

Lebanon: Immediate Measures ... Before Seeking External Assistance

This article by Dr. Saleh Mounir Nsouli and Dr. Abdallah Bouhabib deserves to be placed on the agenda of the Government, as it includes specific ideas and suggestions on the measures that the Lebanese Government needs to take immediately, instead of waiting for external assistance. The value of these ideas and suggestions stems primarily from the expertise and extensive experience of the authors. Dr. Nsouli has served for almost 40 years at the International Monetary Fund, where he was the Director of the European Offices. He also occupied other numerous high-level positions at the IMF and negotiated several programs of macroeconomic adjustment and financial restructuring with Middle Eastern and African countries. He is the author of academic books, studies, and articles on economic and financial policies. As for Dr. Bouhabib, he has twenty years' experience in the World Bank, seven years in the diplomatic service at the Embassy of Lebanon in Washington, where he served as Ambassador during a delicate historical stage (the eighties), headed the Issam Fares Center for Lebanese Affairs over a period of ten years (2007- 2016), and has maintained a close relation with decision makers in Lebanon in recent years. He is the author of two books dealing with US policies toward Lebanon and the Arab World. He frequently writes articles for Lebanese newspapers and websites (180).

Lebanon today is facing a major economic and financial crisis owing to poor economic and financial policies and widespread corruption extending over several decades. Apart from poor economic growth and rampant unemployment, this has been manifested, since late last year, in a critical foreign exchange crisis and a virtual paralysis of the financial sector. The long time - three months - that the government took to reach an agreement on an economic and financial policy direction led to the exacerbation of the crisis and increased the gravity of the situation. The document, which was approved by the Government last week, is without a doubt laudable, but Lebanon still needs a consistent road map of carefully sequenced measures to achieve the desired goals.

Although there are a multitude of factors that can be identified for precipitating the current crisis, there are three overarching factors that account for the current situation:

- 1. Exchange rate policy:** Lebanon was one of the first countries in the world to adopt a floating exchange rate policy, that served Lebanon well for several decades, with healthy growth rates, financial stability, and a flourishing reputable banking sector. Lebanon was the "Switzerland of the Middle East". In 1997, Lebanon abandoned the floating rate and fixed the exchange rate at a highly overvalued rate that affected adversely local production and

promoted imports. This was equivalent to subsidizing all imports, thereby leading to a growing external sector imbalance.

2. **Artificially high interest rates:** To cover that imbalance, Lebanon relied on foreign exchange inflows attracted by the banks that had to offer high interest rates. The banks were supported by artificially high returns on their deposits at the Central Bank and on Government Treasury Bills. These interest rates generated the foreign exchange that was used to support the overvalued exchange rate and implicitly subsidized imports, further harming the domestic industrial, services, and agricultural sectors. Concurrently, the high interest rates weighed more and more on the budget, which had to be financed by increased borrowing, generating a vicious circle of rising public debt and widening fiscal deficits.
3. **Subsidies to the electricity company (EDL):** To further complicate matters, successive Governments, since the end of the civil war in 1990 failed to reform the electricity sector, with EDL falling into disrepair and electricity tariffs being kept at the 1990s level. This required massive Government subsidies that significantly aggravated the budgetary situation and have accounted till now for nearly 40% of total public debt.

This was not a sustainable situation. With public debt mounting, with the banks relying heavily on high interest on their deposits at the Central Bank and on Treasury Bills, and with a widening budgetary deficit and rising external sector imbalance, confidence in Lebanon's banking system started to wane and foreign exchange inflows started to falter. With the continued dwindling foreign exchange to support the artificially overvalued exchange rate and thereby subsidize imports, the banking system effectively run out of foreign exchange. The financial sector crisis was thus precipitated, reflected in the inability of the banks to meet their foreign exchange obligations, a depreciated exchange rate on the secondary market, and a default on public debt. The lack of transparency and reliable data also contributed to the loss of confidence in the banking system and hindered sound public policy making. In these circumstances, Lebanon lacks the credibility to secure any bilateral financial help or financial support from international institutions.

