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The Politics of Lebanon's Economic Collapse

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Lebanon is facing unprecedented social and political pressures and economic collapse. The current round of protests began on 17 October when the Minister of Information proposed a daily $0.20 tax on the use of the social media app, WhatsApp, to make phone calls. Despite the probability that the measure was unenforceable and even illegal, the initiative was widely perceived as yet another attempt by a government that has failed to provide basic services, to increase taxation. The announcement followed a week of devastating forest fires in the Lebanese mountains which the government struggled to combat. The anger of sitting by helplessly as the countryside burned served as a strong impetus for massive protests.[1]

The seriousness of Lebanon's crisis was emphasized at the beginning of November 2019, when, after a meeting with Lebanese President Michel Aoun, the Director of the World Bank's Mashreq Department issued an unprecedented statement. He stated that Lebanon does not have the luxury of waiting to address critical economic and social issues. While political dysfunction captures more attention, the economy suffers the most risks, and with every passing day, the situation is becoming more acute and this makes recovery extremely challenging.

Early in 2019, the World Bank projected a small recession in 2019. Now due to increasing economic and financial pressures, it expects the recession to be much deeper. Balance of payments constraints have resulted in dire conditions for businesses and workers. Declining confidence in the economy has resulted in increased holding of dollars by individuals, which imposes heavy costs on the banking system.

Lebanon is unique in the Arab world in that it has an open economy and political system and a large degree of ethnic diversity. In 1989, following the signing of the Taif Agreement that brought years of civil war to an end, peace prevailed in a deeply divided country with heavily militarized zones controlled by different sectarian groups. In 1991, following a national amnesty, many of those who led the warring factions became political leaders with representation in the parliament and cabinet.

The Taif settlement, with its piecemeal development plan and soft landing for those previously involved in the civil war, was one of the main causes the current economic crisis. In the initial reconstruction phase, despite many corrupt practices, the government made serious efforts to restore normal conditions. In 1993, a "ministry of the displaced" was established in order to restore socio-economic order and provide housing to those who had been displaced by the civil war. Some of the success in that phase was due to the private sector especially a private company, Solidere, that was contracted to rebuild the central district of Beirut.

Solidere was run by the late, Saudi-backed, Prime Minister Rafiq al-Hariri (father of the current prime minister, Saʿad al-Hariri) as part of his attempt to assert the power and enhanced Sunni position after the Taif agreement. The deal meant that the reconstructed central business district was owned and managed by a private company and this resulted in increases in housing prices in and around it. Space was created for the elite in a district that was historically the city's market and residence for the poor as well as the rich. Rafiq Hariri, as prime minister, formed strong political alliances and was able to attract international donors. He lowered the taxation on the rich while increasing it on the poor and this led to an increase in public debt that has gone on ever since.[2]

Lebanon therefore became a highly indebted country. Its foreign debt-to-GDP ratio has been above 150 percent for twenty years. Sovereign default has been predicted for years, but has been avoided by the resilience of the financial sector and the leadership of the central bank. This had a price: Lebanese Eurobonds had to be issued at interest rates that reflected a spread of five percent above those on equivalent US Treasuries. During the past decade there have been virtually no new issues in any significant volume. Meanwhile, the government has run large budget deficits and these have been funded by the banking system with bank deposits equal to more than 300 percent of GDP.

Table 1 (below) shows that in 2013-2018 economic growth averaged only 1.6 percent annually. As the population grew by 3.3 percent annually, national income per capita fell by about two percent a year. The table also shows that the government's deficit averaged over eight percent of GDP and this was more than accounted for by interest payments. They, in turn, reflected the high levels of debt that resulted from the deficits. Domestic government debt rose from 133 percent of GDP in 2013 to 151 percent in 2018, while the foreign debt rose from 167 percent to 191 percent.

