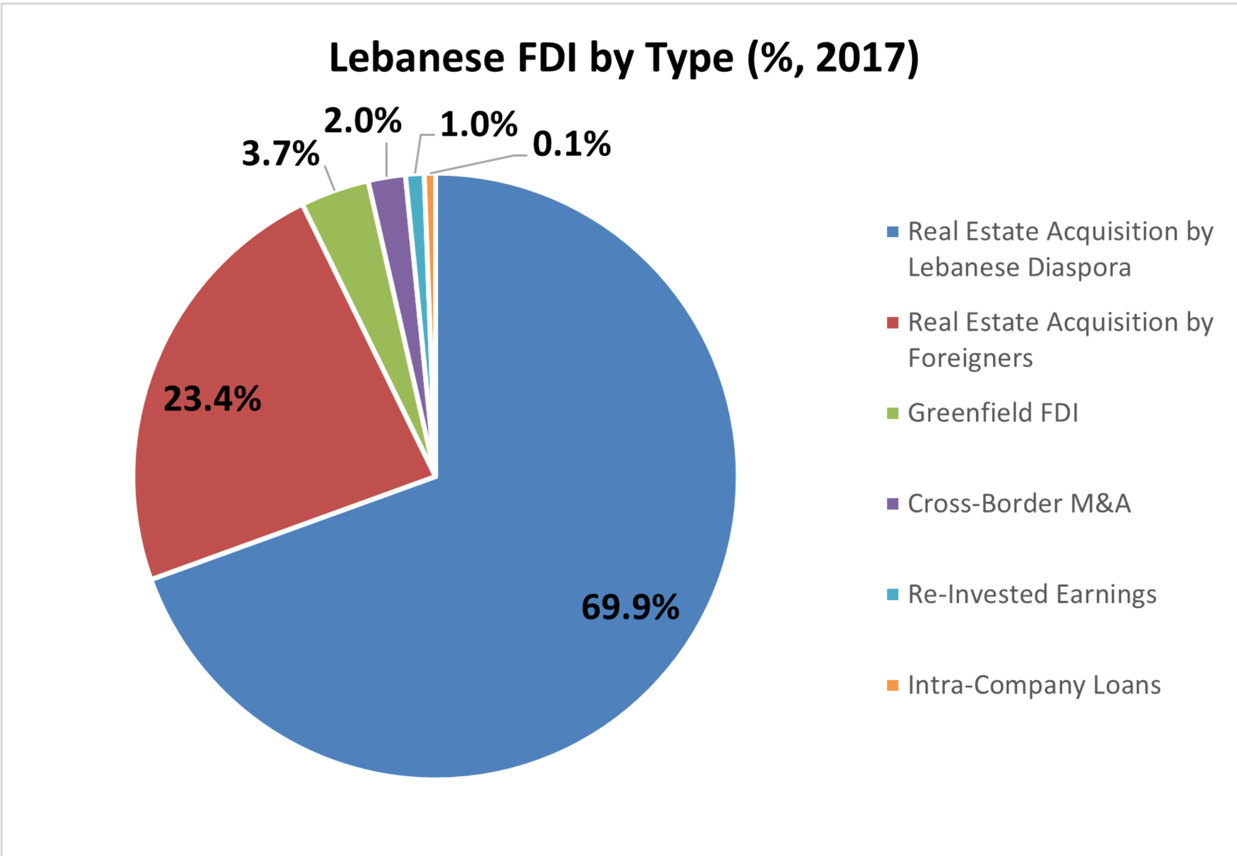
Funding the CA deficit

To fund the large CA deficit, Lebanon has depended on both issuing debt and, to a much larger extent, attracting non-resident deposits. A "normal" economy would follow a path based on reasonable, sustainable debt-creation against potential growth policy scenarios that would allow an economy, through economic fundamentals, to eventually pay back that debt relative to the rest of the world. However, this was not the case in Lebanon. In fact, Lebanon never made serious steps towards becoming a more competitive economy and attracting foreign capital- at least that's what the investment climate and Foreign Direct Investment (FDI) over the years say about the attractiveness of doing business in Lebanon. The World Bank 2020 Doing Business report ranked Lebanon as 143rd out of 190 based on its low standing when it comes to ease of doing business indicators and its bad business regulation. As for the World Bank Global Competitiveness Report 2019, Lebanon ranked 88th out of 137 in the index. Moreover, corruption is rampant; Lebanon ranked 149th out of 180 on Transparency International's 2020 Corruption Perception Index.

The FDI never picked up. And whatever FDI funds were lured into Lebanon were channeled by far into the Real Estate sector rather than productive sectors. For instance, in 2017, a year for which the FDI composition data is available, around 93% of incoming FDI constituted Real Estate investment rather than productive sector investments that actually create jobs and achieve economic growth. As a matter of fact, things got worse after the start of the Syrian crisis in 2011, with the region burning in turmoil and corruption as well as political gridlock at home preventing any meaningful economic development.

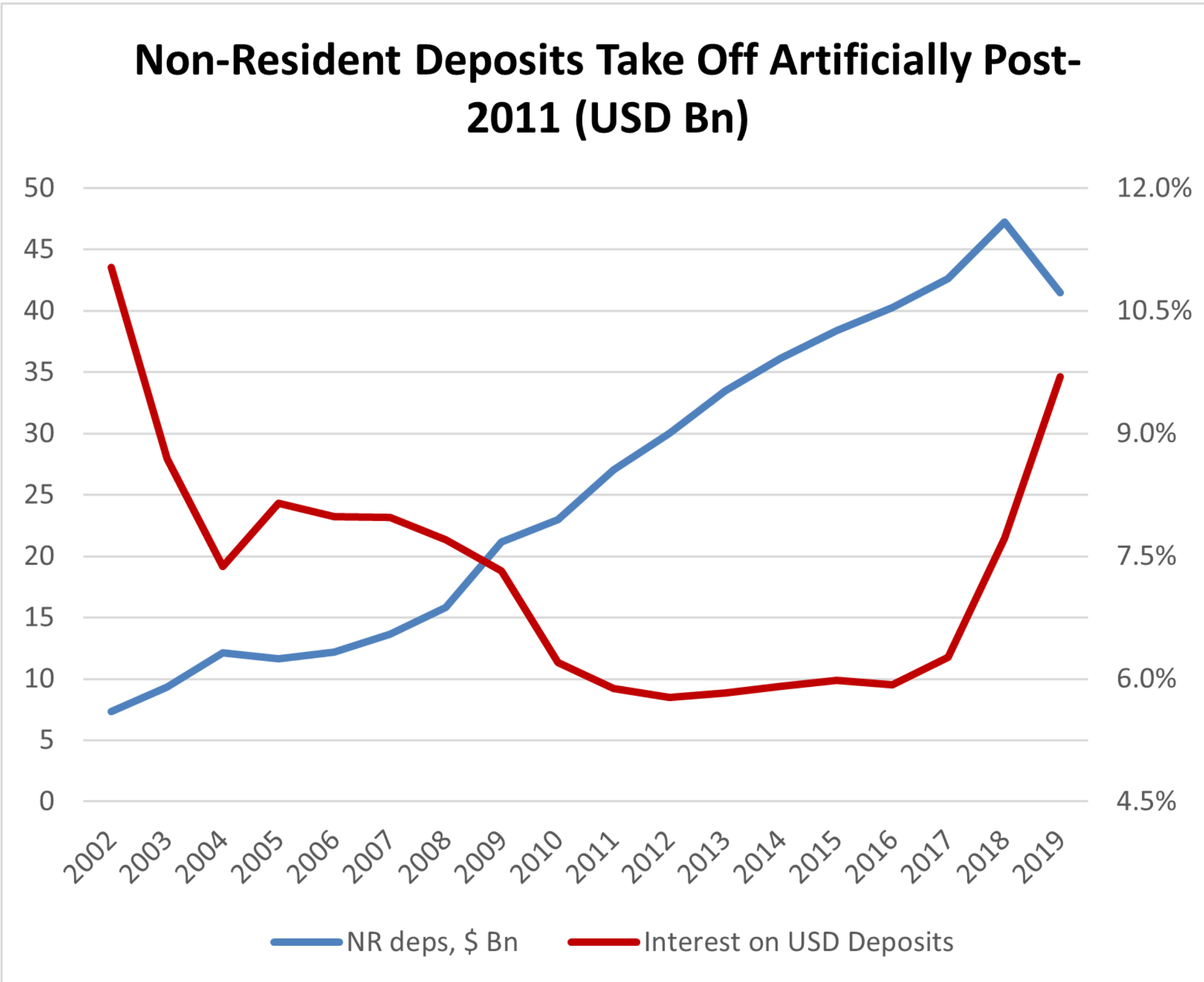

FDI (USD Bn, % GDP)- trends downwards post-2011
6
5
4
3
2
1
0
18%
15%
12%
9%
6%
3%
0%
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018
Gross FDI, USD Bn
Net FDI, USD Bn
Gross FDI, % GDP
Net FDI, % GDP

Source: BDL



Source: IDAL FDI Monitor 2018

On the Non-Resident Deposits front, the 2011 emerging challenges had posed real pressures on the system. The response was to borrow more money from the Lebanese diaspora mainly to attract liquidity and continue to do business as usual. However, the significance this time is that the cost of this debt to the diaspora came in the form of higher returns which raised questions about systemic insolvency and the long-term solvency situation.

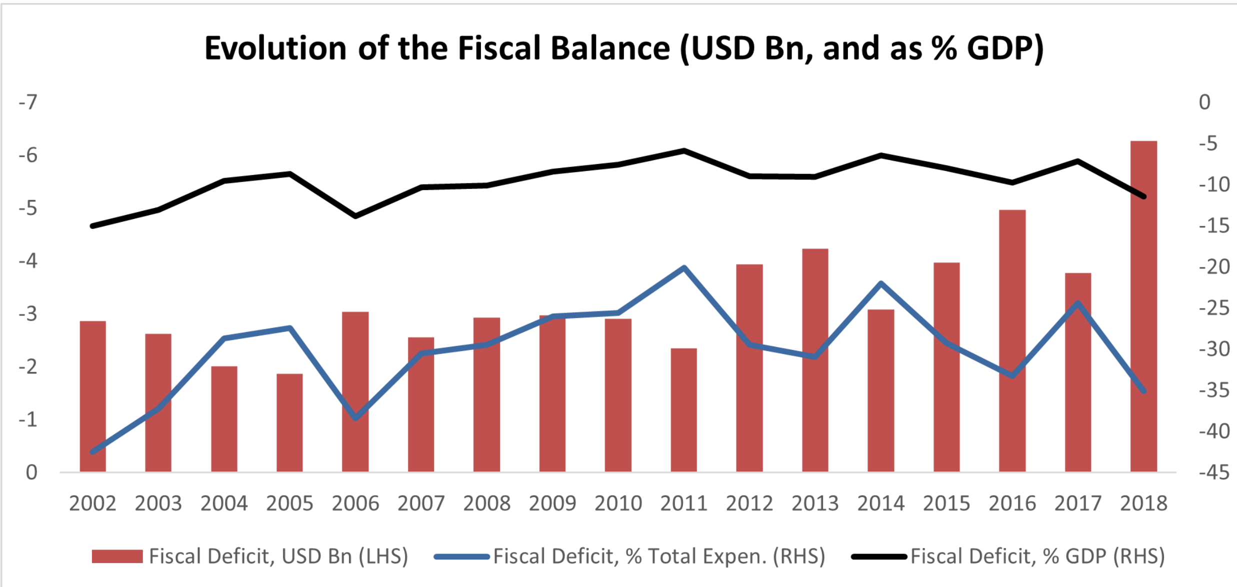


Source: BDL

In conclusion, Lebanon, in seeking a remedy for its fundamental economic problems, had chosen the path of debt, debt and more debt. In fact, this trend accelerated and increased in summer 2016 via the financial engineering and eurobond issuances along with the increasingly higher rates on deposits offered to lure in non-resident fresh deposit money.

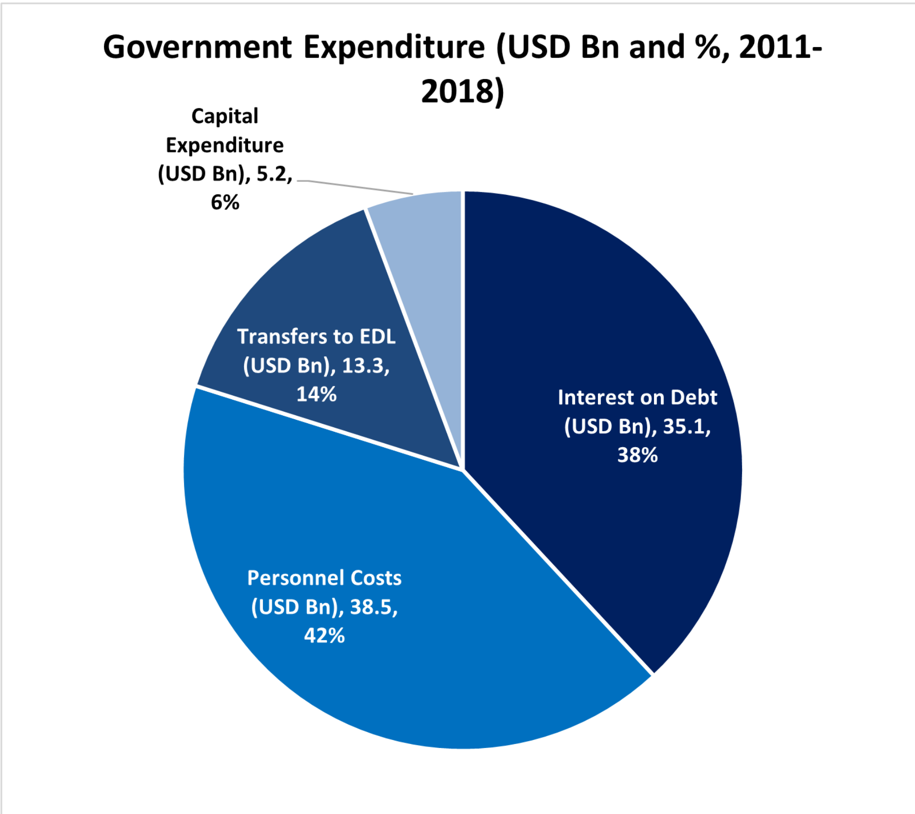
Twin Deficits Part 2- Budget Deficit

Lebanese successive governments have been running persistent budget deficits over decades. Over time, these deficits have deformed the Government's ability to pursue a fiscal policy agenda conducive to growth and development. This is reflected in huge proportions of the annual budget going towards electricity financing, public personnel costs, and a mammoth debt interest bill. What remains is too little to maneuver with to bring forth radical improvements in decaying infrastructure, health, education, and productive sectors.. This is not to mention corruption that hinders any effective use of public money.

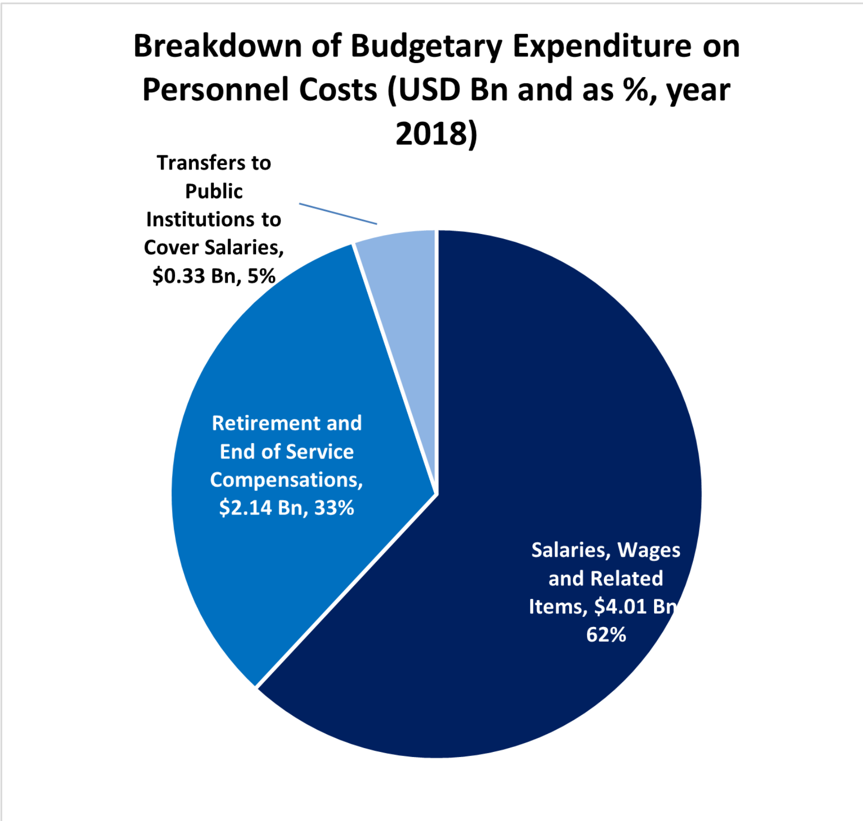


Source: Ministry of Finance

In 2018, government budgetary spending on LBP and foreign-currency debt service reached USD 5.4 Bn, the equivalent of 33.1% of total expenditure and 9.9% of GDP (and a cumulative 35.3% of total expenditure over the 2011-2018 period). Personnel costs, a major budgetary expense and a huge budgetary source of drain, totaled USD 6.5 Bn in 2018, the equivalent of 39.4% of total expenditure and 11.8% of GDP (and a cumulative 38.7% of total expenditure over the 2011-2018 period). As for budgetary transfers to EDL, in 2018, they reached USD 1.8 Bn, the equivalent of 10.7% of total expenditure and 3.2% of GDP (and a cumulative 13.4% of total expenditure over the 2011-2018 period). Capital expenditure, another significant budgetary expense, totaled USD 0.9 Bn in 2018, the equivalent of 5.6% of total expenditure and 1.7% of GDP (and a cumulative 5.3% of total expenditure over the 2011-2018 period).



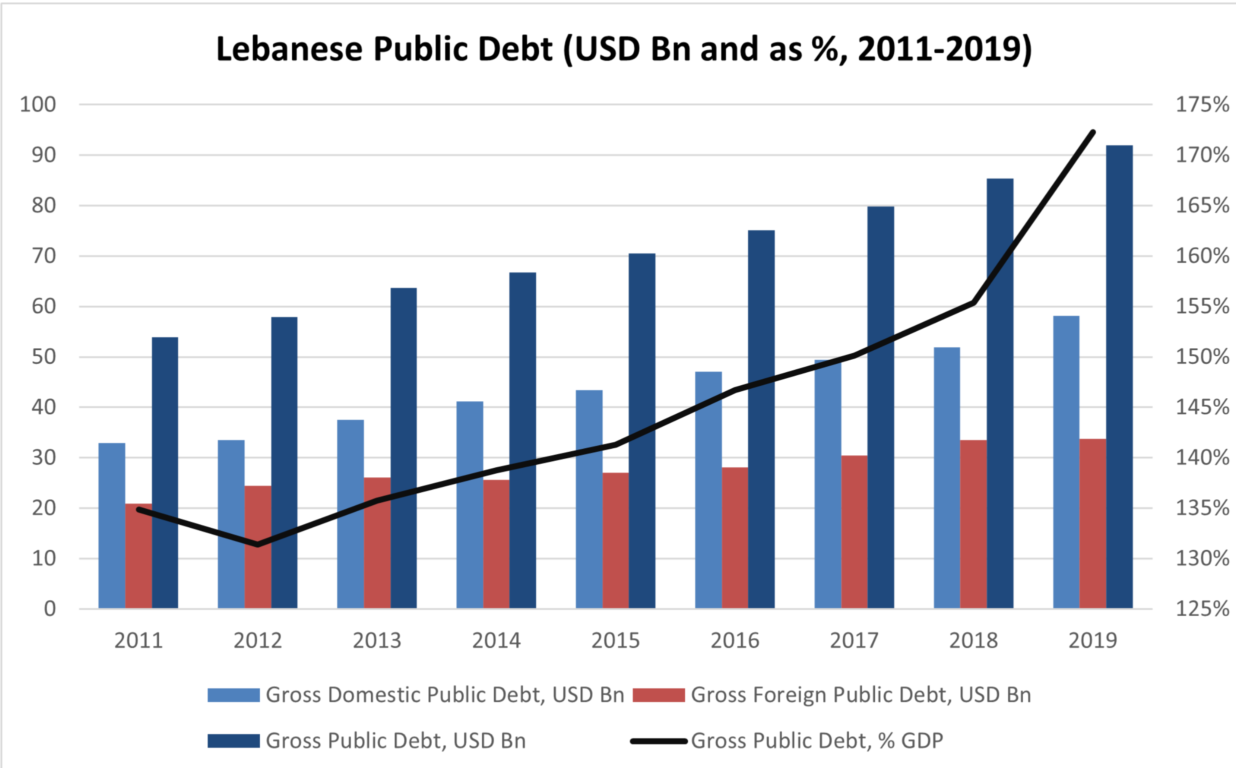
Source: Ministry of Finance



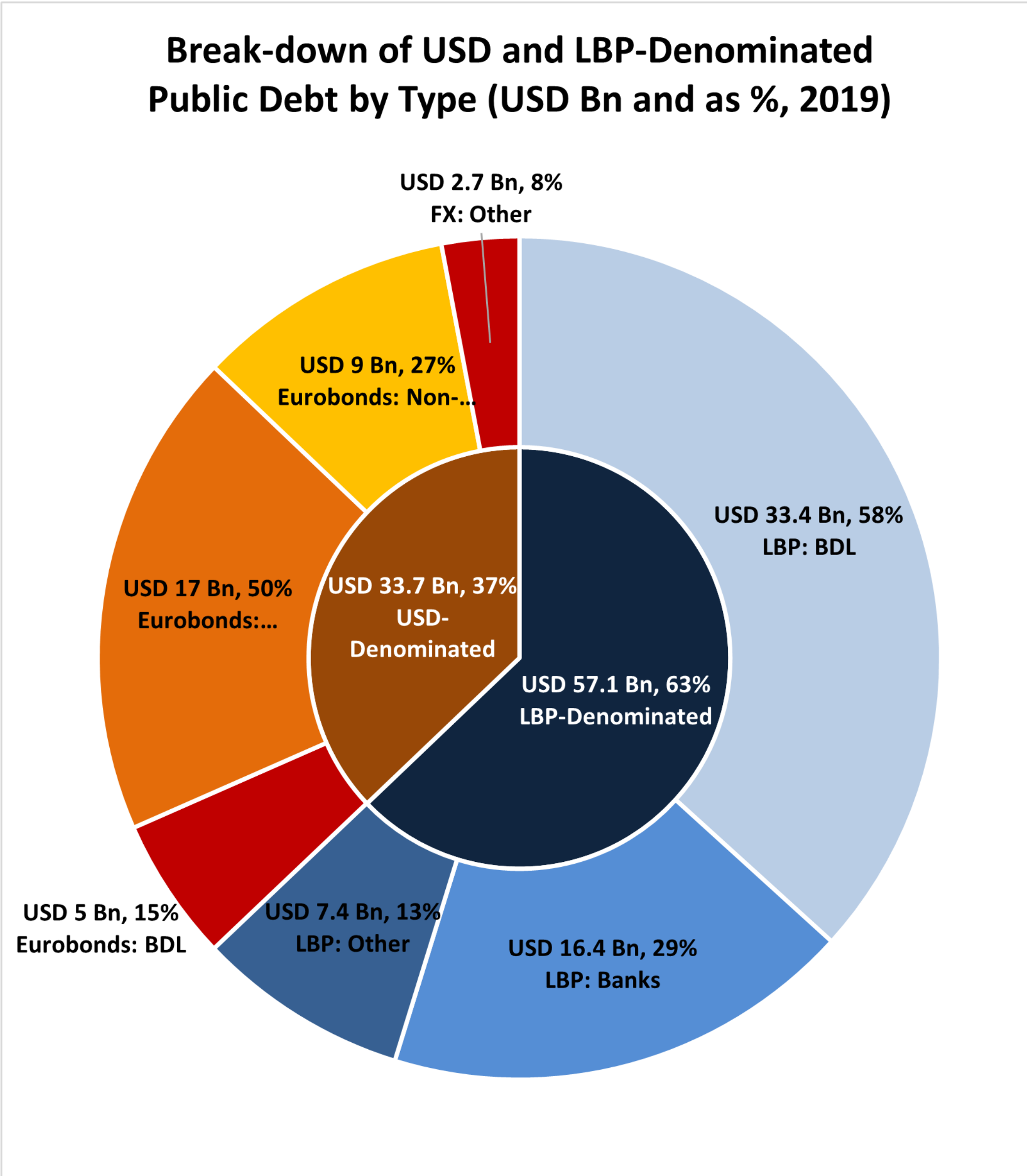
Source: Ministry of Finance

Spiralling Public Debt

All this has resulted in Lebanon building a public debt portfolio that is among the largest in the world. In 2019, Lebanon had the third highest public debt in the world after Japan and Greece[1]. At the same time, foreign-currency liabilities- which to a large extent the banks had accrued as non-resident deposits at an increasingly fast pace and high cost to maintain fresh dollar inflows- had manifested in an external debt of 191% of GDP by end of 2018 according to the IMF- alongside an external debt-to-exports ratio of around 550%[2].



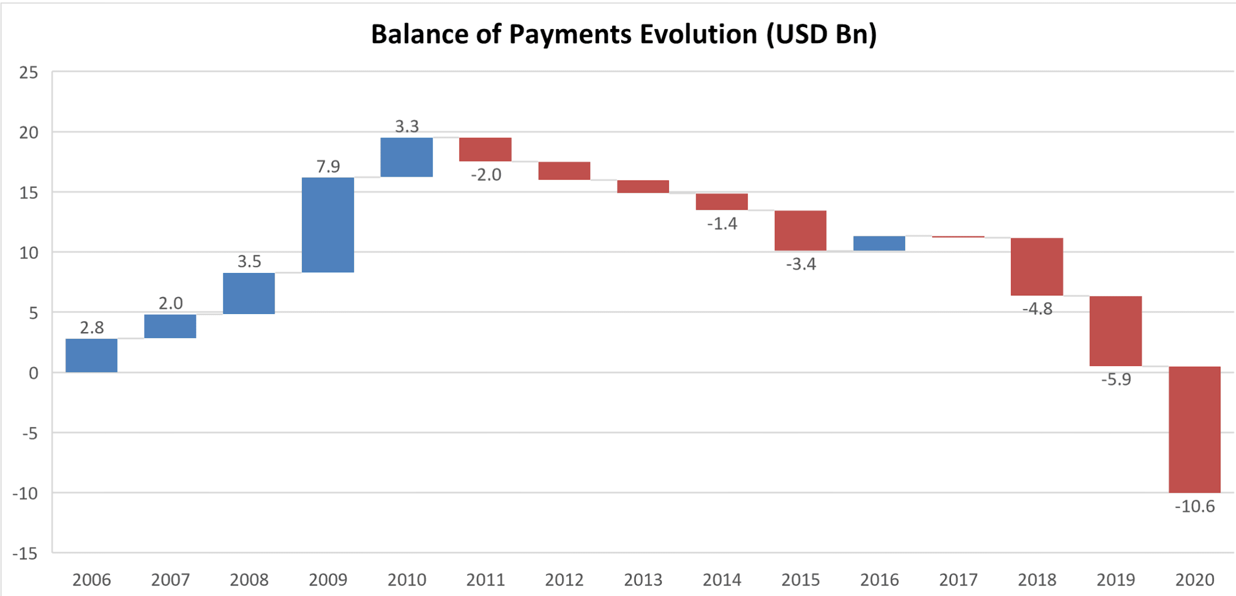
Source: Ministry of Finance



Source: Ministry of Finance

Balance of Payments in Free-Fall

In parallel, and to sum things up, Lebanon's Balance of Payments has been in decline since 2011, when it recorded its first deficit since year 2001.



Source: BDL

B- The Build-up to the 2019 Crisis

2006-2010: The Global Financial Crisis, a Blessing in Disguise

2005 was a turning point in the country's post-war history, given the events that followed over the following decade and a half, turning Lebanon into a "pariah" state (versus the "Switzerland of the East") and the winds of change pitting Lebanon against its historical international allies and Arab natural environment. The same cannot be said about the Lebanese banking sector, which, against all odds, withered the storm- momentarily at least in the years post-2005. Many at the time thought that the Lebanese banking sector was "finished", and that the storm dealt it more than it could handle. But the years that followed- setting politics and war skirmishes aside- turned things around miraculously for Lebanon. It was too good to be true; From 2006-2010, Lebanon's Balance of Payments recorded a net inflow of positive USD 19.5 Bn. The 2008 Global Crisis had spared Lebanon, since Lebanese regulations banned Lebanese banks from participating in the "subprime" bubble abroad. Lebanon became a safe haven, with billions of dollars flowing into a nation with a GDP of just USD 22 Bn in 2006[3].
However, the euphoria was short-lived. The fact is that capital inflows over the 2006-2010 period went largely into the real estate sector as opposed to being channeled into productive sectors, economic development and infrastructure projects. While some may argue that the Lebanese economy did not possess the capacity to digest the inflows received, however, this logic is problematic. There are no excuses for failing to develop a plan immediately to invest excess inflows sustainably in the economy, thereby creating jobs, generating growth, and developing a "post-war" economy away from speculative investment and bubble creation. Yet what happened was that capital was channeled into real estate, creating a real estate bubble at

the expense of the real economy and with detrimental effect on the fortunes of the Lebanese people.

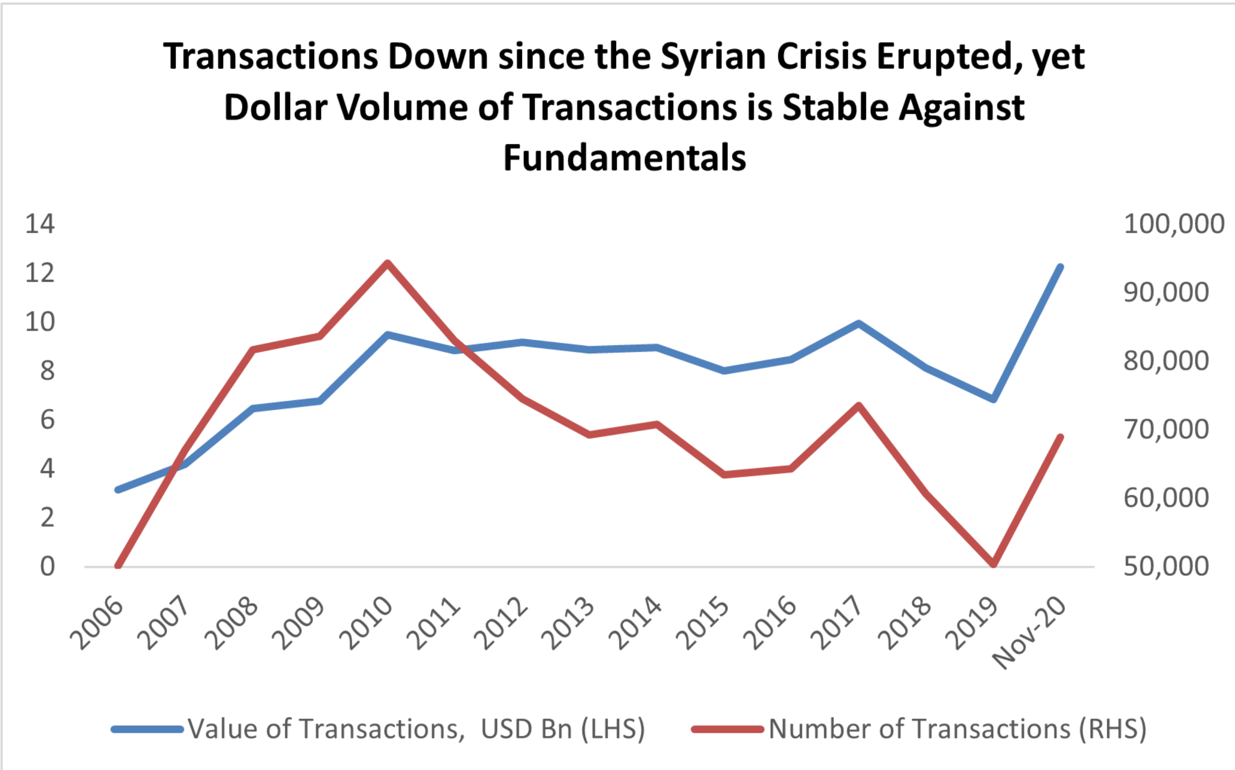
The Lebanese Real Estate Sector- The Formation of a Bubble

The real estate market in Lebanon has been touted as a pillar of the Lebanese economy and a bedrock of growth and resilience, at least that's what's been advertised. From 2007 till start of 2011, the sector boomed, with burgeoning demand, and supply that simply could not keep up pace. Prices skyrocketed. The 2008 Financial Crisis had resulted in huge capital inflows into the Lebanese banking and real estate sectors, with around USD 19.5 Bn in positive net capital inflows into the country in the 2006-2010 period, which was by large channeled into Real Estate.

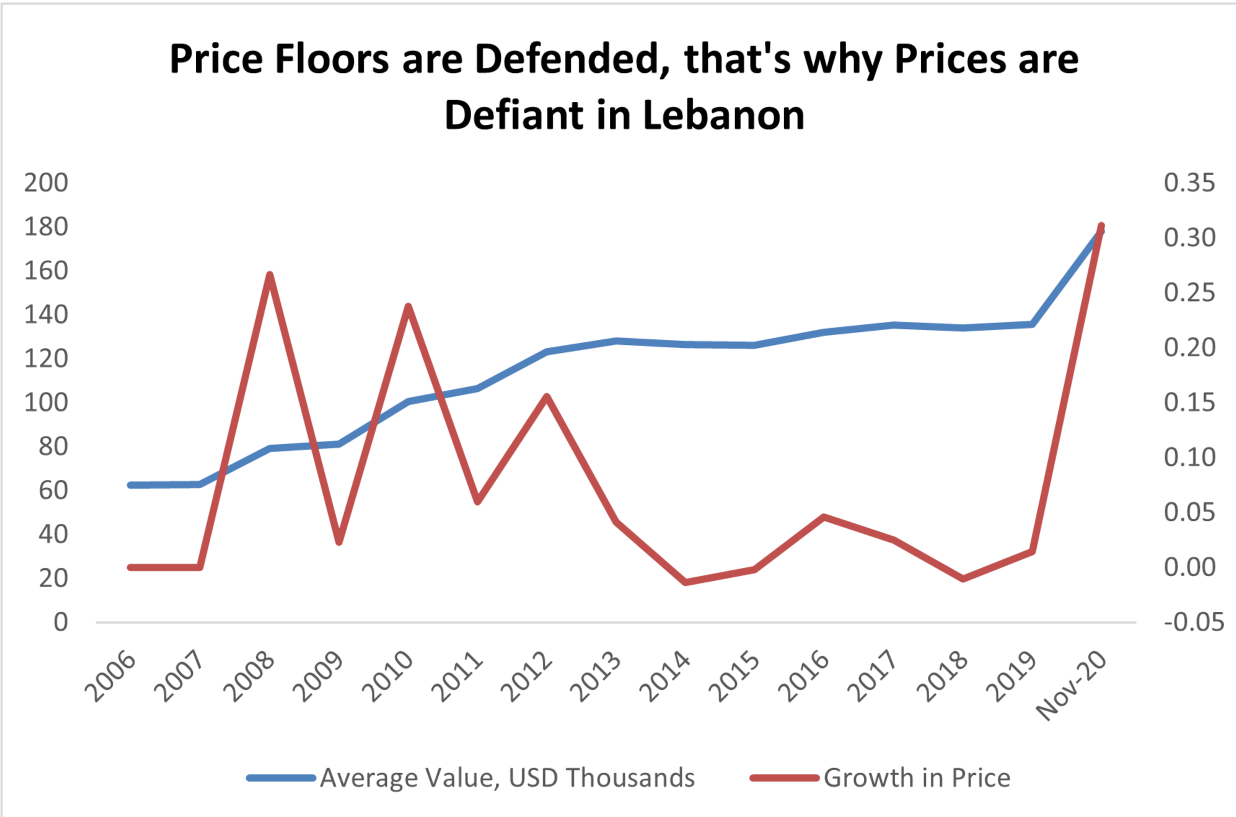
Following the 2007-2010 boom, the regional turmoil starting in 2011- namely the Syrian crisis- heavily impacted the real estate sector, with demand plummeting and foreign inflows into the sector dwindling. Moreover, tumbling oil prices deepened the problem as GCC income contracted, along with Lebanese expats losing their jobs and receiving pay cuts.

