Prepared for

LEADERSCLUB by LEBANON OPPORTUNITIES

Government of Lebanon
Financial Recovery Plan

– A Critique –

May 2020

INFOPRO RESEARCH

The government's Financial Recovery Plan was met by mostly negative reactions by private sector representatives, economists, and the street. Some of them rejected the official document in its entirety. Other parties saw positive elements especially in the plan's assessment of the magnitude of the financial 'black hole' as described by the Prime Minister.

Our review of the government plan shows that it has failed to come up with a correct diagnosis of the crisis and that it has made proposals that would deepen it further. We have proposed an alternative Economic Revival Plan in a separate document (infopro.com.lb/revival).

Without delving into the numbers (they are outlined in our alternative plan), here are the basic points that we take issue with.

1. No confidence-building measures

The plan was devised behind closed doors without serious deliberations with, or involvement of stakeholders. The Central Bank (BDL), Association of Banks, and the Economic Associations have all complained of being sidelined. Other stakeholders representing labor, bank depositors, and civil society at large were either not consulted, or dealt with through hasty formalities. The plan was not paralleled by decisions to be implemented immediately and that aim to mitigate some of the urgent social or financial problems faced by citizens. To compound the problems generated by the lack of measures to restore confidence, the authorities started targeting, in a random and disruptive manner, various segments of the business sector, throwing people in jail and confiscating inventories, without due process, a behavior reminiscent of authoritarian regimes. This has resulted in a widespread attack on the plan by most stakeholders whether rightly or wrongly. What was needed was a plan that can muster support from the largest segment of the population and of the private sector, in order to kindle a light at the end of the tunnel as a start. The first good impression never materialized, and as the saying goes: "One never gets a second chance to make a first impression." The politico-financial system, even though, was faulty, corrupt, and inefficient, had been somehow successful in maintaining a certain balance. When confidence was lost, that balance was broken. Restoring confidence, starting with a buy-in by stakeholders of a recovery plan, is a prerequisite for restoring financial, fiscal, and economic balances.

2. Paltry economic growth targets

The plan forecasts a negative or stagnant economic growth until 2023-2024 when the economy is expected to start registering a growth of three percent. These growth rates are measly – especially considering the cumulative negative (at best) economic growth of 25 percent over the 2019-2021 period forecasted by the plan. The projected growth for 2021 is just 1.6 percent which is practically zero. These growth levels (2023-2024) should be achievable without any effort, given the pent-up demand created in previous years (2019-2022). An economic recovery plan ought to target much higher growth levels (six to nine percent), when the right measures of restoring confidence, especially in the banking sector, are taken.

With such low-ball forecasted results, these massive restructuring and debt programs are pointless.

3. The problem is not well diagnosed

a) **Absence of the political dynamic**
It is a denial of facts when the current economic, fiscal, and financial crisis is expressed solely on the basis of a balance sheet analysis and on what has been deemed 'losses' in the financial and fiscal sectors. Local and regional political factors, since 1993, and especially after the outbreak of the war in Syria, have had a considerable and direct impact on economic and financial developments, as well as on the way the State was run. Political dynamics have also led to a deterioration of the country's goodwill and friendly relations with donor countries in the West and the Gulf, and the international financial system including credit rating agencies. Side-stepping the political component, which is the most influential, is tantamount to behaving like an ostrich hiding its head in the sand. No amount of financial wizardry will be able to portray or bring solution to the predicament we find ourselves in, without a serious modification in political behavior.

b) **Daily nibble at the State**
Political parties, led by Hezbollah, and with the participation of many others, have been nibbling at the State's resources and decision making for years. This nibbling has led to the depletion of the State's financial resources. It resulted in inefficient and fraudulent spending and foregone revenues from Customs and tax collections, as well as in postponed reforms including modernization of laws, the infrastructure, and good governance. The economic and societal landscape has gradually morphed to become more comparable to countries in the Iranian orbit than other emerging economies.

c) **Mixing unmixable debt and financial elements**
The plan has lumped together financial elements that should not be aggregated while defining the scope of the problem or proposing recovery measures. One size does not fit all in this case. The government plan has combined debt denominated in dollars with lira debt (at what rate should it do that?). It has lumped together amounts defaulted on and short-term obligations with long-term obligations. Money owed internally to the financial sector has not been segregated from debt to outside the financial system which is partly owned by residents, and the other part held by foreigners. Even debt owed to foreigners has short and long term maturities. The plan should have looked at each of these components one by one, and proposed courses of action for each separately. The same analysis applies to bank deposits at the Central Bank, and depositors' funds at banks. By dividing into separate components what has been aggregated into one large sum, solutions for each would become easier to devise and implement.

d) **Inflating 'losses'**
Recognizing immediately the entirety of 'holes', as total losses, leads to inflating the numbers unnecessarily. There is also a double and triple counting when combining losses and when assessing seignorage operations at BDL. This aggregation has led to a claim of 'total loss' of LL241 trillion (@LL3,500/USD).

e) **No balance sheet has been presented**
The government has focused solely on liabilities, including its own. No accounting for State assets has been presented – for two obvious reasons. The first one is that the State has never inventoried its total assets and evaluated them. The second reason is that this would lead to suggestions for a possible selling of State assets, which is not just a political tinderbox, but not even open for discussion. No debtor in default can go to a lender without a balance sheet!

f) **Scapegoating Syrian refugees**
The claim that the displacement of Syrian nationals is to blame for costing Lebanon $25 billion is falsely attributed to 'international institutions'. In reality, it was the Syrian security crisis that has cost Lebanon $20 billion which was mitigated by around $10 billion in aid (including its economic multiplier) received in favor of refugees and host communities. Therefore the war in Syria was costly to Lebanon while the displacement yielded positive financial inflows.