As the financial situation became weaker, Lebanon's social fabric was sorely tried. Partly as a result of the policies described above and also because of the influx of Syrian refugees following the outbreak of civil war Syria, poverty rates soared. In 2018, about a third of the Lebanese population lived in poverty, up from 27 percent in 2011-2012. The poverty rate could rise to 50 percent if the economic situation worsens. Unemployment, especially among young people, is already high and could rise sharply.[3]

Table 1: The Lebanese Economy, 2013-2019 (Percent of GDP), IMF data

	2013	2014	2015	2016	2017	2018	2019*
GDP annual growth (%)	2.5	2.0	1.0	1.0	2.5	0.3	0.2
Government revenue	19.8	21.8	18.8	19.0	19.0	20.5	21.5
of which: tax	14.1	13.8	13.5	13.8	13.9	15.0	15.9
Government expenditure	28.6	27.8	26.2	26.9	27.5	31.5	31.2
of which: interest	8.0	8.4	8.8	9.1	9.9	9.6	9.4
Government deficit	8.8	6.0	7.3	7.9	8.4	11.0	9.0
Government debt	133	133	138	144	148	151	155
Balance of payments, current account deficit	25.9	25.3	18.2	17.5	17.4	25.6	26.4
External debt	167	170	175	179	180	191	196
Foreign reserves (months of imports)	12.4	14.6	13.8	14.4	13.4	12.9	10.9

Deposits in Lebanese banks, mainly from the diaspora Lebanese and citizens of Arab countries in the Gulf grew during years of war and tension. These covered the huge deficit on the current account of the balance of payments and helped to finance the government's deficit. The banks, which do not lend much to their customers (loans equal about 25 percent of their aggregate balance sheet), used their excess deposits to finance the government. This was done through the purchase of US dollar-denominated Eurobonds, Lebanese pound-denominated T-bills and holding liquidity in the form of excess reserves at country's central bank, the Banque du Liban (BDL). This arrangement coexisted with the fixed exchange rate of the Lebanese pound ($1=1,500 Lebanese pounds) and large public sector deficits as long as deposits kept growing. If, for any reason, the deposit flow declines, the financial system would crash, since even moderate deposit withdrawals would prevent the banks financing the government deficit. This would, in turn, cause the banks to collapse.

During the last three years, depositors' withdrawals have been compensated by various kinds of "financial engineering" – transactions aimed at maintaining the BDL's reserves. These have been kept at a substantial level to ensure demand for Lebanese pounds and prevent the collapse of the exchange rate. The cost was high: the banks and, the public sector, were forced to pay interest rates of over 20 percent to attract enough dollar deposits. This financial engineering was designed to give the government time to implement structural reforms. That has not occurred; the financial engineering transactions were costly (further increasing the deficit) and have progressively lost their effectiveness, leaving the government in an ever more financially vulnerable position. The central bank's balance sheet has been considerably weakened. The $38 billion of reserves are partially offset by $22 billion in dollar liabilities with the banking system, resulting in by far the lowest net reserve coverage ratio of the money supply since the of the fixed exchange rate system began.[4]

There is a large overlap between the ownership and control of the banks and the political leadership. A study published in 2016 showed that individuals closely linked to political elites controlled 43 percent of assets in Lebanon's commercial banking sector. In 18 out of 20 banks, major shareholders were linked to the country's political elites. Four out of the top ten banks had more than 70 percent of their shares attributed to crony capital. Only eight families control 29 percent of the banking sector's total assets, owning together more than $7.3 billion in equity. Bank Audi is one of the largest commercial banks in the country. Its shareholders, whose holdings were above five percent, were dominated by four ultimate shareholders (families), one foreign bank, and two holding companies. One of these holding companies, FRH Investment Holding SAL, was 100 percent owned by Fahd al-Hariri, another son of the late Prime Minister, Rafiq al-Hariri. Bank Audi's ownership structure includes one former minister (Raymond Audi, the bank's founder) among the controlling shareholders. Three other controlling shareholders have close ties to the monarchies of the Arab Gulf. Bank Audi's net profit was $559 million in 2017.[5]