Given the discrepancy between the level of income of GCC residents as well as Lebanese expats on one hand, and Lebanese locals on the other, and in the absence of foreign inflows into the sector, a real estate bubble was headed for a market correction. But the BDL, in an effort to prevent the housing market from an impending crash, intervened with housing subsidies to protect banking sector balance sheets. That is, until 2018, with BDL clearly not possessing the resources to sustain its housing loan subsidization schemes, and its efforts solely geared towards maintaining the untenable currency peg.
And yet again, instead of a housing market correction, the developments in 2019 led to an appreciation in nominal housing prices. This was not based on market fundamentals nor real demand for real estate, but rather on bank sector depositors scrambling to reduce their exposure to the insolvent banking sector.

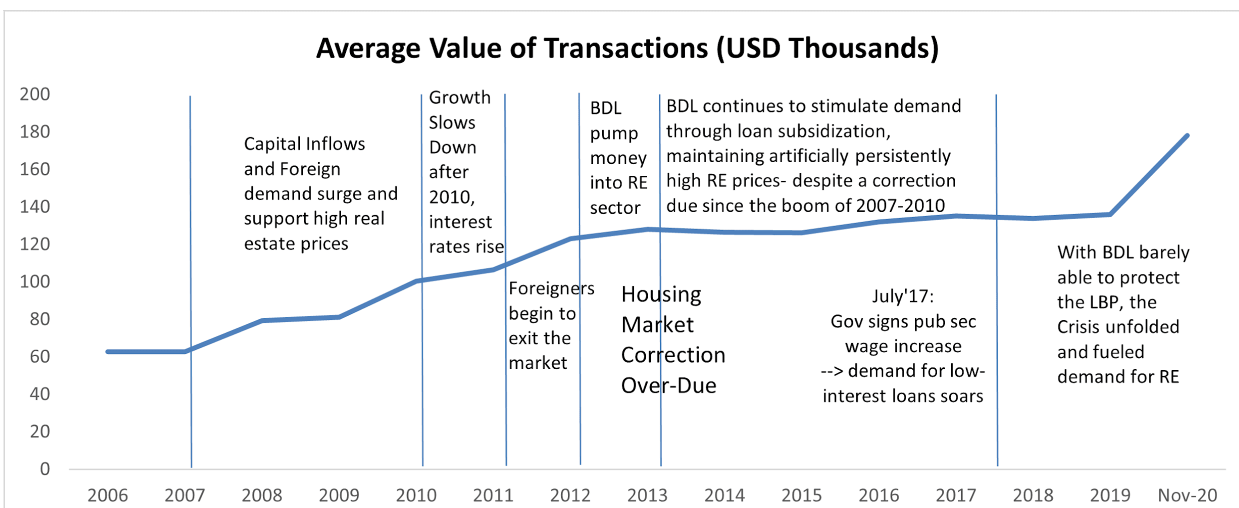
In conclusion, real estate prices have not experienced a correction in asset prices since the boom that began in 2007 and ended at start of 2011- despite the recession that followed and endures till today. Additionally, the prices that are seen today are unprecedented due to the 2019 crisis, and it is clear that the market will witness a large correction sooner or later due to the expected depressed real demand and prolonged depression that will characterize the economy in the short-to-medium term and in the absence of foreign capital inflows. Prices are expected to go down drastically so as to be more aligned with people's local purchasing power. Note that it is very difficult to estimate the intrinsic value of real estate in Lebanon in the absence of statistics, asset quality indicators and a serious national housing price index that tracks the value of individual properties over time based on actual transactions and actual prices.



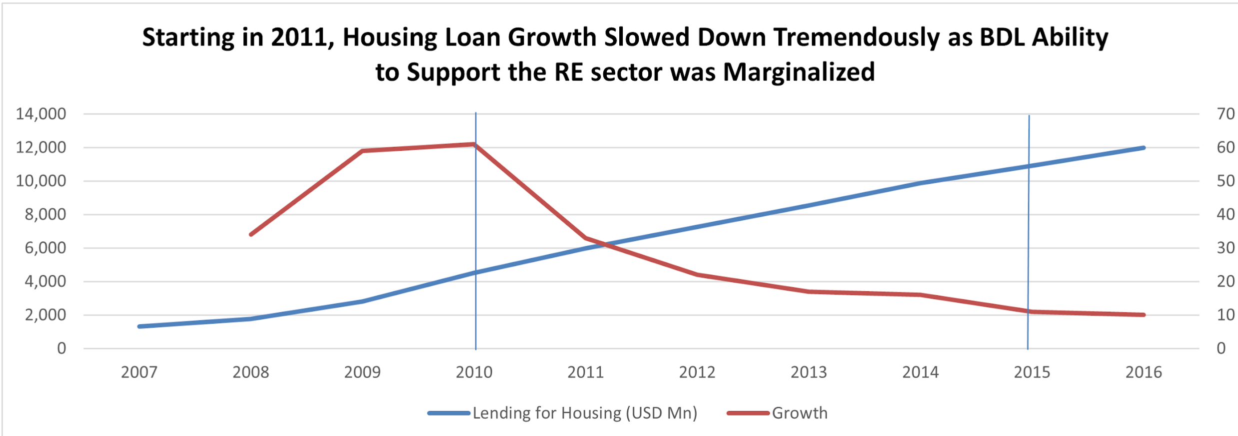
Source: General Directorate of Land Registry and Cadastre



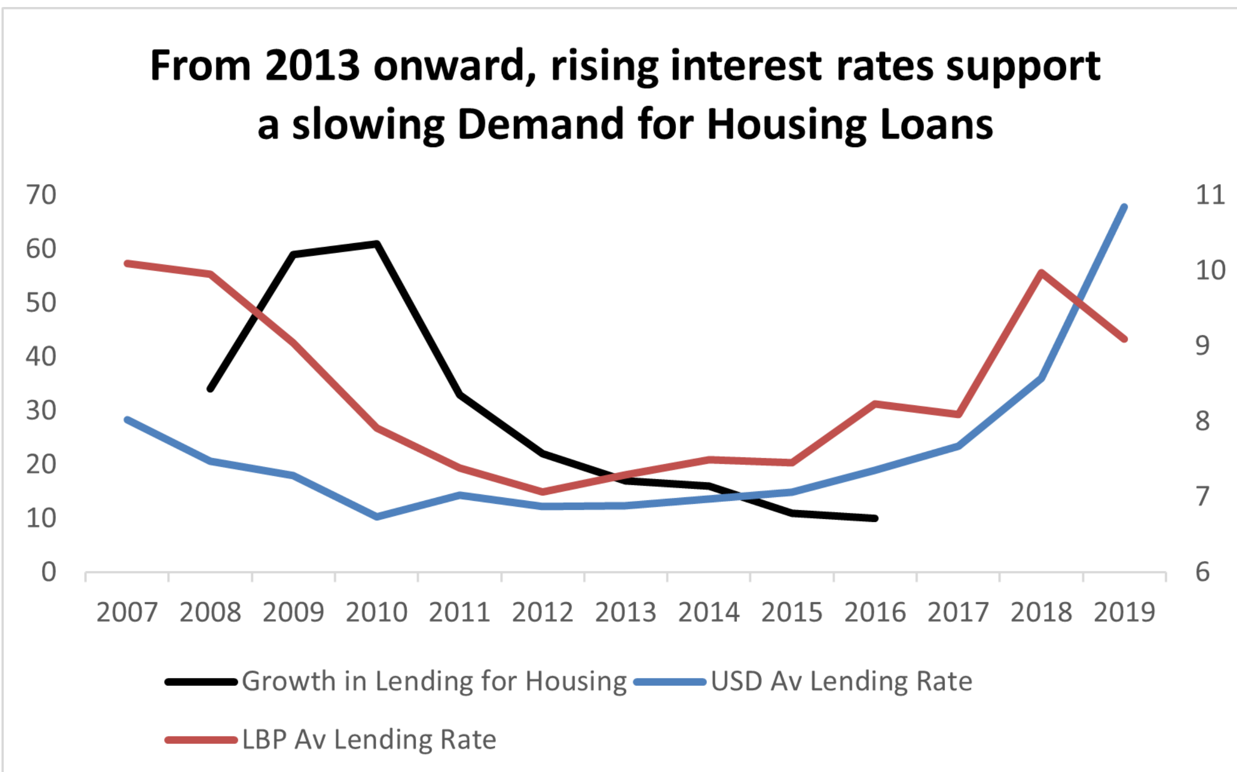
Source: General Directorate of Land Registry and Cadastre



Source: General Directorate of Land Registry and Cadastre



Source: General Directorate of Land Registry and Cadastre

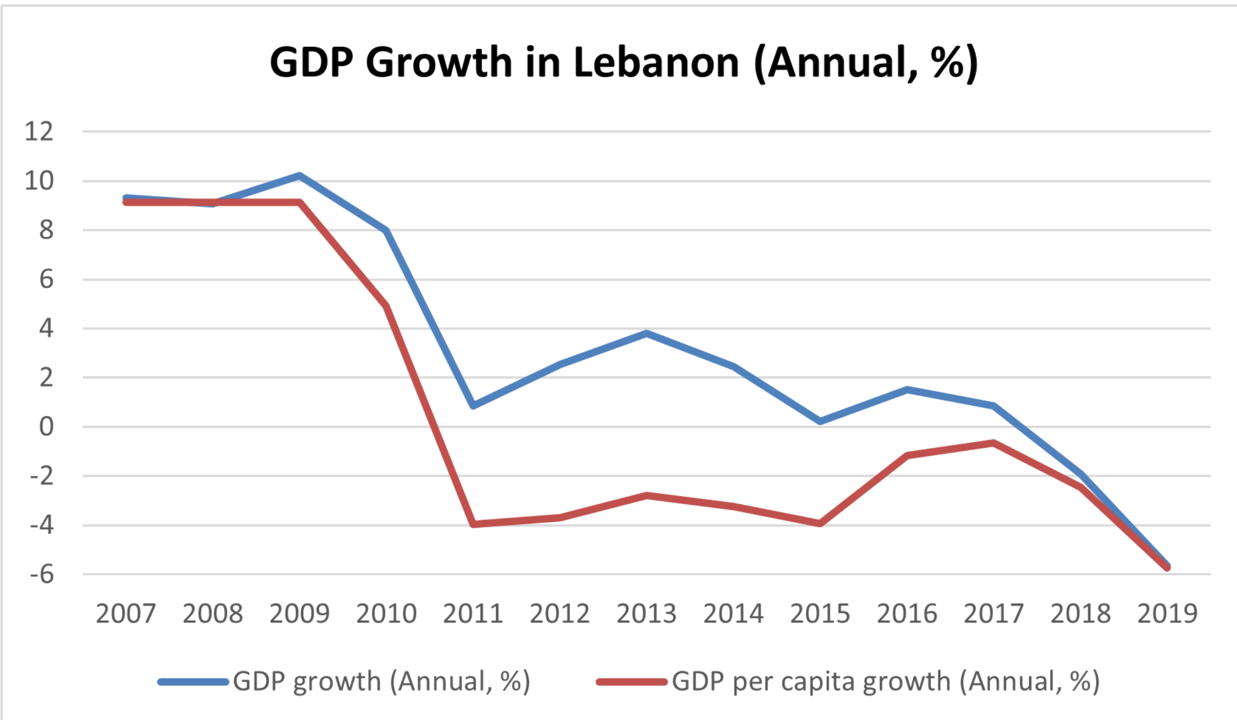


Source: General Directorate of Land Registry and Cadastre

Note that real estate Dollar values for year 2020 do not account for the fact that real estate transactions have, at least for the first 3 quarters of the year, occurred through bank cheques according to the devalued rate of 3,000 LBP/USD. Therefore, the nominal values in the graphs above for the period following the start of the crisis require redenomination based on the changing value of cheques.

The Syrian Crisis Spills Over into Lebanon, Growth Plummets

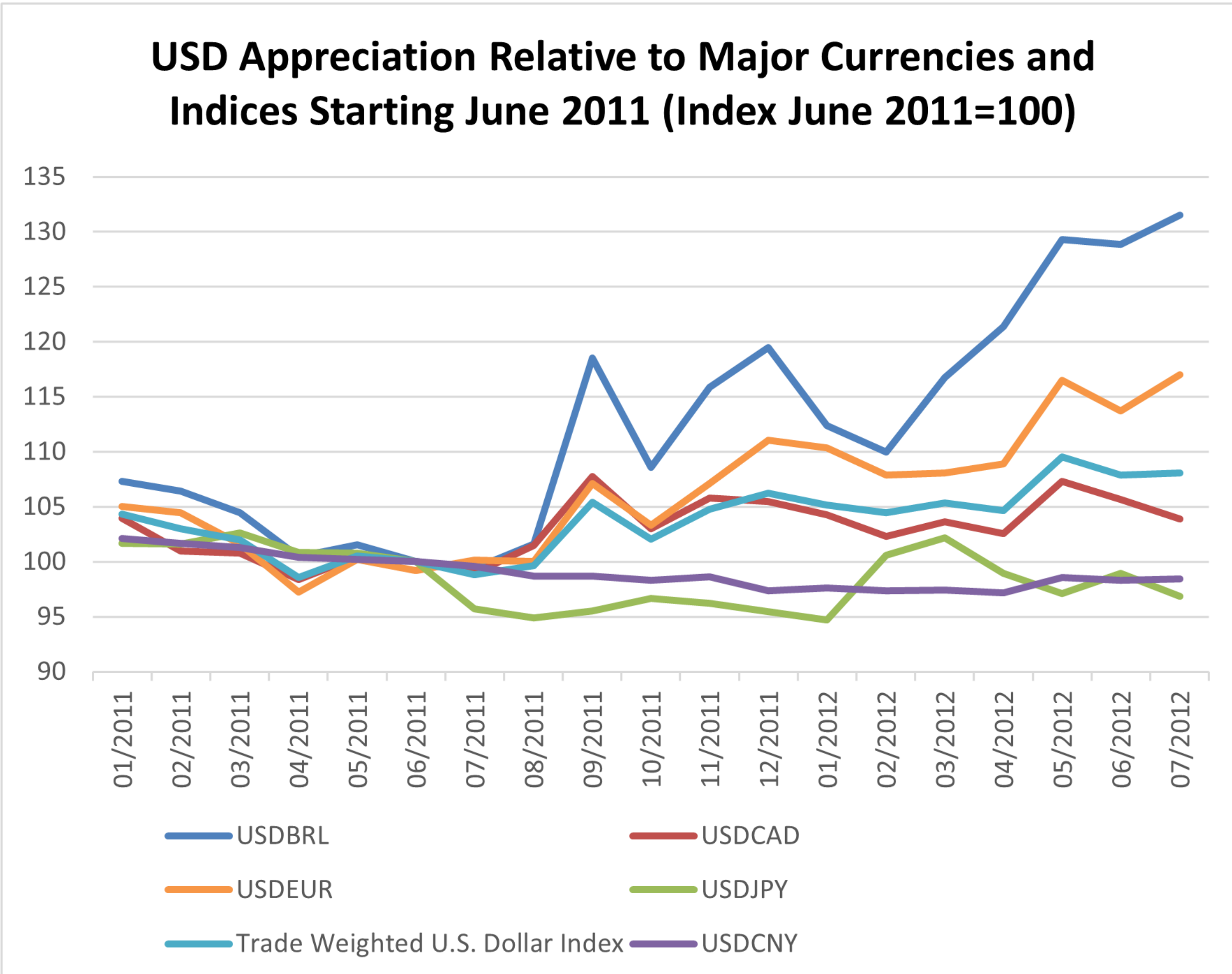
The events in Syria cost Lebanon dearly. In 2011, Lebanon's GDP growth rates reached 0.87%, a free-fall from the 2010 rate of 8% and the 10.2% of 2009. For the 2011-2014 period, GDP growth averaged 1.8%, which, given a population growth rate of 1.6% over the same period, suggests a real growth rate of around 0%. The economic outlook only gets worse from there on.



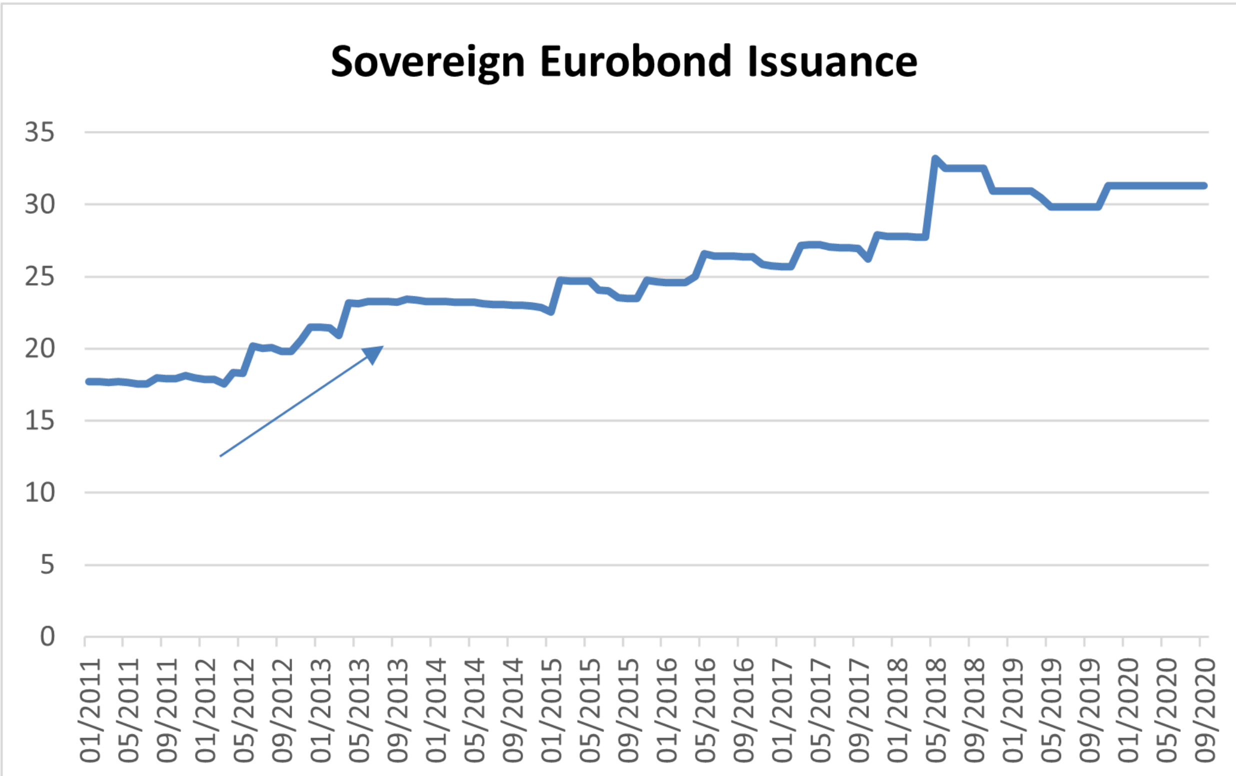
Source: World Bank

2011 Stronger Dollar: The Peg Trembles, as Deposit Inflows Struggle

The emergence of a strong US Dollar starting in late 2011 exerted nascent pressures on the LBP peg to the greenback. The gap was patched through Lebanon's sale of Eurobonds, proceeds from which were deposited at the BDL. Note that Lebanese commercial banks had participated in the purchase of sovereign Eurobonds through its USD-denominated deposit base.



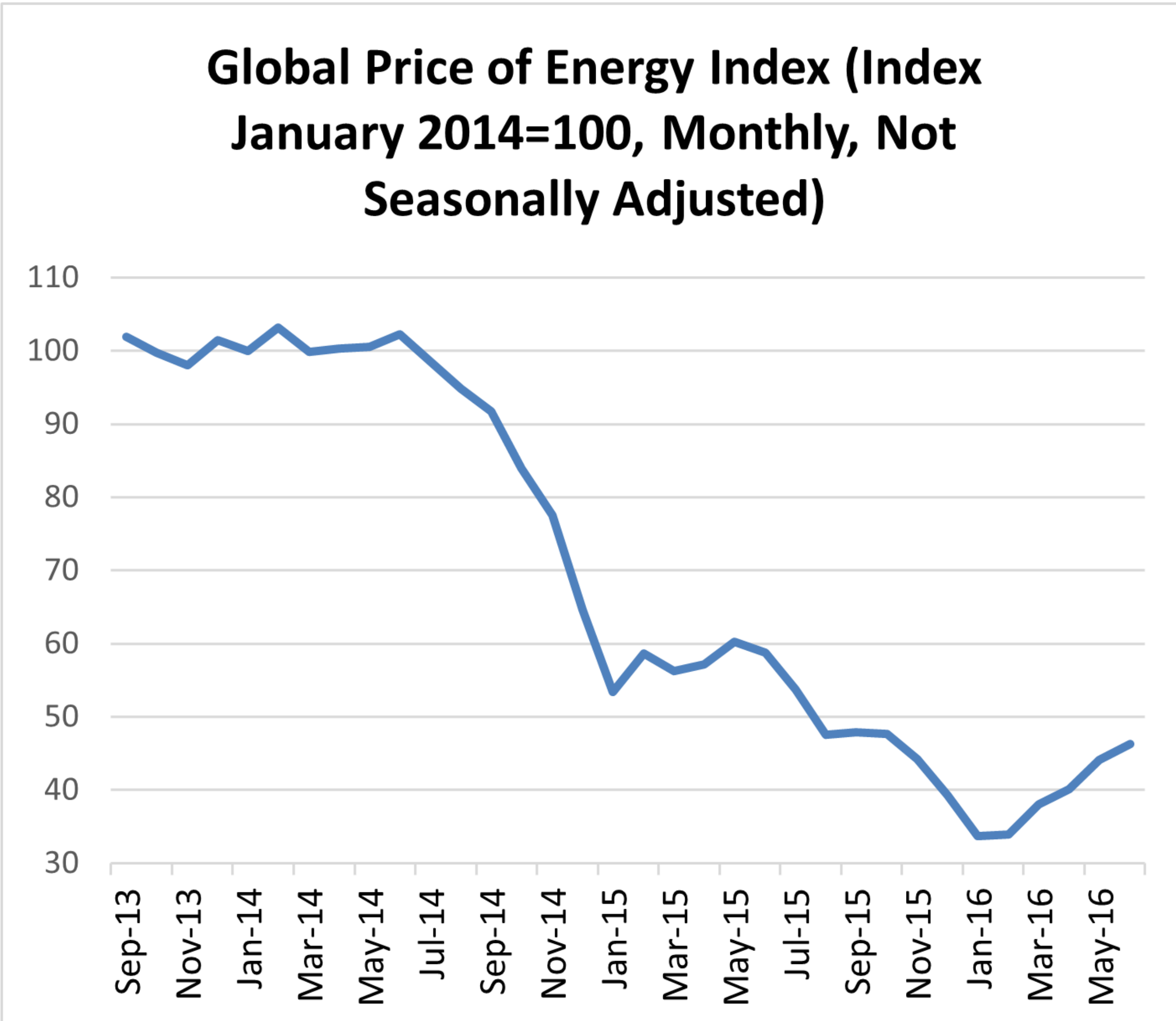
Source: Federal Reserve Economic Data



Source: Ministry of Finance

Price of Oil: A Lebanese Oil Curse

The Lebanese diaspora is among the most successful in the world[4]. The biggest constituent of the Lebanese diaspora is that residing in the oil-rich states of the Arab Gulf. In 2014, a tumbling price of oil unleashed a supply shock to the world economy. In Lebanon, the decrease of the price from about a USD 100 to around USD 25 over the span of 2 years resulted in large job losses and wage cuts to the Lebanese working in the GCC. This translated into a significant slow-down of remittance inflows being sent back to family at home, which formed a life-line for many families, but also for the whole financial sector. According to the “World Bank Migration and Remittances Factbook 2016”, in 2014, remittance inflows from GCC to Lebanon totaled around USD 1.9 Bn, the equivalent of 4.1% of GDP for that year. Additionally, remittance inflows from the GCC in 2014 formed around 26% of total remittance inflows, which in turn stood at USD 7.5 Bn (16% of GDP)[52]. In contrast, the IMF, in its January 2017 report, mentioned the BDL’s estimate of 60% for remittance inflows coming from GCC countries rather than the World Bank’s 26%; the IMF report adds that “remittances now originate mostly in Arab countries”[53].
In effect, pressures on the system piled up, with the peg becoming increasingly a burden on the system.



Source: Federal Reserve Economic Data

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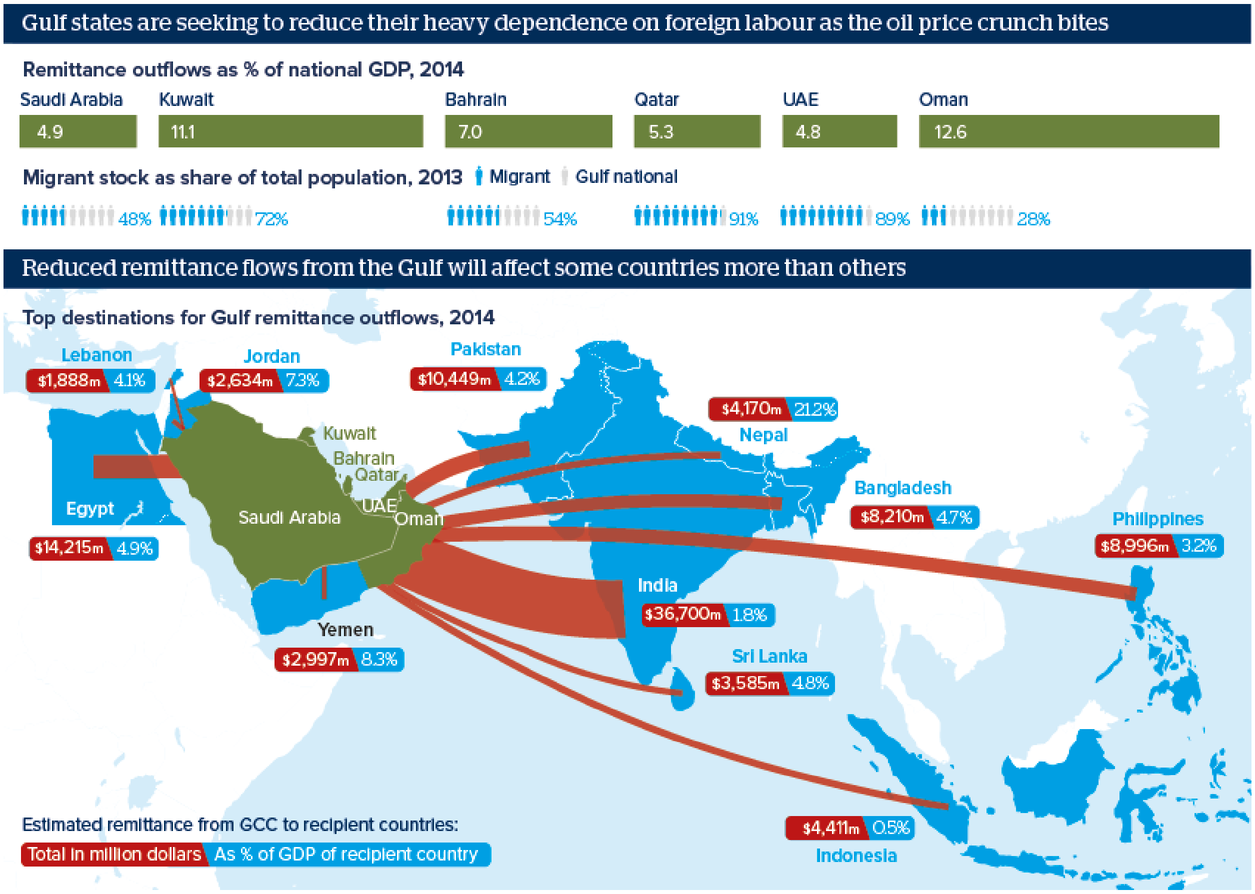
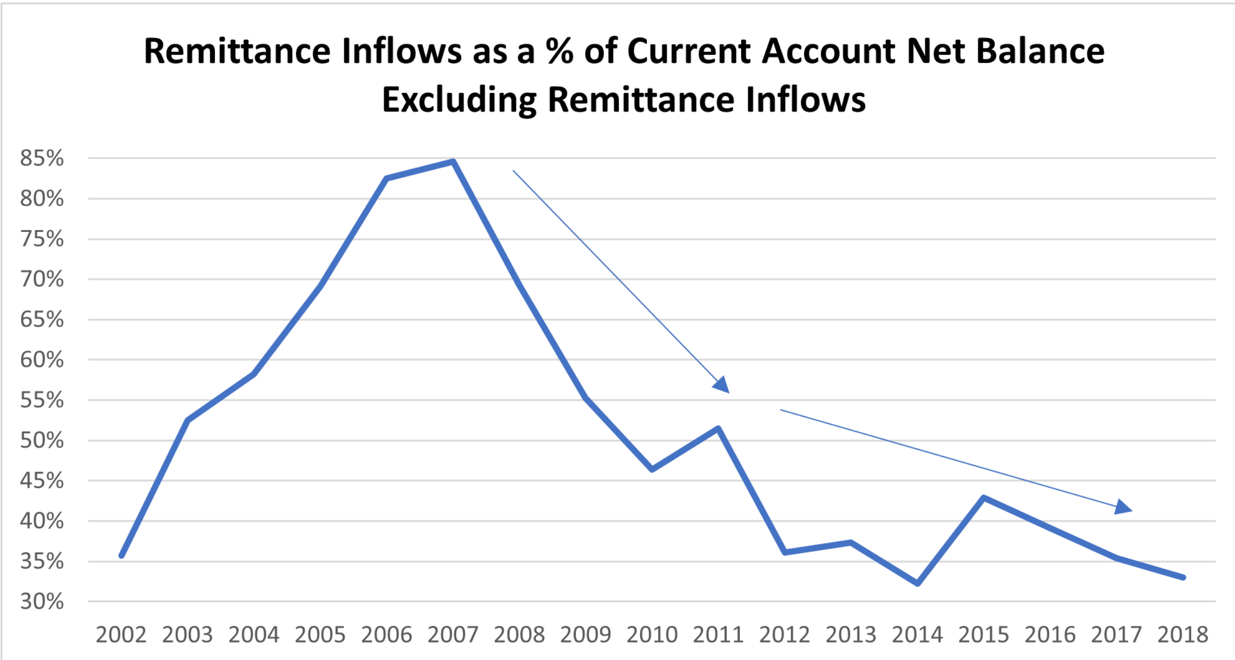


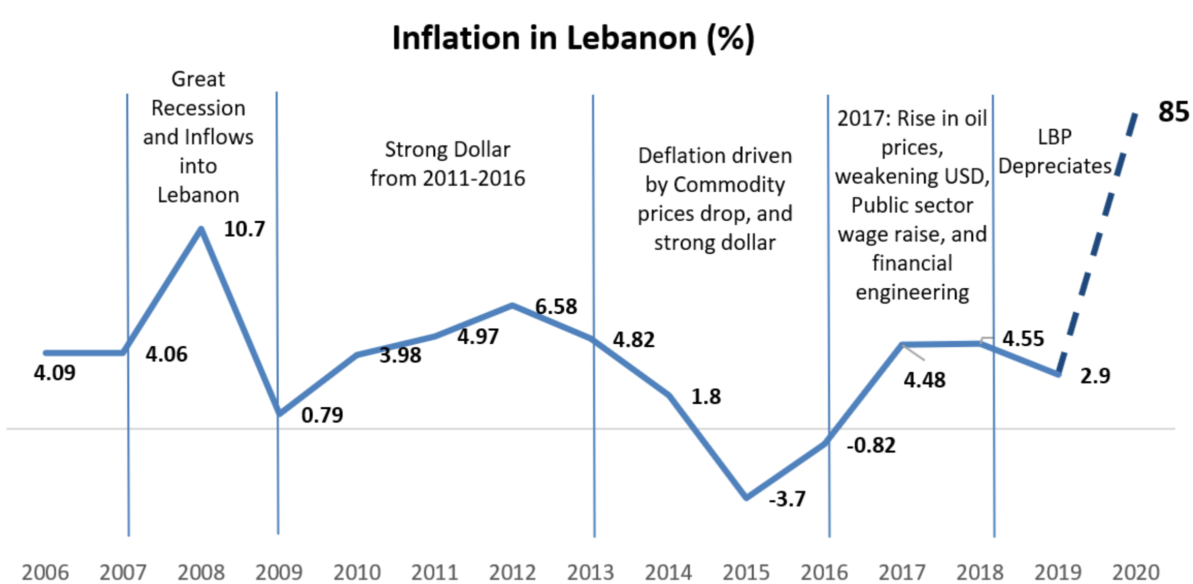
Source: Oxford Analytica[54]



Source: BDL, World Bank

… with Impact on Inflation

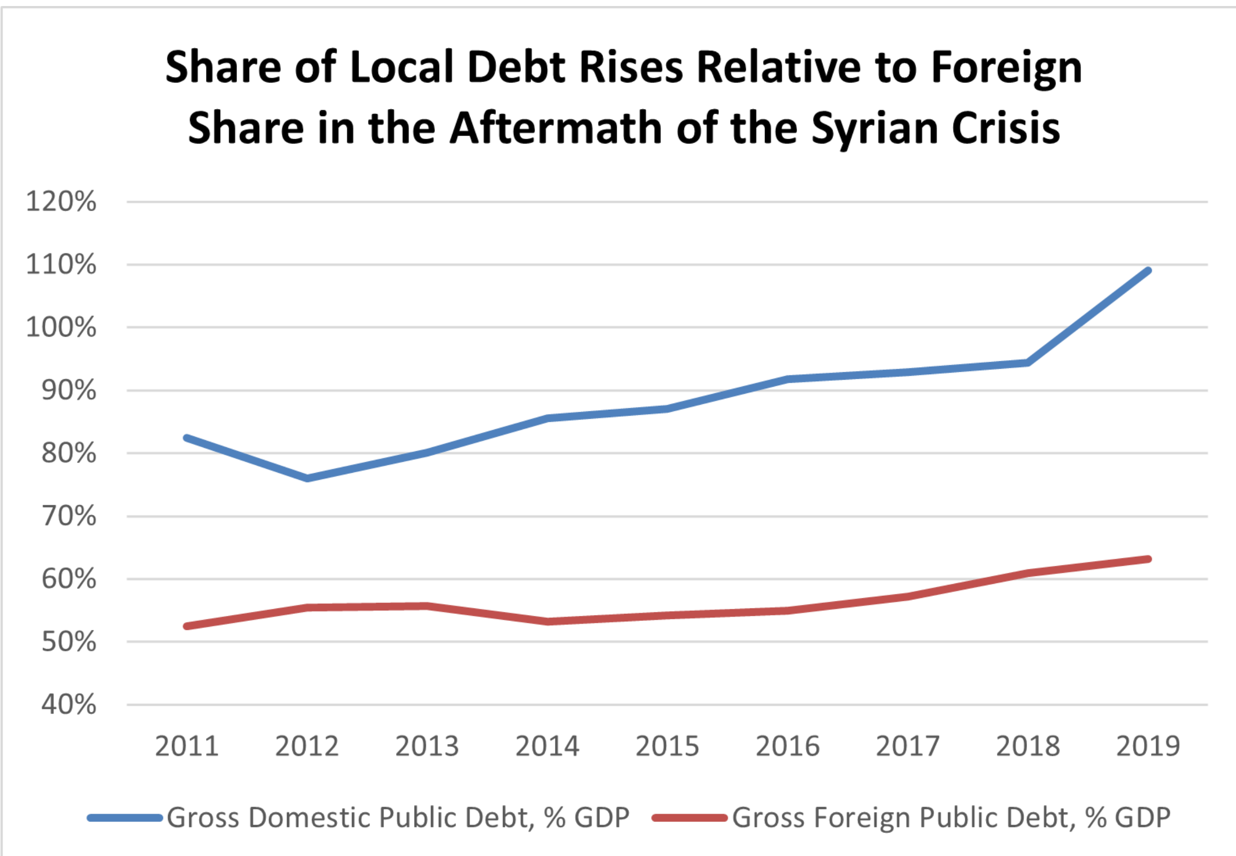
The successive events that occurred over the years are reflected in price level changes..



