



Arab Reform Initiative

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For an Emergency Economic Rescue Plan for Lebanon





Arab Reform Initiative

A group of Lebanese economists, political scientists, and jurists met on November 1, 2019 to consider their priority recommendations on how to deal with the urgent financial and economic challenges that the country is facing at the moment. The group considers that Lebanon must now mobilize to act rapidly and in determined ways to avoid the risk of a financial meltdown and economic collapse. A failure to act fast risks a spiraling devaluation of the Lebanese Pound (LBP), generating inflation, unemployment, impoverishment, and a further deterioration of basic public services.

Our main conclusions, summarized below, relate to urgent need to develop a comprehensive economic rescue package, to be implemented in a coordinated way, and which includes:

- **A careful management of the rapidly dwindling foreign reserves, to defend the value of the LBP, including by establishing tighter measures of capital control;**
- **A deep fiscal adjustment with credible plans to fight corruption;**
- **New social policies to protect those most affected by the current crisis;**
- **Importantly, a negotiated debt reduction plan with a fair burden sharing across society; and**
- **A monitoring mechanism that allows the population to put pressure on the implementation of these reforms, while state oversight mechanisms are reinforced.**

While there is a need to urgently form a credible government that can inspire confidence, some of the actions discussed below cannot wait and should not be held hostage to political events. The caretaker government should mobilize immediately a crisis group to act on these most urgent matters.

In the longer term, the group believes that the national economy is way below its potential, and a more effective governance system is crucial to allow it to export goods and services, rather than its people. An inclusive growth model would diversify into not just tourism and financial services, but also manufacturing, high tech, responsible agriculture, and cultural production. Social justice, gender



equality, and respect for the environment should be at the core of this model, as well as level-playing field competition, innovation, and openness to the world, and to the large Lebanese diaspora.

A Crisis Long in the Making

The rising financial dis-equilibrium is driven by two forces: the rising burden of servicing and refinancing public debt; and the sharp fall in net capital inflows, which have in the past been financing the current account deficit and the servicing of dollar denominated debt. The two sources of imbalance are closely related, and are leading to a rapid depletion of foreign exchange reserves: the fear of a financial collapse is reducing inflow and encouraging capital flight; and the reduced net inflows is making public debt more risky, making it harder to refinance it at reasonable terms.

The deepening financial crisis is reflected in the fast rise of interest rates (15% and more, with even higher costs for the most recent Banque du Liban (BdL) so-called swaps, which are complex operations whose goal is to attract foreign currency deposits); the fast devaluation of the pound on the informal market (up to LBP1800/\$ in the past month); and the acceleration of inflation by at least 5% over the past month on basic consumption goods (according to Consultation and Research Institute preliminary estimates). In the absence of corrective measures, the LBP will continue to devalue in the upcoming period, with the possibility of spiraling out of control if reserves keep on being depleted.

The financial stress predates the October 17 revolt, resulting in BdL starting to ration dollars earlier in September. 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 to the population, given the deterioration of the social situation. The share of population in poverty is approaching the 30% mark (World Bank estimation), unemployment is high, and emigration of skilled youth is at record levels.

But equally, the protesters were not convinced by the recent reform package adopted by the Cabinet on October 21. The plan has good elements, such as reducing the losses of Electricité du Liban (EDL), but there are doubts about the



government's willingness to implement a reform that has been on the table for several years now. Taxing banks is also a move in the right direction, although the foreseen tax (LBP600 billion) is a one shot tax, and is small relative to the huge profits made by the sector in recent years (\$2.6 billion in 2018). Much of the financing of the deficit in the cabinet plan relies however on the BdL, which is tasked to reduce public debt service in half. This is essentially a call to print money, which will create inflationary pressures and put further pressure on the LBP. **The group's assessment is that the cabinet reform plan is inadequate, and is putting too much of the adjustment burden on the exchange rate, which will hurt mainly lower and middle income families.**

Defend the Lebanese Pound in the Short Term

To be sure, a deep depreciation of the LBP will alleviate the public debt overhang by wiping out the real value of LBP denominated debt, which is about 60% of public debt. While this is one possible way to resolve the debt overhang, intentionally or not, it comes at huge social costs - wiping out pension funds and the savings of the middle class and resulting in real wage declines. It would also result in a wave of bankruptcies of companies indebted in dollars, aggravating further the high unemployment rate, weakening the banking sector, and hurting future growth prospects. A moderate and controlled devaluation is needed as part of a pro-growth agenda to make Lebanese exports more competitive, but it should not be the main instrument to resolve the debt overhang.

