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Lebanon, Iraq, and Syria: sinking together?

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This edition of *Iqtisadi*: *The Middle East Economy* examines the rapidly deteriorating economic conditions in the three countries in the Middle East most subject to Iranian influence and interference: Iraq, Lebanon and Syria. These three economies are connected: Syrians traditionally work in Lebanon and many fled there when the Syrian civil war began in 2011. Syrians also use Beirut as their banking center and have suffered from the financial collapse there. Iraqis fled to Syria in 2003 and Syrians have fled to Iraq since 2011. Iraq and Syria are directly affected by conditions in international oil markets while Lebanon is indirectly affected. They are all now affected by the COVID 19 pandemic. Iraq with almost 100,000 officially declared cases on 23 July is ranked 23 in the world. Lebanon, with 3014 cases is 106 on that list. Syria had officially declared 561 cases, which is not thought to be an accurate figure.[1]

Table 1 provides a picture of economic developments in these countries. The figures for Syria should be treated with caution as little data is available, but the scale of destruction indicates the severity of the losses. The World Bank has forecast major falls in GDP in Iraq and Lebanon in 2020 and, when the effect of population growth is allowed for, the decline in GDP per capita is even more dramatic. Since 2010, Iraq has recorded a large increase in GDP, but after allowing for population growth (from nearly 30 million to over 40 million), the GDP per capita rose by only 0.6 percent on average annually. The economic situation in Lebanon has been worse: since 2017, GDP has been declining at an accelerating rate and when population growth (fed by the flood of refugees from Syria) is allowed for, GDP per capita has experienced a massive fall.

Table 1: GDP, GDP per capita and growth rates, 2010-2020 ($, 2010)

	2010	**2015**	**2016**	**2017**	**2018**	**2019**	**2020 forecast**	**2020 % change**	**2020/2010 % change**
Iraq GDP (bn)	138.5	188.5	217.1	211.7	210.8	219.8	198.5	-9.7	43.0
GDP/capita	4,657	5,298	5,931	5,638	5,478	5,591	4,938	-11.7	6.0
Lebanon GDP (bn)	38.4	42.4	43.0	43.4	42.6	40.2	35.8	-10.9	-6.8
GDP/capita	7,762	6,488	6,412	6,317	6,412	5,858	5,191	-11.4	-33.1
Syria GDP (bn)	60						20		-67.0
GDP/Capita	2,817						1,143		-59.0

Source: World Bank

It is hard to imagine the deterioration in Syria, given that so much was destroyed by nine years of war. During the last 12 months, the Syrian currency has been devalued by about 80 percent as the effects of sanctions, COVID-19, the internal financial crisis and strife within the ranks of the ruling elite have pushed what was once a gradual decline of the currency into a collapse. As the Syrian pound reached new lows, President Bashar al-Assad faced a deepening economic crisis, and this eroded support among his supporters.

Measures to combat the worsening economic conditions and restore a semblance of control in the face of growing public discontent have been taken, including the sacking of five governors — the largest shake ups in recent years. These measures have proven to be ineffective, especially as the newest round of sanctions under the US Caesar Act that came into effect on June 17.

The initial decline in the currency's value occurred between November 2019 and January 2020, when the Syrian pound lost almost half of its value. This was mainly due to the beginning of Lebanon's financial meltdown and the passage of the Caesar Act, which allowed President Trump to impose fresh sanctions on the Assad regime and those who assist it.

Beirut is a financial hub for Syria, and was used by Syrians, for trade and as a source of finance for imports. Lebanon is also a large market for Syria's exports. In addition, many Syrians have funds in Lebanon. When Lebanese banks started imposing withdrawal limits and the Lebanese pound started to plummet, those deposits lost much of their value. The sudden halt of money from Lebanon cut off a vital financial artery to Damascus that was made worse by the news that Washington was imposing fresh sanctions on Syria. At the beginning of 2020, the Syrian pound's exchange rate against the dollar was steady. Then COVID-19 brought Syria's economy to a halt. In mid-March, the government imposed a curfew and an economic lockdown that put much of the territory under its control out of business. Initially, the Syrian pound did not seem to suffer too much. Then, in early May, Rami Makhlouf—Syria's richest businessman and cousin of Bashar al-Assad— who owns Syriatel, the largest mobile phone network in Syria, and other retail, banking and real estate companies, released a video that caused the decline in the value of the pound to resume.