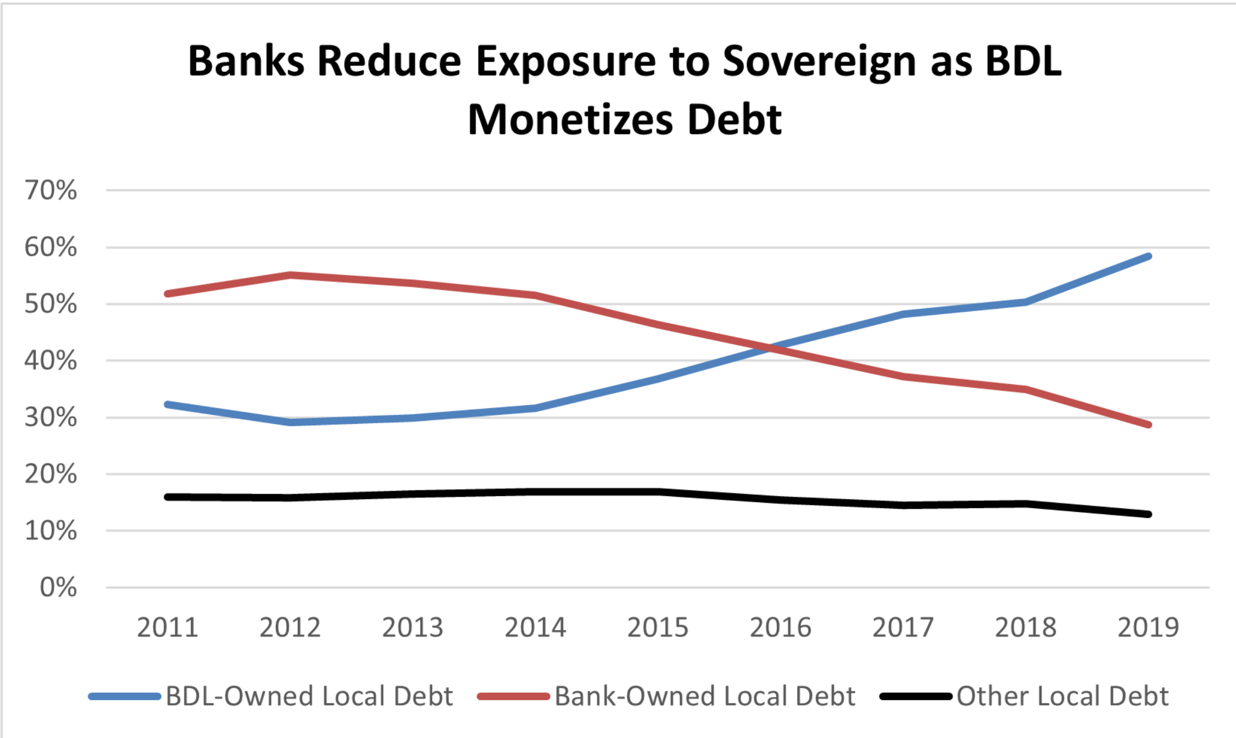
Source: CAS

BDL Monetizing Debt

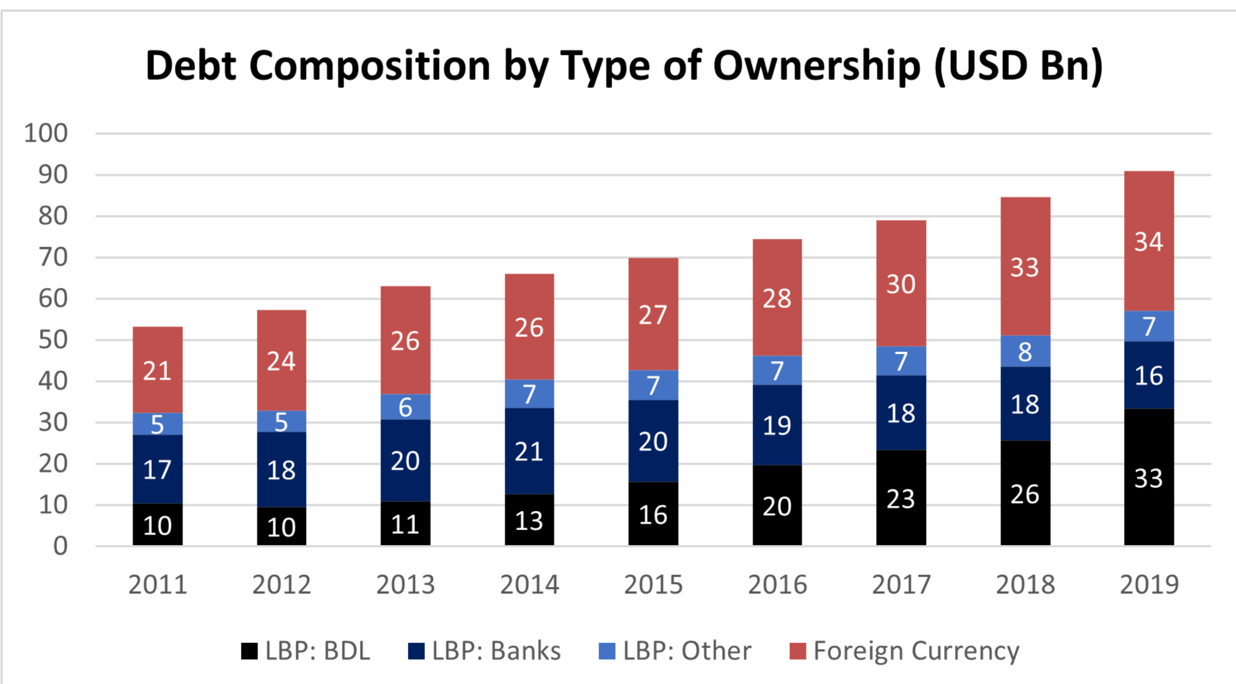
As questions were raised over the solvency of the state, confidence in the system was doubted. Commercial banks reduced their balance sheet exposure to the sovereign, in the form of a decrease in possession of sovereign T-bills from USD 21 Bn in 2014 (32% of public debt) to USD 18 Bn in 2018 (21% of public debt). As Lebanon was kicked out of capital markets, the BDL moved on to assume the role of funding the state- its share of LBP-denominated sovereign debt rose from USD 13 Bn in 2014 (19% of public debt) to USD 33 Bn in 2018 (37% of public debt).



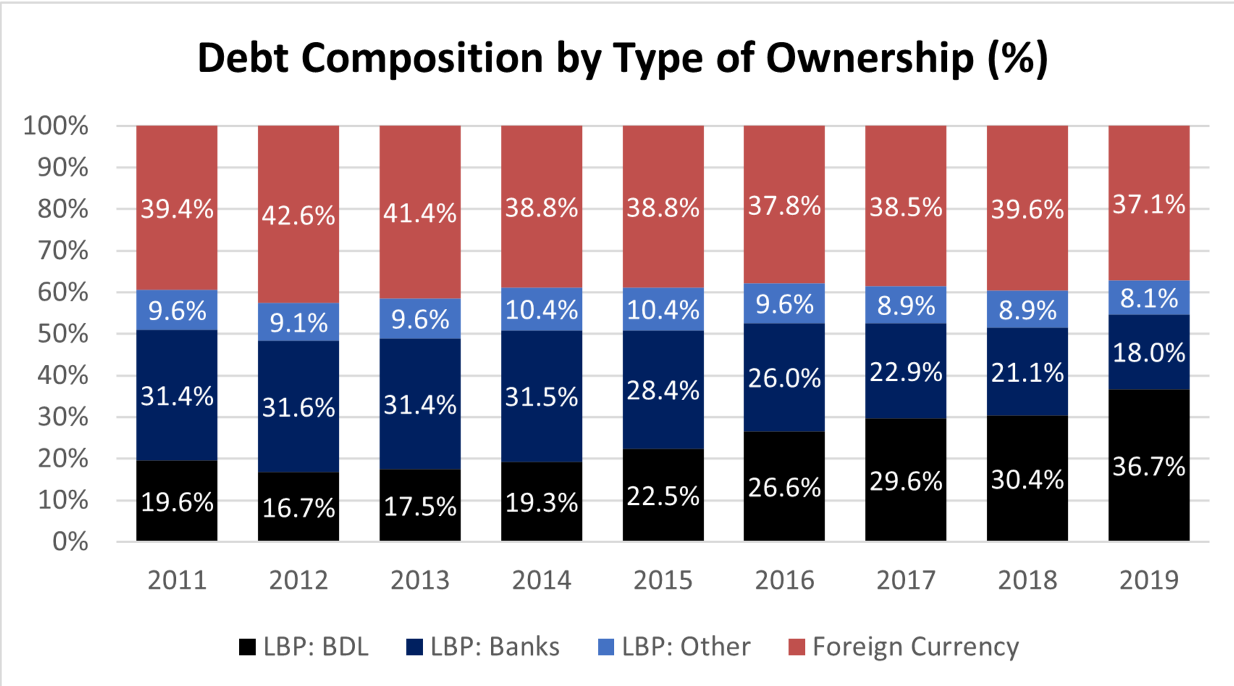
Source: Ministry of Finance



Source: Ministry of Finance



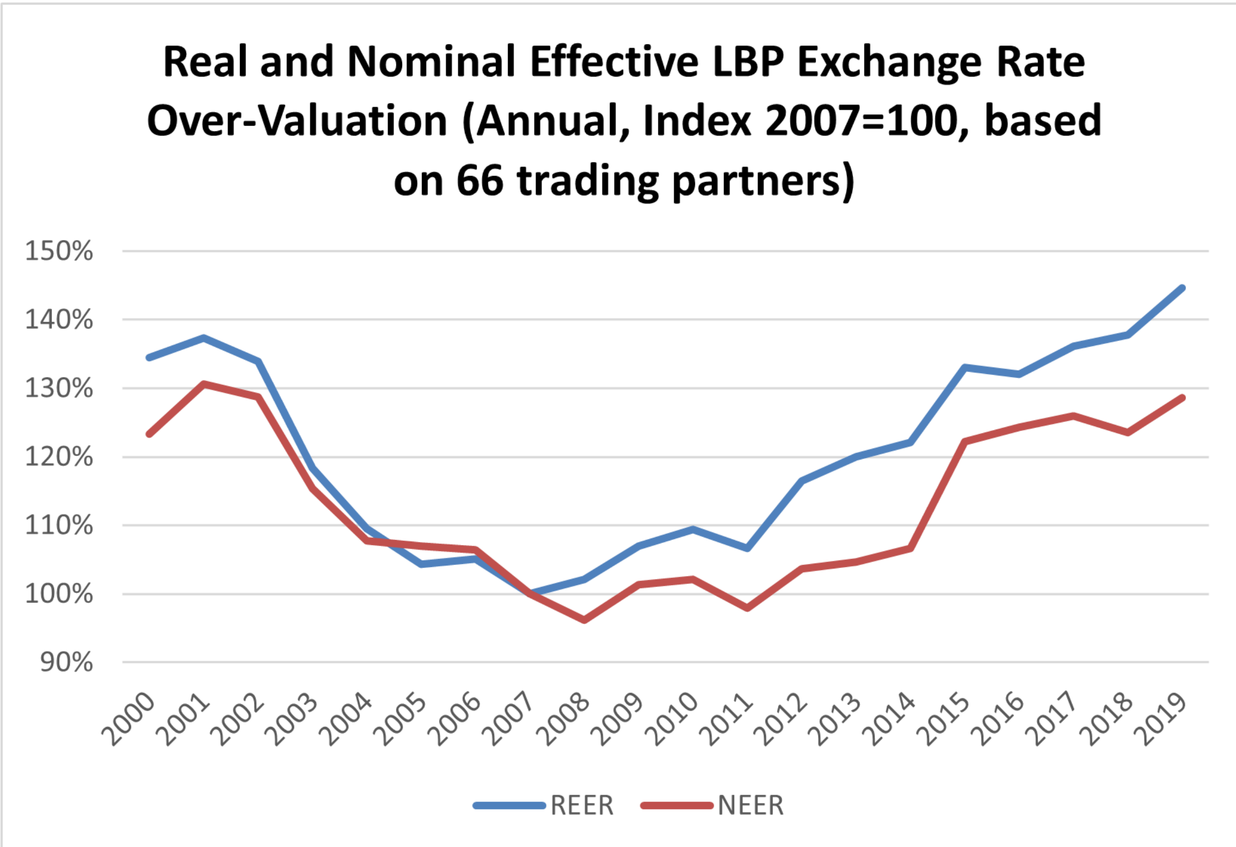
Source: Ministry of Finance



Source: Ministry of Finance

Macro-Economic Mismanagement- LBP Over-Valuation Soars

Given the extent of the imbalances and the negative net foreign reserve position of the BDL, the Lebanese Lira is highly over-valued, and this is manifested in the state of poor external economic competitiveness, as well as through the black market parallel rate that is far from the official rate. If we take the external sustainability approach, the IMF in 2019 estimated a 50% LBP over-valuation if net foreign assets were to be stabilized at the 2018 level of -128% of GDP, while also estimating it at 66% if the net foreign asset position was reduced to -100% of GDP by 2024[5].

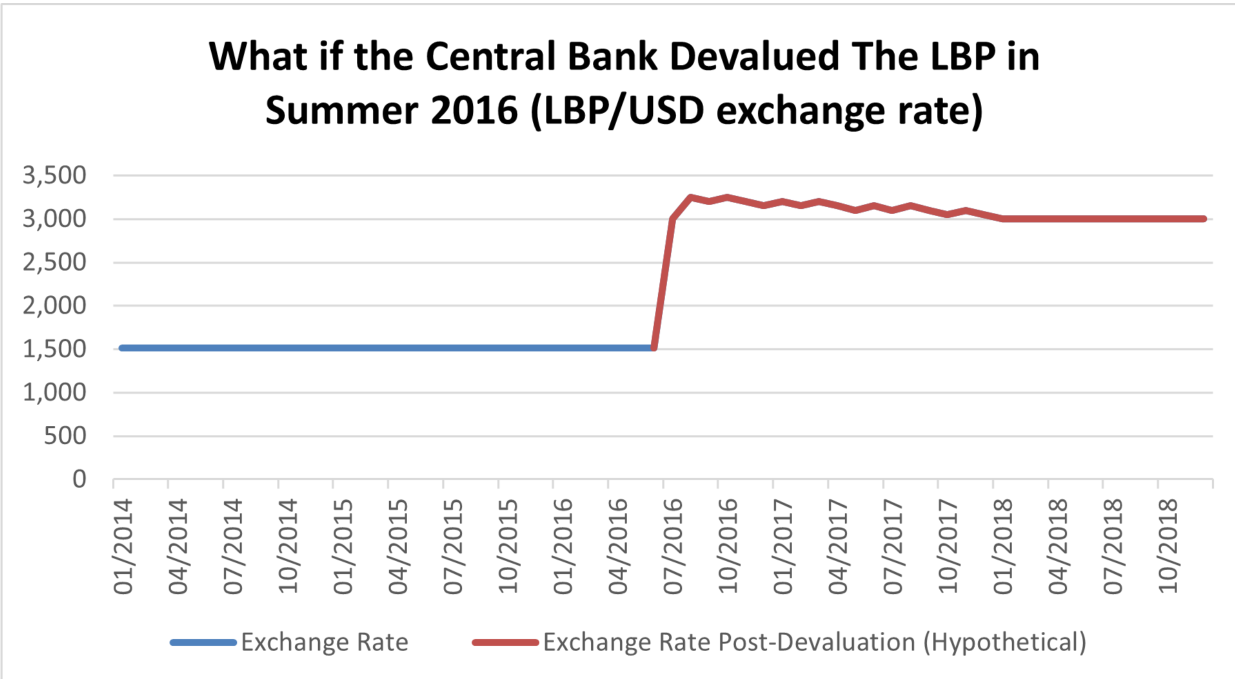


Source: Bruegel, 2019

Summer 2016: Time for a One-Time Devaluation

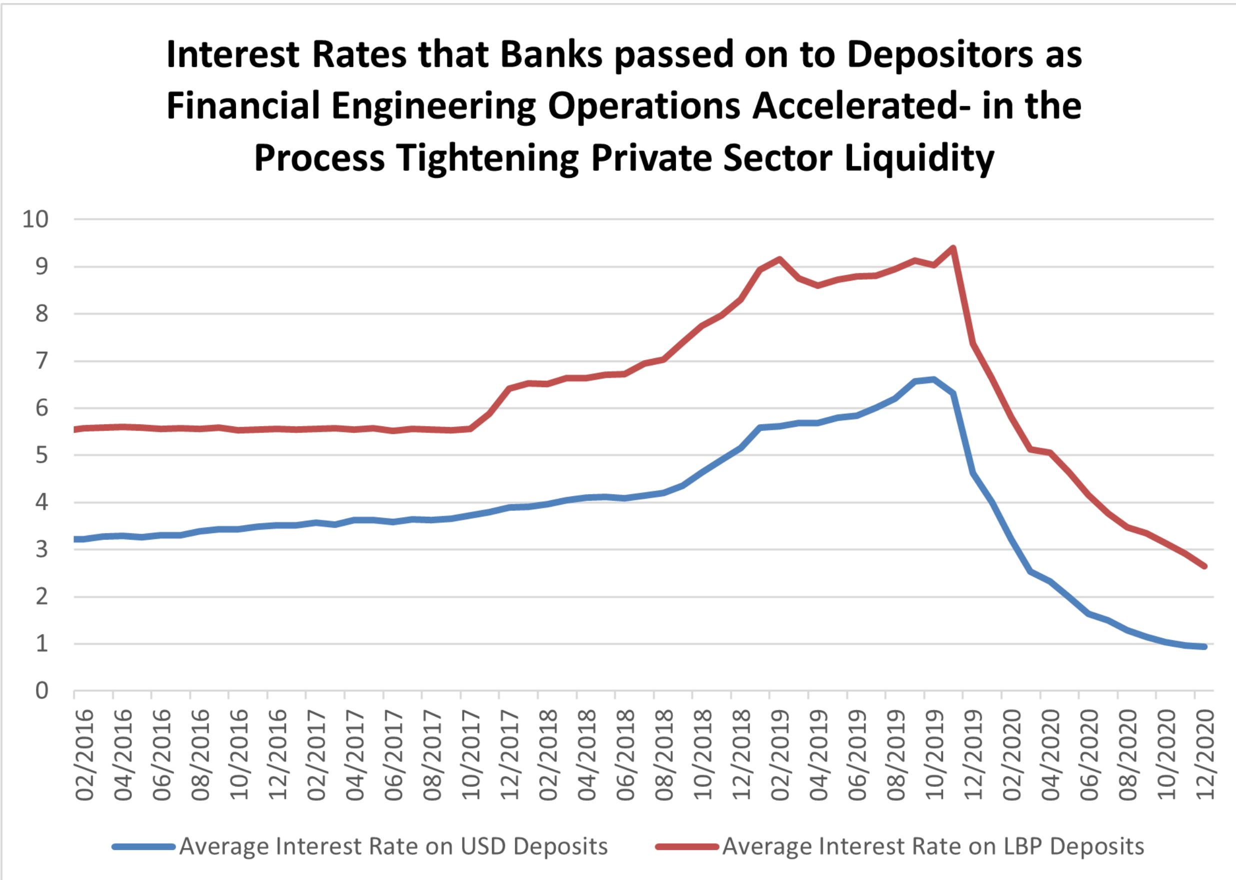
It's easy to talk in retrospect. However, the events that followed in summer 2016, particularly the financial engineering schemes, have inflicted huge damage on the economy and people's lives, while destabilizing the banking system as witnessed in 2019 and till today. Could it be that another path could have been carved on the eve of adopting the inauspicious financial engineering scheme? The political developments were not favorable, surely. Yet when compared with the unabating hemorrhaging of Lebanese people's wealth and future since the end of 2019 and until the present day, then the disadvantages of certain alternatives pale in face of what we've witnessed today, not to mention what is yet to come.

What about the following hypothetical scenario? It goes as follows, "On July 1st, 2016, BDL Governor Riad Salame, in a suddenly-announced televised appearance, announced a one-time devaluation of the Lebanese Lira, pledging to defend it at the new exchange rate of 3,000 LBP/USD. The Governor cited the piling up of imbalances over the past 5 years (2011 till mid-2016), alongside a deteriorating fiscal balance and productivity, and therefore the need for a systemic adjustment to achieve macroeconomic stability. He added that monetary stabilization served the interests of the Lebanese economy and people, while emphasizing the importance of fiscal discipline to achieve public debt sustainability, in parallel with structural economic reforms and a long-term economic vision".



Instead: Financial Engineering

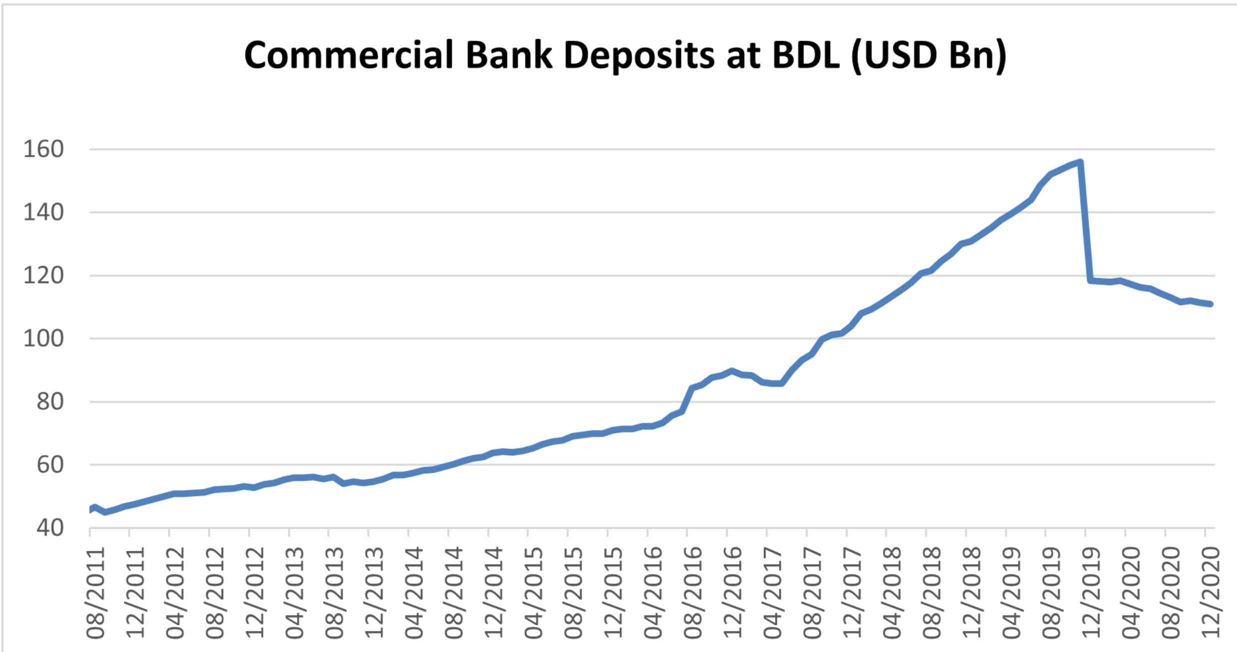
Given the mounting pressure on the exchange rate and the decline in foreign reserves of the central bank, the BDL, in summer 2016, designed financial engineering products in an effort to secure external financing/debt through attracting new deposit inflows. The commercial banks were the vehicle of this operation, with deposits reaching USD 175 Bn or LBP 262.73 Tn by end of 2018 (of which 70.62% were in USD)- more than 3 times the Lebanese GDP. The financial engineering worked as follows: The BDL provided high returns on new USD deposits from the Lebanese commercial banks (around 6.5% interest on the dollar). For each dollar deposited by banks at the BDL, banks became eligible to borrow an equivalent amount in LBP at 2% interest, which in turn would be re-deposited as a loan to BDL at up to 13% interest. The scheme, involving the 6.5% interest on the US Dollar and the 11% interest on the LBP round-trip, combine to reach a whopping 17.5% interest on each new dollar deposit by the commercial banks at BDL- a highly profitable operation for the Lebanese commercial banks. In turn, the BDL boosted FX gross reserves, albeit at an ever-increasing cost of debt service. After the implosion of the system and the imposition of informal capital controls, interest rates collapsed. The figure below presents the average interest rates on USD and LBP deposits in commercial banks. Note that the USD average interest rate jumped from 3.3% by end of June 2016 to its peak at around 6.6% during the second half of 2019.



Source: BDL

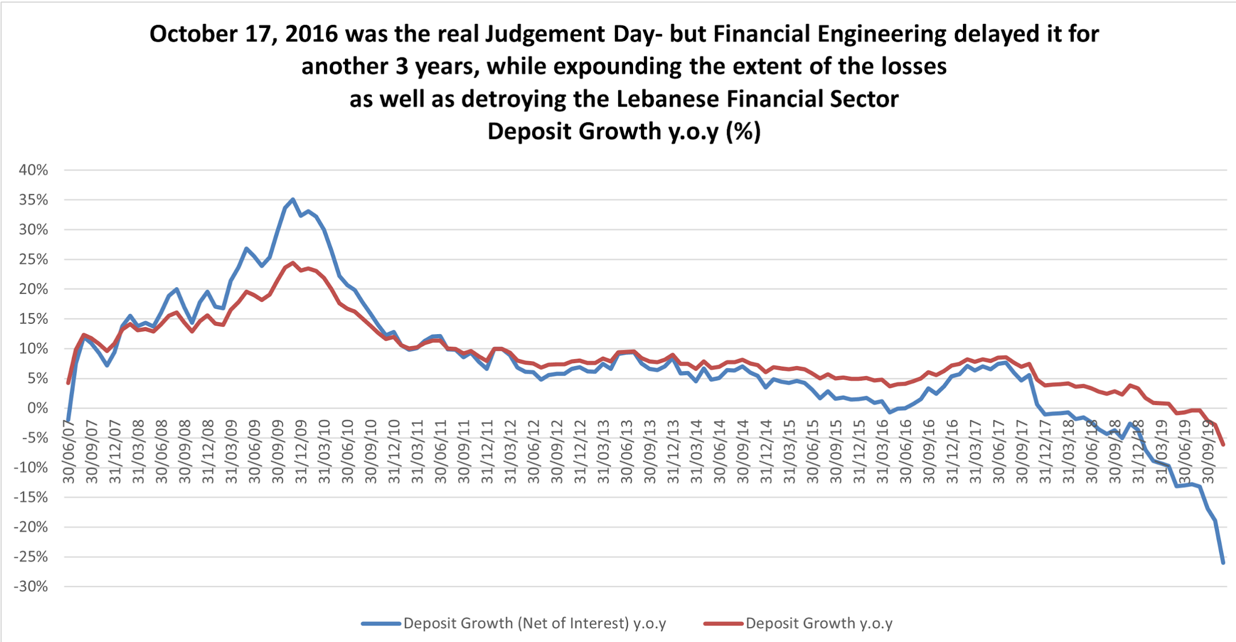
The financial engineering operations were large in scale. According to the IMF, the BDL attracted around USD 24 Bn from Banks through sales and deposits between late 2017 and early 2019[5].

This increased the banking sector balance sheet exposure to the balance sheets of the BDL and the GoL. According to the IMF, this exposure is estimated at 69% of total assets by May 2019. In return, banks, in 2018, earned an additional USD 2.7 billion in income from interest earned on their bank accounts relative to year 2017- producing stable net income of USD 2.2 billion in 2018 in an otherwise weak economy and highly unfavorable economic environment[5].



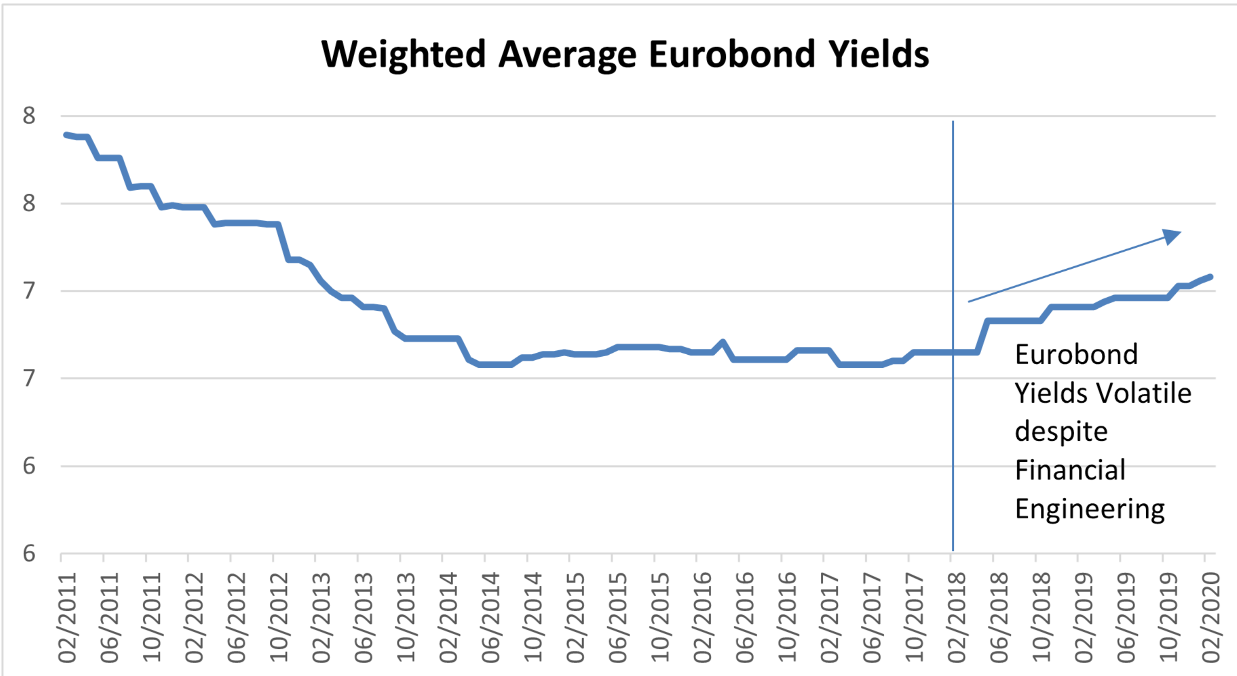
Source: BDL

However, the systemic problems remained. Deposit inflow growth decelerated, with deposit growth net of interest accrual turning negative at end of April 2016, but back in positive territory due to financial engineering that only succeeded in postponing the inevitable collapse- yet at a higher cost, banking sector over-exposure, and without a vision to tackle the root issues. In 2017, deposit inflows grew at a rate of 3.8%, while deposits net of interest accrual grew at -1.09%. As for year 2018, deposit inflows grew at a rate of 3.33%- the lowest pace since the level of 3.89% in 2005- while deposits net of interest accrual grew at -3.65%. In 2019, deposit inflows grew at a rate of -8.85%, while deposits net of interest accrual grew at a negative rate of -31.35% due to the unfolding of the crisis.



Source: Author’s Analysis, BDL

Additionally, the financial engineering did not keep Eurobond yields stable, as evidenced by the evolution of average yields below. In light of regional and international developments- namely a strong dollar and fierce regional competition for capital- the Lebanese Eurobond yields suffered a whole lot as measured by the EMBI spread relative to the US risk-free rate, compared with the respective spread of the Lebanese Eurobonds; they went in opposite directions post-2015.

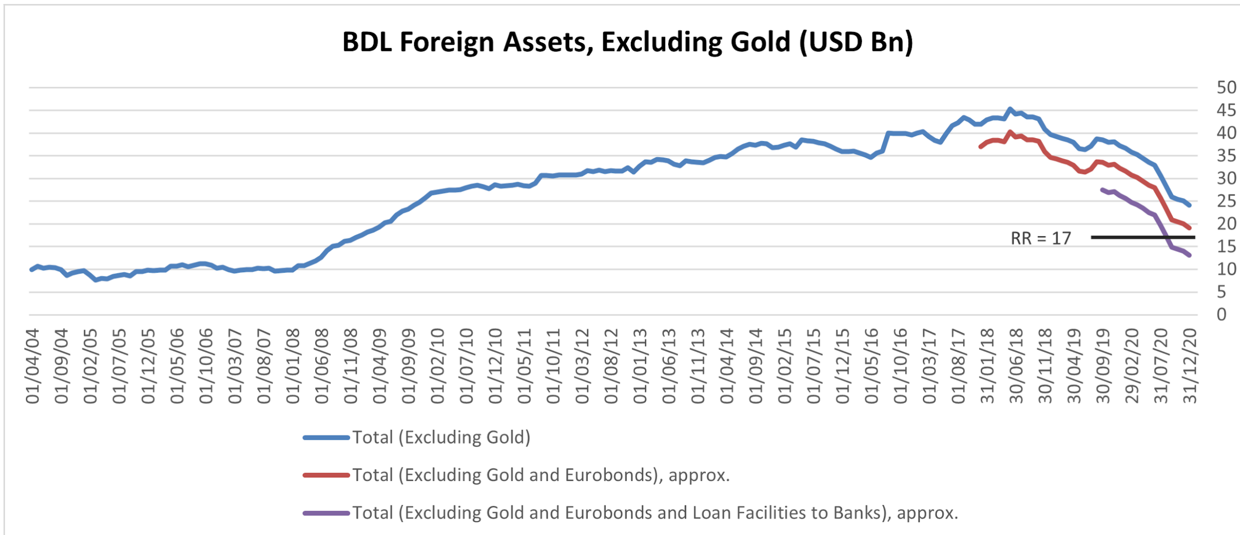


Source: BDL

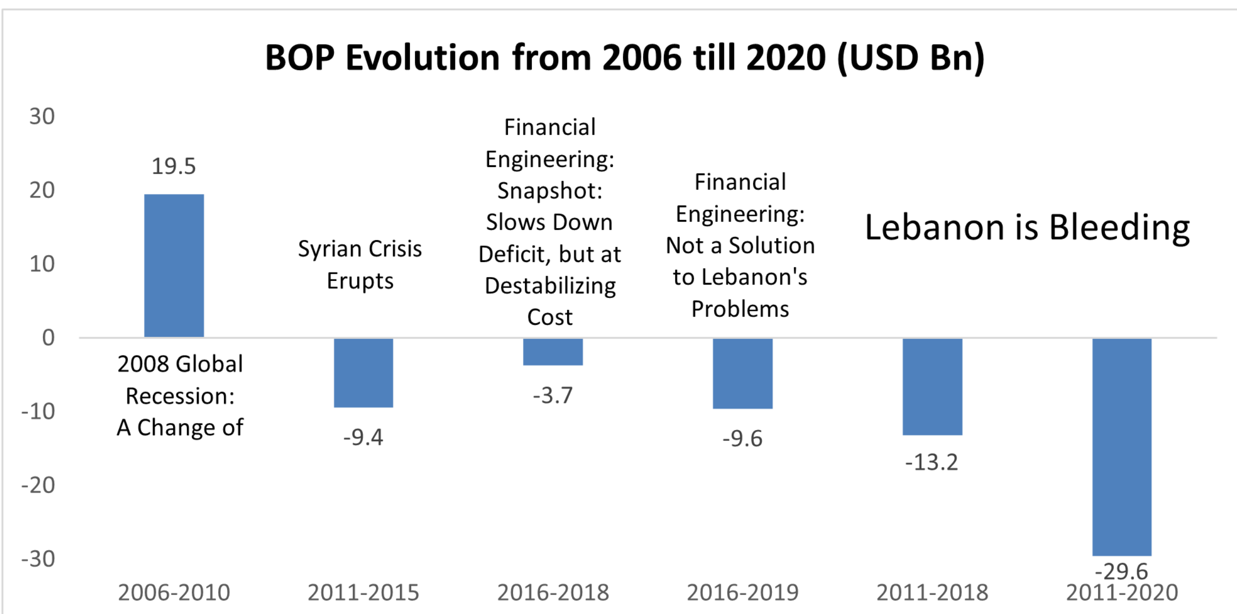
Despite the financial engineering operations and efforts to lure in fresh NR deposit money via high interest rates, BDL foreign assets (excluding Gold reserves) decreased. Given the rapid deterioration of the situation in Lebanon, year 2020 alone has witnessed a BDL foreign reserve decline of USD -13.2 Bn.