The group recommends to defend the LBP in the short term, to give some time for the social and political forces to devise political, financial, social, and economic plans that can deal with the enormous challenges facing the country. The group recognizes that the cost of protecting the LBP could be very significant before market confidence is reestablished, but to allow the LBP to devalue in an uncontrolled way will only deepen further the social crisis. We recommend that the short time that can be gained should not be used to avoid change, but rather to devise the ambitious emergency measures needed in a socially responsible way (see below). The best approach to defend the value of the LBP is to launch the



needed reforms as soon as possible, in order to improve rapidly the country's credibility. In case stabilization measures are delayed, and foreign reserves fall to a level that threatens the ability of the country to import essential goods (such as food, medicine, and fuel), it may become impossible to continue servicing Lebanon's foreign debt. In this regard, the repayments due on November 28, 2019, and in the second quarter of 2020, are particularly worrisome.

Plan Rapidly for a Credible Fiscal Adjustment

Policies needed in the short-term to stabilize the financial situation include agreeing rapidly on deep cuts in inefficient expenditure connected to corruption and mismanagement, starting with the urgent reform of the electricity sector. These rapid measures should be accompanied by long delayed decisions on the implementation of institutional reforms. Although their impacts will be in the medium and long term, they are necessary in order to signal the government's credibility. On the expenditure side, efforts that need to be initiated include: the recuperation of stolen public funds; the restructuring of public institutions, including merging or eliminating redundant ones; and the reduction of the wages and benefits of senior civil servants. On the public revenue side, the government should initiate reforms to unify the income tax system and make it more progressive, as well as to reduce tax evasion and enlarge the tax base, notably by removing tax exemptions on specific sectors and companies.

Restructuring the Debt

While necessary to improve the quality of expenditures and reduce the fiscal deficit, these efforts will not be sufficient to put the public debt on a sustainable path. In the IMF calculations, if Lebanon wants to grow its way out of its current debt situation, this would require a primary fiscal surplus (which is the fiscal balance excluding debt service) of 5% a year for 20 consecutive years (IMF article 4, 2019). Such a deep austerity plan has not been implemented in any country before, and is totally unrealistic.



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Some economic actors are floating the notion that artificially pushing down interest rates on public debt can attenuate the existing financial pressures. This proposal goes in the right direction and would reduce the immediate pressures on the LBP. But as public and private investments require a longer planning horizon, more clarity about the future is needed as well, to be able to liberate credit so that it goes into productive uses, and to create fiscal space for a more inclusive fiscal policy. **Thus, we believe that temporary measures, while necessary in the immediate future, are not sufficient anymore.**

Instead, in our assessment, debt reduction must now be considered.

Lebanon's public debt is above 150% of GDP, while the internationally recognized safe limit is considered to be at 50% GDP. This will be the first, and should be the last time that Lebanon resorts to debt reduction. Debt restructuring should be carefully tailored to meet Lebanon's specific circumstances. The group recognizes that this will affect the country's reputation as a destination of capital inflows. Everything must therefore be done to minimize these reputational costs. Paradoxically, a first principle is thus that debt reduction must be deep enough so it can be believed that it won't happen again. A second important principle is that of fairness. A socially equitable solution to the overhang must distribute the burden of the losses fairly across national and international debt holders of public debt, and place more of it on those who benefitted the most from the large past interest payments. Given the large magnitude of the losses, their distribution will have to include the banks' equity and debt holders, as well as some of their depositors – ideally those above a certain threshold. The third principle is that the banking sector needs to come out stronger, as it is at the center of Lebanon's future growth opportunities. There will be a need for an operational and financial restructuring of the sector, which will be an opportunity to reduce its ownership concentration.

Capital Controls

We recommend the urgent imposition of a well-designed system of capital controls on a transitory basis - not just to trap corrupt capital, as is being recommended by many quarters, but also to reduce pressures on the LBP caused by capital flight. The current soft controls may have slowed down outflows, but



they are also creating incentives for rent seeking and corruption, allowing the capital of influential people to escape, while trapping the savings of ordinary depositors. It appears that nearly \$800 million have left the country between October 15 and November 7, a period during much of which the banking system was officially closed. Capital controls are also needed to preserve the deposit base and allow debt reduction to be done in a fair manner. Parallel measures will need to be taken to ensure that the pressure on the parallel dollar market does not become excessive.

