LEBANON ECONOMIC MONITOR

Time for an Equitable Banking Resolution

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THE WORLD BANK
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EXECUTIVE SUMMARY

Recent Economic Developments

The economy continues to contract, albeit at a somewhat slower pace. Owing to better-than-expected data, we are revising (upward) our estimated contraction in real GDP for 2021 to a nonetheless significant 7 percent (from 10.4 percent in the last LEM). Our 21.4 percent estimated contraction in real GDP in 2020 remains unchanged. While tourist arrivals have risen by 132 percent (yoy) in 12M-2021, up from a Covid-induced low base, the recovery has not been sufficient to compensate for the persistent increase in the current account deficit and the substantive drop in private consumption.

Public finances improved in 2021, but only because spending collapsed faster than revenue generation. Revenues are estimated to have declined from an already low 13.1 percent of GDP in 2020 to 6.6 percent of GDP in 2021, among the lowest rates globally. As the decline in revenue was, however, outpaced by an even larger decrease in total expenditures (10.5 percentage points (yoy) to 5.9 percent of GDP), the 2021 overall fiscal balance is estimated to have reached a surplus (of 0.7 percent of GDP).

Testament to the continued atrophy of Lebanon's economy, the Lebanese Pound continues to depreciate sharply. The Lebanese Pound (LBP) depreciated 137 percent in 2020, by 219 percent in 2021, and in the first 10 months of 2022 is already down an additional 145 percent (Average Effective Exchange Rate as estimated by the World Bank).[1] The steady depreciation is despite BdL's FX interventions to attempt to stabilize the banknote rate (BNR)/parallel market exchange rate at the expense of dwindling reserves.

The sharp deterioration in the currency continues to drive surging inflation, in triple digits since July 2020, impacting the poor and vulnerable the most. Inflation averaged 150 percent in 2021 and 218 percent (yoy) in the first half of 2022 (reaching a peak of 240 percent (yoy) in January 2022). Inflationary pressure was exacerbated by the rise in global food prices since the onset of the Ukraine war. Globally, Lebanon is one of the countries most affected by food price inflation owing to the destruction of its strategic wheat reserves in the Beirut port explosion, heavy dependance on Ukrainian and Russian wheat imports and the depreciation of the LBP; food inflation stood at 332 percent

[1] The Bank-calculated Average Exchange Rate (AER) methodology is detailed in the Lebanon Economic Monitor, Fall 2020: The Deliberate Depression.

(yoy) in June 2022. Inflation is a highly regressive tax, disproportionally affecting the poor and vulnerable, especially since basic goods including food items are the primary drivers of overall inflation.

Surprisingly, for a country in a protracted and deep depression, and in sovereign default, Lebanon continues to run a sizable current account deficit. The current account deficit increased from 2020 to 2021 (from 9.3 to 12.5 percent of GDP, respectively), and is expected to broaden further in 2022. Customs data point to: (i) a higher energy import bill (in US$) as lower volumes are offset by surging global energy prices, and (ii) a significant nominal increase in non-energy imports (by 21.1 percent in 2021). The current account deficit continues to be financed from the remaining usable gross foreign reserves at the central bank and a pervasive cash economy, in which importers have also relied on cash to access credit lines for imports that now require 100 percent cash collateral.

Outlook and Risks

Real GDP is projected to contract by a further 5.4 percent in 2022 assuming continued political paralysis and no implementation of a recovery strategy. The BLOM-PMI index has inched up to 48.5 in the first nine months of 2022 and tourist arrivals have increased by 51.2 percent (yoy) until August. However, net exports remained negative, as imports increased faster (40.7 percent (yoy) in 7M-2022) than exports (12.7 percent). Part of the increase in imports was driven by industrial goods imports (42.7 percent).[2] Anticipated increases in custom duties and the customs duties exchange rate have likely contributed to the substantive increase in industrial goods imports and have driven the hoarding of those goods in anticipation of the price adjustment.

Inflation is expected to average 186 percent in 2022, amongst the highest globally, partly due to the shrinking share of imports based on BdL subsidized rates. This surge in the inflation rate arises despite a relative decrease in narrow money supply growth in 8M-2022, owing to a change in the dynamic relationship between inflation and depreciation. The increase in the pass-through is also linked to higher levels of dollarization in the economy-notably for services that had been previously priced in LBP at lower than market value exchange rates and have now been dollarized.

An unprecedented institutional vacuum will likely further delay any agreement on crisis resolution and much needed reforms; this includes prior actions as part of the April 2022 IMF staff-level agreement (SLA). While Lebanon is no stranger to political paralysis, the price of an institutional vacuum is at an all-time high, as it impedes decision-making and reform ratification, deepening Lebanon's long-term economic woes and the plight of the Lebanese people. An IMF program remains elusive as the authorities have yet to complete ten reforms up front. A fragmented parliament, coupled with governmental and presidential vacuum casts further doubt on the ability to complete prior actions and secure a final agreement in the next few months.