Note that by end of August 2020, BDL liquid FX reserves had reached the RR threshold set by BDL at USD 17.5 Bn at that time. Since BDL does not transparently disclose its foreign currency and foreign reserve position, we take it on ourselves to approximate the reserves remaining. To break the numbers down, by end of August 2020, BDL Foreign Assets excluding gold totaled USD 28.5 Bn. Deducting the USD 5 Bn in GoL eurobonds estimated to be held by BDL from the outstanding value, renders a BDL Foreign Asset (excluding Gold and Eurobonds) position of USD 23.5 Bn. Further deducting loans to Commercial Banks in Foreign currencies, estimated at USD 6 Bn, yields a liquid foreign reserve position of USD 17.5 Bn, which is precisely the symbolic Required Reserve threshold set by the BDL in proportion to foreign currency deposits for that month. Regardless of the RR ratio, it is clear that, given the extent of insolvency of the system, every penny already spent by the BDL is most certainly depositor money.

Note that by end of December 2020, BDL Foreign Assets excluding gold reserves had reached USD 24.1 Bn.



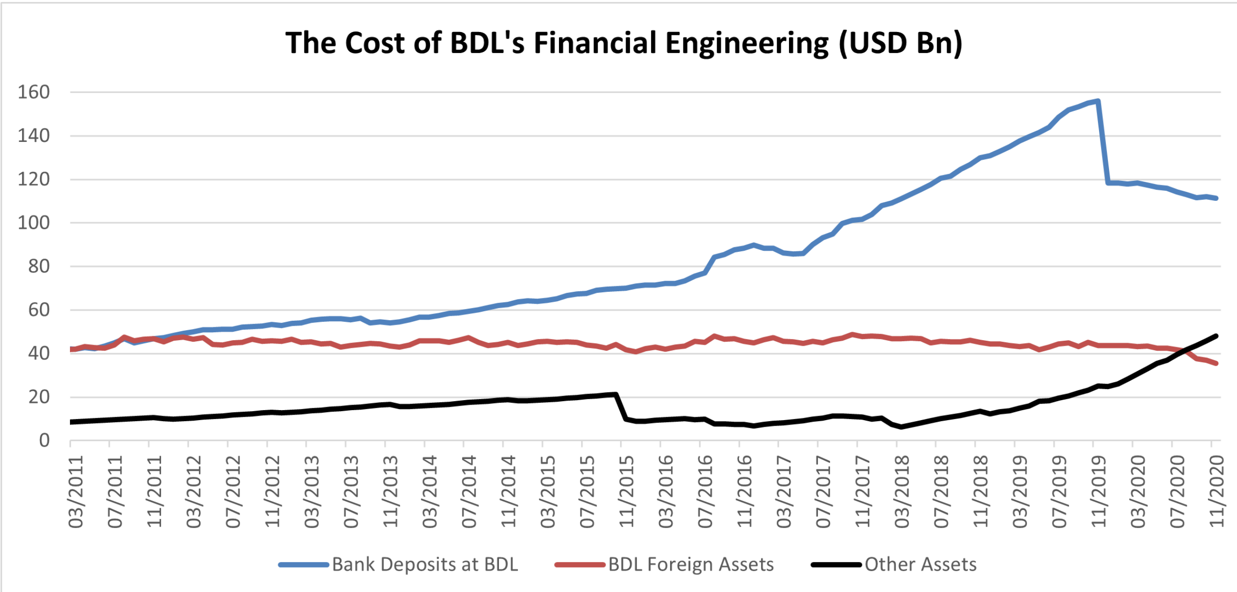
Source: Author's Analysis, BDL



Source: BDL

BDL's Losses from Financial Engineering

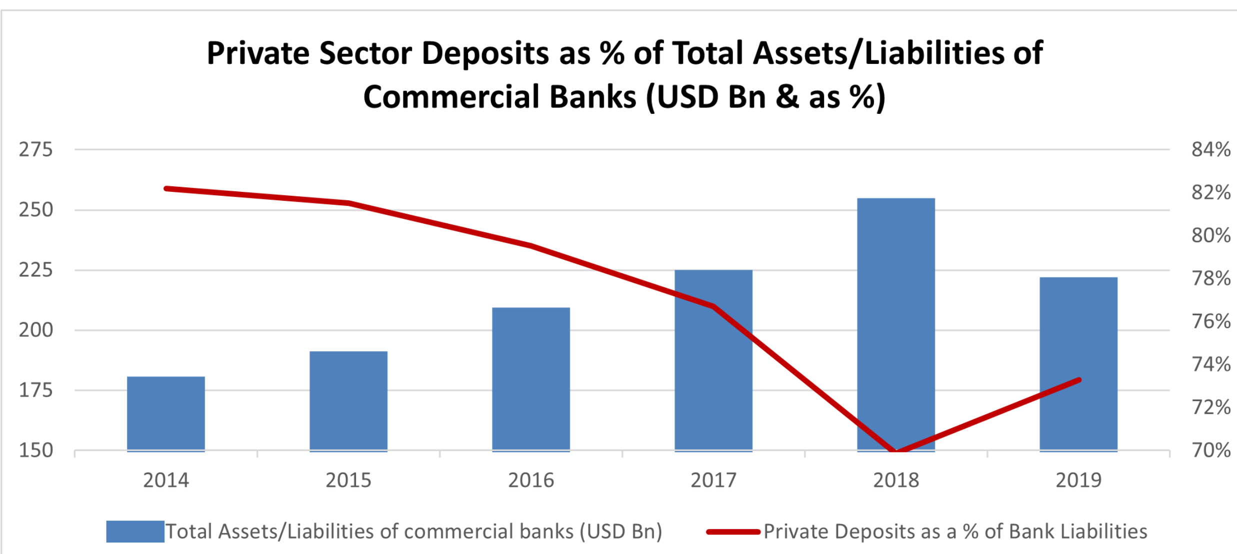
According to The Economist, the financial engineering scheme was costly. While there is no official information surrounding the cost of the operation to increase BDL gross reserves, the losses are suspected to be included in the "Other Assets" category of the central bank's balance sheet[7].



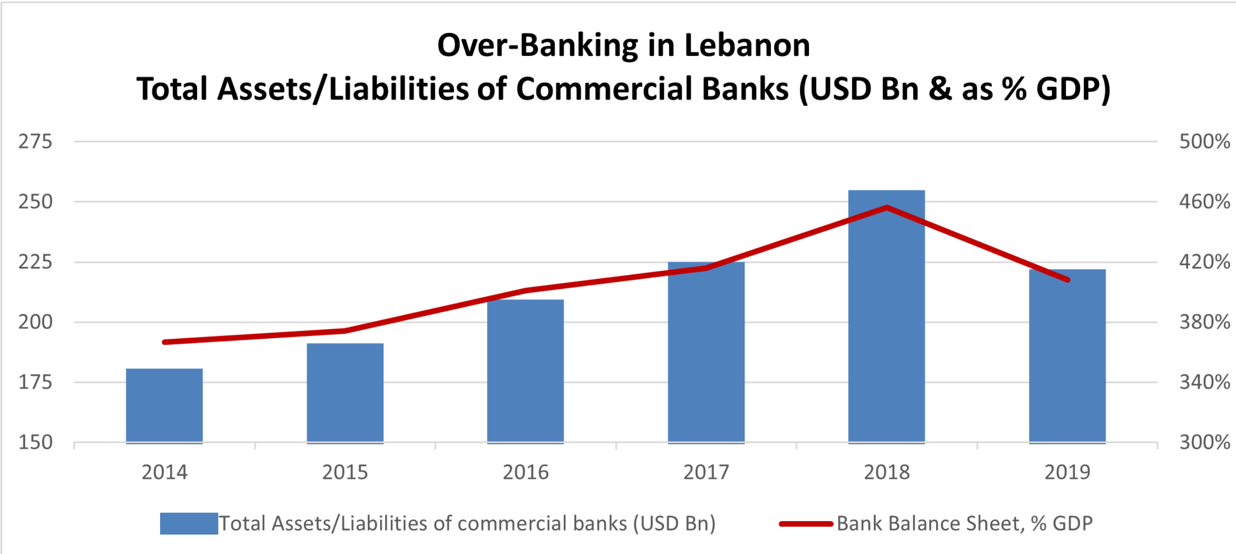
Source: BDL

Bloated Banking

The financial engineering operations aggravated the state of over-sized banking sector balance sheets. By end of 2018, banking sector total assets reached around USD 250 Bn, or 456% of GDP, up from a 2015 level of USD 187 Bn, or 374% of GDP.

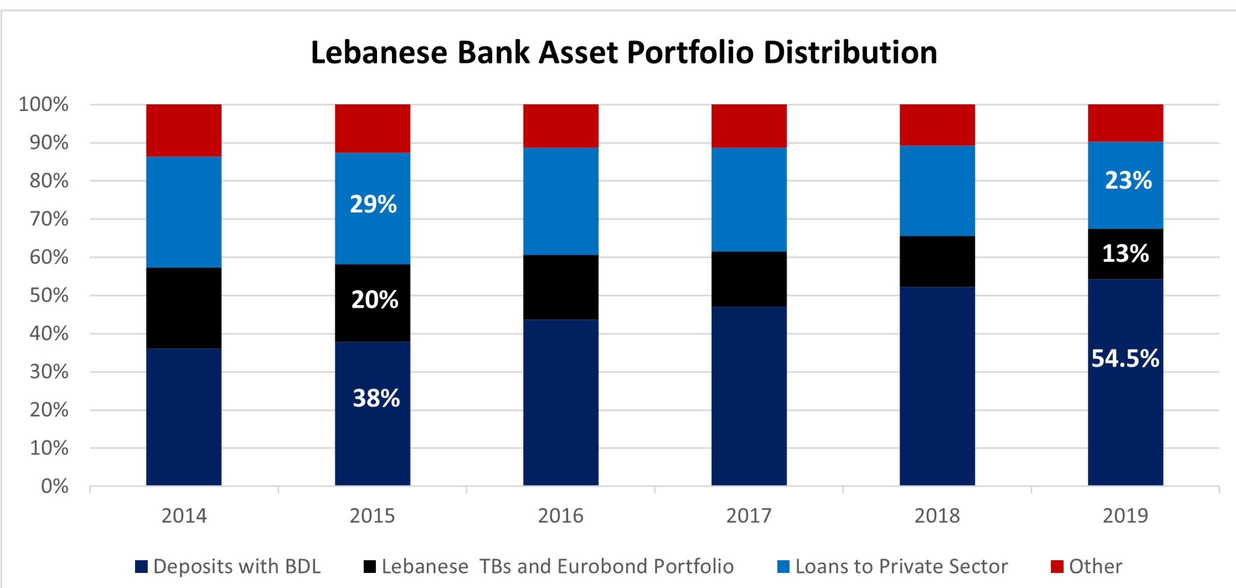


Source: BDL



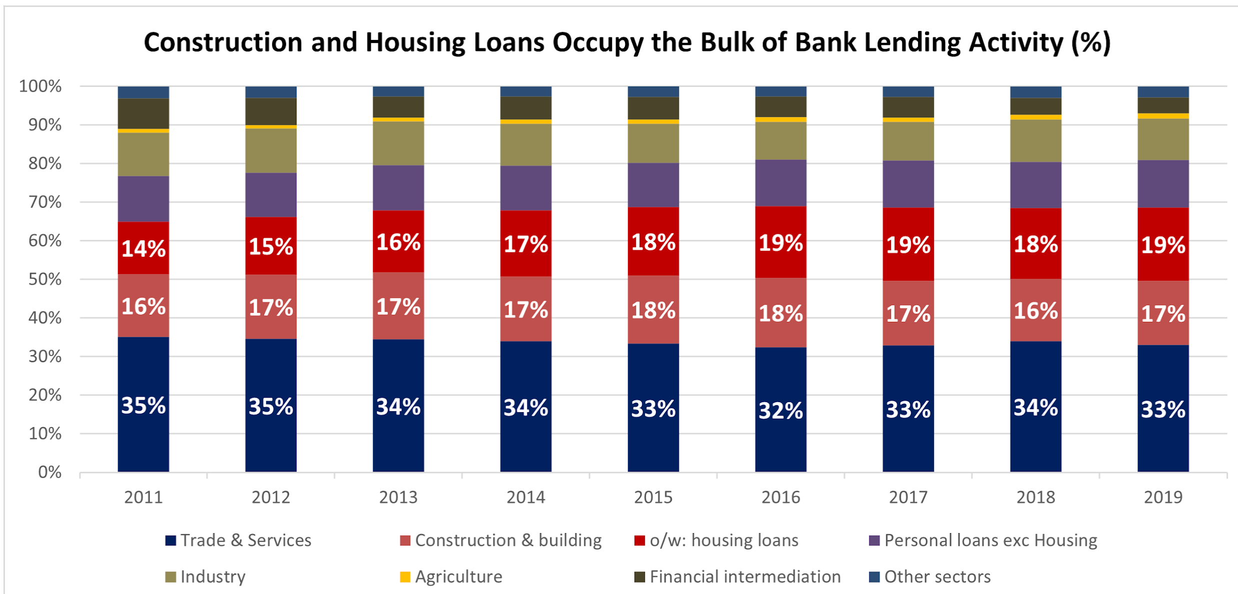
Source: BDL

Relative to a lower-bound private sector share of banking deposits of around 70%, the banks' Lebanese private sector lending portfolio constituted only a fraction of its activities. By end of 2019, loans to the private sector totaled around 23% of its assets, in comparison with a level of 29% in the pre-financial engineering year of 2015. On the other hand, deposits with BDL flourished, totaling around 55% of assets in 2019 in comparison with around 38% by end of 2015. This is not to mention exposure to the Government, estimated at 13% of assets in 2019, which thus demonstrates a public sector risk exposure of around 68% in 2019.



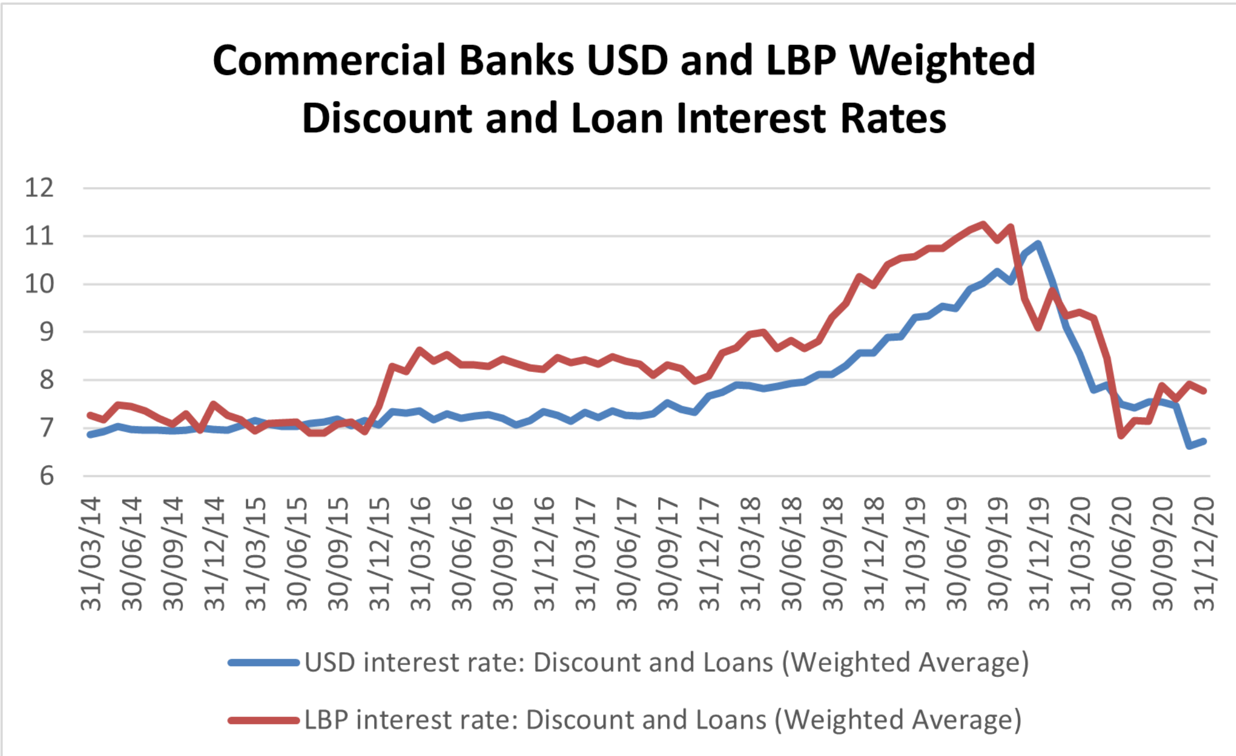
Source: ABL

Additionally, the composition of the loan portfolio to the private sector reveals a lot about the state of private sector finance. The numbers demonstrate that productive sectors are not a priority, with construction and housing loans occupying the biggest share since 2014, when it reached 34%. In 2019, the share of construction and housing loans totaled around 36% of loans. However, if we account for the fact that a significant proportion of “Trade and Services” loans constitute real estate-related exposure, then it is clear that real estate is the biggest component by far of banking sector loans.



Source: ABL

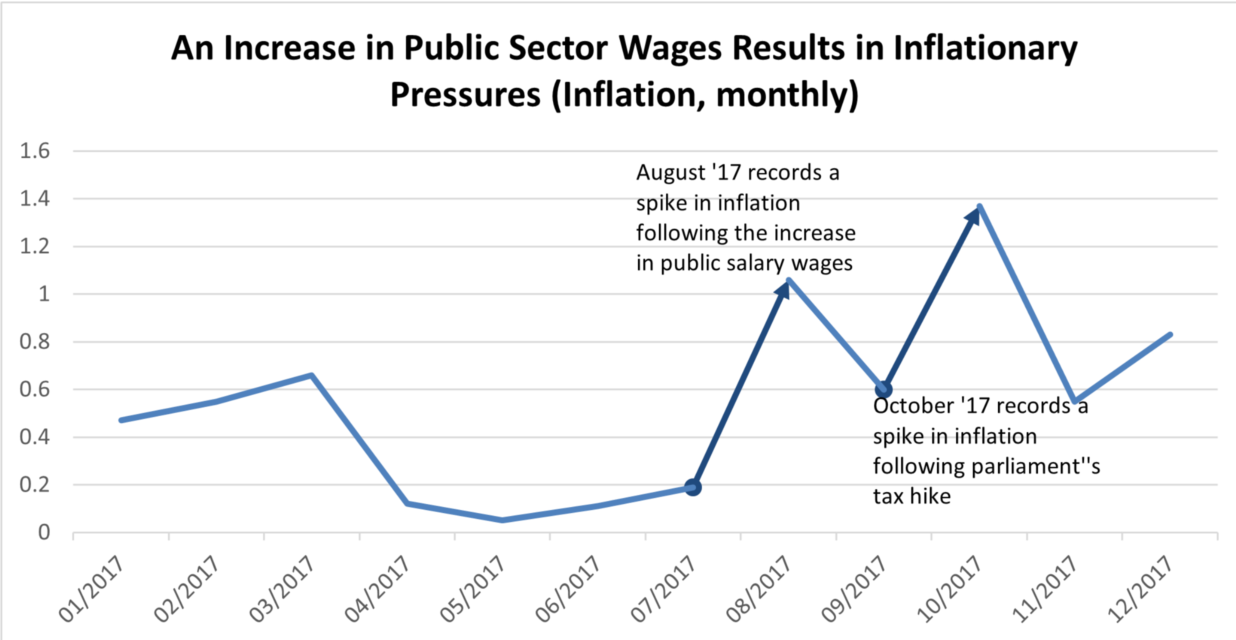
In the meantime, business and private sector economic conditions have deteriorated heavily. This was exacerbated by the financial engineering operations, which, in the name of boosting BDL FX reserves, have incentivized the banking sector to crowd out private sector lending, preferring instead to channel depositors’ USDs to the BDL at exorbitant interest rates. The ensuing monetary tightening took the form of higher USD and LBP lending rates, resulting in increasing NPLs and business liquidity and cash flow problems.. For instance, by end of December 2019, the USD weighted lending rate reached its peak of 10.84%. Similarly, by end of October 2019, the LBP weighted lending rate reached 11.19%.



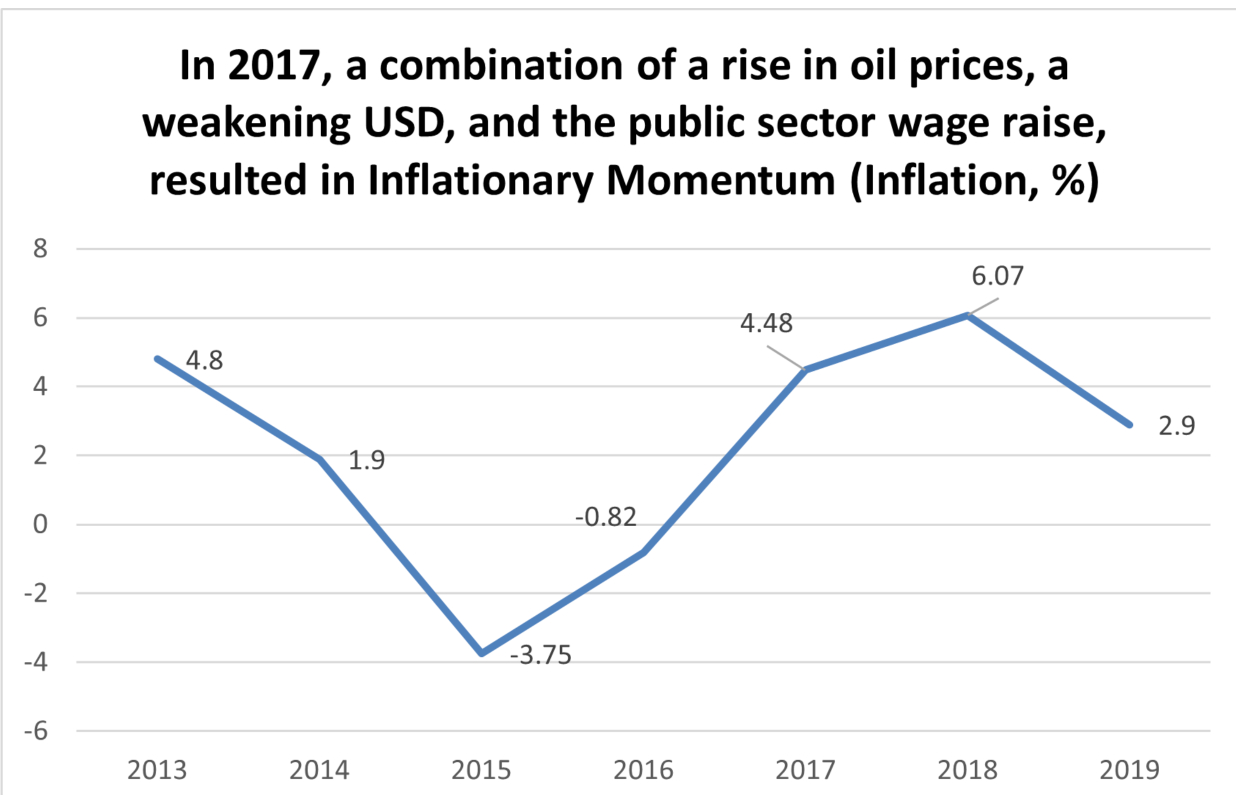
Source: BDL

An Expensive Wage Raise is Passed Prior to the 2018 Parliamentary Elections

It is worth mentioning that in August 2017, Lebanese officials passed a politically popular, yet highly unaffordable, public sector wage raise, coupled with passing a tax increase in October to "fund" the aforementioned wage raise[7]. Despite clear signals and indicators that the market was going to respond directly with price hikes, the wage raise was passed nonetheless, at the expense of ever-crumbling state finances.
Note: This is not a condemnation of the wage raise in itself; on the contrary, the minimum wage has to be in line with the price line, as well as in relation to a level that safeguards the interests of both the economy and citizens' standard of living. However, to pass such an expensive raise, without credible evidence that the tax hike will successfully fund it, while realistically keeping inflation under control, is the definition of the road to financial peril. The reality is that it resulted in inflationary expectations, and no evidence of anything else. The market responded without delay. Moreover, it is also noteworthy that in the runup to the 2018 parliamentary elections, in 2017, around 5,000 citizens were employed in the already-bloated public sector, inflating the wage bill and therefore the public deficit[8]. This number is yet to be validated since no formal statistics nor database exists regarding public sector employees.



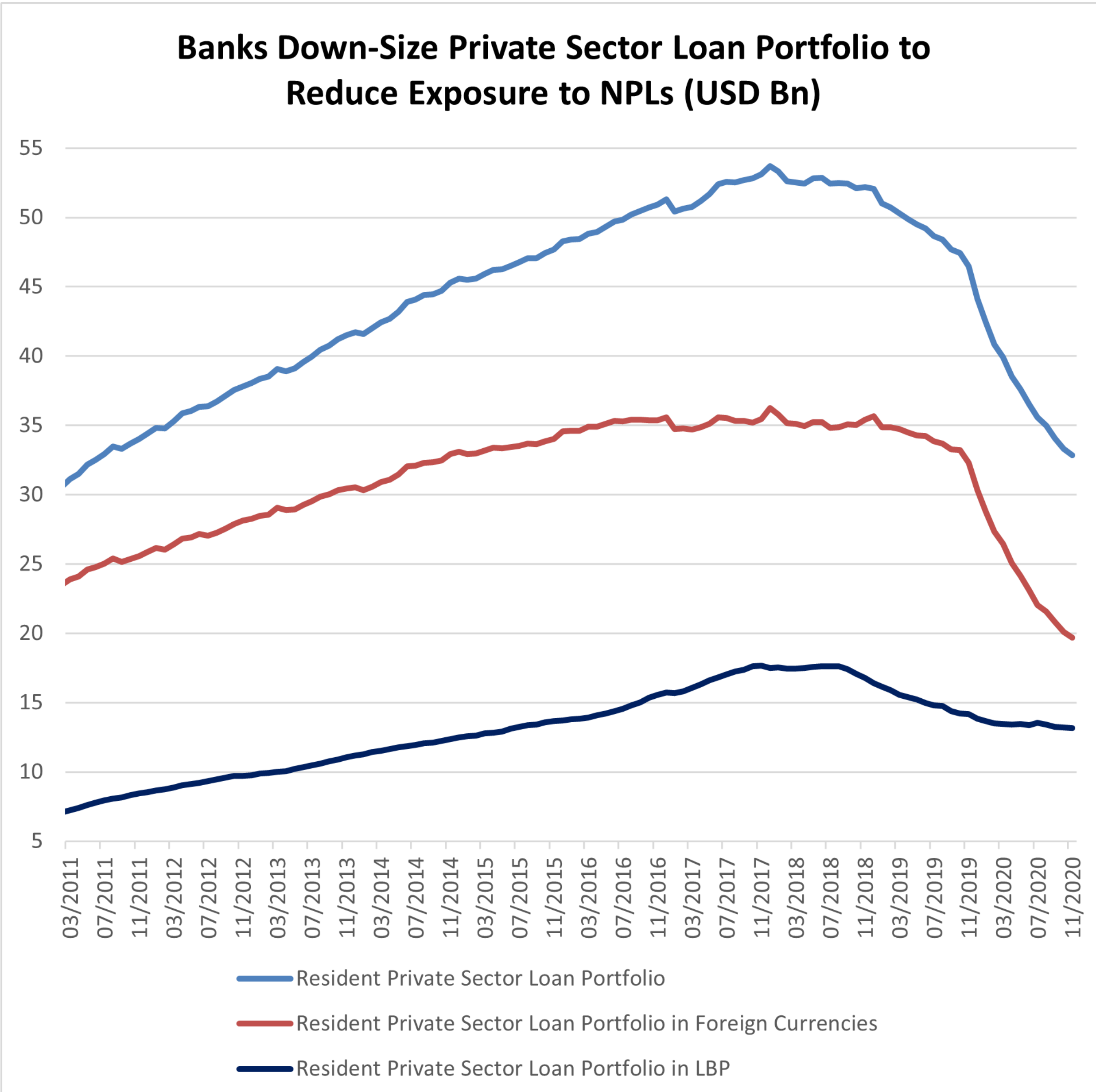
Source: CAS



Source: CAS

Banks Rush to Down-size Loan Portfolio to Private Sector (remember dec ’19)

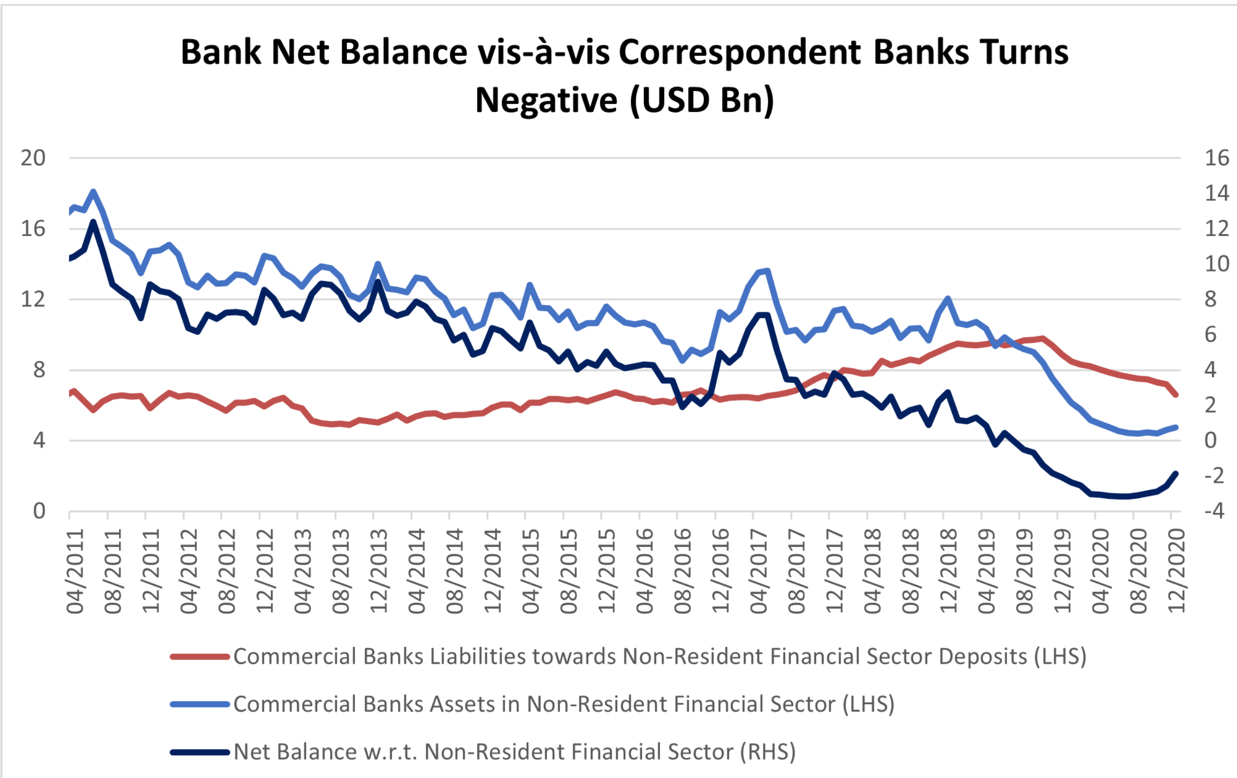
As credit risk surged and NPLs increased, banks rushed to down-size their loan portfolio to the private sector, which in turn experienced a tight credit squeeze as more businesses shut down. The Resident Private Sector loan portfolio fell from USD 47.68 Bn by end of September 2019 to USD 31.93 Bn by end of December 2020. Leading this trend was the Resident Private Sector loan portfolio in foreign currencies, which fell from USD 33.28 Bn by end of September 2019 to USD 18.88 Bn by end of December 2020.



Source: BDL

Meanwhile, Bank Relationship with Correspondent Banks Deteriorates

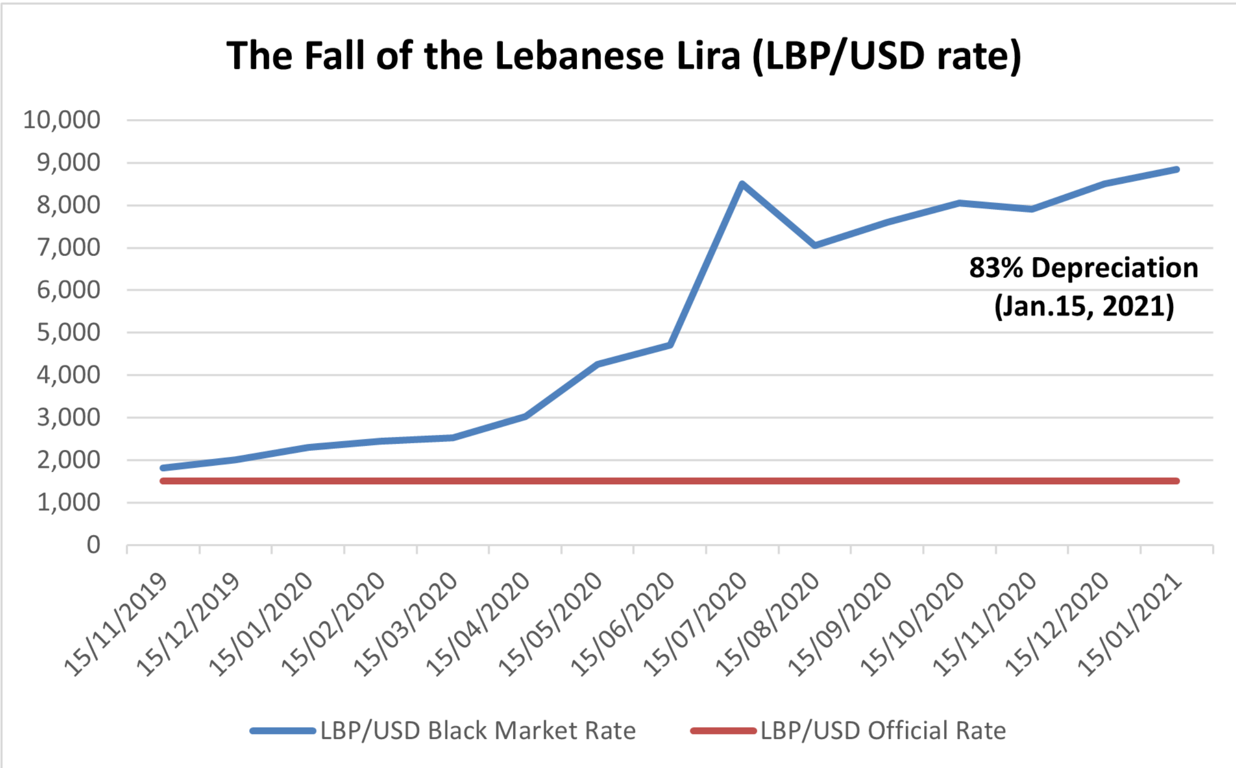
In the background, banks' relationship with correspondent banks deteriorated rapidly, with banks liable to the non-resident financial sector by around USD 3 Bn by end of September 2020, a huge contrast when comparing with historical levels. At end of June 2011, the net balance with the non-resident financial sector reached USD 12.4 Bn- the equivalent of 216% of NR Financial Sector Deposits. With the conditions changing on the ground, the banks reduced their liquidity with the non-resident financial sector and placed it increasingly with the BDL in foreign currencies at high-profit interest rates. This net positive balance was thus reduced to USD 1.91 Bn (with assets at correspondent banks at 129% of non-resident Financial Sector deposits). Despite the financial engineering that occurred from then on, the banks' balance with the non-resident financial sector turned negative for the first time at end of May 2019, to reach USD -3 Bn by end of September 2020- with assets at correspondent banks at only 60% of non-resident Financial Sector deposits, compared with a pre-2015 ratio of at least above 200%.



