

Lebanon: The Last Chance



By : Jamal Saghir*, Professor of Practice. McGill University
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On August 4, 2020, a violent explosion tore through Beirut, killing more than 170 people, wounding 6000 and leaving some 300,000 homeless. This is a turning point for a country devastated by economic, financial, social, and governance crisis, the worst in its history.

If the new government fails to properly implement any of the listed reforms or should it prove impossible to lay down a sound reform program and agree along these lines, Lebanon will enter a new cycle of financial, economic and social disturbances and will plunge in a widespread chaos and social and political unrest, the consequences of which are hard to assess at the national, regional and international levels.

All attention is on forming a new government. This is indeed the starting point, but first some fundamental aspects of the State need to be redefined. One fundamental duty is the protection of its citizens' basic civil rights – life, health, freedom and property. The State failed so far in providing such basic aspect of human rights.

Significant corruption at all levels has exposed not only the flaws in the economic and monetary systems and the weakness of Lebanese institutions, but also a lack of commitment to serious reforms since the end of the civil war 30 years ago. As a result, Lebanon has lost the trust of its citizens. The crises in the regions bordering Lebanon and, in the Middle East, is also putting increasing pressure.

If Lebanon is to survive for years to come, it must pursue the paths of social peace, inclusion and prosperity and through fully independent democratic government empowered with exceptional legislative power to lift the country out of the disastrous economic and financial situation and toward new elections.

The process of building a genuine Lebanese State can start today with the reconstruction of Beirut ground zero and with those fully committed to take all the necessary steps to solve the problems, put our affairs in order and rebuild confidence.

A Dire Economic Situation

Lebanon has been for several months in situation of sudden stop. It is facing a deep accumulation of interrelated political, social, economic, financial and environmental crises, mutually feeding at each other's at different level. The situation is horrifying—a confluence of crises engulfing security, politics and government, integrity in public office, the economy and banking sector, social unrest, and environmental degradation, each feeding off one another to creating a perfect storm rooted in Lebanon's past failed economic, social, environmental policies. The key elements of that perfect storm are:

- o Lebanon imports vastly more goods and services than it exports. Import-export imbalance is creating current account deficit around 25 percent of GDP, compared to other countries that faced similar crisis.
- o Unsustainable currency peg to the US dollar, with devaluation, hyperinflation, and economic depression.
- o Inability of Lebanon to repay international financial commitments
- o banking system completely paralyzed and not able any more to serve its clients and the economy.
- o Excessive government borrowing has inflated the politically well-connected banking sector that lends to the state at high interest rates. Banks also relied on wealthy Lebanese and especially the diaspora to deposit their money in Lebanon. The enormous interest rates earned by these depositors went into very few pockets; about 1 percent of all accounts were estimated to hold roughly half of total bank deposits estimated at US\$ 175 billion.
- o While the wealthy and politically connected got State-induced banking profits, the State is drained of any resources to tackle economic, social and environmental crises.
- o The fact that Lebanon's unproductive rentier economy revolves around banking and real estate, it creates, as a result, significant income inequality.
- o Instead of helping Lebanon getting out of the financial mess and be part of the solution, the Lebanese banking system is now part of the problems.
- o Regional conflict, instability, and economic embargoes and burden on Lebanon of hosting the largest population of refugees per capita in the world with 1,5 million Syrian.
- o A broken political system based on vested interests.
- o Rising inequality (one percent of accounts hold roughly half of Lebanon's US\$176 billion bank deposits; the top 10 percent of earners capturing 57 percent of income, the bottom 50 percent accounting for only 11 percent.)
- o Private sector underinvestment.
- o Burden of dysfunctional electricity, solid waste and water sectors.
- o Non-productive rent seeking economy based on banking and real estate.
- o Widespread corruption and cronyism making Lebanon on the top list.

In sum, Lebanon macroeconomic fundamentals are the worst among previous crises-stricken countries. It is the fifth most indebted country in the World, after Japan, Greece, Sudan and Venezuela with a Debt-to-Gross Domestic Product (GDP) ratio in 2018 of 150% and currently over 156% and a gross public debt of US\$ 87 billion. In addition, Deposit from resident and non-residents in the Banking system have been decreasing since the end of 2018. A year before this crisis, given a signal that something was wrong.

The consequences of these crises individually, and even more so combined, for Lebanon and all stakeholders involved (people, government, universities, civil society, private sector, NGOs, etc.) are devastating unless urgent policy action decisions are taken and implemented by the new government.

Dealing with the Crisis

To stop the downfall, the economy will need an immediate injection of at least US\$ 25 billion in fresh capital to prevent the collapse of the banking system and the economy. This excludes reconstruction needs after Beirut explosion estimated at around US\$3-5 billion. It is therefore critical that Lebanon begin a process of significant fiscal and monetary adjustments and structural reforms to contain public debt and raise economic growth. Structural adjustments, austerity plan, levelling the playing field and serious structural reforms are the only path out of Lebanon's current situation.