As noted in Iqtisadi last month, Russia has asked Bashar al-Assad to pay up for the services that it has provide him. Assad claimed that he did not have the means, and the Russians response was to note that Makhlouf does. This led to Assad's arrest of those working for his cousin, and his accusation that Makhlouf did not pay tax on some of his business interests in Syria. Makhlouf appealed to the Syrian people via Facebook to forgive him for any mistakes but not to allow Assad to take his assets.[2]

The conflict ended with the government ordering the seizure of Makhlouf's assets. This feud, the economic effects of COVID-driven lockdowns and fear over the activation of the Caesar Act sanctions, have all pushed the Syrian pound exchange rate down.

An official in Damascus's Chamber of Commerce has said that he and other traders chose to store their goods rather than sell them on the market and were not buying any products unless absolutely necessary, given the falling purchasing power of the pound. This was an acknowledgment of one of the key concerns of Syrians, as the value of their salaries decrease. At the same time, the price of basic goods has increased as the loss in purchasing power has prevented importers and the government bringing goods into Syria.[3]

Lebanon's crisis has domestic and foreign causes. The Taif settlement of 1989 that brought the civil war to an end, was one of the main causes the current economic crisis. The agreement maintained the interests of the leaders of the different groups that make up the country's confessional political system. The very close connections between the business community, especially the banks, and members of the government has had disastrous consequences. Partly as a result of the policies followed, massive corruption and of the influx of Syrian refugees, the financial situation became weaker and poverty rates soared.

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 used their excess deposits to finance the government. 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, withdrawals of funds by depositors have been compensated by various kinds of "financial engineering" – transactions aimed at maintaining the central bank'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 policy was designed to give the government time to implement structural reforms. That did not happen; financial manipulation increased the deficit and has lost its effectiveness, leaving the government and central bank in an ever more financially vulnerable position.

There is a large overlap between the ownership and control of the banks and the political leadership. In 2016, individuals closely linked to political elites, controlled 43 percent of assets in the commercial banks. 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.[4]

Banking has been a very profitable sector in Lebanon. In the period from 1993 to 2018, the net profits of the banks rose from $63 million to $21 billion. Yet within Lebanese banks, control of shares was correlated with political control in the board of directors. There was also a strong correlation between politically controlled banks and the volume of non-performing loans (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 were to blame. The absence of correlation between political control and more exposure to public debt was a source of anxiety, as there were growing suspicions that the country's banks and the central bank were key stakeholders influencing the growth of public debt.[5]

The Lebanese financial system has been propped up by funding from foreign grants, loans, and inflows from the diaspora to cover its huge current account deficits. Its currency has been pegged to the dollar since 1997. For the last eleven years, parliament did not pass a budget. For 15 years, the central bank (Banque Du Liban) — now at the center of the crisis — did not publish its accounts. Almost 70 percent of the assets of the banking system, which has deposits several times the size of the economy, were lent to an insolvent government built on a sectarian system of inherited patronage.[6]

In March 2020, for the first time in its history, Lebanon failed to repay over $30 billion of Eurobonds that were due. As a result, the government requested assistance from the IMF, but after numerous meetings, the talks on a loan collapsed.[7]

As the exchange rate collapsed to about £L6,000 = $1, imports became more expensive and prices rose. The consumer price index (CPI) in May 2020 rose by almost seven percent. The prices for food and non-alcoholic beverages rose by almost 15 percent. In the year to May 2020, the CPI went up by 56.5 percent while that for food and non-alcoholic beverages increased by 189.8 percent. As wages and other incomes are not linked to the rise of prices, living standards have plummeted.[8]

One of the many problems faced in the talks with the IMF was Hezbollah's participation in the government. It has the health portfolio and is specifically blamed by many Lebanese for the collapse of the hospital system. It is also been blamed, along with other parties, for the stalemate that has prevented effective administration. Hezbollah has suggested closed ties with its Iranian patron as an alternative to Western aid, but this alienates many and lacks credibility.