Source: CAS

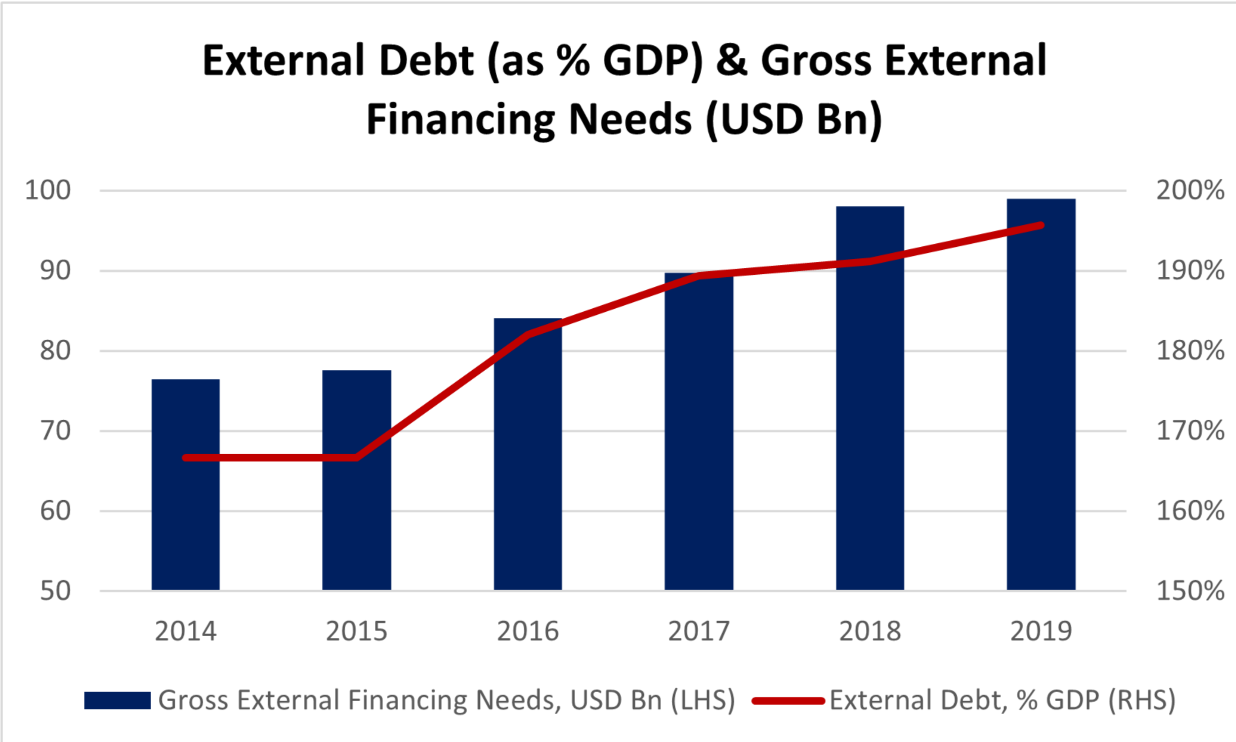
The Ultimatum

The inevitable collapse occurred in 2019 when the financial system became finally unable to produce the estimated USD 4 Bn needed annually to service debt. Crash! According to the IMF, Lebanon's short-maturity external debt had reached around 200% of GDP in 2019, with gross financing needs of around USD 100 Bn[10]. The external debt was highly unsustainable, with non-resident debt-creating flows harder to attract, forex reserves in decline, and unprecedented exchange rate risk.



Source: Lira Rate[9]

Note that by mid-March 2021, the USDLBP black market exchange rate traded at around 13,000 LBP/USD, an 88% depreciation of the Lebanese Lira since the start of the crisis.



Source: IMF

C. Where we Are Now- Monetary Chaos

BDL Printing Money- Spiralling Inflation and Nowhere to Go

Exchange Rate Meltdown vs Inflation- Which is to Blame?

Given the Lira peg to the US Dollar, the financial frenzy of late 2019 paved the way for the emergence of a black market, which has been moving further and further away from the peg as evidenced by the LBPUSD pair trading closer to 9,000 LBP/USD by end of 2020 and closer to 13,000 LBP/USD by mid-March 2021. So what has contributed to the tumbling down of the Lebanese Lira against the Dollar? Monetary-induced inflationary pressures, of course. During crises, increasing money supply within strict limits may play a positive role in supporting purchasing power and economic demand. However, increasing money supply disproportionately higher than the increase in economic output, ceteris paribus, will produce inflation. In the case of Lebanon, Lira printing went out of control, thus eroding trust in the entire economy. Against a background of a decline in state finances and an unsustainable debt stock, confidence in the Lebanese pound as a store of value and a medium of exchange was increasingly under scrutiny. On October 17, 2019, a "Whatsapp tax" imploded the system, and a run on banks ensued[11]. A meltdown of confidence in the state resulted in people hoarding dollars and stocking on food, while bank withdrawal limits resulted in lines and lines of people queuing in front of banks. Also, businesses raised prices to create buffers against potential

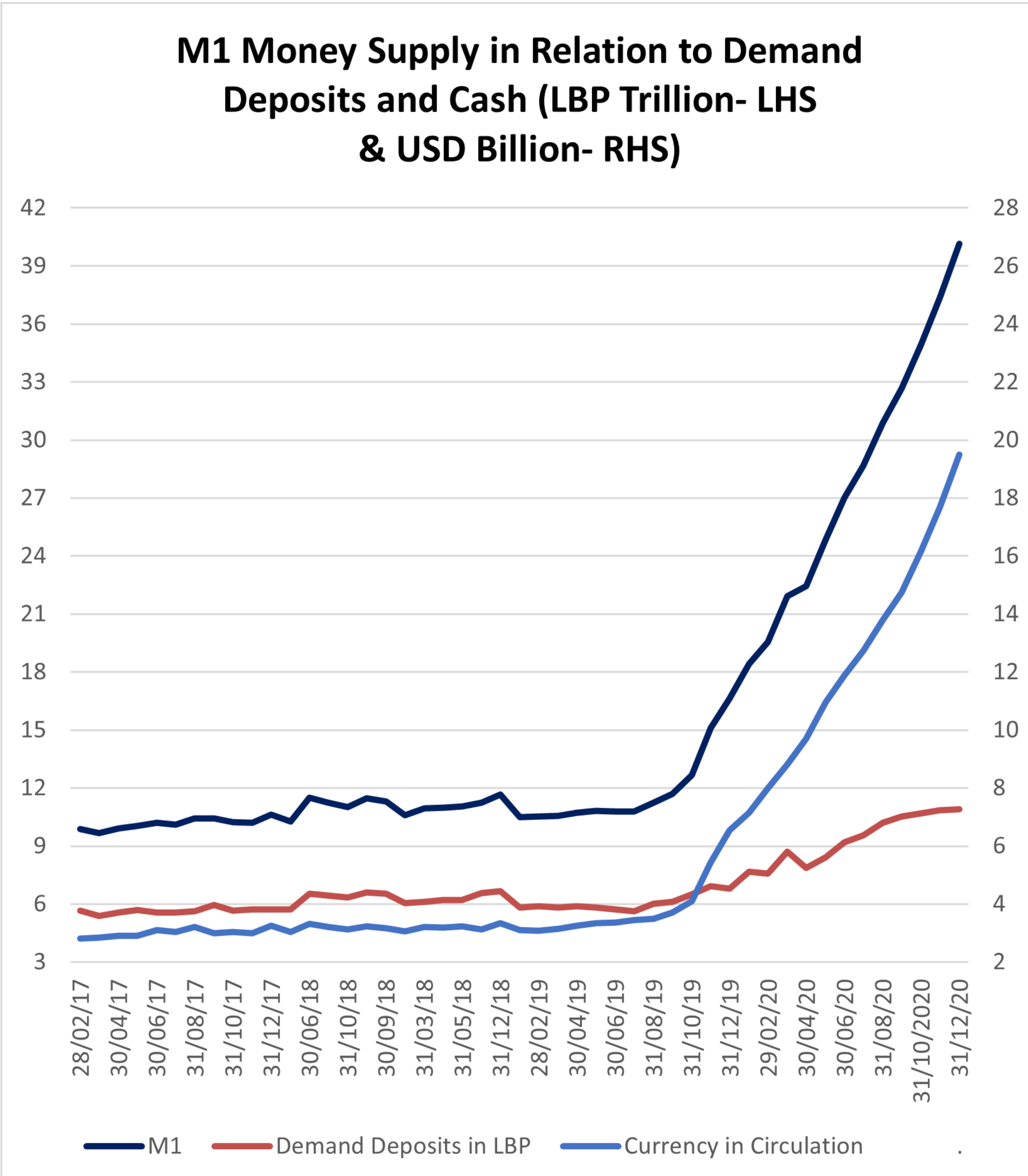
Lebanese Lira market devaluation. Fear, as well as the expectation of inflation itself, which was reflected in price level rises in the market, established a new exchange rate, one that exists and expresses itself independently of the official exchange rate set by the central bank, despite Banque Du Liban's efforts to defend the local currency[12]. Alas, this reality reinforced itself, with the masses selling the Lira in favor of real assets, particularly USD holdings in the form of cash being stashed at home away from insolvent Lebanese banks. People ceased to believe that the Lira would buy them the same value of goods and services, even more so in an economy where goods and services are mostly imported and denominated in foreign currency. Authorities tightened dollar liquidity to protect foreign currency reserves, and this reinforced the trend as well as the fall of the local currency, since people now had to withdraw their bank "Dollars" only in local currency (at a rate of 3,900 LBP/USD versus the official rate of 1,500 LBP/USD), and later sell that fiat currency at devaluating rates in return for actual physical Dollars[13]. Unsurprisingly, black market activity thrived[14]. Moreover, the Dollar stock in Lebanon is finite, while the bank deposit dollarization rate is at around 80% by end of 2020. The Lebanese central bank's monetary sovereignty involves printing Lebanese currency only, and so the only way for a Lebanese citizen to withdraw their bank "Dollars" is to withdraw them in LBP, then rush to the Bureau de Change to get real physical cash Dollars. And this has fueled the surging Lebanese money supply at an extremely higher rate than the size and pace of the economy. Everybody is rich in the strict sense that people are accessing their savings and withdrawing as much LBP cash from the banks in order to buy goods and services and cash US Dollars, both as real assets and as a store of value far away from local currency holdings. So everyone is going to the store with a ton of cash while the supply of goods and services as well as US Dollars have barely hinged. Inflation is the name of the game.

The black market exchange rates seen at end of 2020, fluctuating mainly in the 7,000-10,000 LBP/USD range, indicate a huge meltdown in confidence, with things going out of control and panic leading the market expectations rather than market fundamentals. In the absence of clear policies to anchor the currency and steer the Lebanese psyche away from panic mode, there is no ceiling to Lebanese Lira depreciation. In July 2020, the Bank of America warned that the Lebanese Lira could reach as low as 46,500 LBP/USD if the crisis was not addressed appropriately[15]. Year 2021 is already fulfilling those expectations, with the black market exchange rate trading at around 13,000 LBP/USD by mid-March 2021.

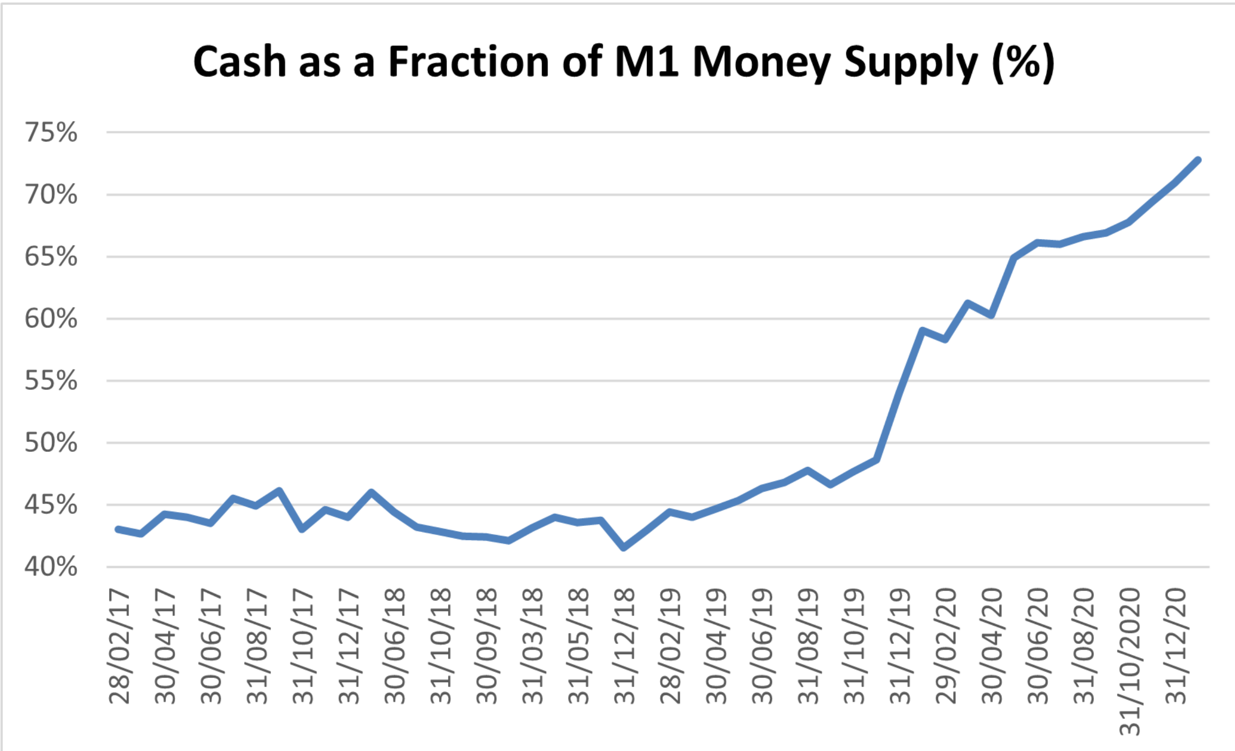
Inflationary Pressures: Cash Society Part 1

The panic mode is worrying, and it has transformed Lebanon into a cash society. In the 12 months of 2020, the BDL has been pumping over LBP 1,000 Bn a month in cash- on average around LBP 1,618 Bn monthly. This is adding pressure against the LBP/USD exchange rate. By end of December 2020, cash formed around 73% of M1 money supply (growth rate of 425% from start of October 2019)- with currency in circulation standing at USD 19.5 Bn (LBP 29.2 Tn), demand deposits in LBP at USD 7.2 Bn (LBP 10.9 Tn), and M1 money supply at USD 26.7 Bn

(LBP 40.2 Tn). Note that by end of December 2018, cash stood at 43%, in line with historical rates- with currency in circulation standing at USD 3.3 Bn (LBP 5.01 Tn), demand deposits in LBP at USD 4.4 Bn (LBP 6.65 Tn), and M1 money supply at USD 7.7 Bn (LBP 11.66 Tn).

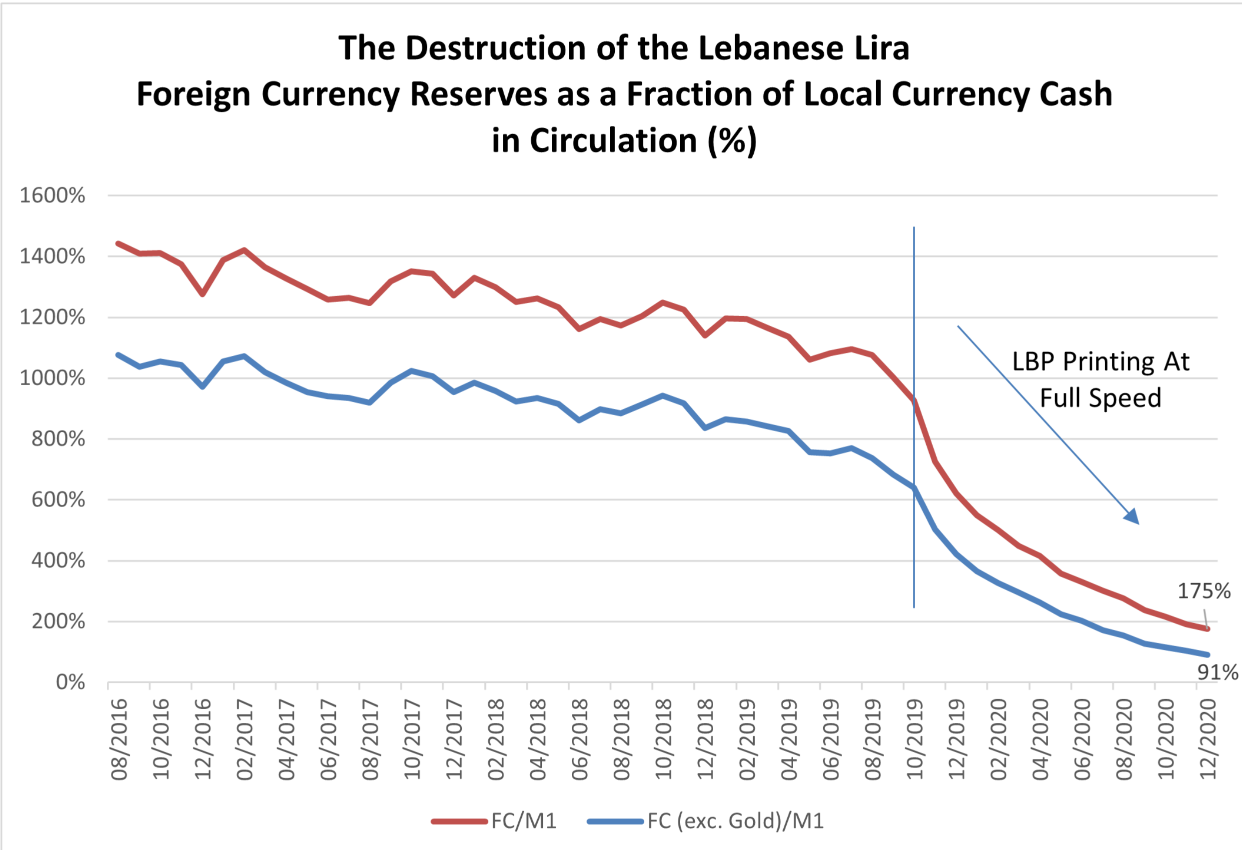

M1 Money Supply in Relation to Demand Deposits and Cash (LBP Trillion- LHS & USD Billion- RHS)
42
39
36
33
30
27
24
21
18
15
12
9
6
3
28
26
24
22
20
18
16
14
12
10
8
6
4
2
28/02/17
30/04/17
30/06/17
31/08/17
31/10/17
31/12/17
30/06/18
31/10/18
30/09/18
31/03/18
31/05/18
31/12/18
28/02/19
30/04/19
30/06/19
31/08/19
31/10/19
31/12/19
29/02/20
30/04/20
30/06/20
31/08/20
31/10/2020
31/12/20
M1
Demand Deposits in LBP
Currency in Circulation

Source: BDL

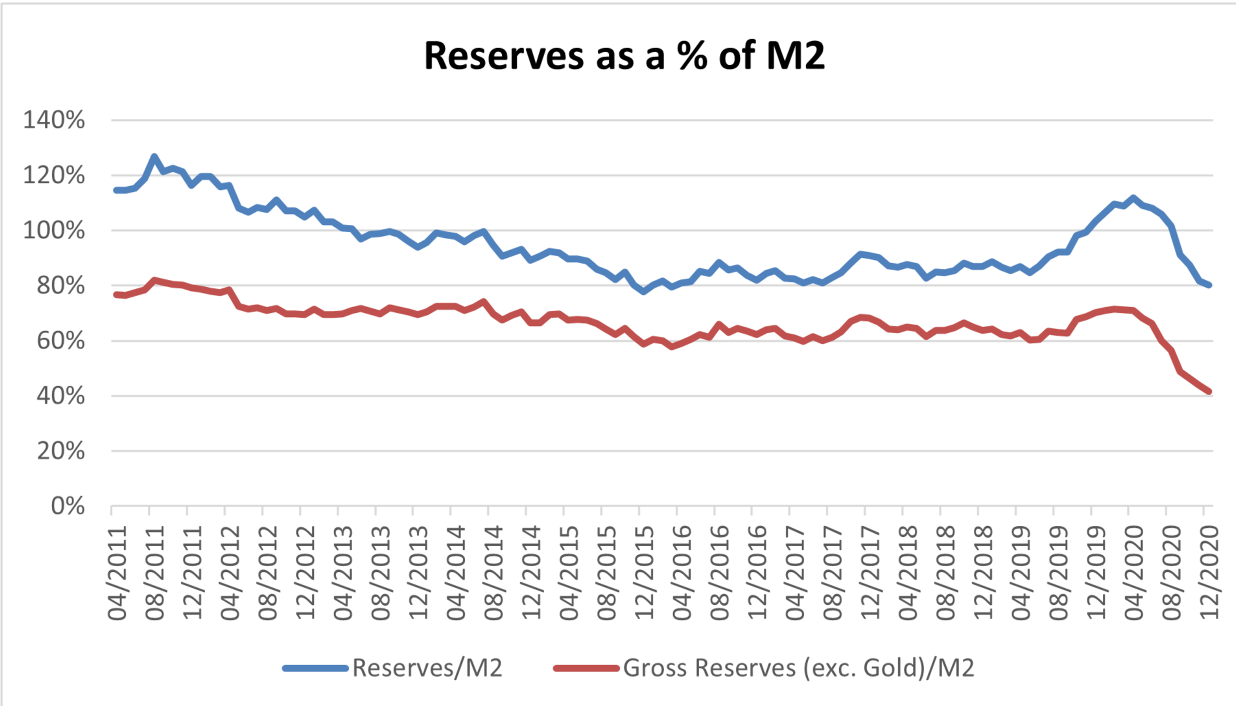

Cash as a Fraction of M1 Money Supply (%)
75%
70%
65%
60%
55%
50%
45%
40%
28/02/17
30/04/17
30/06/17
31/08/17
31/10/17
31/12/17
30/06/18
31/10/18
30/09/18
31/03/18
31/05/18
31/12/18
28/02/19
30/04/19
30/06/19
31/08/19
31/10/19
31/12/19
29/02/20
30/04/20
30/06/20
31/08/20
31/10/2020
31/12/20

Source: BDL

Author: Majd Itani
Published November 2020
Version 6- Updated May 2021



Source: BDL


Reserves as a % of M2
140%
120%
100%
80%
60%
40%
20%
0%
04/2011
08/2011
12/2011
04/2012
08/2012
12/2012
04/2013
08/2013
12/2013
04/2014
08/2014
12/2014
04/2015
08/2015
12/2015
04/2016
08/2016
12/2016
04/2017
08/2017
12/2017
04/2018
08/2018
12/2018
04/2019
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12/2019
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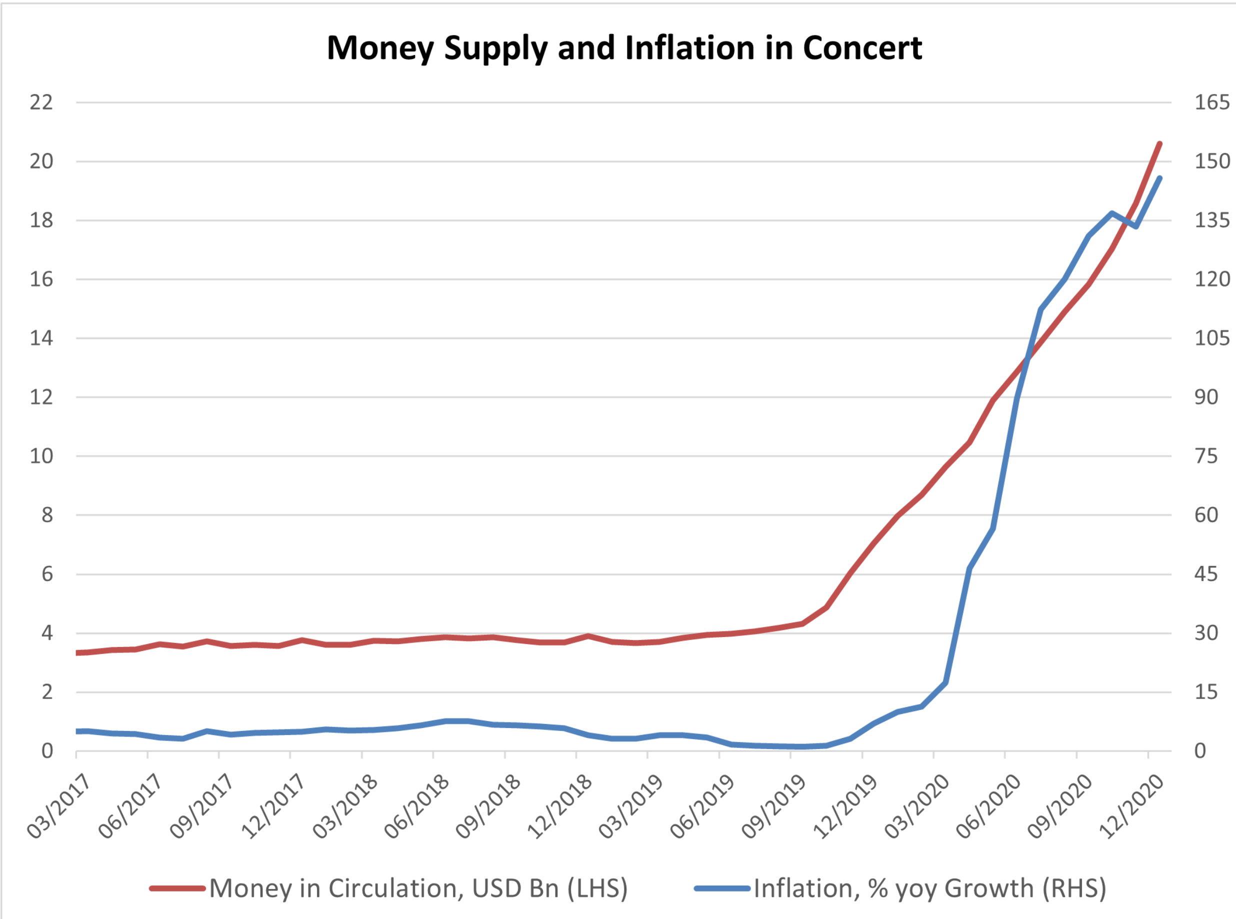
08/2020
12/2020
Reserves/M2
Gross Reserves (exc. Gold)/M2

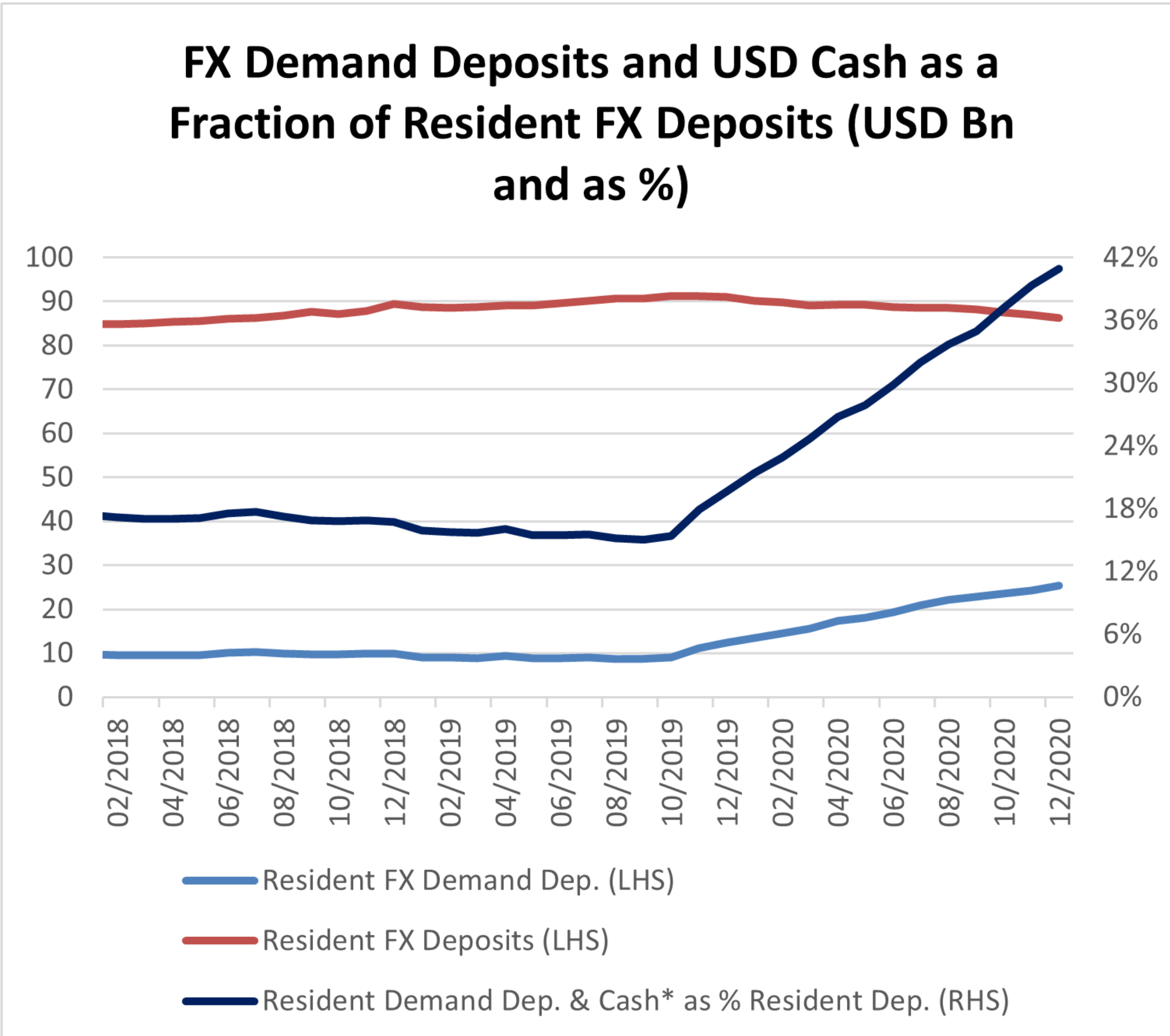
Source: BDL



Source: BDL

Inflationary Pressures: Cash Society Part 2

Adding fuel to inflationary pressures against the LBP, nobody today accepts to be paid in USD cheques or through a bank local transfer post-capital controls. These "Dollars" in banks are being withdrawn in LBP and supporting the mass selling of LBP for real cash Dollars as well as goods and services, majority of which is denominated in foreign currency. Resident demand deposits in USD have reached USD 25.6 Bn by end of December 2020, while resident FX deposits stood at USD 87.16 Bn. Accounting for an additional estimated USD 10 Bn in cash (as will be demonstrated later in this paper), resident demand deposits in USD now account for around 40% of resident FX deposits- an unprecedented level in comparison with a historical benchmark in the range of 10-15%. Note that by end of October 2019, demand deposits in USD accounted for 15% of resident FX deposits.



Source: BDL

Payment in LBP at USD Prices

So when trading of goods and services occurs in cash in LBP against a background in which goods and services are priced in USD according to the black market exchange rate, the result is a huge demand for a finite number of available dollars. In the 12 months of 2020, the monthly additional demand for LBP cash is around LBP 1,600 Bn, relative to a pre-crisis level of roughly LBP 100 Bn. At the conservative rate of 5,000 LBP/USD, or the rate of 7,000 LBP/USD, this is the equivalent of USD 230 Mn to USD 320 Mn in additional demand- which makes the inflationary spiral possible.

Buying Goods and Services vs Hoarding Cash Dollars

Author: Majd Itani
Published November 2020
Version 6- Updated May 2021

It's about time we get our hands dirty getting to the bottom of this money supply mystery. What are people doing with all those newly-printed LBP notes? If we take import data as a proxy for people's consumption trends, we learn that people's consumption (imports) has declined rapidly since the start of the crisis- by around a compounded rate of 4.9% monthly from September 2019 till September 2020, which is the furthest date for which data is available. We will take this average rate for the September'19-September'20, and assume a conservative 0% decline in consumption volume over the months of October, November ~~and December,~~ 2020 (no data for December). We also adopt the USD value equivalent for the change in the Money Supply for the month of August 2019 as an upper-bound reference point for the Dollar volume of consumption at the start of the crisis, since it conforms to consumption/levels in preceding pre-crisis months. Thereby, we go ahead and estimate the USD-denominated value of goods and services transactions in Lebanon using the money supply, assuming a 4.9% monthly decline in line with the contraction in consumption (imports). Accordingly, the value of goods and services traded declines from USD 110 million (our reference point) in September 2019 to USD 60 million in November 2020. Since transaction prices are USD-denominated, but fulfilled in Lebanese Lira, then the funding of these transactions occurs at the black market rate which varied across the duration at hand. As the table demonstrates, goods and services transactions (assuming all else equal, including velocity of money etc..) are estimated at around LBP 4.6 trillion and explain only 27.5% of the change in the money supply over the September 2019 to end of November 2020 period. Correspondingly, it is estimated that the remaining money pumped- around LBP 16.9 trillion (72.5%)- has gone towards demand for cash Dollars which people are hiding at home as a hedge against future uncertainty. Accounting for black market fluctuations in the exchange rate across the duration at hand, it is estimated that the former LBP-denominated value is equivalent to USD 5 billion in physical cash that has been acquired from September 2019 till November 2020. If we add the estimated USD 5 billion cash dollar notes that are estimated to be in circulation prior to the start of the crisis, then adding both figures results in an estimate of around USD 10 billion currently hoarded at home. This is in line with the BDL chief's recent statement in which he remarked that around USD 10 or 11 Bn are being stored inside homes.

Note: The above analysis used dollars (the actual USD) to approximate consumption, while using black market exchange rates to identify Lira cash needs to fulfill transactions across different points in time during the crisis, and by extension the value of hoarded USD cash. This is a simplification of the real world but serves the purpose of this exercise.

Rough Approximation the Stock of Cash Dollars Hoarded During the Crisis						
	Black Market Exchange Rate (USD)	Dollar Demand for Goods and Services (USD Mn)	LBP Goods and Services Transactions (LBP Bn)	LBP Other Transactions (LBP Bn)	Dollar Hoarding (USD Mn, approx.)	Total Dollar Stock (USD Mn, approx.)
09/2019	1680	110	184.8	34.3	20.4	5020.4
10/2019	1730	105	181.0	650.3	375.9	5396.3
11/2019	1,820	99	181.1	1568.5	861.8	6258.1
12/2019	2,010	95	190.2	1318.4	655.9	6914.1
01/2020	2,300	90	206.9	1186.5	515.9	7429.9
02/2020	2,450	86	209.6	884.6	361.1	7791.0
03/2020	2,525	81	205.5	1193.8	472.8	8263.8
04/2020	3,020	77	233.7	1011.0	334.8	8598.6
05/2020	4,250	74	312.8	1836.9	432.2	9030.8
06/2020	4,700	70	328.9	1113.7	237.0	9267.7
07/2020	8,500	67	565.7	965.2	113.5	9381.3
08/2020	7,050	63	446.2	1094.0	155.2	9536.4
09/2020	7,600	60	457.5	927.6	122.1	9658.5
10/2020	8,050	60	484.6	1342.7	166.8	9825.3
11/2020	7,900	60	475.5	1838.5	232.7	**10058.0**
Total		**1,197**	**4,664**	**16,966**	**5,058**	**10,058**

Source: BDL, Lira Rate, Author's Analysis

D. The Status Quo

GoL Defaults on Eurobond Payments due March 12, 2020

Following its decision to default on the USD 1.2 Bn Eurobonds maturing on March 12, 2020, Lebanon suspended all principal and interest payments on foreign currency debt, the first time in its history[17]. On the eve of the default, Eurobonds were traded at 57 cents to the dollar, while yield surged astronomically[17]. The move was viewed unfavorably by many, especially that "Eurobonds are a small part of external financing needs", and this will have long-lasting effects on the country's ability to access debt markets for the foreseeable future[18]. Lebanon is a fragile state; these developments are likely to compromise its ties with foreign creditors and the Lebanese diaspora substantially and irreversibly. Given that the move was not coordinated with the IMF nor with creditors, and in the absence of any vision as to how to move forward, Lebanon's default will go down in history as the most disorganized sovereign debt default. By end of March 2021, neither IMF negotiations nor a debt restructuring agreement with creditors had been reached.

