Forum: Advisory Panel on Question of Middle East

Issue: Addressing the Lebanese Liquidity Crisis

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Introduction

In light of the fact that the majority of Lebanon's population is on the verge of poverty, the country currently has one of the highest debt to Gross Domestic Product (GDP) ratios in the world and a banking industry that is under pressure to fail. The structural issues in Lebanon, corruption, and rent-seeking among the political class are to blame for this grave condition. These latest events simply serve to highlight how fundamentally political the Lebanese dilemma is, stemming from a lack of sound economic and political leadership as well as the political practice of relying on outside protection and funding. Such an issue that affects the entire Lebanese nation is mainly caused by the downfall of Lebanese economical policies which is widely known as the Lebanese liquidity crisis.

The COVID-19 epidemic in Lebanon and the 2020 Beirut port explosion both served to significantly intensify the existing financial crisis in Lebanon, which first became widely recognized in August 2019. The problem has deep-rooted causes, and the nation had a liquidity crisis in the years before 2019, but the central bank governor's financial engineering masked the real degree of the economy's fragility.

The commencement of significant protests in October 2019 appears to have signaled the start of Lebanon's current economic and financial crisis. A community that was typically divided along religious and sectarian lines appeared unified during those three to four months against the whole ruling political elite, demanding their resignation with phrases like "all of you means all of you." The widespread and unifying movement quickly dissipated as the Lebanese people felt pressure from the rapidly depreciating national currency. All efforts to try to form coalitions failed because activists could not even agree on the actual reasons for the unraveling crises, the priorities, or the types of political reforms they would fight for. As a result, the uprisings failed to produce any party or formation that could independently provide a political alternative.

Definition of Key Terms

Budget deficit: An overrun in spending over income results in a budget deficit, which can be a sign of a nation's financial stability. The phrase is frequently used to describe government spending rather than that of companies or people.

Bangue Du Liban (BDL): Banque Du Liban is the national central bank of Lebanon. It is responsible for the monetary actions and the economical policies followed by Lebanon.

Gross Domestic Product (GDP): The total monetary or market worth of all the finished goods and services produced within a nation's boundaries during a certain time period is known as the gross domestic product. It serves as a thorough assessment of the state of the economy in a particular nation because it is a wide indicator of total domestic production.

Fixed Exchange Rate: A fixed exchange rate is a system used by a government or central bank that links the value of the nation's official currency to the currency of another nation or the price of gold. A fixed exchange rate system's goal is to maintain a currency's value within a specific range. In order to ensure that their money stays at a fixed rate, central banks use up lots of foreign currencies to exert upward pressure on their devaluating currency, leaving countries such as Lebanon in a hard place.

General Overview

Tensions between Lebanon's Muslim and Christian populations led to the Lebanese Civil War, which lasted from 1975 until 1990. Socioeconomic divisions and the presence of PLO combatants in Lebanon throughout the 1970s both served to intensify the conflict (PLO). Muslims and leftists in Lebanon supported the PLO in 1975 and sought increased political influence; Christians, who wanted to maintain their political hegemony, opposed the PLO. Through the early months of 1976, the sides fought furiously, and Lebanon effectively split into two, with Christians in the north and Muslims in the south. Israel and Syria both originally intervened on the side of the Christians, who had started to lose ground, out of fear of a wider war. Israel invaded southern Lebanon in 1982 to demolish Palestinian insurgent bases. PLO forces were expelled from Beirut, and by 1985 Israel had largely left the country. At that time, Lebanon was internally divided on whether to recognize Syria as its government. When parliament failed to choose a successor in 1988, a crisis between two competing governments with competing claims to legitimacy resulted. In 1989, the Arab League brokered a peace agreement after Christian leader Gen. Michel Aoun's failed attempt to expel Syria from Lebanon. The fall of Aoun from power in October 1990 signaled the end of the civil war and removed a significant barrier to the execution of the 1989 Taif peace agreement.