Time for An Equitable Banking Resolution

Divergent views among key stakeholders on how to distribute the financial losses remains the main bottleneck for reaching an agreement on a comprehensive reform agenda. Such discord prevents banking sector resolution which is critical for restoring financial sector stability and economic recovery. Global best-practice principles endorse a financial sector rehabilitation strategy that recognizes and addresses the large losses in the sector upfront, respects the hierarchy of claims, protects small depositors, and refrains from recourse to public resources. Key stakeholders in Lebanon, however, strongly oppose such a resolution, calling on the State to bear responsibility for the ongoing crisis and to privatize public assets and/or draw on future government revenues to bail-out the financial sector.

[2] This includes imports of the following categories: Wood, Rubber and Chemical Products; Non-Metallic Products; Textiles; Capital Goods; and Equipment Other than Capital Goods.

The size of the balance sheet and associated losses make Lebanon's financial sector, *too big to bail*. Financial losses exceed US$72 billion, equivalent to more than three times of GDP in 2021. Combined losses stem from a public sector in default, a central bank holding the largest negative reserves position in the world, and an oversized and insolvent banking system. Therefore, the magnitude of the holes in the intertwined balances sheets of the Central Bank, the banking sector and the Sovereign, dwarfs the current and future assets that the sovereign could realistically mobilize for a bailout. State-owned assets and public real estate are worth only a fraction of the estimated financial losses, as are any potential revenues from oil and gas, which are still indeterminate and in any case years away. Given the uncertain valuation of both assets, any crisis resolution plan that relies on these would lack credibility and fail.

A bailout of the financial sector by taxpayers would redistribute wealth from poorer to richer households, as the public would be asked to compensate bank equity holders and wealthy depositors. Pre-crisis, 50 percent of deposits in Lebanon's banking system were owned by 1 percent of depositors; with 20 percent of deposits held among 0.01 percent of depositors. The heavy concentration of deposits amongst a few high-net-worth individuals, marking one of the most unequal distribution of deposits in history, must serve as a basis for equity and fairness considerations. As argued in our Spring 2021 Lebanon Economic Monitor issue *Lebanon Sinking (to the Top 3)*, not only is a bailout of the financial sector unviable, but it is also inconsistent with the restructuring principles that protect taxpayers and small depositors and foster equitable burden sharing.

A bail-in solution, based on a creditors' hierarchy, along with comprehensive reforms is the only realistic option for Lebanon to turn the page on its flawed development model. A bail-in, makes large creditors and shareholders bear the main cost of bank restructuring, by writing down, canceling and/or converting liabilities into equity; this allows viable banks to regain solvency and ensures the protection of small depositors. Lebanon's post-civil war development model has been characterized by strong interlinkages between the fiscal-monetary-financial sectors, rendering one overly dependent on the other, and in the end leading to systemic failure. With the sovereign default of March 2020, the erstwhile equilibrium has collapsed. Lebanon must now move to a new sustainable development model. Delays in the day of reckoning with the magnitude and viable distribution of financial losses will only compound human and social capital losses. As repeatedly called for, Lebanon needs to urgently adopt a domestic, equitable, and comprehensive solution that is predicated on: (i) addressing upfront the balance sheet impairments, (ii) restoring liquidity, and (iii) adhering to sound global practices of bail-in solutions based on a hierarchy of creditors (starting with banks' shareholders) that protects small depositors.

Special Foci

Lebanon's four-year contraction in real GDP has already wiped out 15 years of economic growth and is scarring the country's potential for recovery. The depth of the cumulative economic contraction ranks Lebanon's ongoing crisis among the worst ever since the 1850s.[3] In **Special Focus I**, we assess the severity of Lebanon's crisis by comparing it to a select group of Fragile and Conflict States (FCS). We conclude that Lebanon's macroeconomic performance is worse—or—at best—on par, with those of this specific FCS group (Zimbabwe, Yemen, Venezuela and Somalia). Strikingly, the contraction to date is comparable to that Yemen during the first four years of war. The depth and duration of the Deliberate Depression[4] is reducing Lebanon's potential for growth as its physical, human, social, institutional, and environmental capital are rapidly and potentially irreparably being depleted.

In Special Focus II, **we analyze dollarization in Lebanon, and conclude that the current crisis will likely reinforce high levels of dollarization, even upon recovery.** Historically, multiple currency crises led to hysteresis in dollarization in the country,

3 See Lebanon Economic Monitor, Spring 2021: Lebanon Sinking (to the Top 3).

4 See Lebanon Economic Monitor, Fall 2020: The Deliberate Depression.

with the extent of dollarization widening over time for deposits, lending, and public debt. We find that Lebanon's financial system was not developed beyond the banking sector, and the lack of a capital market has prevented the development of diversification and hedging instruments that could have helped to reduce or reverse dollarization. Going forward, the current crisis will further reinforce the hysteresis driver of dollarization. The development of capital markets remains unattainable under current conditions and will require macroeconomic stability in the short term and new growth model in the long term.

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