Author: Majd Itani
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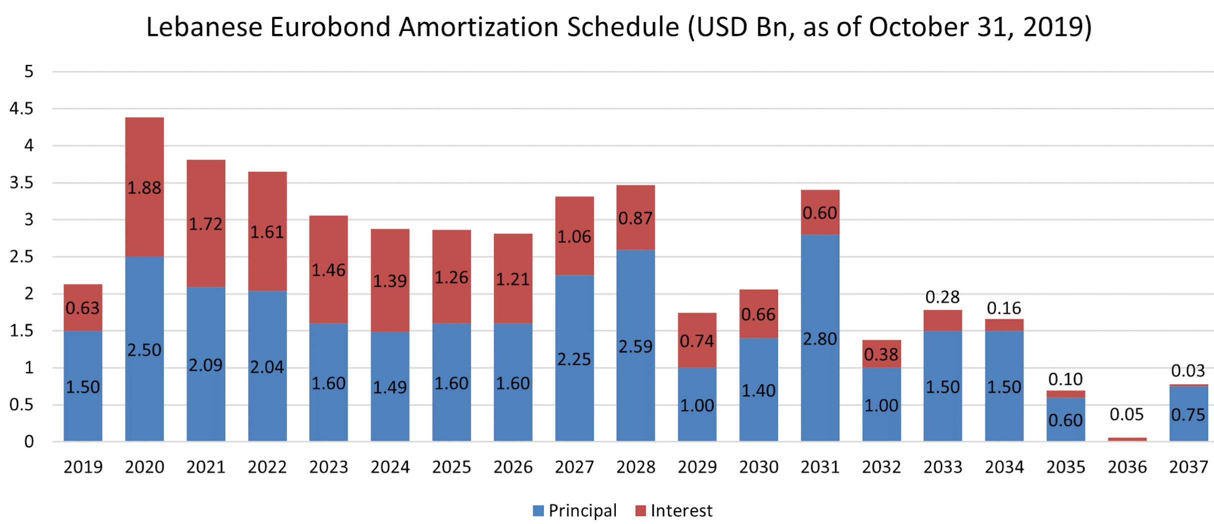


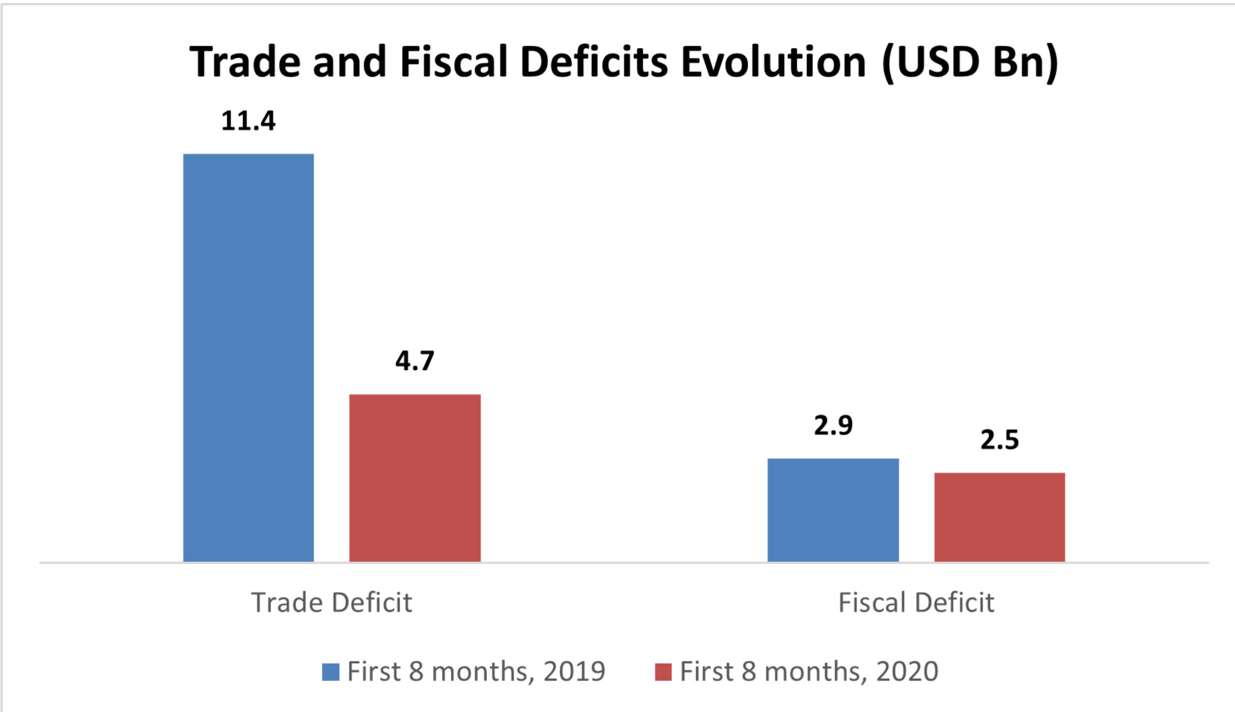
Source: Ministry of Finance

First 8 Months of 2020 Reveal Persistent Unsustainable Debt and Finance-Structural Fiscal Adjustment is the Priority

According to the most recent data available, in the first 8 months of 2020, Lebanon witnessed a trade deficit contraction by around 59% y.o.y., reaching USD -4.7 Bn from USD -11.4 Bn for the same period in 2019. Imports had declined by 50% while exports declined by 8.3% in the first 8 months of 2020. The trade balance developments should not be viewed favorably; rather, they merely reflect the large worsening of Lebanon’s living conditions, especially in the absence of a plan to tackle structural imbalances in the system, namely the CA deficit and the inability to attract economy and productivity-induced financial inflows.

The first 8 months of 2020 also witnessed a decline of the fiscal deficit by 14.1%. Total public expenditures fell by 18.5% to reach USD 8.72 Bn (at the official rate of 1,500 LBP/USD), owing to the GoL’s March default and subsequent fall in interest payments. In turn, total public revenues fell by 20.2% to reach USD 6.17 Bn, the reason being the ongoing economic crisis that prevails at the expense of the economy.
In total, the overall public finance deficit decreased from USD -2.9 Bn to USD -2.55 Bn, a change of around -14%. However, the deficit as a percent of public spending increased to 29.2%, up from 27.7%. The picture is even darker when taken as a percent of GDP, given the huge GDP meltdown projected for year 2020- estimated at USD 19.5 Bn. Moreover, the primary balance turned negative in the first 8 months of 2020, reaching USD -1,136 Mn, down from USD 369 Mn, and emphasizing the unsustainable public finance outlook in Lebanon relative to the

size of its economy. Lebanon's root problems live on, yet in a depressed economy and unprecedentedly isolated from its historical global allies and its natural Arab environment.



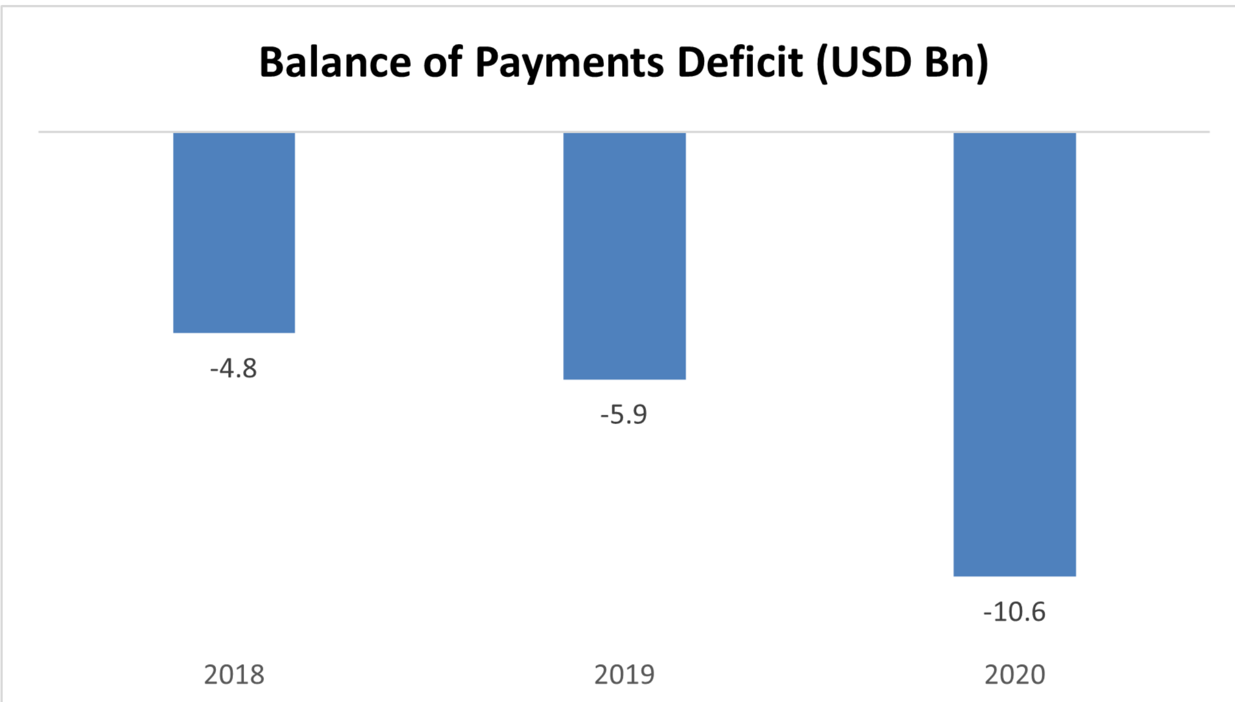
Source: BDL, Ministry of Finance

Large BOP Deficit- BDL is Bleeding whatever Remains of Depositors' Gross Reserves

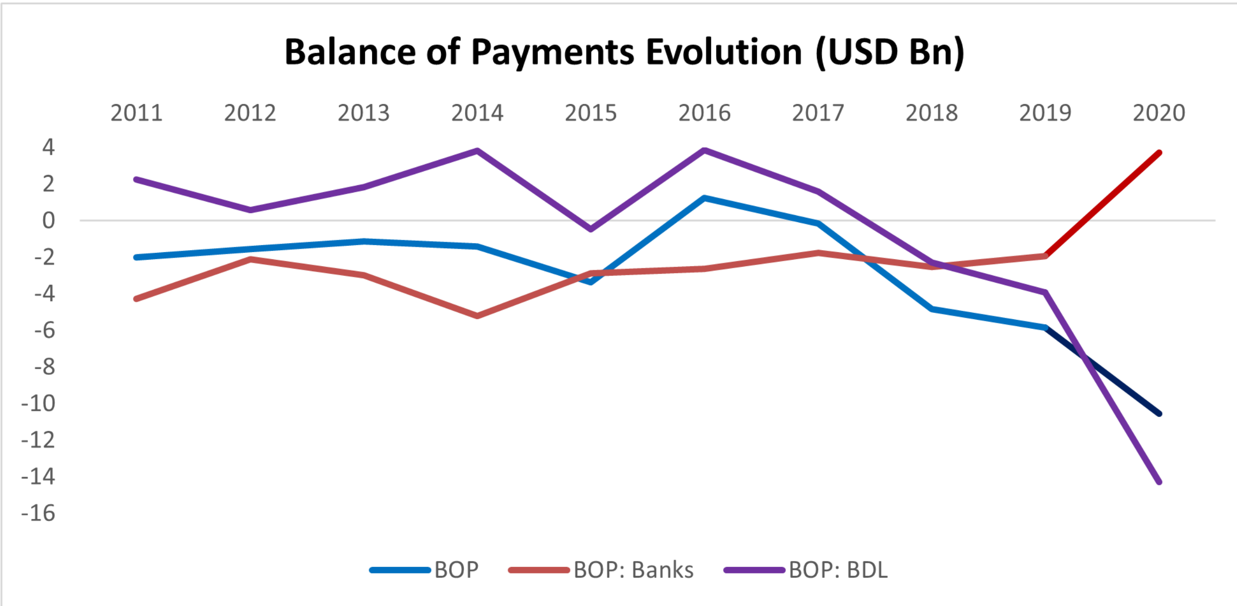
As a result, in the 12 months of 2020, Lebanon recorded a Balance of Payments deficit of around USD 10.5 Bn, compared to a deficit of USD 5.8 Bn by end of December 2019. Net Foreign Assets of BDL fell by USD 14.3 Bn, while Net Foreign Assets of commercial banks increased by USD 3.7 Bn.

Many questions are left unanswered regarding the BDL bleeding its remaining gross reserves at an unprecedented rate. The fact is that only a fraction of the USD 14.3 Bn spent by BDL has gone towards the subsidies schemes- including the inefficiencies and corrupt practices, as well as hoarding of subsidized goods that is occurring. If half the amount roughly was spent by BDL on subsidies, then there are billions of dollars that have been spent that would otherwise contribute decisively in any financial restructuring plan, and would help reduce the losses inflicted on depositors once all is said and done. However, till now, there is a lack of transparency surrounding BDL's accounting. What is the exact value of remaining gross FX and liquid FX reserves? How much is BDL spending on imports every month? What is the Dollar/Lira composition of bank deposits at BDL? Has BDL used FX gross reserves to pay back a portion of commercial bank deposits since the crisis began? What is the USD/Lira composition of BDL loans to commercial banks? Nobody knows..

These questions are vital, given the importance of safeguarding what remains of BDL gross reserves. Any missteps come at the cost of an even harsher restructuring and a bigger burden imposed disproportionately on the depositors. The country will need every last US Dollar available if it indeed intends to get out of this hole. Only a forensic audit of BDL, followed by a fair restructuring procedure, can help quash all doubts and gain the trust of donor countries that are prepared to help the Lebanese people[19].



Source: BDL

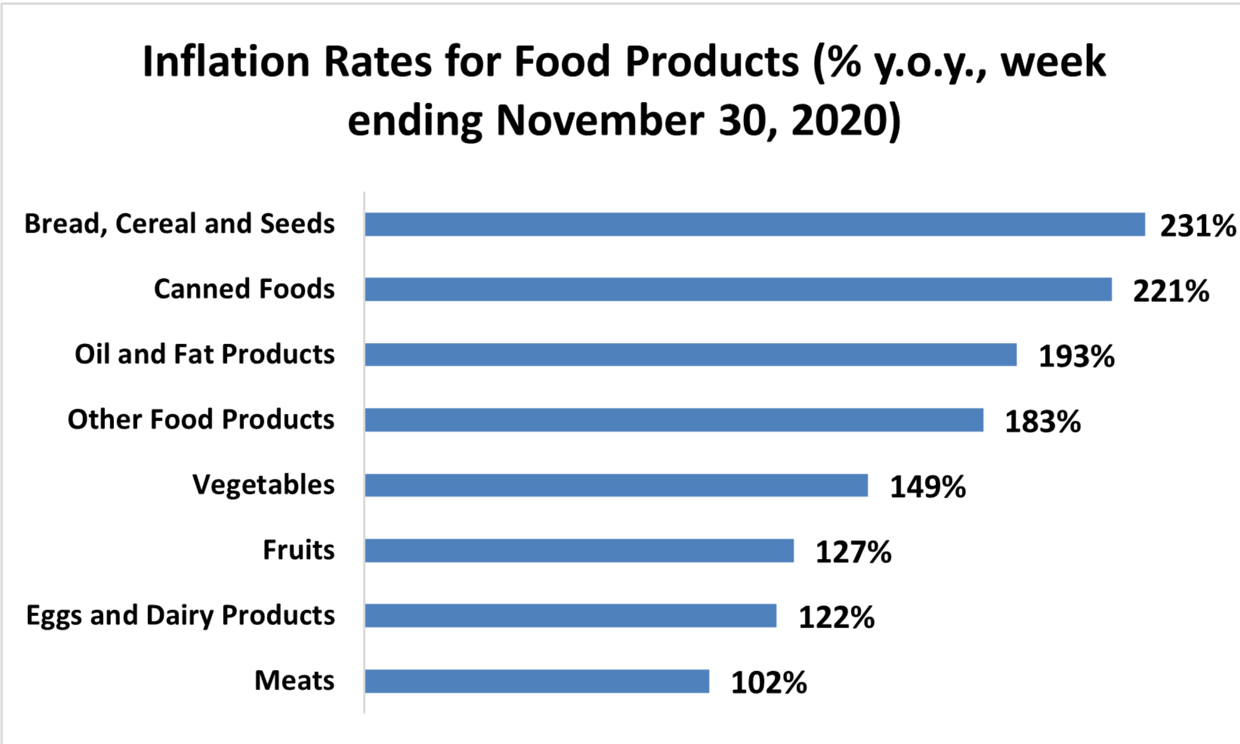


Source: BDL

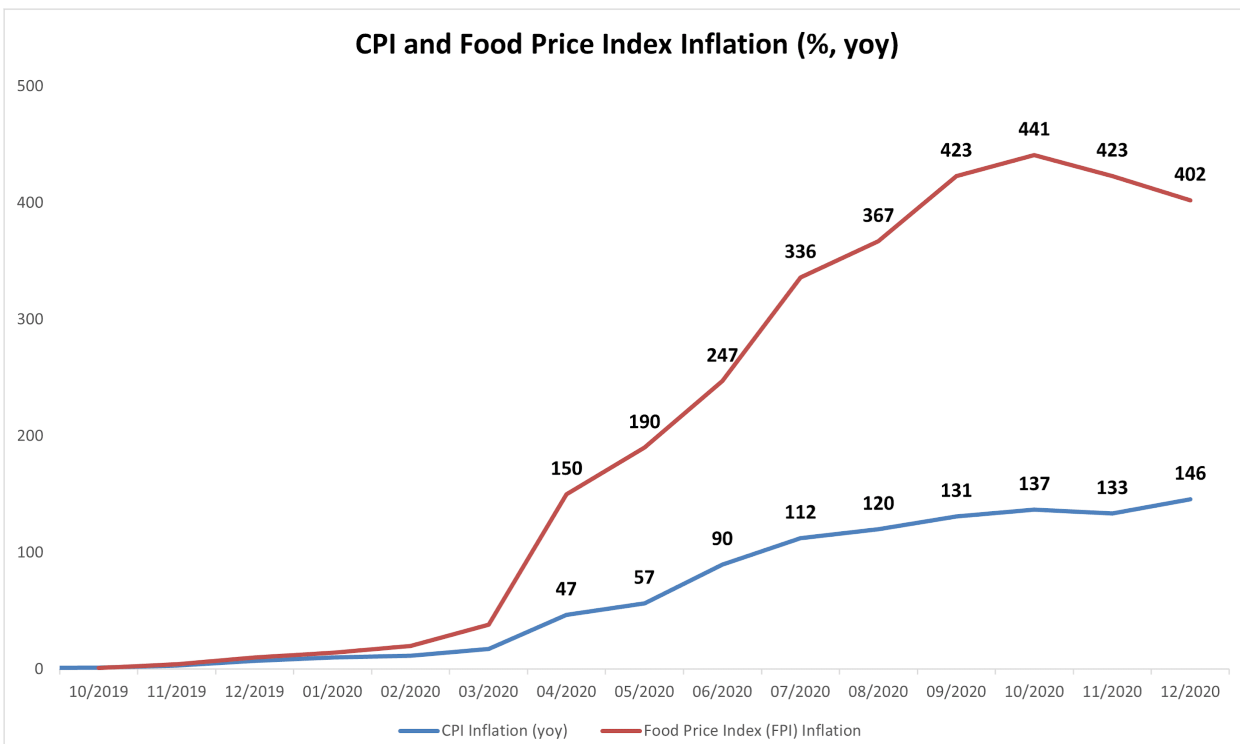
Inflation Hits a Historical 146% a Year After the Crisis Began

Lebanese people continue to struggle as more and more businesses shut down, people lose their jobs, and purchasing power plummets further via hyperinflation. The multiple crises occurring simultaneously in Lebanon- from the financial crisis, to COVID-19, to the August 4th explosion, as well as restrictions on access to foreign currency- have resulted in a food security crisis. According to ESCWA, over 50% of the population in Lebanon are at risk of failing to access basic food needs by end of 2020. Inflation has skyrocketed; by end of December 2020, the CPI hit 146% y.o.y. (CAS). By end of December 2020, the Food Price Index registered 'all-time-highs' inflation of 402% (CAS). The World Food Program's monthly average food Survival Minimum Expenditure Basket (SMEB) Price registered an increase of 189% by end of December 2020.

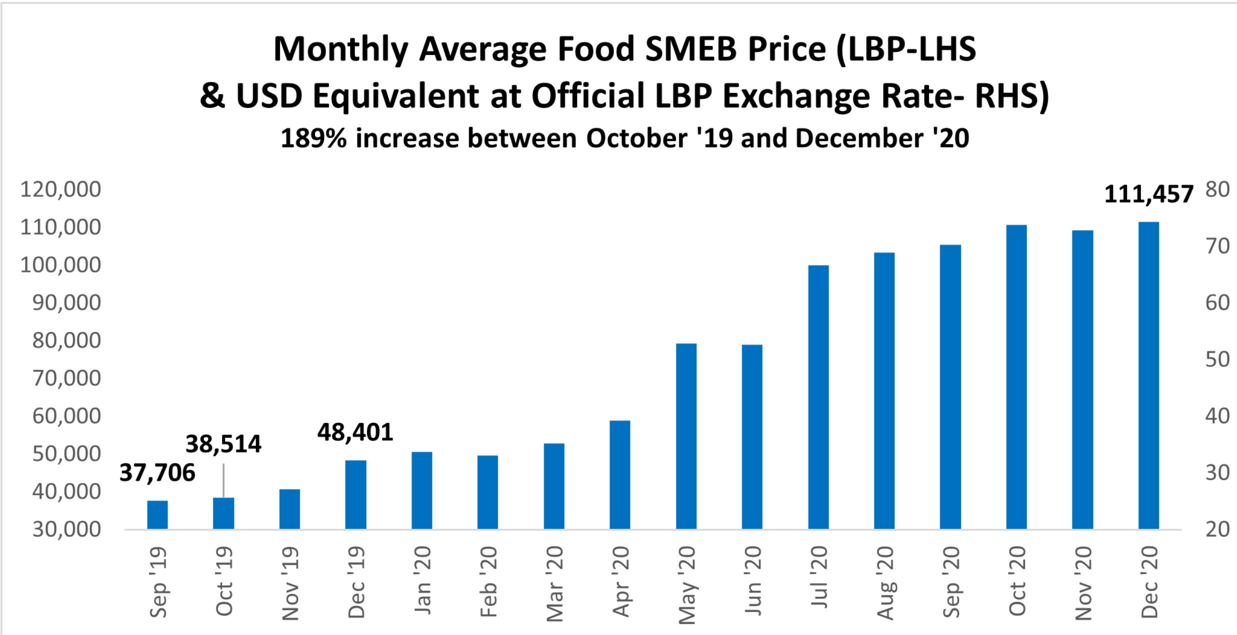
Social living conditions are deteriorating fast. In May 2020, the headcount poverty rate had reached 55%, up from 28% in 2019, according to ESCWA[20]- and that was before the August 4 doomsday. Additionally, as a result of the August 4th explosion, 300,000 people are homeless and 50,000 residential and economic units have been heavily damaged. Lebanon is on the brink of a humanitarian catastrophe[21].



Source: CAS



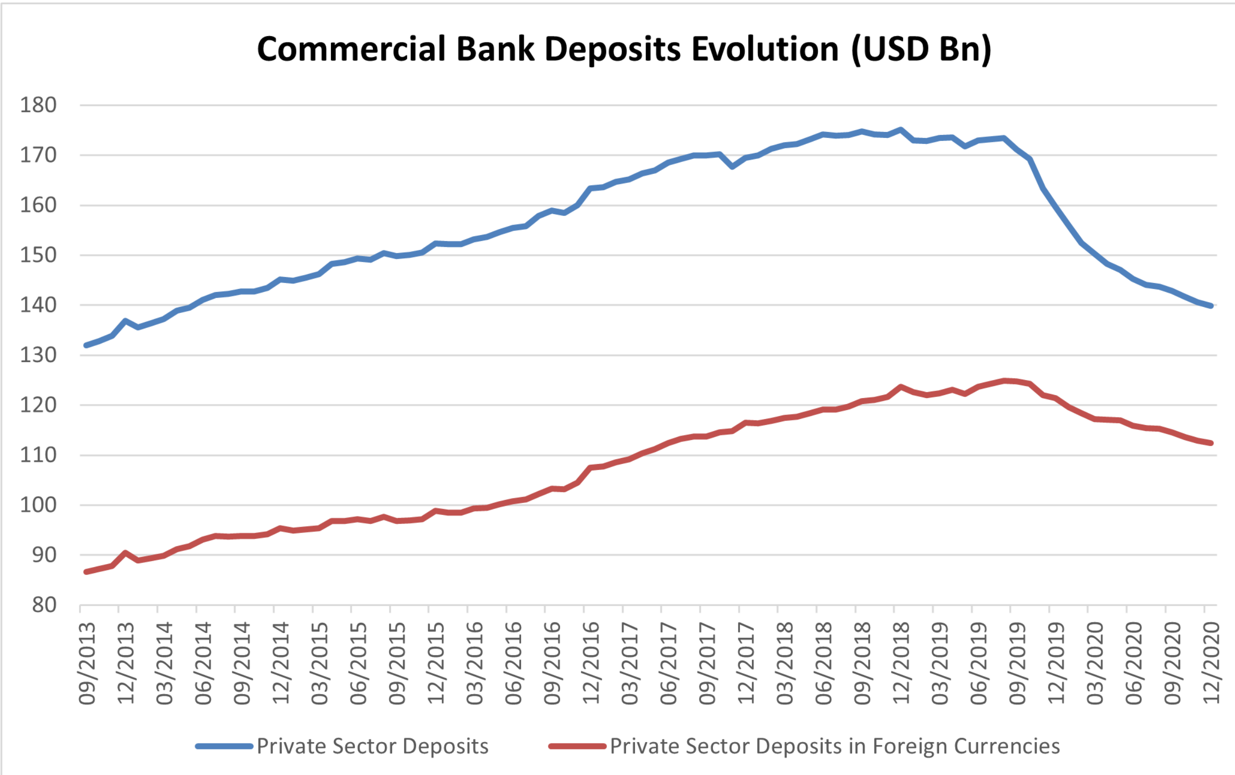
Source: CAS



Source: World Food Programme, 2019 and 2020

Prevailing Status Quo- Depositors Single-Handedly Cleaning Bank Balance Sheets

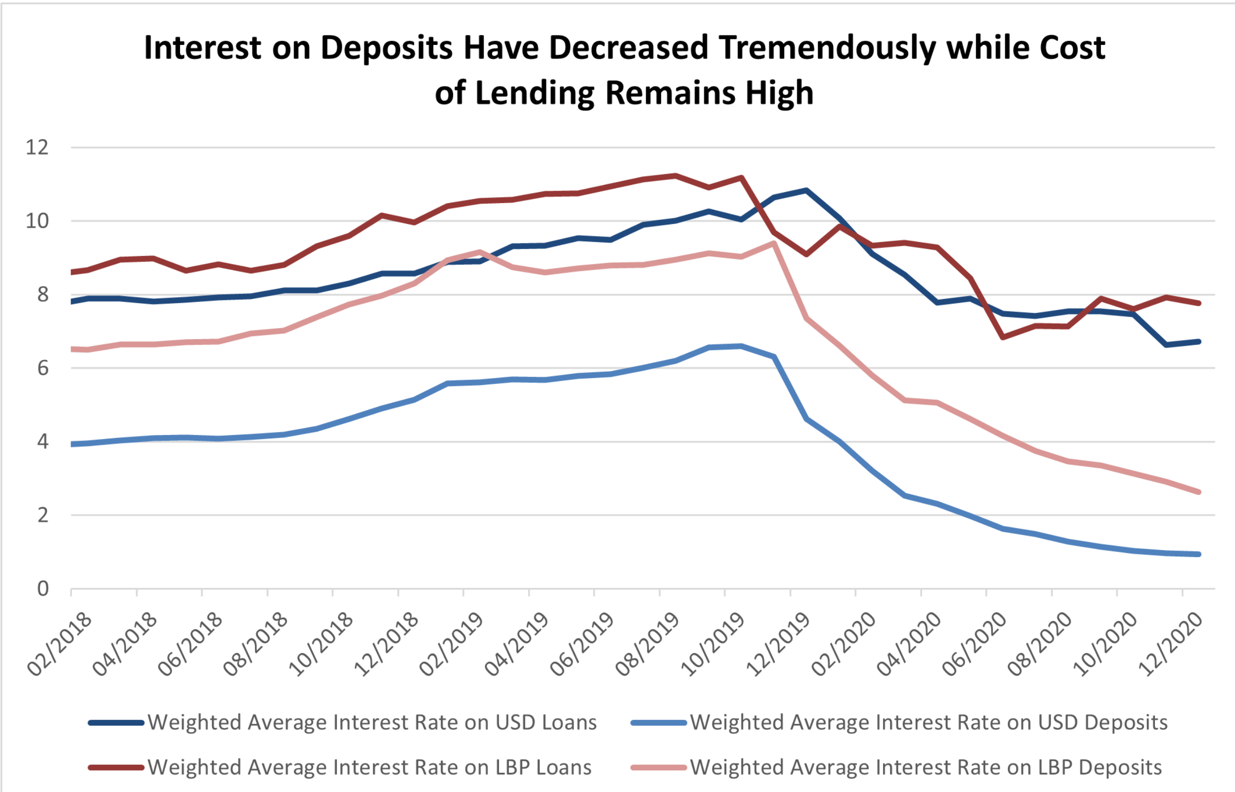
The status quo that has prevailed is one in which the country does not seem anywhere near enacting any reforms or making solid steps towards adopting a resolution to the financial/political crisis. Since April, people have been allowed to withdraw money from their USD accounts- but only in local currency, and at a rate of 3,900 LBP/USD (versus the out-of-reality official rate of 1,500 LBP/USD). When comparing with the de-facto exchange rate of 8,500 LBP/USD at mid-December 2020, depositors are thereby inflicted a haircut of 54% on every Dollar withdrawn. This contributed highly to banks' customer Dollar deposit liabilities decreasing by around USD 12 Bn (10%) to around USD 112.4 by end of December 2020, down from around USD 124.3 Bn by end of October 2019. More broadly, banks' customer deposits plummeted by USD 29.4 Bn (17%) to reach USD 139.8 Bn, down from USD 169.2 Bn over the same duration.
Passing a capital controls law as soon as possible to protect depositors is paramount- yet the status quo prevails.



Source: BDL

Banks Struggle to Minimize Losses

In response to the economic developments in the country, the central bank's Circular 147 issued new regulations starting December 2019 that placed caps on interest rates earned by new or renewed deposits- a 5% cap on USD Deposits and an 8.5% cap on LBP deposits. Following, the Association of Banks in Lebanon (ABL) reduced the Beirut Reference Rate (BRR) lending rate on USD-denominated loans from 9.35% to 8.5% and LBP-denominated loans from 12.45% to 11.5%[22]. In February 13, 2020, BDL issued its intermediate circular 544 setting new ceilings on deposit interest rates, which the ABL responded to by reducing the BRR on USD lending from 8.5% to 6.75% and on LBP lending from 11.5% to 9%[23]. A look at the resulting spreads between weighted average lending rates and weighted average deposit rates does a good job at describing the state of Lebanese banks. At the end of October 2019, weighted average rates on LBP lending and deposits were 11.19% and 9.03% respectively; weighted average rates on USD lending and deposits were 10.05% and 6.61% respectively. At the end of December 2020, weighted average rates on LBP lending and deposits were 7.77% and 2.64% respectively; weighted average rates on USD lending and deposits were 6.73% and 0.94% respectively. Despite bank costs going down tremendously, lending rates remain high, and this net spread is supporting banks' efforts to reduce losses incurred by the banking sector's exposure to the public sector. Meanwhile the Lebanese economy struggles.

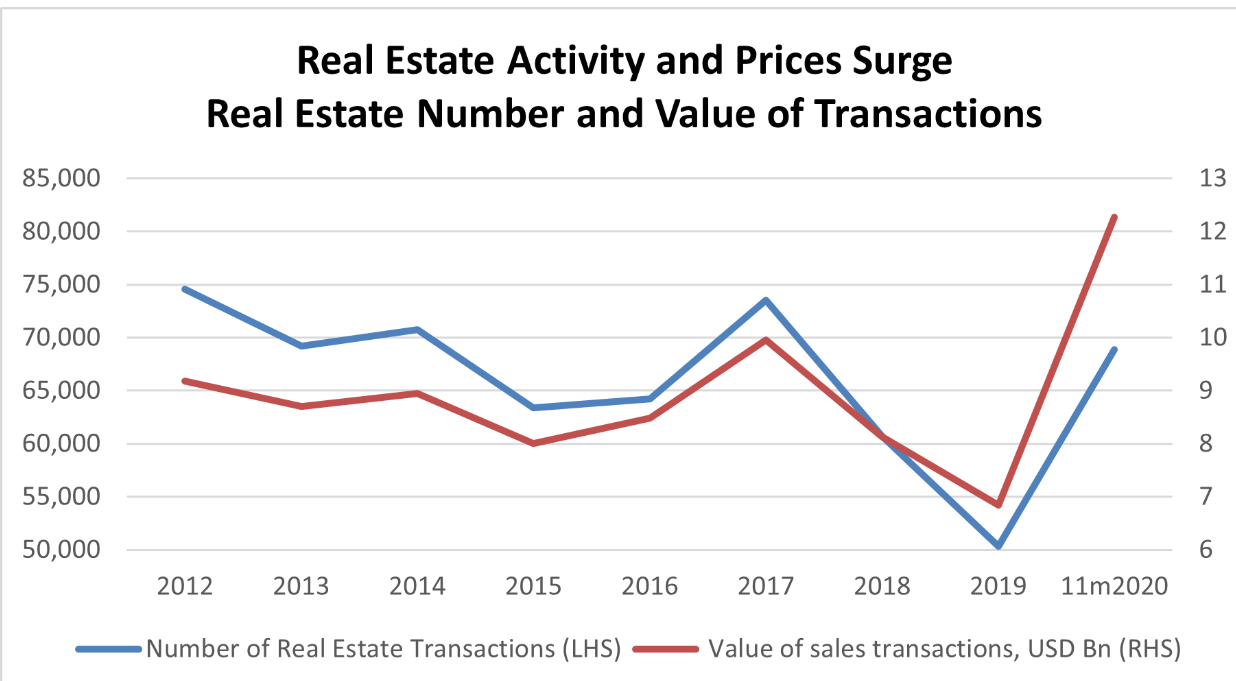


Source: BDL

Depositors Rush towards Cash Liquidity and Real Estate

Depositors today fear the reality that their money in banks awaits a mammoth haircut, as well as a potential forced Lira-fication. The reaction so far has been a rush to acquire “real assets” as a store of wealth away from exposure to the insolvent Lebanese financial system. However, given the recently adopted additional restrictions on local currency withdrawals from banks (on top of the already-existing foreign currency restrictions), the LBP local currency deposited at banks, and which is now paid via bank cheques, has devalued against the cash LBP- and this has intensified even more the movement towards a totally “cash society” away from banks as payment intermediaries. Thus, people are hoarding cash Liras and USDs, with detrimental effect on the LBP through the inflationary effect posed by the black market demand for dollars. Moreover, the bank LBP deposits (non-cash) are losing status as a medium of exchange, with virtually all business and trade demanding cash LBP.
The only exception was the real estate sector, which, for the first 3 quarters of 2020, was reducing its high debt exposure to the local banking sector, which in turn accepted LBP cheques and continued to close its private sector loan portfolio and deleverage its balance sheets. In the first 10 months of 2020, real estate transactions totaled 62,773- an increase from 40,863, or

53.6%, for the same period in 2019. The volume of real estate transactions reached USD 11.3 Bn in the first 10 months of 2020, an increase of 115.5% from USD 5.2 Bn for the same period in 2019. In terms of the average value per transaction, it reached USD 180,008 in the first 10 months of 2020- an increase by 40.3% from an average of USD 128,310 for the same period in 2019. This new, elevated, price level factors in the fact that bank cheques are devalued relative to cash, hence the higher bank cheque price tags on real estate. Since the majority by far of the USD 11.3 Bn dollar value for 2020 real estate transactions does not account for this distinction, it is noteworthy to mention that redenomination at an exchange rate of 3,000 LBP/USD returns an adjusted dollar value of USD 5.65 Bn- much lower than the nominal value. By end of November 2020, the real estate sector had reduced its debt exposure to the banking sector considerably, and this explains the recent move away from bank cheques as an acceptable form of payment for real estate, and the resultant demand for a significant portion of the price tag in USD physical cash.