Leaving a long-lasting civil war with major devastation on its country's economy, BDL was seeking additional financial policies to support the Lebanese economy. BDL and the Lebanese authorities decided that to pick up the Lebanese economy back to its place and to ensure economic growth, the unstable currency rates should be fixed. Thus, ever since 1997, the Lebanese pound has been fixed at a rate of £L1,507.5 to one US dollar. For more than 20 years, the Lebanese central bank's policy has been based on the pound's stability. It was intended to bring about the nation's urgently required stability following a significant depreciation of the Lebanese pound following the end of the Lebanese Civil War. In order to keep this fictitious exchange rate in place, Lebanon's post-war economy depended on a variety of foreign currency inflows, including tourism, real estate, remittances from its over ten million-strong diaspora, and a sizable financial sector that provided depositors with highly valued anonymity through banking secrecy and high-interest rates. The massive trade needed these inflows in order to be funded.

Since the end of the civil war in the late 1980s, Lebanon has had a chronic deficit in its trade balance. From 1990 to the eve of the global financial crisis in 2007, the negative balance fluctuated between $3.5 billion and $6.5 billion annually. Annual deficits rose to almost $10 billion per year starting in 2008 and peaked in 2011. The trade imbalance continued to rise, hitting $15 billion in 2014 and fluctuating between $13 billion and 2019 thereafter. Since 2010, these deficits have continuously ranged between 25% and 35% of GDP, which is quite high relative to the size of the economy. The so-called developments seen towards the end of 2019 with a 20% GDP deficit are essentially the outcome of a sharp decline in consumption as imports plummeted against the backdrop of the economic catastrophe. According to various estimates, the average deficit since the end of the civil war in 1989 has been close to 32% of GDP, while the global average is closer to 5% or 6% of GDP. This highlights the size of the trade deficit and the scope of the accumulated deficits, which have grown to be a key aspect of the Lebanese economy.

The BDL's monetary policy did not seem to take into account the change in economic activity because of its reliance on currency inflows. Between 2011 and 2015, interest rates stayed high at around 6%, and they nearly hit 10% in 2016. According to official statistics, the GDP remained anemic, growing at a rate of 0%, and it entered a recession starting in 2017. It appears that the economy didn't need this high-interest rate approach at all. It demonstrates the BDL's decision to decrease interest rates to jump-start GDP development while putting private banks' appeal ahead of the national economy and local jobs. The BDL's first aim was to advance the strategically significant collection of foreign currency deposits for the sake of its own stability. The Association des Banques Libanaises (ABL), a syndicate of bank owners, had an exponential increase in the amount of interest revenue it collected from 2016 onward, from an already high level of $3.5 billion in 2014 to approximately $8.5 billion in 2018. In 2018, these earnings made up more than 15% of the GDP. In France, where the banking industry plays a big role in the economy, revenues made up 6% of GDP in the same year. The same pattern held true for dividends. They climbed in just two to three years, during a period of decreasing economic growth, from a level of $600 million to more than $1.1 billion, an increase of about 100%.

In addition, the central bank actively pursued a lending strategy to the government through the underwriting of debt instruments, principally in Lebanese pounds but also in some US dollars as well. It demonstrates the interwoven interests of the numerous actors and the crucial roles played by the ABL and the BDL in this context that over 40% of the bank shares belong to influential political personalities from the succeeding governments since 1990. Which highlights the uprising corruption that has led Lebanon into its current state.

Increase in Public Debt and Income

In December 1997, it was also decided to set the Lebanese pound's exchange rate to 1507 to the US dollar. Long-term efforts to stabilize the national currency since 1992 led to this conclusion. Following the Taif peace negotiations at the end of the civil war, the Lebanese pound went through a period of severe instability and depreciation. The Lebanese currency fell to roughly 3,000 to $1 in the final three months of 1992 from a ratio of 500 to $1 at the start of 1990. Rafic Hariri was elected prime minister in the same year that Nabih Berri was elected speaker of the parliament. In 1993, Riad Salameh was chosen to serve as governor of the central bank. The ability to draw foreign direct investment, notably from the Gulf nations, was the cornerstone of Hariri's plan for the country's rehabilitation. However, a major barrier was the local currency's general instability and depreciation. The Lebanese Pound gradually stabilized over the course of four years under Mr. Salameh, with the level being set at 1507 to 1$ in December 1997. Only by increasing foreign currency reserves was this made possible. The decision to begin borrowing in US dollars was made, and in 1993, the debt load began to increase. The amount of foreign debt grew dramatically starting in 1997. Over time, this turned out to be a disastrous tactic. It imposed high-interest rates and tight monetary policies, which made it difficult for the economy to adapt to changing conditions. This posed a significant risk to a small, heavily dependent on international trade economy. Two lost opportunities for the fixed exchange rate to be modified to reflect the worsening of the global liquidity position were the events of 2011 and the adjustments to the global oil markets in 2014.