Lebanon's resolution of the crisis depends critically on the Government's economic and financial policies and on their quick and effective implementation. It also requires a major effort to eliminate widespread corruption decisively and resolutely.

To start addressing this crisis and restoring confidence, internally, regionally and internationally, as well as laying the foundation for elaborating a credible program for the rest of 2020 and the medium term, Lebanon needs to take at least the following key corrective urgent actions with immediate effect:

1. **Restore a unified floating exchange rate** that reflects the reality of the economy and market forces, thereby eliminating the subsidies. To dampen the impact on the population all taxes on medicines, medical supplies, and oil

products will be suspended for the rest of 2020, with the floor price on oil products also suspended, while continuing to provide transitional support for flour.

2. **Undertake audits** by an independent internationally recognized auditing firm of the Banque du Liban (BDL) and all commercial banks to be completed within 30 days in order to assess the real situation of the financial sector, without which no credible policy formulation can take place.
3. **Cancel all Treasury Bills owned by the BDL**, which is part of the public sector, to reduce the interest burden on the budget, improve the budgetary situation, and reduce the overall public debt profile.
4. **Assure depositors that their deposits will be safeguarded**, with no limits on withdrawals of LL on both LL and \$ deposit. Set limits on dollar deposits withdrawals in foreign currency at \$5,000 per month, with phased further increases in the limits. Instruct BDL to provide all necessary liquidity in Lebanese pounds to commercial banks to meet withdrawals and all necessary advances in foreign exchange to meet dollar withdrawals, including a reduction of the required reserve ratio on banks' dollar deposits to 5%. With a unified floating exchange rate, the public will be indifferent on the currency of the withdrawals.
5. **Lift all controls on interest rates at commercial banks** and set interest rates on commercial bank deposits at the Central Bank consistent with international levels.
6. **Abolish limits on current account payments**, while maintaining restrictions on capital outflows.
7. **Initiate the reform of the electricity sector** involving the construction of new electricity plants and the repair of existing ones through transparent tenders according to international standards, at the lowest possible cost to the budget. It is preferable to undertake this through the BOT (build-operate-transfer) mechanism or through borrowing from international or regional development institutions, provided that the tender includes a temporary PPP (public-private-partnership) energy purchase plan to secure the electricity needs during the transition phase pending the completion of the construction and repair work. At the same time, the tariff rates of EDL must be reviewed in line with production costs, while benefiting from the current lower oil prices and establishing graduated tariffs according to consumption levels, and concurrently improving revenue by further lowering costs to EDL and the Government through technical improvements, strict collection, and increased hours of electricity supply. The prompt start of this reform is crucial given the exceedingly high cost of maintaining the current situation to the consumers, the budget, the balance of payments, and the public debt.

In addition, the government should endeavor to develop a coherent and carefully sequenced roadmap of coordinated measures for the year 2020 and the medium term for public sector reform, tax administration reinforcement, expenditure prioritization, civil service reform, transparency and anti-corruption promotion, banking system soundness and supervision, energy production and pricing, debt

restructuring, judicial reform, private sector development, and domestic and foreign investment promotion. Judicial reform is particularly urgent for the private sector to recover and to attract foreign investment.

The effective and immediate implementation of these proposals is not only urgent but necessary and may even avoid the need for resorting to external financial assistance. In the event that such assistance is still needed after implementing the proposed policies, Lebanon will be in a better position to secure stronger support from international institutions, including the International Monetary Fund, the World Bank, and the countries concerned to restore Lebanon's economic stability.

Delaying the implementation of such measures pending negotiations with the IMF will not only exacerbate the economic and financial crisis but will also contribute to a further loss of confidence and will require even stronger and more painful corrective measures.

International institutions and donor countries will only have the confidence to support Lebanon if it proves that it is determined to help itself before seeking their help.

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