4. Counterproductive solutions and non-realistic expectations

The government plan has presented a series of ideas and proposals that are not realistic, will lead to severe recession, and will delay the restoration of confidence.

a) More and more debt

The government, lamenting 30 years of past wrong policies, has resorted to an upfront massive debt package, up to $28 billion (under an optimistic scenario!), from the IMF, CEDRE conference pledges, and the market. This entails the following problems:

i) It is a continuation of the policies of the past 30 years which consisted of more borrowing and kicking the can of reforms down the road.
ii) It has not presented a cash flow scenario of how the debt will be repaid.
iii) It seems it had forgotten that CEDRE money is earmarked for infrastructure projects, not Treasury operations. We will need to come up with several billions of dollars to pay our portion of the infrastructure investments (CEDRE money does not finance 100 percent of projects).
iv) The additional borrowing will double foreign currency debt and will increase by several multiples the debt held by foreign entities.
v) The plan does not explain how the eventual new debt will be used. Will it be used by BDL to support the deficit in the balance of payments, or will it go to the Treasury to close budgetary gaps?

b) Going to the IMF for the wrong reasons

The government is going to the IMF for a quick $10 billion. Assuming that external and internal political impediments will be lifted from the road to concluding an agreement with the IMF (an overreaching assumption), what should be sought at first from the IMF is a validation of a reform program. The plan does not include any draft of that program. Instead it presents some random ideas, without a timeline, or the means and resources needed to implement them. For example, how will the government be able to improve tax collection when at the same time it has to apply a moratorium on new hiring? The current headcount of tax inspectors is much below what is needed to increase tax collection (assuming that companies will generate taxable profits in the foreseeable future). This applies to almost every reform suggested in the plan.

c) Managing the peg

The plan assumes a ‘flexible’ currency exchange rate, with the official peg being gradually lifted to reach LL4,300/USD in 3.5 years (2024). This approach encompasses many deficiencies. It assumes the availability of sufficient currency control mechanisms and of liquidity which are not there, and also does not factor in the fact that the market will immediately discount the gradual progressive un-pegging. No country in the world, large or small, has had long-term success in controlling the rate of foreign exchange when faced with a negative balance of payments. The market always wins.

d) Unconvincing budgetary reform

The budget forecasts for 2021-2024 are all expressed as percentages of theoretical GDPs, rather than in nominal values – which makes them difficult to assess. The focus is on increased taxation in a recessionary period, which is a disincentive for investment. The mechanism of enlarging the tax base, by improving collection, is not well-defined, especially that the current administration is not capable of achieving this goal. This is a long term endeavor that will not yield sizeable results in the short term, or during the plan’s time horizon. Similarly, most of the measures for reducing expenditures, as outlined by the plan, will not bear fruit within this time frame.

e) Ambiguous capital controls

The plan foresees, in passing, a gradual lifting of capital controls starting from 2021, and predicts an initial outflow of funds, to be recovered after restoration of confidence. There is no indication as to the level and period of time when these controls will be lifted, and the extent of the impact that the outflows will have on the balance of payments. The balance of payment projections are not detailed enough to discern that particular element.

f) Recovery of 'Stolen Funds'

The State should go after 'Stolen Funds', prosecute the thieves, and recover any assets illicitly misappropriated that it is able to apprehend. But tagging an arbitrary sum of $10 billion as 'stolen funds' – just like that – in a 'Recovery Plan' is a sign of a lack of professional seriousness. The plan assumes $10 billion recovery of 'stolen funds' without any justification of the amount, or serious assessment of where has this money been stolen from, by whom, where is it located, what judicial measures will be taken, and how long it will take to recover it. Some misappropriated funds may be easier to find such as inflated contracts, commissions paid, funds diverted, etc. But the biggest amount consists of missed revenue opportunities such as those lost to contraband, under-declaration to Customs, tax evasion, cheating at the level of quantities of imported fuel and other resources. Most of these funds do not belong to politically exposed people (PEP), and are extremely difficult to trace. Comparisons with countries with a deposed dictator are not applicable, because in those countries only one person or a very small circle around the ruler were taking advantage. In Lebanon, one should assume thousands of people were taking advantage of the situation. The 'stolen funds' landscape is very fragmented and difficult to define.

g) Recovery of 'Evaded Funds'