In the summer of 2014, oil prices started to drop quickly. Prices dropped below $45 per barrel at the start of 2015 from around $120 per barrel in July 2014. In February 2016, prices dropped below $30 per barrel amid extremely high volatility. The majority of oil exporting nations, particularly the Gulf states, saw a significant decrease in economic activity as well as severe fiscal and balance of payments deficits as a result. Lebanese workers in the Gulf countries are the primary senders of remittances to Lebanon, accounting for 50% to 60% of all transfers. The ability of the diaspora to maintain the same level of transfers was significantly hampered by the sharp decline in oil prices. They began to fall in the summer of 2016, and many institutional depositors and customers from the Gulf states started to remove part of their accounts as a result of pressing liquidity needs.

2016 witnessed no increase in the number of deposits held by Lebanese banks. In response, the BDL swiftly increased interest rates to assist banks in safeguarding and expanding their critical deposit base. Net deposits moved into negative territory at the end of that same year after a brief recovery in the last quarter of 2016 and the beginning of 2017, and they decreased by 5% at the end of 2018. As soon as the upheavals started in the fourth quarter of 2019, all banks imposed rigorous limitations on deposit withdrawals.

The primary components of state spending demonstrate the rentier underpinnings of Lebanon's economy, which was built on a strictly consumption-based framework. To pay off the growing debt, interest costs take up more than a third of consumption. Almost 25% goes to pay employees in the public sector, and almost 40% is spent on subsidies. The deficit of the country is greatly influenced by subsidies. They have recently contributed $5.2 billion toward the $12 to $15 billion annual gap. Energy-related subsidies make up roughly 60% of all subsidies. Subsidies for energy and gasoline are inherently regressive, favoring those with the highest disposable incomes. This encourages excessive consumption and the further widening of the already unacceptably high inequality gap. Payroll costs for governmental employees and current operations make up 95% of overall spending. There is no room for any significant infrastructure investments as a result. In light of this, Lebanon has some of the lowest tax receipts in the world, with the corporation and income taxes never amounting to more than 5% of GDP and the sum of all taxes never reaching 14%–15% of GDP. These actions caused the financial system to completely collapse, resulting in a bankrupt banking industry and exhausted foreign exchange reserves, as well as an unpayable national debt.

In 2019, debt as a percentage of GDP was 170%. Due to the high cost of interest paid on the current inventory, the debt keeps expanding. GDP was barely $34 billion in 2020, while debt levels kept rising at the same time. Thus, the debt burden reaches 250% of GDP. However, this is probably an understatement. The debt ratio will be substantially higher in 2021, approaching levels closer to 350% of GDP, according to GDP estimates. This amount of debt is unpayable. Because it had no other choice, the Lebanese government announced a default on a debt obligation in 2020.

At the end of 2019, Lebanese banks unilaterally implemented measures to severely restrict access to customers' deposits in US dollars at the official rate of 1507, establishing de facto capital control and breaking the fixed exchange rate. This was done in response to a snowballing trend of deposit withdrawals and in anticipation of a full-blown bank run. All of these measures were imposed despite there being no legal framework.