Political control of shares was strongly and positively correlated with political control in the board of directors. There was a strong correlation between politically controlled banks and the volume of non-performing loans (defined as the ratio of the sum of substandard loans and doubtful loans, over total gross loans). Favoritism and preferential treatment of companies and persons within one's political party or support base are to blame, as banks with more political control overlook financial soundness markers at the expense of rent distribution. The absence of correlation between political control and more exposure to public debt in all its forms (treasury bills in local and foreign currency, and the BDL's central bank's certificates of deposits) was a source of anxiety, as there have been growing suspicions that the country's banks and the BDL were key stakeholders influencing the growth of public debt.[6] Banking has been a very profitable sector in Lebanon. In the period 1993 to 2018, the net profits of the banks came to $22.1 billion, increasing from $63 million in 1993 to $21 billion in 2018.[7]

The financial crisis is the result of the increasing burden of servicing and refinancing public debt and the sharp fall in net capital inflows, which financed the current account deficit and the provided the means of servicing foreign debt. These imbalances were closely connected, and led to a rapid depletion of foreign exchange reserves. The financial collapse has reduced capital inflows and encouraged capital flight. It has also made public debt riskier to hold, and therefore harder to refinance. The crisis has also resulted in the rapid rise of interest rates, the devaluation of the pound on the informal market and the acceleration of inflation by at least five percent over the past month on basic consumption goods.

Severe financial stress began in September 2019, resulting in the central bank rationing dollars. It increased when it became clear that an approach to reduce the financial imbalances by increasing indirect taxation and reducing public services has become unacceptable, given the deterioration of the social situation.

Protesters were not convinced by the recent reform package adopted by the Cabinet on October 21. The plan reduced the losses of Electricité du Liban (EDL), but there were doubts about the government's willingness to implement a reform that has been contemplated for several years. Taxing banks is also a move in the right direction, although the proposed tax of 600 billion Lebanese pounds was a one-off tax, and is small relative to the huge profits made by the bank in recent years. Much of the financing of the deficit in the cabinet plan relies however on Central Bank, which has been tasked by the government to reduce public debt service in half. This would mean printing money, which would in turn create further inflationary pressures and put further pressure on the exchange rate.[8] In the second week of November, the free market exchange rate for the US dollar reached 1,800 Lebanese pounds, 20 percent more than the official one.[9]

Protests in Beirut on September 29, heightened the sense of crisis. Many automated teller machines have ceased dispensing dollars and banks reduced withdrawal limits to $1,000 a day and imposed arbitrary rules, such as banning dollar transactions after five p.m. and on weekends that in effect bar workers from using their accounts.

The first to suffer were businesses that needed foreign currency. Petrol stations sold fuel in pounds bought buy it in dollars. They briefly went on strike on September 26th to protest against a dearth of dollars at the official rate. Worried drivers queued in bumper-to-bumper traffic. Wheat millers have the same problem and have warned of possible bread shortages.

On September 30th the BDL promised to provide dollars at the official rate for firms that import fuel, medicine and wheat. The guarantee should prevent any immediate scarcity. It could also leave Lebanon with, in effect, a two-tier exchange rate. A shortage of dollars is not all bad news, since it should discourage imports and trim a current-account deficit that was 25 percent of the GDP last year. But it will be painful for a country that relies so much on imported goods.

Such a decision is well beyond the mandate of most central bankers. Riad Salamé, who has headed the BDL since 1993 and is admired for keeping the currency stable through years of political chaos. The BDL is highly capitalized, with $37 billion in foreign reserves at the end of July. It should therefore have had no difficulty financing essential imports, at $4 billion to $5 billion a year. The bank's assets are, however, dwarfed by its liabilities. To preserve the fixed exchange rate against it, it borrowed dollars from commercial banks at above market rates. For a few years this was a viable arrangement and the banks, many of which were controlled by politicians and their relatives, made healthy profits and the BDL had a supply of dollars to cover Lebanon's huge deficits. Last year's fiscal shortfall was 11 percent and public debt of more than 150 percent of GDP, is among the highest in the world.

