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LEBANON

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I – The basic Lebanese conundrum.

Lebanon lives in a contradiction :

- It produces very limited goods and services,
- But it consumes – and imports – significantly more than it can export – the fiscal deficit being a main cause of this situation – and this explains the country’s structural and persistent current account deficit,
- Therefore, Lebanon – if it wants to maintain its living standards – can only survive by importing permanently foreign capital.

But capital flows - which were provided usually by the diaspora - will only take place if and as long as monetary stability is ensured.

As soon as confidence in the currency dwindles, as soon as corruption is seen as absorbing too great a part of capital inflows, the exchange rate will depreciate and foreign capital will dry out.

This is what happened two years ago.

The economic situation was so deteriorated that capital inflows disappeared, the limited reserves were called upon and the fixed exchange rate - overvalued (1500 LBP per dollar) - collapsed.

The Central Bank has tried to lure investors by providing them very high returns, but such gimmicks could not last long and the “Ponzi type” schemes unraveled. The authorities had to announce a default on public-bonds in March 2020.

The public debt had reached 170% of GDP (close to 100 billions \$).

The party had run out of resources : the country appeared under its true light, bankrupt :

- Devaluation and hyperinflation (more than 100%) have impoverished the country (some 70% of the population are poverty stricken),
- Banks that had loaned their foreign denominated deposits to the State have kept their liabilities but have no more assets : they have been spent by the State.

II – What to do ?

1 – the classical answer is basically this one :

“start the reforms that have been postponed during the last decades”. The list is as ominous as obvious. A few examples :

- Reduce drastically the fiscal deficit and the weight of an overextended administration,
- Reform the energy sector that is one of the causes of the hemorrhage,
- Eliminate the subsidies that are intended to protect modest people from high prices (but are, in fact, captured by corrupt and powerful networks).

Such reforms can only be carried out gradually and therefore will need to be part of an IMF program with an adequate amount of funds to finance the gap.

2 – but the above recommendation seems unrealistic and theoretical under present conditions.

Indeed the main difficulty is to gather a political majority in Lebanon to back a meaningful program of reforms that has always been deferred.

It seems that such a political consensus just does not exist. The country is fragmented in a number of parties, clans, ethnic, religious (and even armed) groups that are not willing nor able to set aside their personal ambitions in order to promote the well-being of the country.

After a year of waiting, the recent formation of the new government lead by Mr Mikati can be seen as a glimpse of hope.

3- but one has to be prudent :

- No program has yet been delineated,
- Next parliamentary elections would be held earlier in order to concentrate demagogic favours in time, and each faction is counting on the election to strengthen its position,

- The country is in a disastrous situation (energy shortages, hyperinflation, poverty, exodus ...),
- Is the government really in a position to decide on a comprehensive policy of reforms with the same parties that have failed up to now ?
- What is the understanding with the Hezbollah ?

III – Why a currency Board ?

In any successful IMF programs there are 3 layers :

- a) The restoration of confidence in the currency. Without that, the execution of reforms is, in fact, impossible. When the money loses value, no economic agent will invest in a threatening future ;
- b) The combination of structural reforms and fiscal discipline is the basis of any Fund program : it gives a direction to the whole effort and allows better expectations ;
- c) And lastly, the “wrapping up” : the way measures are presented and communicated. It is essential to put the reform programme in a social framework. The poor must not be left aside and classified as the “losers”.

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In the present situation, it seems impossible to achieve the threefold objective mentioned above.

1) Monetary stability cannot be restored forthwith just by announcing a negotiation with the IMF.

Such negotiations take time and, in the meanwhile, the monetary situation will continue to deteriorate : the depreciation of the exchange rate and inflation will eat up what remains of the purchasing power of the population.

Such a situation must not be allowed :

The urgency of stopping the debasing of the currency is overwhelming, Lebanon cannot afford another 6 months of further depreciations.

We already see the old bad habits coming back : civil servants salaries should be increased, says the Government, but how ? by Government borrowing from the Central Bank !

The energy – that has caused at least half of the Lebanese deficits – is given to the same party that was in charge of the energy Ministry during the disastrous past. The government is postponing the date of the elections to give more time to cajole the electors with demagogic favors.

2) Therefore, in order to stop the deadly process of depreciation of the Lebanese pound and the subsequent impoverishment of a very poor country, one has to STOP HYPERINFLATION and currency depreciation now. The only way to do that is to introduce a currency board with a fixed exchange rate.

A currency board will immediately stop the inflationary process : indeed the Central Bank will no more be able to create money and feed inflation as it does it presently.

The currency board is based on a currency (the Lebanese pound) that is freely convertible in dollars or euros at a fixed rate.

And the system only allows an increase in the money base if there are corresponding inflows of hard currencies in Lebanon.

The source of monetary instability (credit by the Central Bank) automatically disappears and inflation stops immediately, by construction.

Therefore, the first layer : “restoring confidence” is achieved.

And then ,when confidence is reinstated in the private sector, one can expect :

- Entrepreneurs to start investing again,
- Consumers to stabilize their inflationary expectations and start looking into the future (not the next hour),
- A meaningful relationship with the IMF.

3) This remedy – the currency Board – has worked remarkably well in previous cases : Estonia, Bulgaria, Bosnia, Hong Kong among others, and has never failed.

4) An objection is sometimes presented :

Blocking the creation of Central Bank money is seen as tantamount to more austerity. The pain stemming from such a “radical” measure may be too strong and could lead to major social unrest.

To this objection I would answer the following :

Criticizing currency Boards as too radical, and, at the same time proposing a continuation of the “flexible rate” policy seems rather odd when one knows that its precisely the “flexible exchange rate policy of the Central Bank” that has reduced by 90% the purchasing power of the people in a year !

5) *The truth is completely different :*

It is hyperinflation that hurts the poor.

It is corruption that has captured the subsidies emanating from “preferential” multiple exchange rates. Subsidies on fuel prices have allowed organized groups to import oil at a low price and sell it in Syria with a huge profit. The cost of these policies has been enormous and established groups continue to pretend that the fuel problem is one of lack of availability while it was mainly the product of subsidized exchange rates captured by corruption.

None of that is possible with a currency board : the fixed exchange rate forbids tinkering with multiple rates to the advantage of special groups.

Far from introducing more austerity, the currency board stops the impoverishment process and allows private activity to start again.

Furthermore, humanitarian aid, targeted to the poor, is available to alleviate the pain.

6) *A currency board will stabilize the Lebanese pound :*

While 80% of bank deposits are in dollars (and banks have squandered them by lending to a bankrupt government), the remaining 14 Billion \$ in foreign exchange, still in the Central Bank, will guarantee 100% of the Lebanese pounds in circulation as well as reserves.

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We must realize the extreme gravity of the Lebanese situation and understand the urgency of taking adequate and bold measures now.

According to the World Bank, this is one of the greatest economic crises in the last 175 years.

This dramatic crisis, under a misguided and corrupt leadership, has led to the pauperization of the majority of the population and to the exodus of professionals with marketable skills internationally such as doctors, nurses, teachers and engineers.

If this terrible ordeal is not stopped immediately, Lebanon's private sector (the only hope for the country) will never be able to recover to where it used to be even if, miraculously, the IMF and Lebanon managed to agree on all the public sector required reforms.

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