The BDL developed numerous exchange rates "specific to sorts of transactions," refusing to formally accept the fixed exchange rate's effective collapse. As a result, the financial system completely lost public confidence, the payment systems were disrupted, and many international banks in Europe and the US imposed restrictions on money transactions to and from Lebanon. After two years of financial instability, the most recent analysis of these estimates shows that there are still around $110 billion in deposits, with 70% of them being in foreign currencies. In the context of what has been referred to as "financial engineering" in recent years, the banks' combined assets show that 70% of total loans were made to the government and the central bank through a mix of purchases of treasury bonds and loans to the central bank. The central bank has an $85 billion debt to the banking industry in its most recent public balance sheet, despite having just $12 billion in reserves on hand. The BDL is compelling its debtors to accept the LBPs it is issuing at an increased rate in order to close this shortfall. As a result, the national currency is further depreciating and hyperinflation is being fueled. The LBP is now worth 34,000 on the black market, up from 2,000 at the start of 2020. Nothing can stop this trend from continuing in the direction of 50,000 and beyond. The current financial system is insolvent and broken. The economy of Lebanon cannot recover.

The black market exchange rate peaked at LBP1,600 per US$1 in the fourth quarter of 2019. It then rose to LBP3,000 per dollar in April 2020, LBP14,000 per dollar in March 2021, and LBP15,200 per dollar in June 2021. At a rate of LBP2,000 to US$1, one bank let depositors withdraw Lebanese pounds from their dollar accounts. The prime minister harshly criticized the central bank governor over his administration's performance as a result of this, which greatly enraged the banks. The devaluation of the Lebanese pound brought on by severe dollar shortages inside of Lebanon causes the USD black market exchange rate to vary significantly even today. Additionally, 785 restaurants and cafés closed between September 2019 and February 2020 as a result of the dollar shortage, which led to the loss of 25,000 employees. The biggest economic crisis in decades has resulted in a 580% surge in consumer goods prices since October. The economic crisis caused Lebanon's gross domestic product to decrease from roughly $55 billion the previous year to about $44 billion.

Effect on Lebanese People

One of the major issues people faced, aside from the aforementioned block on their bank accounts, was electricity. By itself, the operational deficit created by the Lebanese electricity company during the past 30 years accounts for 46% of the estimated $95 billion in overall public debt at the end of 2020. The primary causes of this issue are, on the one hand, the high rate of unpaid bills and, on the other, the unit kWh cost to the consumers. Based on the $22 per barrel oil price at the time, the price per kWh was established in December 1997. Lebanese electricity company's losses grew dramatically as oil prices reached levels of $140 per barrel. For more than 20 years, no government was ready to alter the reference prices for the Lebanese electricity company. Lebanese electricity company ultimately went bankrupt and was unable to supply electricity. Thus, many people implemented their own electricity generators and were buying oil to produce their own electricity. However, the skyrocketing oil prices also left the Lebanese people choiceless.

There was even a 24-hour blackout in Beirut and an incident of oil generation that led to the death of 33 Lebanese people.

The overall economic impact of this economic downfall is even worse. According to the report published by UNICEF in June 2021: "*Over 30 percent of children went to bed hungry and skipped meals in the past month. Seventy-seven percent of households do not have enough food or enough money to buy food. In Syrian refugee households, the figure reaches 99 percent. Sixty percent of households have to buy food on credit or borrow money. Thirty percent of children are not receiving the primary health care they need, while 76 percent of households said they are affected by the massive increase in medication prices. One in ten children has been sent to work. Forty percent of children are from families where no one has work and 77 percent are from families that do not receive any social assistance. Fifteen percent of families stopped their children's education. Eighty percent of caregivers said their children had difficulties concentrating on their studies at home – which might indicate hunger or mental distress.*"(UNICEF)

Many people have limited access to vital medicines and various services crucial for living. About 80 percent of the Lebanese people live under the poverty line. There are many Lebanese people railing into banks trying to draw their investments in dollars. Many Lebanese people took bank workers hostage and negotiated to receive a portion of their investments and savings in dollars. Some of these people are even called "heroes" among the public.

Major Parties Involved and Their Views

Lebanon

Obviously, being the main party in this issue, Lebanon's government in its entirety is responsible for this crisis. The inability to implement economic policies, irresponsibly planned monetary and fiscal policies, and corrupt officials who are caught taking bribes and using governmental tools for themselves are the major problems of Lebanon. Government officials consistently denied the issue in the past which led to an inevitable crisis.

