Towards a Sustainable Recovery for Lebanon's Economy

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Executive Summary

Lebanon's current economic crisis ranks among the worst in recent history. GDP has collapsed by 38% in real terms. The Lebanese lira, which was fixed to the dollar in 1997, has lost more than 98% of its value on the parallel market. The government has defaulted on its debt, and depositors are unable to access their funds held at commercial banks. Consolidated public sector debt, including both government debt and commercial banks' claims on the Banque du Liban (BdL), represents more than seven times the current GDP. Public services delivery has crumbled. In short, the country is undergoing a debt crisis, a banking crisis, a currency crisis, and a growth collapse. Four years into the crisis, a resolution remains elusive, and each passing day increases the economic and social burdens faced by the population.

Given the increasing cost of delaying a resolution, we propose a strategy for Lebanon's economic recovery that addresses all the dimensions of the crisis while recognizing the need to rapidly kick-start the economic recovery.

We propose transitioning as soon as practical to a monetary system based on full dollarization. In a context of weak policy credibility and recognizing that the economy and the financial system are already highly *de facto* dollarized, we deem official dollarization the superior alternative. A flexible exchange rate system with inflation targeting, in an already highly dollarized economy, would lead to high and volatile interest rates and an unstable and fragile macroeconomic setting, that will slow down the recovery.

We suggest a bank restructuring that is informed by our understanding of the origins of the crisis. The insolvency of the commercial banking system is caused by the fact that the main asset of banks – dollar deposits at the BdL – has lost the bulk of its value because of BdL's own insolvency. In turn, the BdL is insolvent because its dollar liabilities, accumulated mostly in the process of funding the public sector, are multiples of its dollar assets, courtesy of a massive currency mismatch. With the depreciation of the currency, the mismatch has translated into a large negative equity position. Despite its seigniorage power (*i.e.*, its ability to issue currency in Lebanese lira), the magnitude of its net dollar liabilities makes the BdL insolvent.

We propose to resolve the insolvency of the banking system by converting, as soon as practical, ~USD 76 billion in commercial bank dollar deposits at the BdL into interim restructuring certificates. These certificates will consist of new local-law instruments that will represent a claim on the government (as opposed to the BdL). 90% of those certificates will be distributed to bank clients in exchange for their commercial bank deposits above a threshold, which we tentatively estimate at around ~USD 100,000-150,000. These numbers imply that the remaining deposits at the BdL and banks will be more than fully backed by international reserves.

As a consequence of these operations, commercial banks' balance sheets will represent a small fraction of their pre-crisis size. This will also mean that the statutory equity required will also have diminished. Still, it is likely that the equity position of a large proportion of banks will stand below the advisable capital-asset ratio in a dollarized economy, which we estimate at about 15%. We propose that the BdL provide capital injections in the form of subordinated debt to ensure that all banks have sufficient capital. Bank shareholders will have to buy out BdL's loan at book value within two years if they wish to retain control of their institutions. This will leave the country with a solvent, although much smaller banking system. BdL will also emerge from this operation with a solvent, though a smaller balance sheet, given the reduction in its dollar liabilities to banks. As a result, the Lebanese economy will be in a position to start its recovery process and, in particular, will regain access to its remaining deposit base. This will allow the banking system to resume domestic credit operations, even if the public debt restructuring takes more time.

Through the mechanism of the interim certificates, the bulk of the insolvency will have moved to the government. The certificates will be restructured together with the Eurobonds and other claims on the government, in accordance with an IMF program. The haircut will need to be large enough to make the debt sustainable, after taking into account of the new borrowing that will be needed to finance the recovery of the economy. Through this sequence of operations, the economy will have solved the over-indebtedness problem in the banking system, the BdL, and the government.

We propose to target a 3% of GDP primary surplus by 2030, which represents a 6 percentage-point improvement over the current estimated deficit. The proposed fiscal adjustment is gradual because of the need to balance the immediate needs for reconstruction and recovery of public services with the medium-term needs to service the resulting debt. This transition will require additional financing which we estimate at ~USD 8 billion and a haircut of the existing debt plus the interim certificates which we tentatively estimate at around ~82-90%.

To make this program feasible, the government will need to shore up its revenue base. Part of the rise in revenues will come from the disinflation process, which will eliminate the unfavorable effects of inflation on the fiscal accounts. The new monetary framework will also mechanically contribute to increased revenue, by changing the way tariffs, excises, and VAT on imports are assessed. In addition, we propose to broaden the VAT tax base and increase its rate from 11% to 15%, as well as strengthen efforts to increase income taxes and tax collection.

This crisis resolution plan will enable the economy to narrow the gap with its potential, but also to develop new drivers of growth. Full dollarization, the rapid resolution of the banking crisis and a gradual resumption of credit, improved fiscal accounts, and the eventual resolution of the debt crisis will underpin economic recovery. This recovery will have to go beyond restoring the previous economic structure, which lacked dynamism, and increasingly rely on newer sources of growth based on the country's evolving comparative advantage. Industries with production and export potential include high-quality agro-processed products, increased tourism activities, the expansion of knowledge-intensive business services, and the exploitation and use of natural gas resources. In all these endeavors, ambitious diaspora engagement will prove crucial.

About the Growth Lab

The Growth Lab's multidisciplinary team, led by Professor Ricardo Hausmann, pushes the frontiers of research on economic growth and development policy. The Growth Lab advances academic research on the nature of economic growth and conducts applied, place-based projects with governments at the national, state and city levels that aim to understand growth opportunities and how to seize them.

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