Source: General Directorate of Land Registry and Cadastre

The False Choice- Burning Through Depositors' Required Reserves vs. Removing Subsidies

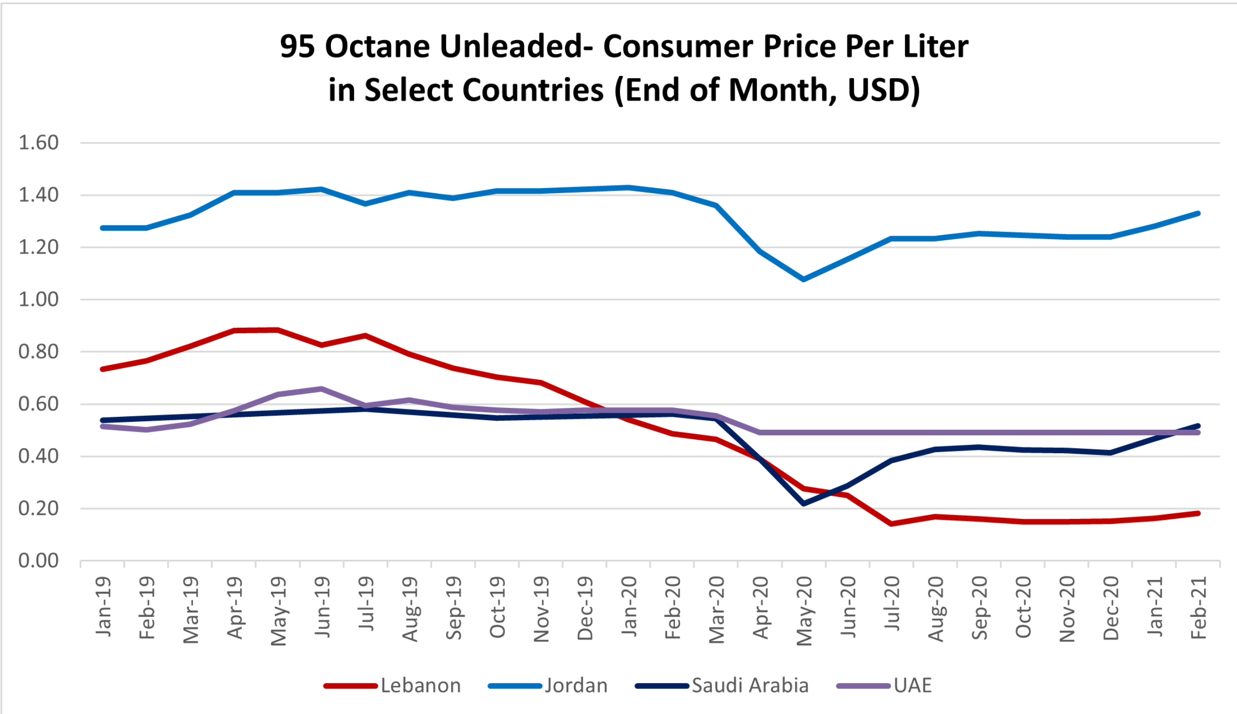
As BDL foreign assets decline, and in the absence of an economic roadmap for the country, it is inevitable that the BDL will have to downsize if not rescind the subsidies programs that it currently operates- with detrimental impact on the living conditions of the majority of the Lebanese society[24]. Energy and fuel subsidies, for instance, cost the BDL a staggering USD

300 Mn each month, of which a significant chunk goes to Electricite du Liban (EDL) in the form of transfers. Removing energy subsidies would most certainly fuel hyperinflation, given the economic dependence on hydrocarbons and fossil fuels.

On the other hand, there are voices demanding the BDL to reduce the required reserve ratio from 15% to 12% or any other level, allowing the BDL to free up foreign currency resources that can be used to prolong financing subsidy programs for another few months. Advocates of this viewpoint do not recognize that the remaining required reserves- around USD 17 Bn according to the BDL governor's last speech- are actually entirely depositors' money, and will be crucial in any potential financial recovery plan for the country[25].

The crux of the story is that depositor money should be safeguarded, rather than spent to prolong an inefficient subsidies program that has, through corruption, failed to serve its intended recipients- the Lebanese people. Instead, the Lebanese officials should muster a deal with the IMF, pass a Capital Controls Law, allocate losses fairly, remove subsidies gradually in parallel with currency devaluation and an efficient social safety net program, and liberalize the currency in a managed manner to achieve one exchange rate for all Lebanon. Implementing these measures is the only way to avert extreme poverty and chaos.

In fact, Lebanon's subsidies program is a huge source of drain, with minimal effect on the deteriorating lives of the Lebanese people[24]. Most notable is Lebanese energy subsidies, which, with the collapse of the Lebanese pound, have caused brazen illegal smuggling activity to prosper across the border with neighboring Syria. Incompetence at securing the borders to control smuggling have been so insufficient, allowing smuggling to occur in such a blatant, barefaced manner. Blame the smugglers? In fact, Lebanese 95 Octane Unleaded energy prices, for instance, are among the cheapest in the world. By end of February 2021, Octane 95 Unleaded consumer price stood at USD 0.18 per liter in Lebanon[26], while Saudi Arabia, a global energy producer, sells to the end-consumer at around USD 0.52 per liter[27]. Note that Lebanon is not an energy producer; rather, all energy products are imported. Another example is Jordan, a neighboring country; it sells 95 Octane Unleaded energy at USD 1.33 per liter[28].



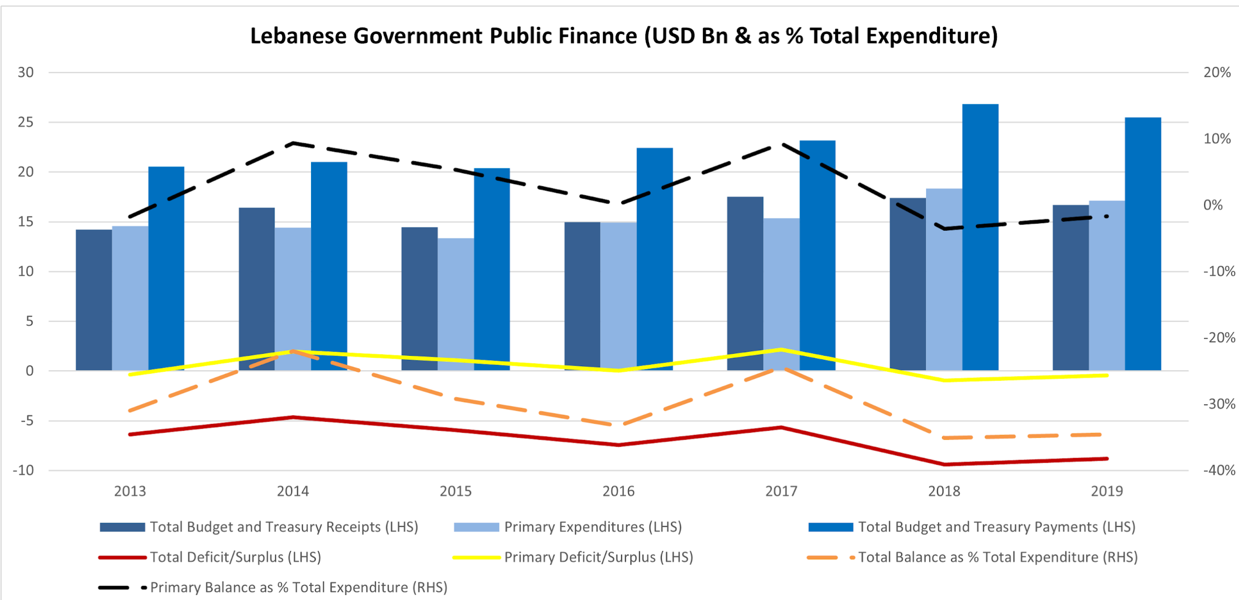
Source: Lebanese Ministry of Energy and Water, Saudi Arabian Ministry of Energy, Jordanian Ministry of Energy and Mineral Resources, UAE Ministry of Energy and Infrastructure [26, 27, 28, 29]

Implementing a Social Safety Net with the World Bank

In 2017, the UNDP placed Lebanon at 129th out of 141 countries in terms of income inequality based on the calculated Gini coefficient[30]. Bank deposit ownership says a lot about the state of inequality in Lebanon. In November 2020, less than 1% of bank accounts owned 46% of bank deposits (a mask for private wealth). Additionally, less than 2% of bank accounts held 59% of bank deposits, while around 5% of bank accounts owned around 75% of banking private sector deposits.

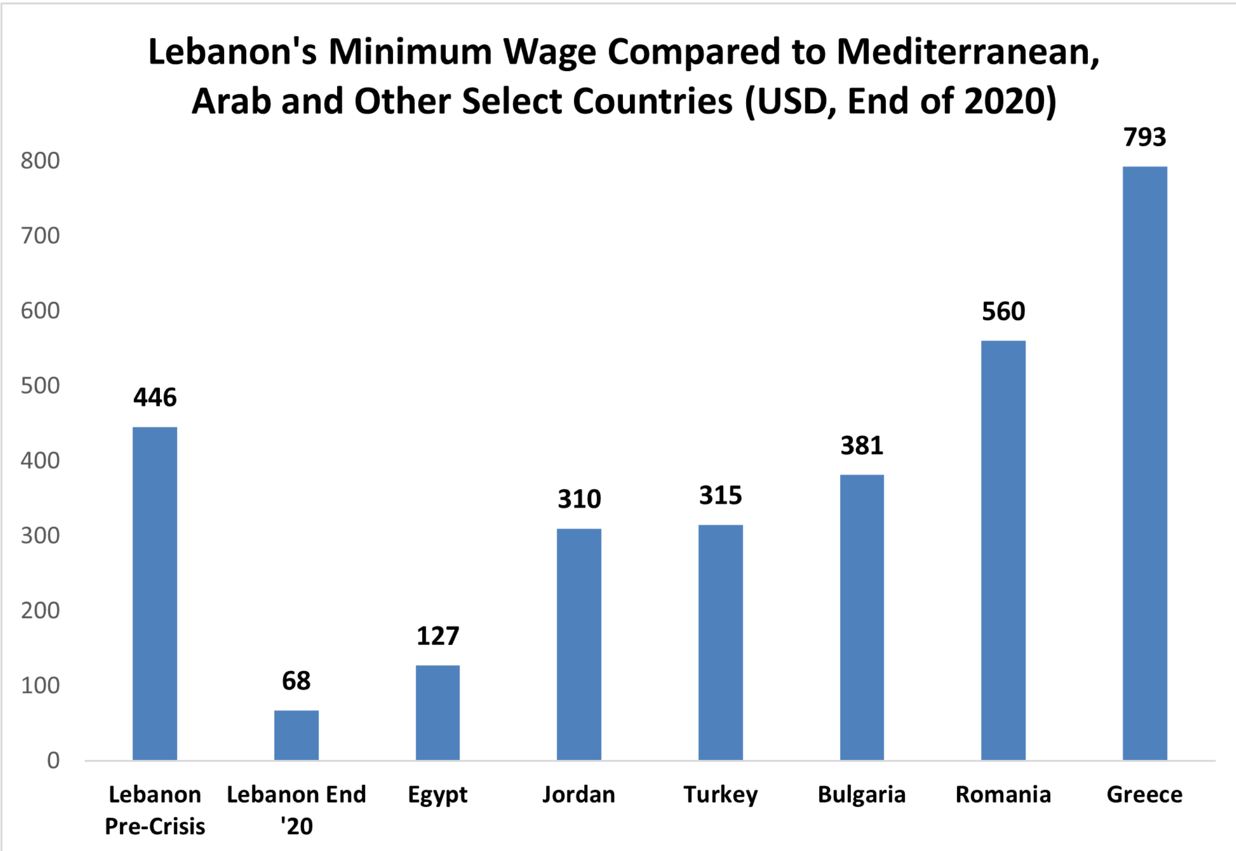
In January 2021, the World Bank approved a USD 246 Mn, 3-year project- the “Emergency Crisis and COVID-19 Response Social Safety Net Project (ESSN)”. The ESSN will “provide cash transfers and access to social services to extreme poor and vulnerable Lebanese populations affected by the economic and COVID-19 crises”. Under the main component of the ESSN- ‘Component 1’, the project allocates USD 204 Mn to be distributed in the form of cash transfers through pre-paid electronic cards for around 786,000 poor and vulnerable Lebanese citizens- or around 147,000 extremely poor households[31]. The ESSN will also support the implementation of a national social safety nets system.
The socio-economic situation is deteriorating quickly; authorities will need to act fast to provide for a rapidly growing portion of the population that is under the poverty line, especially during the coming years of austerity and fiscal tightening. If a big chunk of the subsidies system is lifted,

then the proportion of people under the poverty line is expected to surge from 55% to roughly 75% of society. Therefore, the coming Lebanese governments will have to also commit significant fiscal money towards social security expenditure that shields the most vulnerable throughout this political and economic transition phase. Given a maturity extension implemented on the existing stock of local debt, alongside a total freeze on local treasury interest payments and progressive taxing of previously-subsidized commodities such as energy resources, the Government should be able to create fiscal capacity to take care of its people and provide for the less-endowed. If done properly, the Government has the chance to regain some legitimacy as the primary caretaker of society.



Source: Ministry of Finance

Note that since October 2019, Lebanese people have been struggling to fulfill their basic needs. Soaring inflation has completely eroded local purchasing power. The Lebanese minimum wage, a nominal LBP 675,000[32], was equivalent to around USD 446 at the official exchange rate. By end of 2020, the minimum wage had reached a miniscule USD 68.



The August 4 Beirut Explosion

The August 4 Beirut blast rocked Beirut, destroying a large part of the city, and inflicting casualties- many dead, thousands injured, thousands homeless, infrastructure severely damaged. Such a tragic event can only happen in a country captured by elites, where corruption and private interests prevail at the expense of a society lacking basic rights and ability to influence power dynamics in its favor. Lebanese people know. And now the whole world knows.

V, U, K or L-Shaped Recovery- Which One is Lebanon Headed For?

Let's agree that a deal with the International Monetary Fund (IMF) is our best bet at the moment. This is not to say that there were no other options- such as internally addressing the core issues at our own terms- that could have been adopted. However, the country is already in too deep; Lebanese people, once there is a political will to avert impending famine, are left to the tender mercies of the IMF.

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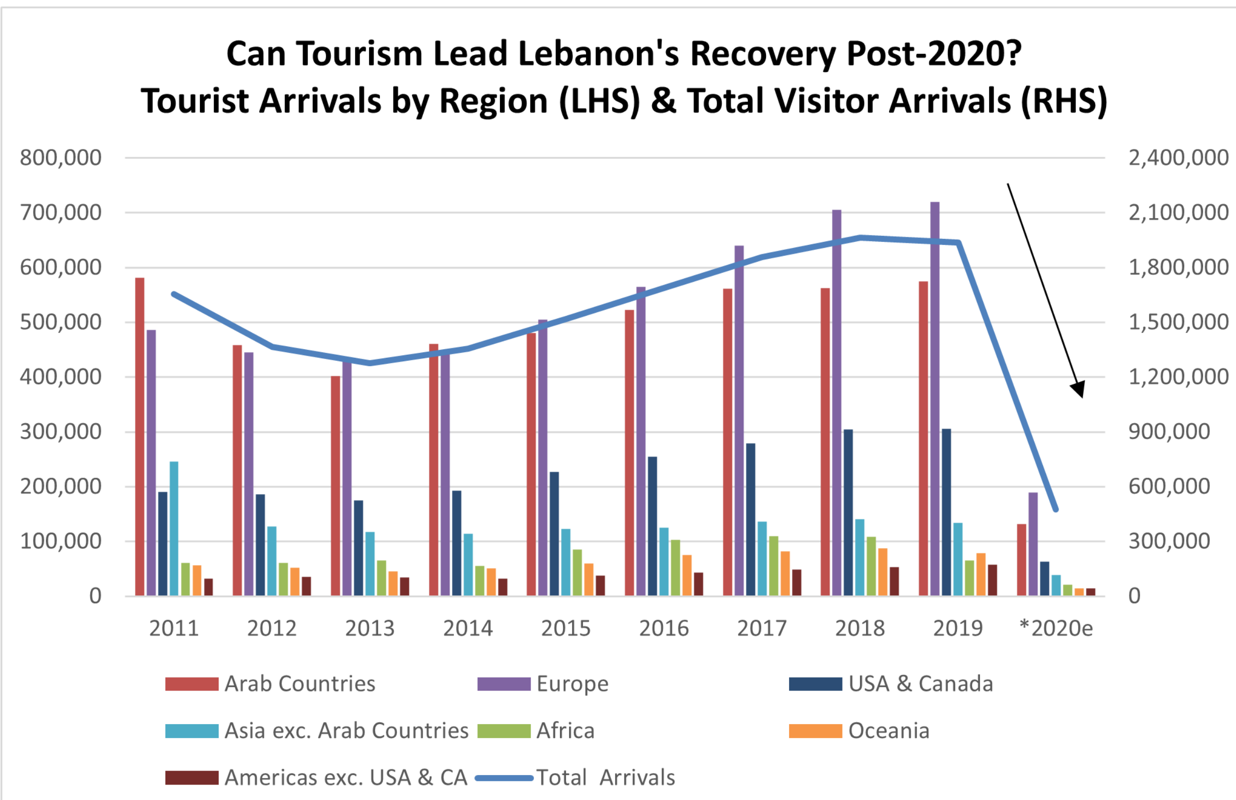
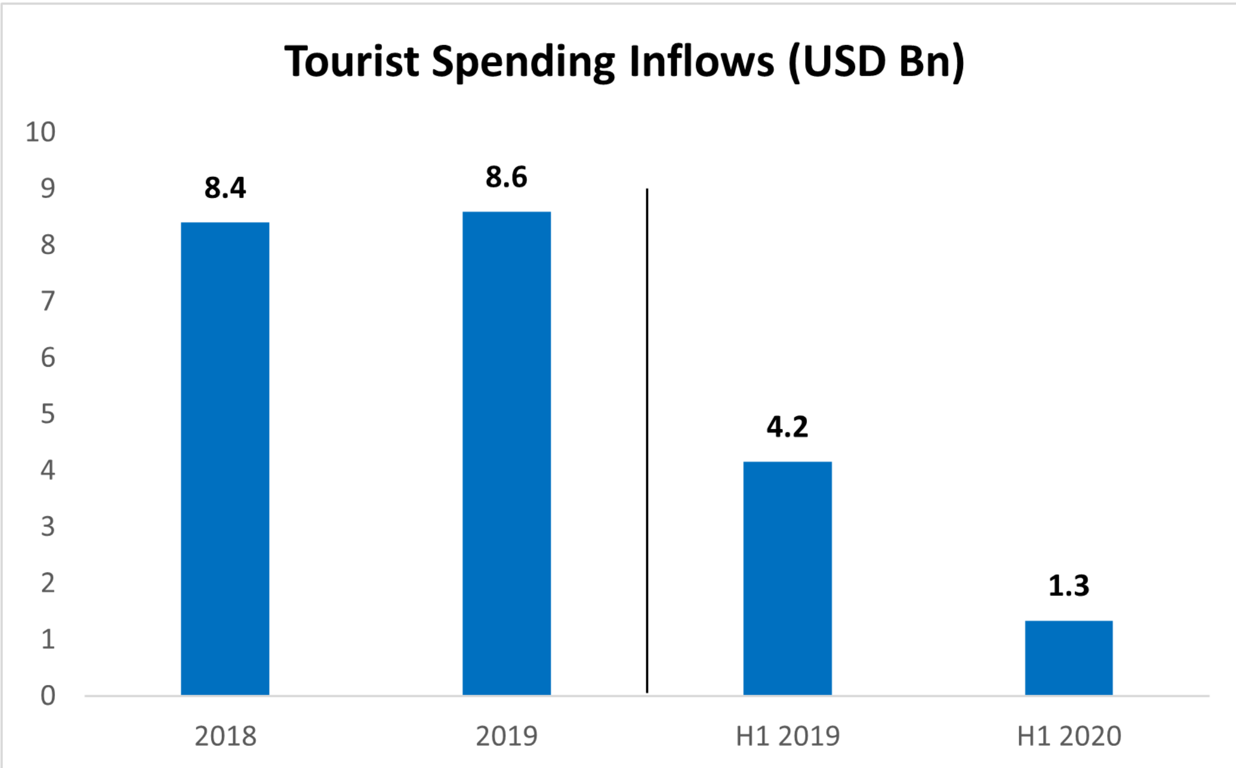
But to get there, Lebanon needs to sell a “plan” to the IMF, one based not on dubious future state finance projections nor on misplaced hope, but rather a plan that envisions a Lebanon that can, upon receiving generous foreign taxpayer money, move quickly to live by its own means. So which plan do we intend to sell to the “lender of last resort”? A V-shaped recovery, or maybe a W-shaped one? A U, an L or K-shaped road to resuscitation?

Tourism says it all. The Lebanese tourism sector is the thermometer of the economy, but also a measure of political stability and the general mood in Lebanon. All is well, as long as tourists come over to Lebanon. Any other day, the tourism sector could have played its part in supporting Lebanon’s recovery. Today, in the aftermath of the emergence of Covid-19 along with the August 4th explosion, the numbers have hit rock-bottom, and nobody can predict the timing of a trend reversal, if any. A package of minor reforms, FDI incentives, austerity and tourism-to-recovery will prove a tough sell in meetings with the IMF.



Source: BDL, Ministry of Tourism[34]



Source: BDL, Ministry of Tourism

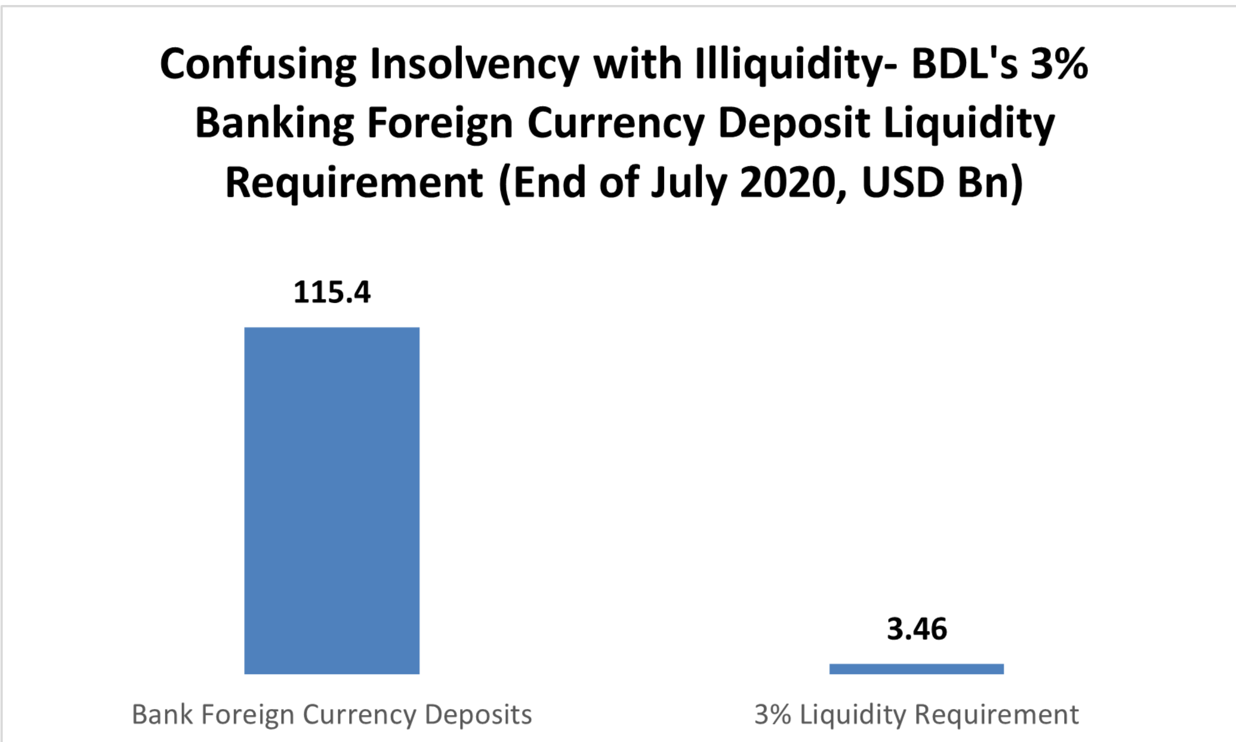
Going back to our alphabet soup, Lebanon is in an unenviable situation, and at the moment, in the absence of a vision, we're all but heading towards the last option, the infamous "N-shaped" recovery.

Hopes of Implementing the Forensic Audit of BDL Dealt another Blow

The GoL had partnered with Alvarez & Marsal, KPMG, and Oliver Wyman, giving them the task of performing the forensic audit of BDL. However, after a long exchange, the companies were not given access to documents required to perform the forensic audit. As a consequence, the deadlines agreed in the contract were breached, and the contract was terminated. Note that the forensic audit of BDL is a firm demand of the Lebanese people, but also the International Monetary Fund (IMF), which emphasized the conditionality of emergency aid money on performing a forensic audit of BDL along with other requirements[35,36].

BDL's Circular 154- Recapitalization or Naiveté

BDL's Circular 154, issued in August 2020, provided a set of rules and recommendations for banks to comply with as part of an effort to improve banking sector liquidity and capital adequacy. While the Circular incentivizes banks to return a certain portion of the funds transferred abroad post July 2017 (Article 2), these recommendations are not enforceable stipulations backed by law. More significantly, the Circular requires (Article 3) banks to possess at their correspondent banks by February 28, 2021, a foreign currency liquidity amount equivalent to 3% of the volume of its foreign currency deposits as of the end of July 2020, which stood at USD 115.4 Bn[37]. This is equivalent to USD 3.46 Bn. Whether banks comply or not is not the main subject of interest, but rather the hollow objective of the Circular. A 3% foreign currency liquidity ratio will not in any way create confidence in the system, nor in banks with huge foreign currency liabilities and no real foreign assets. Banking activity will not resume normally without addressing the problem of a broken banking sector; thus a bank reopening will trigger another chaotic wave of capital flight before shutting down right away.



Source: BDL

Timeline for Debt Restructuring

Lebanon today needs a timely restructuring agreement so as to refocus the national capacities on reviving the economy, caring for the less endowed, and moving forward. Moreover, Lebanon needs a restructuring agreement that is deep enough so as not to be back at the IMF's doorsteps in 3 years as has happened in neighboring Greece in its dealings with the Troika, at the expense of its economy. Additionally, debt restructurings are far from orderly; messy and contentious, it may take years and years before a country re-accesses debt markets. The experience in Argentina, for instance, was novel, and set a precedent with implications for future sovereign debt restructuring agreements- particularly an increase in risk of holdout situations. Argentina in mid-2000 had reached a restructuring agreement with a vast majority of around 92% of creditors. Of the 8% remaining creditors, around 2% consisted of vulture funds. The vulture funds basically exploited a change in the law of the State of New York to successfully block payment to “good-faith” creditors who had reached a restructuring agreement with the Argentinian state. The litigation went on for over a decade.

From the recent history of sovereign debt default, debt restructuring durations vary and depend on several factors. One is whether restructuring was pre-emptive (pre-default) or post-default. The trend post-2014 is towards pre-emptive restructuring. In Lebanon, unfortunately, official communications with the IMF were not even established until after the announcement, and this was later followed by the meetings that failed to materialize due to political reasons. Another factor is whether debt is mostly domestic or external; domestic debt restructuring usually occurs much faster than external debt restructuring (for instance, Argentina restructured its domestic debt by end of 2001, but took another 4 years to restructure its external debt. Russia in 1999 restructured domestic debt, and in 2000 restructured external debt)[44]. In this regard, Lebanon’s whole eurobond portfolio is around USD 31.5 Bn, which is significant but pales in relation to the bigger picture, which involves a highly bankrupt and destabilized banking sector- who will invest in Lebanon post-restructuring? A third factor is the law governing the bonds. Lebanon’s eurobonds in specific are exclusively foreign-law bonds, which will prove most significant in tough negotiations with private creditors- which may have their own agendas, tools and lobbying power to legally blackmail the Lebanese state to advance their own terms- not to mention tools to obstruct and slow down a restructuring process that does not serve their interests.

An additional factor is whether Collective Action Clauses (CACs) were used in sovereign bonds. CACs are a mechanism through which majority bondholders can agree to debt restructuring terms with the sovereign in a legally binding agreement that is voted for, and that binds dissenting bondholders. While the literature does not provide conclusive evidence showing that CAC bonds offer substantially higher levels of protection for private creditors than No-CAC bonds, the fact is that markets price CAC bonds higher and perceive them as less risky (lower yields). It is in the interest of the state to possess the ability to reach a final agreement with creditors without the possibility of facing ex-post litigation with dissenting creditors, nor with individual private creditors- especially small ones- exercising legal “veto” power in the case of No-CAC bonds. These things can go on forever. In the case of Lebanon, it seems that a substantial portion of Lebanese Eurobonds issued do not possess CACs or possess the weakest form of CACs, and this will play a pivotal role in the coming restructuring talks with creditors. In fact, Lebanon has issued around USD 15 billion in eurobonds since October 2014 without enhanced CACs, “more than any other country”[46]. In the absence of CACs, Lebanon will have to get majority agreement for every eurobond issuance event in the case of any potential restructuring- which allows dissenters to obstruct the restructuring and demand payment through litigation in court. Note that since the start of 2013, CACs are standard practice in the

EU, with “Euro Area authorities requiring member countries to include ‘collective action clauses,’ or ‘CACs,’ in sovereign bonds with a maturity over one year”[45]. An article taking on the topic of Lebanese Eurobonds finds the legal language adopted to be highly troubling. It specifies in detail the areas that are problematic for a Lebanese Eurobond restructuring scenario. Specifically, it mentions that while the quorum requirements and voting threshold for key terms (such as for modifying payment terms) are outlined clearly, what is unclear is the voting threshold for the relatively unimportant modifications, those specifically “targeted via exit consents”- exit consents being a means for the Sovereign to exercise significant power. Thus, “every modification seems to constitute an Extraordinary Resolution subject to a 75% vote”, rendering any potential restructuring highly complex[47]. A bondholder such as Ashmore, which is said to possess over 25% of the outstanding stake, will be able to exercise its veto power against any modifications, including via exit consent[47].

Debt markets can be unforgiving; countries that implement bigger haircuts tend to take longer to return to debt markets. Lebanon belongs to the former group, with a mammoth haircut awaiting bondholders and depositors, as will be explained in detail later in this paper[48]. Therefore, the idiom “Forgive and Forget” won’t stand a chance in the case of Lebanon. Having mismanaged the whole default situation, and then failed to produce a meaningful roadmap at the IMF negotiating table, Lebanon has committed every faux-pas in the etiquette of sovereign debt default. What next?

The Vultures are Circling- “Republic of Argentina v. NML Capital, Ltd.”

In 2001, Argentina was in the midst of a severe economic depression, which forced it to default on around USD 100 Bn of public debt. The Republic of Argentina wanted to settle the dispute in order to re-access debt markets to serve its funding and financing needs which would play a big role in its economic recovery. That didn’t happen. Instead, Argentina was trapped in a 15-year-long litigation with a subset of bondholders (“The Holdouts”) in what was known as The Republic of Argentina v. NML Capital, Ltd.- which is the name of the case pursued by a vulture fund against the Republic of Argentina[49]. While the majority of creditors agreed to a 70% haircut on their Argentinian Eurobond holdings, NML Capital Limited did not. NML Capital Limited commenced proceedings in November 2003 in the District Court (State of New York) to recover its unpaid principal and interest[50]. The litigation got messy. On February 23, 2012, the District Court “granted an injunction (the injunction) that enjoined the Republic from making payment of any percentage of the amount due under the exchange bonds without concurrently or in advance making payment of a similar percentage of amounts due under the FAA bonds”[50]. Basically, what happened was that the vulture funds had succeeded in blocking payment to other bondholders that had successfully agreed to recover 30 cents on the dollar for the value owed to them by the Argentinian state. Dramatically, the Republic of Argentina, on June 26th, 2014, transferred funds to make the interest payment on the exchange bonds (versus the FAA bonds possessed by the vulture funds) due on June 30th, 2014. The payment included a EUR 225 million in interest on euro debt securities. Unsurprisingly, the next day, NML Capital Limited and other Holdout Creditors "filed a motion before the District Court alleging that the payment was a breach of the injunction". And with the Law on their side, the payment was reversed[50]. Yes, the Argentinian state intended to make an interest payment to a vast majority of its creditors- based on a restructuring agreement in 2010 that around 92% of creditors had agreed to- and actually successfully made the transfer for the interest due; yet the District Court declared that the payment by the Republic was "illegal and a violation of" the 2012 injunction.

After years of legal battles, it was clear that Argentina had to settle. President Kirchner had refused to pay back the vulture funds at their terms, since paying them back could trigger a series of similar payments to other bondholders, which was unimaginable. However, Argentina's newly-elected President Macri, in 2015, adopted a reconciliatory approach with hopes of settling once and for all. Years of litigation have limited the state's ability to attract sufficient finance, while shaking confidence and hampering economic recovery. Argentina was also facing a financial squeeze in 2016, and simply couldn't maintain its stance. A settlement was reached on February 29th 2016, whereby Argentina agreed to pay USD 4.56 billion to four hedge funds (vulture funds)[49]. The vulture funds got paid lucratively. While the vast majority of bondholders recovered 30 cents on their dollar, a steep loss, the vulture hedge funds on the other hand recovered 75 cents on their dollar[49,51]. It is estimated that NML Capital Limited received around USD 620 million for a portion of its Argentinian bonds that it bought in 2008 for USD 48 million. This represents an annual return of 38% over 8 years[49]. It's hard to name a business or economic activity that offers even half that type of return over the same duration.

Remember the case of Argentina. Having set a legal precedent and demonstrated the size of influence that can be exercised by investment funds internationally, the case of Argentina is a warning to sovereign debtors of the rising risk of holdout scenarios. Lebanon's case has its own distinguishing features such as the fact that Lebanon's eurobond terms mandate an agreement among at least 75% of creditors for restructuring relative to Argentina's 100%; however, the differences do not change the fact that holdouts have grown increasingly complex and costly financially, economically, politically and socially[46].

Note: Currently, there is no publicly available information that reveals the composition of Lebanese Eurobond bondholders. Have the authorities identified precisely the identities of the various bonholder groups? This is important in the context of the restructuring negotiations, and given the fact that people who initially invest in eurobond issuances are not necessarily the same people who will be sitting at the debtor-creditor negotiating table, given the sales that occur often in the buildup to default as well as post-default announcement.