Syria

One of the greatest refugee-to-population ratios in the world is seen in Lebanon. Since the start of the war in Syria in 2011, a sizable influx of refugees has put tremendous strain on the social system, particularly on the consumption of food and energy. Even if each person consumes very little in the way of goods and services, the sheer volume of refugees is shocking in every way. According to statistics by the UN and World Bank, there were 35% of refugees in the world in 2014. In addition, Syria used to be its major trade partner Lebanon, with its downfall to terrorism, the economical collapse of Lebanon was also caused by Syria's crisis with terrorism.

United States of America

Being one of its top trading partners, the United States has been both helpful and harmful to the Lebanese economy. The United States is an active member of the global economy of Lebanon. However, there have been constant sanctions implemented on various Lebanese individuals due to their connections with Hasbullah-backed Iran. The United States also plays a crucial role in this issue since the Lebanese Pound is fixed to the Dollar and the BDL lacks a severe Dollar reserve.

Timeline of Events

13 October 1990	Lebanese Civil War ends
December 1997	The exchange rate has been fixed at LBP 1,507.50 per US dollar.
May 2015 - May 2016	The BDL experienced a decrease in its dollar reserves, for the first time in 11 years.
17 October 2019	The first large-scale protests against the Lebanese Government took place.

UN Involvement

While there haven't been any direct involvement by the United Nations, organizations such as the World Bank, International Monetary Fund, and UNICEF have been working towards the advancement of the Lebanese economy and helping the Lebanese people. There have been many reports prepared and suggestions made to correct the Lebanese economy by the aforementioned organizations, such as the ones listed below.

Relevant UN Documents

Visit to Lebanon Report of the Special Rapporteur on extreme poverty and human rights, Olivier De Schutter (11 April 2022, A/HRC/50/38/Add.1)

Lebanon’s Crisis: Great Denial in the Deliberate Depression, Press release by the World Bank (https://www.worldbank.org/en/news/press-release/2022/01/24/lebanon-s-crisis-great-denial-in-the-deliberate-depression)

Security Council Press Statement on Lebanon (25 May 2022, SC/14905)

Treaties and Events

2020 Beirut Port Explosion

A significant quantity of ammonium nitrate stockpiled in the Port of Beirut in Lebanon's capital city erupted on August 4, 2020, resulting in at least 218 fatalities, 7,000 injuries, $15 billion in property damage, and an estimated 300,000 people being made homeless. 2,750 tonnes of the chemical, which is roughly equivalent to 1.1 kilotons of TNT, had been taken off the abandoned ship MV Rhosus by the Lebanese government and had been kept in an unprotected warehouse for the previous six years. The same warehouse experienced a fire before the explosion. In reaction to the catastrophe, the Lebanese government proclaimed a state of emergency lasting two weeks. Following the accident, protests broke out across Lebanon against the government for failing to stop it, adding to a bigger wave of demonstrations that had been occurring since 2019. Prime Minister Hassan Diab and the Lebanese cabinet resigned on August 10, 2020. The nearby grain silos suffered significant damage. Part of the silos collapsed in July and August 2022 as a result of a weeks-long fire in the leftover grain. On top of the economic downfall on the verge of COVID-19, the Lebanese government faced another economical catastrophe.

Evaluation of Previous Attempts to Resolve the Issue

For many years into this crisis, the Lebanese government and various officials have denied the issue and corrupted the data. Aside from those, the constant borrowing of many from different sources such as Eurobonds and the International Money Fund was not only ineffective but also increased the public debt of Lebanon. The insufficient and incapable administration of BDL also led to a major loss during solutions as well.