Against Privatization in the Current Environment

We oppose privatizations in the current environment. Given the low level of confidence and liquidity, these would amount to fire sales. While some privatizations may end up being necessary, they must await the emergence of a more stable political and economic environment with better oversight and accountability mechanisms. Moreover, privatization undertaken now will end up transferring monopoly power to an oligopolistic private sector, especially the politically connected part of it, if it preceded the establishment of stronger regulatory capacity.

Social Measures Needed

We also recommend to immediately develop social measures to help the vulnerable sectors of the population cope with the current and evolving environment. It is estimated that a LBP depreciation of 30% would lead to a rise in the poverty rate to over 50% of the population (World Bank recent estimates). This imminent risk requires many measures, among which the following: Adopt automatic wage and pension payment adjustments when consumer prices increase by more than 10%; replace the many public and para-public health schemes by a universal health system; strengthen and enlarge the safety nets that protect the poor; and implement urgent measures to upgrade public and vocational education. Moreover, a reduction in interest rate would impoverish many middle class individuals that have withdrawn from the labor market and



have been living off interest income. A program that helps bring back such individuals to the labor market, in parallel to the measures taken to increase growth, would help them adjust to the new economic circumstances.

Establishing Credible Monitoring Mechanisms

It is crucial to invest rapidly in the state mechanisms of control, which have been corrupted and weakened over time. To this end, the independence of the judiciary must be ensured; the Court of Accounts (Cour des Comptes), strengthened; the procurement agency, empowered to subject all public contracts to transparent and competitive bidding; and the regulatory authorities, activated in the electricity and telecommunication sectors. In addition to these reforms, which would serve to fight corruption, there is a need to set up a clear mechanism to retrieve stolen public money as well as evaluate and audit publicly funded projects for malpractice.

These measures will take time to be effective. **We recommend the urgent creation of a participatory monitoring mechanism of the performance of government (including the BdL).** In order to rebuild trust with citizens, policymakers need to enhance the way they communicate with them, and they must make information publicly available, including by activating the new law on access to information. **In the same vein, the group recommends the establishment of a consultation process with key stakeholders to build consensus on the rescue package,** including with the Economic and Social Council, business associations, trade unions, independent labor movements, and civil society organizations.

Lebanon Needs all the External Support It Can Get

External support would be extremely valuable in supporting these efforts.

Short-term emergency financial support would beef up foreign reserves, help stabilize the LBP, and avert a possible over-shooting of the exchange rate. Medium



term support would reduce the social pain associated with the needed reforms. Existing international commitment can play a useful role in improving growth prospects. However, these commitments need to be updated and adapted to the current situation, including in terms of providing more support for the needed short-term measures, and a discussion of the desirability of a supportive IMF program, if it can be fully adapted to the specificities of the Lebanese situation.

A Call for Responsible Action Now

There is a need to urgently form a credible government that can inspire confidence, and reduce the catastrophic risks looming ahead. An empowered cabinet needs to begin to bridge the trust gap between the government and its people, as well as with the international community, and take the fateful decisions needed for the preservation of the public good. The needed reforms will require aggressive and sustained action, and the ability to force powerful domestic actors into compliance. In the meanwhile, it is irresponsible to leave the crucial decisions needed in the next days and weeks, especially on the monetary and financial fronts, to the BdL alone. **It is thus necessary for the caretaker government to organize a crisis group immediately, including financial and legal experts, with the institutional capacity, and the legal means to act on the most urgent matters that cannot wait.**

The meeting was organized by the Lebanese Center for Policy Studies (LCPS), the Political Economy Observatory on the Middle East, and the Arab Reform Initiative.

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About Arab Reform Initiative

The Arab Reform Initiative is the leading independent Arab think tank working with expert partners in the Middle East and North Africa and beyond to articulate a home-grown agenda for democratic change. It conducts research and policy analysis and provides a platform for inspirational voices based on the principles of diversity, impartiality and social justice.

- We produce original research informed by local experiences and partner with institutions to achieve impact across the Arab world and globally
- We empower individuals and institutions to develop their own concept of policy solutions
- We mobilize stakeholders to build coalitions for positive change

Our aim is to see vibrant democratic societies emerge and grow in the region.

Founded in 2005, the Arab Reform Initiative is governed by a Plenary of its members and an Executive Committee.

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