The IMF forecasts that GDP will fall by 12 percent, even worse than that of the World Bank (see Table 1).[9] Sections of Lebanon's middle class have been ruined by the financial crisis and the effects of COVID-19 have worsened the situation.[10] The World Bank forecasts a 69 percent increase in poverty in 2020, using the $5.50 daily income, 2011 purchasing power parity (i.e. measuring what can be bought inside the country) and a 22 percent increase in extreme poverty, using the $3.20 a day measure.[11]

In Iraq, the measures taken by the government to curb the spread of COVID-19 have included curfews, school closures and restrictions on travel, including into and within the country. The rapid spread of the virus has exacerbated an already fragile economic situation, impacted by social turmoil, political standstill, and the collapse in international oil prices. Prior to the onset of COVID-19, Iraq's labor participation rate was one of the lowest in the world (49 percent in 2019) and the country suffered from lack of competitiveness in various economic sectors, as well as high government spending on civil servant salaries. While protests, which engulfed different governorates of Iraq in 2019 to demand jobs among other issues, inevitably calmed down as a result of the curfew. These were quick to resume in May after some restrictions were eased.

Livelihoods have been widely disrupted across the country, mainly the result of by restrictions on movement. In the private sector, which employs approximately 58 percent of the workforce in Iraq, production and employment have been both negatively impacted by the measures. The lockdown measures needed to contain the pandemic have dealt a severe blow to economic activities – especially to the service sectors such as transport, trade, banking and religious tourism, which constitute around half of the non-oil economy.[12]

Financial and economic crises have become so severe in Iraq that no single measure will be enough to bridge the gap between government revenues and expenditures. The inadequate level of government revenues results from low oil prices and falling oil production. Iraq is playing its part in OPEC's production cuts: in June output was 3.16 million barrels a day (mb/d) This was 21 percent lower than in June 2019 and as the price per barrel was down 41 percent, hence revenues were 54 percent lower.[13]

The government relies heavily on these oil revenues. In order to fund the salaries of 3.5 million public servants, 500,000 employees of state-owned enterprises, and 2.5 million who receive state pensions), Iraq needs other revenues but will not be able to rely on external borrowing. The government has borrowed some $2.5 billion from local banks, but this will mean that less funding will be available for the private sector, further reducing the potential for an economic recovery in non-oil sectors. In June 2020, a law was passed by Iraq's parliament authorizing the government to borrow US$18 billion. It set a $5 billion ceiling limit for external borrowing and a $13 billion goal for internal borrowing via the issuance of treasury bonds to local banks, financed by the central bank.[14]

The World Bank forecasts that the number of people in Iraq in the most extreme poverty group, (defined as having an income of up to $1.90/day, 2011 purchasing power parity), could increase by 50 percent in 2020.[15] In 2018, the poverty rate was estimated at 20.5 percent or 7.9 million. In 2020, this could rise to 12 million or about 30 percent of the population.

According to the World Bank, if oil prices remain in the $30-35/barrel range in 2020 and no reform measures are taken, the budget deficit would exceed 29 percent of GDP. The total of its financing needs, including debt servicing, would reach $67 billion or 39 percent of GDP. In this situation, Iraq would have no choice but to borrow at home and abroad to finance the deficit. Heavy reliance on local banks would not only crowd-out liquidity for private sector credit, but access to international markets may prove to be difficult given global market conditions and a weak macro-framework for Iraq. Closing the gap through the sale of local currency bonds will weaken central bank's balance sheet and create pressures on the exchange rate and inflation. The resulting current account deficit, estimated at 18.8 percent of GDP in 2020, could also draw-down the central bank's foreign currency reserves to below three months of imports by 2022, further increasing the exposure of the economy to external shocks.[16]

Iraq also faces huge political challenges. In May 2020, after months of political conflict, the chief of Iraqi intelligence Mustafa al-Kadhimi, was appointed prime minister and has appointed a largely technocratic government. Kadhimi has inherited numerous problems. He must navigate Iraq's troubled 'Muhasasah' political system dominated by heavily intrenched factions. He also faces poverty, widespread corruption, and the broken electricity system that regularly results in social unrest. This is in addition to Iraq's perennial security concerns and US-Iran tensions. The economic challenges he now faces are greater than any since the Islamic State rampaged through the country. The assassination in July of Hisham Al-Hashimi, a government advisor and leading expert on armed groups, presents another challenge. Both Sunni extremists in the Islamic State and pro-Iranian Shiʿi extremists are under suspicion and the pressure on the government to bring these groups under control has increased.

For previous issues of *Iqtisadi*, go to our website, http://dayan.org/journal/iqtisadi-middle-east-economy.

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