The BDL started a string of financial engineering procedures that the media came to refer to as the swap. The Lebanese pound-denominated public debt that the central bank held was exchanged for Eurobonds, or debt denominated in foreign currencies, for the amount of US$2 billion. The central bank swapped these Eurobonds for genuine foreign currency with a number of commercial banks between June and October 2016. As a result, the Lebanese economy was able to avoid the effects of a liquidity crisis at the time. However, the operation cost the entire economy a fortune and increased the public debt in dollars significantly. According to the International Monetary Fund, the operation made the banks that participated US$5 billion while costing the central bank US$13 billion in foreign currency. According to these numbers, the banks who participated in the deal generated a 40% profit. In the years that followed, the central bank carried out similar financial engineering. Even with these operations, Lebanon was unable to bring in enough foreign investment to meet the escalating demand. Some commercial banks began limiting depositors' access to their own savings in foreign currency as early as late 2018; typically, they levied a significant extra fee on cash withdrawals in US dollars to discourage customers from withdrawing dollar cash. Briefly, every action taken by BDL such as financial engineering or the money-borrowings was unsuccessful and made the crisis even worse.

Possible Solutions

A thorough revamp of the banking industry is necessary, necessitating extremely challenging decisions. Restructuring the banking industry would require a thorough audit and complete access to all accounts and payment flows. It is necessary to announce a distribution of losses policy with the goal of safeguarding society's weaker groups from suffering losses of income or assets. The principal beneficiaries of such arrangements would be deposit accounts with balances below a to-be-determined amount and retirement and health insurance fund accounts.

In the meantime, the Lebanese energy business accounts for close to 50% of the nation's entire debt in compounded losses. Without addressing this main issue, there is no feasible departure route. The Lebanese energy company's production costs are nearly twice as high as global averages. It must be quickly brought down to levels that are more typical. Parallel to this, fuel subsidies must be replaced with a system that is more focused on helping users with lower incomes, while implementing increased taxation through a progressive value-added tax on users with higher incomes, as well as users in the business and public sectors.

One of the greatest gold inventories in the world is held by the BDL. The reserves are thought to be 9.2 million ounces in weight. It is currently worth $17 billion. Concerns about other comparable assets include Middle East Airlines, Casino du Liban, Intra Bank, and a sizable property estate. For the objective of reviving economic activity, state-owned assets must be protected to the greatest extent possible and used as guarantees for new infrastructure and social programs. They shouldn't be utilized just to make up for losses suffered and unpaid debt. It is extremely crucial to come up with ways of diversifying the Lebanese Economy to prevent a reoccur or the continuation of this crisis.

Another and final way to eliminate any other cases like this crisis to occur is to eliminate the corrupt government as much as possible. It must be ensured that the laws of Lebanon are implemented and followed transparently by capable and clear government officials.

Finally, human aid must be considered during the solution suggestions, it must not be forgotten that most people are living in poverty and some people have very limited access to even the most basic goods and services.

Notes from the Chair

Due to the severity of the financial crisis in Lebanon, both the social and cultural accord that had been in place since the 1990s and the state's very foundation have been undermined. Many typical responses and attitudes show a condition of denial in the culture, and the general populace is too stunned to comprehend this reality. A move away from a rigid consumption-based economy is necessary for exit strategies, as is a precise and systematic reallocation of resources. With unreliable financial sources, Lebanon cannot sustain its current high trade deficits. Deep reforms are therefore improbable. The most likely conclusion is a first step minimally acceptable deal with the IMF. The European Union and other financial institutions might step up their help in response. On this restricted basis, a push towards a reconstruction plan where specific agreements can be made using a public-private partnership model with the assistance of international financial institutions could be expected. Although this will undoubtedly have a positive effect, it will not address the fundamental demands for profound economic, social, and constitutional change and enable the emergence of a viable economy and a long-term stabilized Lebanese society on the borders of Syria, which is seeking its own strategy of reconstruction. Beyond just the Lebanese people, the region will be impacted by how Lebanon resolves this situation. Lebanon can demonstrate that it is possible to take advantage of a crisis of this magnitude to create a modern state where everyone has the same rights. Alternately, it can demonstrate that the present and following generations do not yet have access to the promise of secure, affluent, socially democratic constitutions. As a result, the well-being of not only one state but the whole Middle Eastern/Gulf countries should be sought through the clauses and solution suggestions experts will come up with. While the issue at hand called for big scaled and major economic actions, the Lebanese people, the ongoing political crises the issue has led to, and the unfunctional government branches must be addressed as well.

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