The plan calls for recovery of 'unlawfully evaded funds'. There is no legal basis for doing that, whether in Lebanon or in any other country provided that the money has not been laundered. No capital control law was in force at the time, so the transfer of money outside the country was not unlawful. What was not lawful is detaining depositors' money and preventing it from being withdrawn and/or transferred abroad. Some banks may have acted unfairly and favored some depositors over others. This is probably a civil dispute between the banks and depositors to be resolved amicably or by the civil courts. If by some 'miracle' the 'evaded' money is returned to the country, is it going to be confiscated by the State?!! The plan suggests applying those recovered funds against bank losses but the 'evaded funds' are withdrawals, not losses. Finally, a sizable portion of these funds belongs to non-nationals, or was disbursed to meet pressing external obligations. How will they be recovered? Do foreign laws allow such a recovery?

h) On 'Excessive Interest Rates'

The plan refers to 'excessive interest rates' paid to depositors. Putting aside the financial engineering topic which will be discussed in the following point, it will be impossible to prove that interest rates paid on deposits are excessive. There is no reference or benchmark to support that argument. When compared to interest rates paid by the Sovereign on debt, or interest rates paid on deposits in similarly rated countries, the interest rates in Lebanon are below average. If the rates on deposits are nevertheless deemed excessive by some mechanism, then lending rates to the private sector (which are based on deposit rates) should also be recognized likewise as excessive. Will borrowers be compensated, and if so, by whom?

i) Financial engineering was sanctioned by the State
The financial engineering operations undertaken by the Central Bank have generated a lot of controversy, and were criticized by many. Opinions differ regarding these operations in which the State was a stakeholder whether by approving them having members at BDL's Central Council (board of directors), and by agreeing to a special taxation targeting these operations. Therefore, while one may be of the opinion that these operations were not optimal, or even a bad strategy, they were legal (unless fraud has occurred), and acquiesced by the State. There is no legal basis, or process, to undo these operations.

j) Crushing the financial sector
The government plan entails restructuring 'losses' of BDL and the banking system by taking a "contribution" from banks' deposits and holdings of certificates of deposits (CDs). The government is vague regarding the amount of that haircut which will necessarily lead to getting its hands on depositors' money in banks. It will also confiscate (bail-in) bank capital and require existing bank shareholders to re-inject capital equivalent to all dividends earned during the 2016-2020 period. Finally, the government will contemplate the issuance of five new banking licenses (ignoring that it is the Central Bank, not the government that has this authority). Should the government pursue this strategy, and assuming it finds the legal mechanism to do so – which is tantamount to nationalization of private assets – it will delay the restoration of confidence by at least a decade. No plan or series of measures (as expressed in the plan) will be able to mitigate the damage caused by seizing private assets. It will also deprive the economy from accessing these funds for investment or consumption purposes.

k) Continuation of subsidies to the wealthy
The plan foresees a continuation of ineffective subsidies of the import of fuel, medicine and wheat, all of which benefit the rich, and companies, much more than the poor, since they constitute the largest portion of their consumption. Subsidies to the poor must use mechanisms that are different from the current across-the-board approach.

5. Missing from the plan

a) Sacred cows

Many essential topics we call 'sacred cows' are excluded from the public and economic discourse. They are wrapped in dogmas and misconceptions that have accumulated since decades. They constitute together a barrier to progress, and are at the origin of our economic and political predicaments. It will not be possible to achieve recovery if society and the political landscape do not revise them with 21st century concepts.

Partial list of 'Sacred Cows'

Usage of gold • Partnering with the private sector • Combating tax evasion • Reforming the National Social Security Fund • Transparency in contracts • Recovering seashore and riverside public land • Combating contraband and dodging Customs • Subsidies • Pensions • State assets • State and private sector monopolies • Tariffs • Effective bill collection • Administrative modernization and reform • Publishing detailed financial statements of the Central Bank • Enforcing regulations protecting the environment including quarries • Combating all forms of corruption • Confessional nepotism in the administration • Fiscal accounting on an accrual basis • Modernizing an independent judicial system

b) Optimizing State assets

One of these sacred cows is the issue of involving the private sector in the management of State assets, including privatization and its derivatives such as a build–operate–transfer (BOT) system, management contracts, concessions, etc. Common wisdom amongst most is that State assets should not be sold today because their prices are distressed. The argument does not hold for the following reasons:

i) The only criterion is to compare the future revenues (and residual values) of these assets (next ten years for example) should they remain in State hands with revenues realized under a private sector scheme.

ii) These assets should not have been in State hands in the first place. The State should not own real estate it does not need for its operations. It has no business operating utilities and companies.

Privatizing State assets or embarking on other schemes with the private sector will yield more revenues to the State from taxation. It will lead to employing more people with better jobs at higher salaries, and will increase sales, profits, productivity and service quality. It will also attract investments from within the country and from abroad. If done correctly, the majority of shares of privatized entities will be sold to the public, creating alternative savings avenues and an additional source of dividends, and will invigorate capital markets. The advantages far outweigh any potential increase in the future value of the asset. Anyway, considering how the public sector operates, the value of these assets is likely to decrease in time if they remain in the hands of the government.