The International Monetary Fund- All Roads Lead to the Lender of Last Resort

Countries with problems such as Lebanon's often fail to get their shit together and find solutions to well-understood problems. Often, they end up seeking help from the lender of last resort, the International Monetary Fund. In Lebanon's case, the LBP had overvalued over time, causing payments system imbalance as a result of cheap imports and expensive exports. Being a member country, Lebanon is eligible for technical and financial support from the IMF. IMF programs typically encourage exchange rate liberalization to reflect prices of the world economy or trading partners, improve productivity so as to improve payments imbalance, improve access to credit to encourage investment.. The IMF does offer financial support to countries adopting IMF programs, and this support is strictly conditional on implementation of the reforms. Given Lebanon's need for vast economic structural reform rather than short-term liquidity, Lebanon will likely adopt a longer-term program if it is to seek a deal with the IMF.

Egypt's Experience with the IMF

On November 11, 2016, the IMF approved a three-year extended arrangement under the Extended Fund Facility (EFF) for Egypt, for about USD 12 billion[38]. Egypt was suffering from external imbalances, an overvalued currency, low foreign reserves, fiscal imbalance, inflation, low growth and high unemployment. The authorities demonstrated political will to commit to the IMF program. On November 3, the Central Bank of Egypt adopted a flexible exchange rate regime so as to stop the forex drainage and improve competitiveness. The CBE in parallel tightened monetary policy to control inflation and manage liquidity. Additionally, the authorities on November 3 also announced a fuel price hike, which is a signal of its political willingness to adopt considerable fiscal discipline. Around a week later, the IMF announced the agreement, and USD 2.75 billion were released directly to support Egypt's approved "home-grown" economic reform plan[38]. Egypt implemented a set of reforms, starting with monetary liberalization. On the fiscal side, Egypt implemented a Value Added Tax (VAT) program that raised tax revenues considerably. Public sector wages were contained, while subsidies programs were rolled back, starting with the fuel price hike. A pension reform roadmap was designed. Of the tax revenues raised, an amount of funds equivalent to 1% of GDP was allocated towards additional social safety net spending- going towards low-income groups, vulnerable groups, food subsidies, school meals, cash transfers.. Structural reforms aimed at promoting economic growth and creating jobs were key elements of the IMF agreement, whereby Egypt was required to perform radical reform in areas such as business regulation and ease of doing business, SME financing, public financial management, and labor market liberalization..

The IMF program did get Egypt back in business and running, but at a hefty cost. On one hand, proponents of the IMF program point to Egypt's successful emergence from the crisis, having produced growth, lowered unemployment, stabilized the currency and eliminated multiple exchange rates, stopped the payments imbalance, achieved fiscal consolidation, reinvigorated the private sector and entrepreneurship. On the other hand, opponents point out that 3 years after the program, a third of Egyptians were living in poverty. The headcount poverty rate jumped from 27.8% in 2015 to 32.5% in 2017 (26.3% in 2012). From 2014-2018, GDP grew by 4.2% annually, while per capita income grew by 2%. The numbers conceal the fact that 6 million Egyptian citizens fell below the poverty line[39].

The Cost Of Austerity- Greece Post-2008

IMF programs come at a cost. The IMF helps governments make politically unpopular moves such as enacting fiscal restraint and implementing macroeconomic stabilization, as well as other reforms related to business and labor markets to promote employment and growth. But there is also another side to the equation- the social cost. Reforming business and labor regulation can help promote growth, but the pain that society may be forced to stomach can be huge, and should not to be understated. Austerity, coupled with labor market reform, for instance, means in essence that the citizen will suffer, and, if unaddressed, inequality will soar.

Look no further than Greece. Greece managed to reduce its harmonised consumer price index by 6.1% relative to 1.2% decrease across the Eurozone from 2010-2014[40]. Moreover, Greece reduced its real unit labor cost by around 11.8% over the 2010-2013 period, compared with a reduction of 0.1% for the Eurozone. Greek internal devaluation did not generate growth as intended. From 2010-2014, Greece recorded negative growth each year, totalling an aggregate contraction of 24.51% of GDP while the Eurozone recorded growth of 3.41% over the same period[40]. Fiscally, for the same period, Greek public revenues increased by 5.1% while expenditure decreased by 2.6%. However, this illusory improvement in public finance is the result of pension reform, fiscal restraint and increase in taxation. Additionally, Greek unemployment rose by 13.8% relative to 1.5% in the Eurozone from 2010-2014, with youth unemployment rising much more severely[40].
A country already in severe recession in the aftermath of the global financial crisis, the Greek citizen suffered. Pensions were reduced, minimum wages slashed, social benefits cut back. Inequality rose above pre-crisis levels, and the new income distribution exacerbated the difficulties inflicted on the poor, the unemployed pensioners, and households at large. Socio-economic wellbeing, social cohesion and the mental health of a nation suffered, while growth generated was less than desirable, and did not translate into improvements in the standard of living of the average citizen.

The moral for Lebanon’s purposes is that any IMF program should not be celebrated as an end in itself. While it will bring forth much-needed improvements and reforms- reforms that the Lebanese elites have proven incapable of pushing through- it is up to the Lebanese state and people to make the IMF program a success. This happens by taking on responsibility to protect citizens and promote an economic vision. In terms of protecting Lebanese labor, the Lebanese government should be ready to implement initiatives to monitor the labor market, including monitoring of wages, working conditions and price developments. Furthermore, it should tackle the issue of long-term unemployment, carry out targeted income support to reduce poverty incidence, along with strengthening tax collection and disincentivizing firms from exiting the formal economy. McKinsey’s “Lebanon Economic Vision” is a starting point[41].

E- A Path to Debt Restructuring and Equitable Loss Allocation

The case of Lebanon is particularly troubling given the extent of the external imbalances that have accumulated over the decades. This becomes all the more complex since the balance sheets of the troika, manifested in the Government of Lebanon (GoL), the Central Bank (BDL), and the Banks- are highly exposed to each other. Therefore, the adjustment will be a very painful exercise.

Note that the following restructuring exercise aims to reduce public debt to levels deemed sustainable, as well as resolve the large FX mismatch that characterizes the BDL as well as commercial banks' balance sheets. BDL, upon realizing a net FX position of 0, can restart its operations at a negative LBP balance. We adopt the negative starting target equity position adopted by the April 30 GoL plan- a position of minus LBP 14 trillion. Following, commercial bank balance sheets are sanitized through a combination of equity wipe-out (followed by sale of foreign subsidiaries, real estate, and foreign assets etc..) and then a haircut on depositors' accounts if necessary. We will assume the worst case scenario in which banks contribute solely through a complete equity wipe-out, and thus the restructuring exercise will warrant a significant haircut on depositors' money. Further, no forced Lira-fication will be applied to depositor Dollar accounts whatsoever; the Lebanese Lira needs a break. Nor is it advised to swap maturing public debt owed to the banks with longer-term debt at lower coupons, since this would give the false illusion of extra time and space and in the process turn Lebanon into a desert in less than a decade. As for local debt, note that domestic Treasury Bills and CDs are governed by Lebanese local law; therefore, restructuring is a purely local affair. However, since a devaluation would significantly dwarf the magnitude of LBP-denominated debt, and given that any haircut on local debt will in parallel require a recapitalization effort by the government in the same order, thus, it is recommended that no haircut be applied to LBP-denominated debt; rather, maturity extension coupled with coupon holidays are adopted. Finally, the objective of this process is to have a clean banking sector so as to attract deposits once again and resume lending to the economy.

GoL Haircut on Public Debt

It is clear that Lebanon has been, over decades, unable to generate, through economic fundamentals, the FX capital needed to sustain the levels of indebtedness reached. In fact, the current state of deep insolvency will require a large-scale restructuring. In this paper, we propose a haircut of 75% on FX debt (Eurobonds mainly) and no haircut on LBP-denominated debt. With the region in turmoil, having lost the confidence of the Lebanese diaspora, fierce regional competition for FDI, lack of support from traditional wealthy GCC Arab allies, and high cost of lending to the government, it is clear that Lebanon's emergence from the crisis towards growth and fiscal surplus will be anything but straightforward. In an effort to avoid a repeat of the current crisis, the adjustment required is larger and more painful. Note that no distinction between local and foreign bondholders should be made; rather, a standard haircut is adopted. The aforementioned haircut decreases public debt from USD 90.2 Bn (169% of GDP in 2019) to USD 42.5 Bn (80% of 2019 GDP). If we take the 2020 GDP projection of a depressed USD 19.5 Bn, then 75% haircut on foreign debt and no haircut on local debt results in a public debt level of 155% of GDP at ER= 4,000 LBP/USD, and a level of 132% of GDP at ER= 5,000 LBP/USD. And if we factor in a devaluation to 6,000 LBP/USD, then the haircut results in a public debt level of 117% of GDP. For reference, scenarios involving a 20% and a 40% haircut on local debt are presented in the table below.

Lebanon Foreign Currency Balance Sheet (USD Bn)

Government		Banque Du Liban		Commercial Banks	
USD Assets		USD Assets		USD Assets	
Asset Sale	NO	GoL Eurobonds	5	GoL Eurobonds	11.5
Other	X	Loans to Banks	6	Required Reserves	17
		Foreign Assets	14.12	Holdings at BDL	60
		Gold	16.36	Private Sector Loans	22.33
				Other Foreign Assets	4.6
Total Foreign Currency Assets	**0**	**Total Foreign Currency Assets**	**41.48**	**Total Foreign Currency Assets**	**115.43**
Government		**Banque Du Liban**		**Commercial Banks**	
USD Liabilities		USD Liabilities		USD Liabilities	
Eurobonds: Banks	11.5	Required Reserves	17	Loans from BDL	6
Eurobonds: BDL	5	Bank Holdings at BDL	60	Customer Deposits	112.9
Eurobonds: Non-Resident	15	Other	X	Other Foreign Liabilities	7.2
Other Institutional Debt	2				
Total Foreign Currency Liabilities	**31.5**	**Total Foreign Currency Liabilities**	**77**	**Total Foreign Currency Liabilities**	**126.1**
Net Foreign Currency Position	**-31.5**	**Net Foreign Currency Position**	**-35.52**	**Net Foreign Currency Position**	**-10.67**

Source: Author's Analysis

Public Debt as a % of GDP- Scenario 1: 75% Haircut on Eurobonds and NO Haircut on LBP Debt (As of End of 2020*)							
Scenario	2019 GDP w/o Haircut	2019 GDP w/ Haircut (1,500 LBP/USD)	2020 GDP w/o Haircut	2020 GDP w/ Haircut (1,500 LBP/USD)	2020 GDP w/ Haircut (4,000 LBP/USD)	2020 GDP w/ Haircut (5,000 LBP/USD)	2020 GDP w/ Haircut (6,000 LBP/USD)
GDP (USD Bn)	53.367	53.367	19.5*	19.5*	19.5*	19.5*	19.5*
Public Debt (USD Bn)	90.2	42.5	92.96	67.34	30.2	25.7	22.7
Public Debt as % GDP	169%	80%	477%	345%	155%	132%	117%
Public Debt as a % of GDP- Scenario 2: 75% Haircut on Eurobonds and 20% Haircut on LBP Debt (As of End of 2020*)							
Scenario	2019 GDP w/o Haircut	2019 GDP w/ Haircut (1,500 LBP/USD)	2020 GDP w/o Haircut	2020 GDP w/ Haircut (1,500 LBP/USD)	2020 GDP w/ Haircut (4,000 LBP/USD)	2020 GDP w/ Haircut (5,000 LBP/USD)	2020 GDP w/ Haircut (6,000 LBP/USD)
GDP (USD Bn)	53.367	53.367	19.5*	19.5*	19.5*	19.5*	19.5*
Public Debt (USD Bn)	90.20	42.50	92.96	55.44	25.71	22.15	19.77
Public Debt as % GDP	169%	80%	477%	284%	132%	114%	101%
Public Debt as a % of GDP- Scenario 3: 75% Haircut on Eurobonds and 40% Haircut on LBP Debt (As of End of 2020*)							
Scenario	2019 GDP w/o Haircut	2019 GDP w/ Haircut (1,500 LBP/USD)	2020 GDP w/o Haircut	2020 GDP w/ Haircut (1,500 LBP/USD)	2020 GDP w/ Haircut (4,000 LBP/USD)	2020 GDP w/ Haircut (5,000 LBP/USD)	2020 GDP w/ Haircut (6,000 LBP/USD)
GDP (USD Bn)	53.367	53.367	19.5*	19.5*	19.5*	19.5*	19.5*
Public Debt (USD Bn)	90.20	42.50	92.96	43.55	21.25	18.58	16.79
Public Debt as % GDP	169%	80%	477%	223%	109%	95%	86%

Source: Author's Analysis

BDL is already in the uncharted waters of the Required Reserves

As of December 1, 2020, BDL foreign assets excluding Gold stood at around USD 25 Bn. Liquid foreign holdings, however, have reached around USD 14 Bn (relative to a required reserve level of USD 17 Bn). Given that the RR ratio is a symbolic benchmark, and given the extent of the insolvency of the system, every penny already spent by the BDL to fund the system is most definitely depositor money.
The post-haircut BDL balance sheet reveals an FX mismatch of around USD 39.27 Bn. On the asset side, foreign assets excluding loans total USD 19, while gold holding are estimated at USD 16.36 billion. Adding loans to banks, estimated at USD 6 billion, along with the post-haircut Eurobonds estimated at USD 1.25 billion, yields a foreign asset position of USD 37.73 billion. On the liabilities side, liabilities consist of required reserves at USD 17 billion and bank holdings at BDL, estimated at USD 60 billion. This yields a foreign liabilities position of USD 77 billion. The debt restructuring plan adopted in this paper strongly recommends a post-restructuring BDL balance sheet net FX balance of 0. Therefore, BDL will have to default on USD 39.27 Bn in liabilities to the banking sector.

Lebanon Foreign Currency Balance Sheet (USD Bn)

Government		Banque Du Liban		Commercial Banks	
USD Assets		USD Assets		USD Assets	
Asset Sale	NO	GoL Eurobonds	1.25	GoL Eurobonds	2.87
Other	X	Loans to Banks	6	Required Reserves	17
		Foreign Assets(14.93 or 20.63 or 19.5)	14.12	Holdings at BDL	60
		Gold	16.36	Private Sector USD Loans	22.33
				Other Foreign Assets	4.6
				BDL Restructuring: Wipe-Out	-39.27
Total Foreign Currency Assets		**Total Foreign Currency Assets**	**37.73**	**Total Foreign Currency Assets**	**67.53**
Government		**Banque Du Liban**		**Commercial Banks**	
USD Liabilities		USD Liabilities		USD Liabilities	
Eurobonds: Banks	2.87	Required Reserves	17	Loans from BDL	6
Eurobonds: BDL	1.25	Bank Holdings at BDL	60	Customer Deposits	112.9
Eurobonds: Non-Resident	3.75	Other	X	Other Foreign Liabilities	7.2
Other Institutional Debt	2	BDL Restructuring: Wipe-Out	-39.27		
Total Foreign Currency Liabilities	**7.87**	**Total Foreign Currency Liabilities**	**37.73**	**Total Foreign Currency Liabilities**	**126.1**
Net Foreign Currency Position	**-7.87**	**Net Foreign Currency Position**	**0**	**Net Foreign Currency Position**	**-58.57**

Source: Author's Analysis

Banking System- The Greatest Banking Insolvency in History?

Banks are insolvent, and the ensuing restructuring operation will prove painful for a nation that touted its banking system for so long. Let's take a look at the Banking Sector balance sheet. On the asset side, private sector loans total USD 14.51 billion at the conservative NPL rate of 30%, knowing that NPLs rise much higher during similar crises. Bank required reserves at BDL stand at USD 17 billion, while holdings at BDL amount to a massive USD 60 billion (financial engineering). As for the GoL post-haircut Eurobond portfolio, it totals USD 2.87 billion. Other foreign assets total USD 4.6 billion. Lastly, factoring in a BDL loss of USD 39.27 reduces foreign assets to a total of USD 59.71 billion. On the liabilities side, customer deposits total around USD 113 billion. Adding BDL loans estimated at USD 6 billion, and other foreign liabilities estimated at USD 7.2 billion- yields a foreign liabilities position of USD 126.1 billion. Therefore, netting assets and liabilities gives a banking sector balance sheet FX mismatch of USD 66.39 billion.

Lebanon Foreign Currency Balance Sheet (USD Bn)

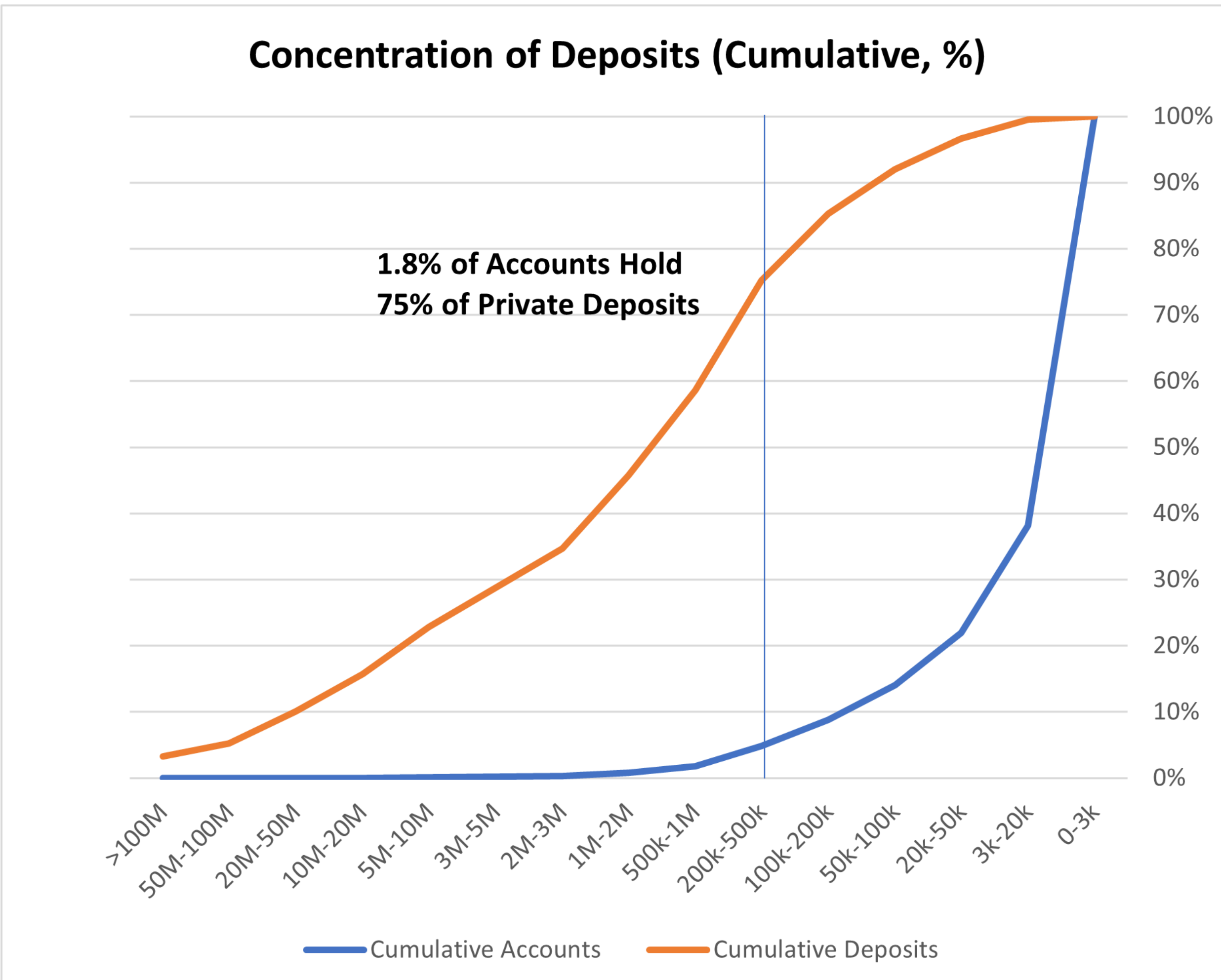
Government		**Banque Du Liban**		**Commercial Banks**	
USD Assets		USD Assets		USD Assets	
Asset Sale	NO	GoL Eurobonds	1.25	GoL Eurobonds	2.87
Other	X	Loans to Banks	6	Required Reserves	17
		Foreign Assets	14.12	Holdings at BDL	60
		Gold	16.36	Private Sector USD Loans	14.51
				Other Foreign Assets	4.6
				BDL Restructuring: Wipe-Out	-39.27
Total Foreign Currency Assets		**Total Foreign Currency Assets**	**37.73**	**Total Foreign Currency Assets**	**59.71**
Government		**Banque Du Liban**		**Commercial Banks**	
USD Liabilities		USD Liabilities		USD Liabilities	
Eurobonds: Banks	2.87	Required Reserves	17	Loans from BDL	6
Eurobonds: BDL	1.25	Bank Holdings at BDL	60	Customer Deposits	112.9
Eurobonds: Non-Resident	3.75	Other	X	Other Foreign Liabilities	7.2
Other Institutional Debt	2	BDL Restructuring: Wipe-Out	-39.27	Hole in Bank Sec: 59% of Deposits	-66.39
Total Foreign Currency Liabilities	**7.87**	**Total Foreign Currency Liabilities**	**37.73**	**Total Foreign Currency Liabilities**	**59.71**
Net Foreign Currency Position	**-7.87**	**Net Foreign Currency Position**	**0**	**Net Foreign Currency Position**	**0**

Consolidated Foreign Curr. Balance Sheet USD Bn	
Assets	49.59
Liabilities	59.46
Net FX position	-9.87

Source: Author's Analysis

The reality is that every penny out of the outstanding USD 66.39 Bn in losses inflicted on Banks' balance sheets will have to be paid in full- starting with a banking sector equity wipe-out, followed by sale of foreign subsidiaries and real estate assets, and if needed depositor contributions through haircuts in order to close the remaining balance if any. In the case of Lebanon, politics is interfering with the process of loss allocation and financial sector restructuring. Regardless, the banking sector will not be open for business again before balance sheets are sanitized. Nobody will invest in a bankrupt banking system.
First, banking sector equity is estimated at USD 20 Bn (at a rate of 1,500 LBP/USD). Wiping out banking sector equity entirely yields a net negative FX position of USD -46.52 Bn. Given the extent of insolvency, a progressive haircut is highly recommended to avoid inflicting an unjust

haircut on small and mid-sized depositors. Indeed, small depositors (accounts less than USD 100k) should not be included in the adjustment process, their accounts guaranteed in full. Note that Lebanon is among the most unequal countries in the world, with 1.8% of accounts holding around 75% of private sector USD deposits. Unfortunately, mid-sized accounts will have to be involved in the process, which is why a progressive haircut is paramount.



Following is a demonstration of the various haircut scenarios that Lebanon can adopt. Adopting a regressive haircut implies a one-size-fits-all haircut that disproportionately hurts the poor and the less-advantaged people of society. Using this logic, and assuming all accounts above USD 100 K participate in the process, then a restructuring process that involves accounts above USD 100 K will require a haircut of 55.4%, assuming a bank equity wipe-out. A similar process involving accounts above USD 1 million would require a haircut of 83.1%. Additionally, for reference purposes, failing to implement a complete bank equity wipe-out would result in a haircut of 79.3% assuming the process includes accounts above USD 100 K.

Regressive Haircut on USD Deposits (accounts insured up to $100,000)		
Regressive Scenarios	OneBrush-Fits-All Haircut Awaiting Depositors (%) w/ Equity Wipe-out	OneBrush-Fits-All Haircut Awaiting Depositors (%) w/o Equity Wipe-out
Haircut only on Accounts above USD 100 K	55.4%	79.3%
Haircut only on Accounts above USD 200 K	57.3%	81.9%
Haircut only on Accounts above USD 500 K	67.5%	96.5%
Haircut only on Accounts above USD 1 M	83.1%	118.8%

Source: Author's Analysis

We now adopt a progressive approach that attempts to allocate the haircut as justly as possible after performing a complete bank equity wipe-out. Below is a set of sample possibilities based on various clusterings of the deposit accounts. Basically, the USD deposit base is divided into 3 distinct groups, one for less wealthy groups, a second for the wealthy group, and a third for the top wealthy brackets. Wealth and fairness are subjective terms. However, for the purpose of this paper, we will take various symbolic cutoff scenarios to distinguish the three wealth groups and thereby show a few possible haircuts for each cutoff scenario, all leading to the same intended outcome- which is to finally close the banking system imbalances. The point here is that in the presence of political will, there are a variety of solutions that may lessen the impact on the vulnerable sections of society.

Progressive Scenarios			
Haircut on USD Deposits w/ complete Equity Wipe-out (accounts are insured up to USD 100,000)			
Sample Progressive Scenarios	Cluster 1: Accounts Between USD 100 K & USD 500 K	Cluster 2: Accounts Between USD 500 K & USD 5 M	Cluster 3: Accounts Above USD 5 M
Haircut Scenario 1 (%)	25%	57%	69%
Haircut Scenario 2 (%)	35%	57%	64%
Haircut on USD Deposits w/ complete Equity Wipe-out (accounts are insured up to USD 100,000)			
Sample Progressive Scenarios	Cluster 1: Accounts Between USD 100 K & USD 1 M	Cluster 2: Accounts Between USD 1 M & USD 5 M	Cluster 3: Accounts Above USD 5 M
Haircut Scenario 1 (%)	36%	63%	69%
Haircut Scenario 2 (%)	40%	61%	67%
Haircut on USD Deposits w/ complete Equity Wipe-out (accounts are insured up to USD 100,000)			
Sample Progressive Scenarios	Cluster 1: Accounts Between USD 100 K & USD 500 K	Cluster 2: Accounts Between USD 500 K & USD 3 M	Cluster 3: Accounts Above USD 3 M
Haircut Scenario 1 (%)	25%	59%	65%
Haircut Scenario 2 (%)	36%	55%	64%
Haircut on USD Deposits w/ complete Equity Wipe-out (accounts are insured up to USD 100,000)			
Sample Progressive Scenarios	Cluster 1: Accounts Between USD 100 K & USD 1 M	Cluster 2: Accounts Between USD 1 M & USD 3 M	Cluster 3: Accounts Above USD 3 M
Haircut Scenario 1 (%)	36%	60%	68%
Haircut Scenario 2 (%)	40%	58%	66%
Haircut on USD Deposits w/ complete Equity Wipe-out (accounts are insured up to USD 100,000)			
Sample Progressive Scenarios	Cluster 1: Accounts Between USD 100 K & USD 500 K	Cluster 2: Accounts Between USD 500 K & USD 2 M	Cluster 3: Accounts Above USD 2 M
Haircut Scenario 1 (%)	25%	57%	65%
Haircut Scenario 2 (%)	35%	53%	64%

Source: Author's Analysis

F- Concluding Remarks

Beware The Lebanese Lost Decade

Lebanon is a bankrupt, insolvent state. To pretend that the crisis is merely a liquidity problem is- aside from being outright false- counter-productive, and will only postpone the problem. Short-sighted solutions will only "kick the can"; yet Lebanon's problems require drastic solutions Today. Postponing the problem doesn't serve anybody, especially the banks, because they depend on fresh capital inflows and investor confidence in order to re-ignite lending to the private sector. If a system "clean-up" does not occur, nobody will invest in Lebanon- including the Lebanese diaspora, investors and capital markets. Investors see through paper balance sheets as well as accounting practices. One of the lessons of the 2008 financial crisis is that markets indeed do see through artificially-priced asset valuations. When banks and institutions fail to do “mark-to-market”, markets will self-correct. Crash. The message here is that sanitizing balance sheets is an exercise that should be done once and for all. Injecting a few billions into the system will fool no one.

Moreover, assuming Lebanon does navigate successfully through this mess, what happens the day banks are open again for business? Regression to capital controls due to out-of-control capital flight is no path forward.

No Carte Blanche- A Silver Lining

President Macron has emphasized that there will be no carte blanche when it comes to the Lebanese crisis. The IMF has also maintained the position that aid is strictly conditional on real reforms. Moreover, it is highly unlikely that any aid will go directly into recapitalizing insolvent banks. After the 2008 crisis and in the aftermath of COVID-19, no country is prepared to waste taxpayer money for the sake of recapitalizing banks in Lebanon. Lebanon is important when it comes to the Syrian refugee crisis, however, Western aid will go towards long-term infrastructure projects.

Lebanon 2.0- Do Not be Greece

Lebanon should learn the lessons of the Greek debt crisis that started in 2008. Greece, while having considerable differences in comparison with Lebanon in terms of economy demographics fiscal spending capacity and economy income model, ended up signing a deal with its creditors, without resolving the fundamental economic problems, in effect settling for a low-growth equilibrium at the expense of the economy’s prospects as well as the wellbeing of its people- all without altering the power relationships of the economy.

The Lebanese restructuring procedure, if done properly, has the potential of founding a new contract between citizen and state- one based on equality, accountability, transparency, prosperity, and solidarity. If successful, Lebanon will manage to re-create the relationship between citizen and state/politics, but also between citizens and the banks, the private sector and banks, as well as the interaction between the state and the real economy. We should not waste this opportunity.

Bank Recapitalization- Burden-Sharing, Not Privatization

Any bail-in of the banking sector should occur fairly, with a just burden-sharing agreement that cleans the mess without unfairly targeting depositors. The banking sector should pay its fair share, starting with a complete wipe-out of its equity, estimated at USD 20 Bn dollars (at a rate of 1,500 LBP/USD), but also through other contributions- namely sale of foreign subsidiaries, real estate assets, foreign assets.. Depositor money should only be touched as a last resort..

Bringing All Stakeholders to the IMF Negotiations

While the banking sector and the Hassan Diab government have been negotiating directly with the IMF, it is a real pity that the Lebanese society has not been included in the debate- even more so when we consider that any austerity resulting from an IMF deal will be imposed on the Lebanese people, and will be tremendously painful. It is vital that the Lebanese society- including not only depositors but also civil society, is organized and included in the negotiations with the IMF.

Infrastructure Loans- Not an Immediate Need

Lebanon today does not need the long-awaited infrastructure loan packages promised by CEDRE and the IMF. Lebanon's crisis is today, right now. We need to restart the banking sector afresh with clean balance sheets, in order to attract foreign investment and re-ignite private sector activity so that whatever businesses remain survive, and so that jobs are preserved. We're talking real liquidity needs. Any negotiations with the IMF need to secure liquidity funding of roughly USD 5 Bn per year over at least 5 years. Infrastructure loans and other loans do play a role, but Lebanon needs access to liquidity to satisfy funding needs in the short term. Any aid will be conditional on confidence-building measures, starting with devaluing the currency coupled with downsizing the subsidies programs.

2024- Back at the Doorsteps of the IMF

The restructuring process adopted is steep for a reason. There are two choices. The first choice involves a Lebanon that decides to patch the problem with a soft haircut and an even softer bank restructuring process- effectively pretending that the problem was a minor liquidity problem. In this scenario, Lebanese banks never recover, and the Lebanese economy is stuck with a bunch of zombie banks for decades. It'd take us a mere few years before we're back to "t0". As soon as 2024, Lebanon can well be kneeling on those same rotten doorsteps of the International Monetary Fund (IMF), where some mediterranean neighbors have found a refuge along the lines of "beggars can't be choosers".
The other choice is to fix the core issues, stabilize the debt at a level that Lebanon can actually shoulder, and clean those balance sheets once and for all. Next, we build an economy that actually works, and where banks' interests coincide with the interest of the Lebanese people and economy, and where giving industrial and agricultural loans for instance, is actually a profitable operation for the banks. No country ever produced

substantial economic advancement with a banking sector that can't profit off of its country's real productive sector activity. Speculative investment and one-offs don't count. Political risk and instability no longer stand as credible excuses either.

Other Mediterranean Experiences

Cyprus in 2012/13 offered equity conversion of 48% of uninsured deposits in the Bank of Cyprus[42]. As for Iceland, it needed nine years before capital controls were lifted and confidence restored[43]. Lebanon, however, is in a really bad place. Given how the country was run, and given that everybody will want to transfer their money abroad, capital controls will have to be legislated by the government and managed over at least 10 years.

Regardless, comparing Lebanon to other neighboring experiences is a futile exercise. In other experiences, successfully restructuring debt with creditors and rebuilding the economy is highly related to the presence of a popular executive branch that possesses the political will to make tough policy trade-offs and exercise high levels of sovereignty. These governments don't last long, given the unpopular choices that they have to make, but also given the impatience of the masses in the face of rapidly deteriorating living conditions. An example is Greece's Tsipras government of 2015, which negotiated with the Troika and creditors on behalf of a Greek majority, setting aside the outcomes of the negotiations. Lebanon possesses none of it; a country in disarray, political parties are currently struggling to cut deals and negotiate power-sharing mechanisms instead of designing a roadmap for a less "bleak and barren" future in Lebanon.

McKinsey's "Lebanon Economic Vision"[41] Is A Starting Point

For the success of any potential IMF plan, Lebanon should present an economic vision through which Lebanon can attract the investment necessary to generate sustainable growth. Lebanon should promote productive investment to not only generate growth, but also support the economy's structural transformation. McKinsey's "Lebanon Economic Vision" of 2018 is not your typical jargon-ridden publication; as such, it should not remain dusty and unread on cold academic library shelves. It is the most comprehensive development plan in existence that diagnoses Lebanon's problems and reform needs, while putting in place a plan to transform the economy and reposition Lebanon globally. The McKinsey report prioritizes productive sectors as the center of priorities, and sets key targets for Lebanese governments to achieve by 2025 and 2035, with aims at transitioning Lebanon from a consumption-based system to a productive economy- through reforming the agricultural and industrial sectors, investing in infrastructure, raising productivity, developing high value-added tourism products, reforming the public sector, and rebranding Lebanon internationally. The report envisions Lebanon utilising its vast talent pool to reinvent itself as a regional tech hub. The McKinsey vision also advocates for reform of the banking sector, which should focus on lending the productive economy, while opening up the financial sector to non-banking services, capital markets, insurance, VC services, private equity etc..

The Desertification of Lebanon

As if climate change was not bad enough; an unserious restructuring process in Lebanon will, in as soon as a decade, turn the country into a desert. The fact is that an unpayable debt by a bankrupt country cannot be repaid; therefore, the only choice is to get it right the first time and allow the economy to recover. This means not raising taxes by so much, nor deciding on unrealistic primary surplus targets etc.. The alternative is an even more bankrupt state, shrinking incomes, no youth left in Lebanon, and no investment in this non-economy.

The Coming Lebanese Migration

Yet again, a new wave of Lebanese youth are leaving Lebanon in search of opportunity and stable living conditions. Talented, hopeful and full of resolve, they will find success wherever they wander, wherever they rove. It is every Lebanese man's story over generations. In fact, Lebanese people pride themselves on being the descendants of the ancient Phoenicians, who roamed the warm waters of the Mediterranean. Over the past century and a half, the Lebanese have attained fame and fortune abroad- in the Americas, Africa and Europe..
History repeats itself today. The Lebanese society today is a victim of deep elite capture. The forensic audits of BDL and Government accounts, heavily resisted by the elite class, could be the spark that sends Lebanon into prolonged civil unrest as was under the recent Lebanese civil war of 1975-1991.

Pity the Nation- by Khalil Gibran

"Pity the nation that is full of beliefs and empty of religion.
Pity the nation that wears a cloth it does not weave
and eats a bread it does not harvest.

Pity the nation that acclaims the bully as hero,
and that deems the glittering conqueror bountiful.

Pity a nation that despises a passion in its dream,
yet submits in its awakening.

Pity the nation that raises not its voice
save when it walks in a funeral,
boasts not except among its ruins,

and will rebel not save when its neck is laid
between the sword and the block.

Pity the nation whose statesman is a fox,
whose philosopher is a juggler,
and whose art is the art of patching and mimicking

Pity the nation that welcomes its new ruler with trumpeting,
and farewells him with hooting,
only to welcome another with trumpeting again.

Pity the nation whose sages are dumb with years
and whose strongmen are yet in the cradle.

Pity the nation divided into fragments,
each fragment deeming itself a nation."

— Khalil Gibran, The Garden of The Prophet (1933)[55]

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