This type of fiscal policy works only with a constant supply of new money and is therefore a kind of pyramid scheme. After a decade of steady growth, deposits in commercial banks have begun to shrink (see chart on previous page). Interest rates as high as 20 percent fail to attract dollars. The banks kept pouring money into the BDL. They had $147 billion (in dollars and pounds) there at the end of July, 23 percent more than a year earlier. About 57 percent of the banking sector's total assets are now at the BDL, up from 51 percent a year ago and the highest level this decade.

In the past, the Arab Gulf states might have offered a bail-out but are no longer willing to do so. This is because of their frustration with a government which they perceive as too tolerant of Hizballah, the Iranian-backed militia and political party. An international aid package of $11 billion (mostly in concessional loans) agreed in 2018 has been frozen until Lebanon implements promised reforms. The government will find it increasingly hard to raise capital abroad. Fitch, the credit ratings agency, recently downgraded Lebanon's debt to junk rating.[10]

Why has reform been delayed? The delays of stabilization have been explained as a consequence of the struggle of powerful interest groups to shift the cost of reform onto each other. As reform comes at a cost for elites, they prolong political bargain by embarking on a ‘war of attrition’). Stabilization, which involves a change in the status quo, occurs when economic conditions deteriorate sufficiently so that one of the groups concedes and agrees to bear a higher burden of the costs. Politically connected firms concentrate in sectors that are not (or are relatively less) affected by a downturn of the overall economy Economic conditions, at least until recently, were not severe enough to pressure individual actors in Lebanon to concede and agree to bear the costs of reform.

An economic downturn leaves sectors in which more than half of all firms are politically connected comparably well off. These include hotels and waterfront resorts that are closely connected to political elites. Passenger numbers at Beirut’s airport increased constantly over the past years, while the number of tourists increased by almost 45 percent from 2012 to 2017. Accordingly, hotels and waterfront resorts recorded a major improvement in their booking records. The occupancy rates of four and five-star hotels in Beirut reached 69 percent (up from 59 percent in 2018) while the average room yield rose by 30 percent.

The banking sector is the other major example. Benefiting heavily from the huge margins paid by treasury bills, the profitability of domestic banks remained – until recently – relatively high. In 2017, Lebanese commercial banks significantly expanded their profits, reaching a return on average equity of above 11.2 percent for the group of major banks.

Other sectors are structurally less affected by an economic downturn and exhibit a low elasticity of demand – meaning consumption is still high in them even when prices go up. Security companies, for example, are employed by politicians, business people and other public figures, for whom security remains a necessity in the face of prevailing political and security uncertainty. The same was true for garbage collection, the collection of which ceased for months on end.

Shipping lines are also spared much of the effects of Lebanon’s economic woes, since foreign trade activity must be done by ship after the closure of land routes through Syria in 2011. In fact, the number of vessels at Beirut’s port remained almost constant between 2012 and 2018. Public works and investments enjoy rosy prospects due to internationally funded major capital investment programs worth almost 40 percent of the GDP.

Real estate was the only major sector with a high share of politically connected firms that suffered from a gradual decline in activity and output. Since the boom year of 2010, the area of new construction permits has almost halved in the period until 2018.

Slowing demand reduces the value of sales transactions, which plummeted by 40 percent from $4.504 billion to only $2.726 billion in the first six months of 2017 to 2019. Given the central role that the real estate sector plays in Lebanon’s economy –

at 15 percent, the largest contributor to national GDP – a collapse of major real estate developers could well be the tipping point for the economy to crash.

Lebanon has been bailed out by international support in the past when conditions became untenable. Lebanese elites may assume that the country remains 'too small to fail' for influential regional players. This time things may well be different. With declining interest in the country by Europe and the Gulf countries, the war of attrition could not be lost by Lebanese citizens suffering prolonged periods of economic stagnation. As other crucial sectors have begun to follow the declining trend, uncertainty about the strength of the economy threatens the nation's stability.[11]

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