The new government should immediately agree with the IMF on a financial support package to address the macroeconomic imbalances problems while safeguarding the most vulnerable groups. Enhancing tax compliance and removing banking secrecy are needed since several professionals do not pay tax or under report their tax.

Fiscal discipline must be accompanied by economic and social reforms. A better balance must be struck between fiscal reforms and sector investment in growth and jobs. Fiscal reform is not viable without social justice. Tackling youth unemployment must be the priority. But such a reform program needs to be supplemented by a considerable financial support from the international community for Lebanon to stand on its feet again, in light of latest rebuilding and reconstruction needs and the financial crisis. IMF support would not doubt allow for a desperately needed debt restructuring to restore confidence. This would mean the nominal sum of debt would have to be reduced, interest payable cut and maturities extended. Only if the IMF is on board, the holders of debt will be willing to accept the restructuring.

A capital control program with a clear economic plan should be enacted to rebuild sustainable economic and financial conditions. This capital control will put pressures on our import activities, which is suffering from the parallel market devaluation of the Lebanese Pound, and increase the cost of imported products. Together with IMF financing, hope to resume remittance inflows and limited capital flight, Lebanon can expect a limited drain on the balance of payments in the coming few years. As the situation improves the capital control will be gradually eased. The choice of the best landing scenario for Lebanon will depend on the vision of the new government, its independence, and its ability to balance the potential social and financial costs.

The energy sector should be a core of the reform program. Only 64% of Electricity du Liban bills are being paid and the electricity sector account for around 50% of budgetary deficits. The private sector has a big role to play specially in supporting the shift towards renewable energies (sun and wind etc.). Decentralization of power generation is a global trend and now is the time for Lebanon to take this option. Another level of private sector participation to be considered is private generation given that the government has no money to invest in energy infrastructure. However, for that to materialize, some of the obstacles must be removed. The most important of which is the lack of a coherent legal framework and an independent regulatory body, which serves to balance the interest of private developers and the government while protecting the consumers.

The education sector is also crisis in Lebanon. In the last few years, it is estimated that the dropout rate levels have increased being the highest in low socioeconomic societies. Data shows that a child born in Lebanon today is 50% less productive in terms of achievements compared to children who completed their education elsewhere. In addition, because of the crisis, several schools closed. As part of the reform program the new government should propose suitable innovative solutions to reform the education sector.

The environment is also in crisis. Damages perpetrated to the environment in Lebanon during the last several years are substantial. The political elite and its cronies have caused its destruction and generated tremendous damage. From the use of crushers and quarries to inefficient allocation of water resources and wasting potable water to disregarding the problem of solid waste, successive governments led by vested interests failed to find suitable solutions. Lebanon is also facing climate change challenges and the total direct cost from climate change is estimated to be around \$2 billion in 2020. Lebanon is also witnessing a decrease in agricultural production impacting the GDP by 7-8%. The new government needs to seriously tackle these issues and reform the agriculture, water, solid waste and environment sectors and propose an ambitious climate change program.

The new government needs also to tackle up front smuggling through illegal ports and entry points and make rapid progress to reform the judicial systems, imposing rule of law and addressing the burden of debt which is destroying opportunity for too many citizens.

Economic reform is contingent on a political will to provide unquestionable efforts to cut costs, slash its public deficit, increase budget revenues, and improve the fiscal and balance of payments conditions. Only by creating the tools and resources for economic, financial, banking and industrial/manufacturing/agriculture policies, Lebanon can be put back on steady growth.

Lebanon does not need only a new government, it needs to recreate a sound governance structure. Thus, a prerequisite for the new government and aid support is to lay down good governance, unqualified transparency and full accountability, reforming the rule of law, the economic and financial systems and consolidating the social fabric.

Such an ambitious reform program needs to be enhanced by a substantial financial support from the international community without which it would be extremely hard for Lebanon to recover, especially in light of latest emerging reconstruction needs. The reality is that with over 50% below the poverty line, Lebanon is not a middle-income country anymore.

In conclusion, the new government needs to start implementation of reforms and show the political will for reforms. Whether Lebanon can confront such challenges robustly remains to be seen. Doing so is critical to unlock the international aid the country's economy so badly needs to resolve its staggering debt crisis and reconstructions needs.

*Jamal Saghir is a Professor of Practice at the Institute for the Study of International Development at McGill University, Montreal, Senior Fellow at the Payne Institute, Colorado School of Mines; and Distinguished Senior Fellow, Issam Fares Institute for Public Policy and International Affairs, American University of Beirut. He a former Director at the World Bank, Group, Washington DC. jamal.saghir@mcgill.ca.
<https://www.linkedin.com/in/jamal-saghir-96453097/>