The government's plan:
Bankruptcy as an alternative to reforms

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The second edition of the government's plan, published on April 30, 2020, opened the door wide for a national debate across-the-board with both residents and non-residents joining the conversation in addition to prominent international bodies including the International Monetary Fund (IMF), the World Bank, and a group of countries that support Lebanon. Global financial institutions have also participated in the debate such as Bank of America and Morgan Stanley.

As the plan's stance towards the banking sector (both the Central Bank and commercial banks) was extremely negative, and in order to take part in this unique national endeavor, the Association of Banks (ABL) prepared and published a paper as a 'contribution' for the financial and economic recovery of Lebanon.

ABL's paper included five strategic courses of action (or priorities) that I will briefly outline in the second part of this article. In the first section, I will address the major gaps in the plan of the government which is doggedly determined to bankrupt the financial sector as a prelude to annex it. The plan's aim is to achieve this takeover by overestimating so-called gargantuan losses. I will expound the accounting and methodological errors committed in this guesstimate.

In a nutshell, in order to elucidate the government's plan, I presume that an agreement was concluded between the task force of the Ministry of Finance (MoF), Lazard, and the IMF, according to which the latter imposed the necessity of reducing the debt-to-GDP ratio to at most 100 percent. The government plan estimated that the GDP would be around $24 billion, which means bringing public debt to $24 billion as well, that is reducing it by $68 billion.

This approach implies recouping the same amount from the capital of banks, especially from the citizen's deposits at the rate of 60 percent to 80 percent of these deposits. In the end, recouping from deposits is the primary option of the troika behind the plan: the MoF, Lazard, and the IMF. Obviously, the ABL, like all authorities and major players in Lebanon, refuses to impair the citizens' deposits. In spite of bank restrictions, the entitlement of citizens to their deposits still exists. Moreover, interests are still paid on these deposits which could also be used in full for domestic payments. I would like to draw attention to the fact that depositors have used their deposits extensively to purchase both built and unbuilt properties. They also drew on the deposits to a large extent to settle debts owed to banks. Likewise, they used the deposits to hoard cash in lira and dollar in their homes.

Before discussing the plan's assumptions, one should challenge the hypothesis of reducing GDP from $49 billion in 2019 to $24 billion in 2020 and in parallel inflating debts and losses and therefore undertaking a deduction (Haircut) to reach a debt-to-GDP ratio below 100 percent to satisfy the IMF. In my assessment, it is unlikely that the GDP will fall below $40 billion, and the public debt would exceed $39 billion as a result of the deterioration of exchange rates and Eurobond prices, which result in a debt-to-GDP ratio of around 98 percent, without the need for any deduction of capital, especially of depositors' money.

It's easy to criticize the government's plan and even to debunk it as it does not address the root causes of the crisis which are represented by three factors: First, the chronic weakness of the productivity of the Lebanese economy and the lack of growth and job opportunities. The second factor consists of rampant corruption, the misappropriation of the country's resources and squandering its potentials. The third and last factor is weakening the State and preventing it from performing its basic functions in order to benefit sectarian political forces, which have fought each other over public resources as if over spoils and which have divided amongst themselves leadership and administrative positions while performing these roles in utter incompetency. This style of governing has actually exhausted the country financially as demonstrated by accumulated fiscal and trade deficits.

As a way out of this unsustainable quagmire, the authors of the government's plan proposed casually to solve the problem by immediately writing off all State debts while charging the counter-value to banks and the Central Bank (BDL).

In other words, the planners decided nonchalantly if not foolishly, to zero the public debt and record it as losses in the balance sheets of banks and BDL, which in turn justifies putting their hands on the banking sector and replacing it by five banks whose ownership and management comes under the control of certain political forces. The planners rationalized their misguided proposal by taking advantage of justified public indignation against the banks which have lent the State and had to impose restrictions on transfers abroad. The banks had to resort to these measures after the foreign currency reserves at BDL dwindled to critical levels, thus making financing imports unsustainable, especially that the financing requirement exceed the country's needs due to smuggling and leakages to Syria.

The authors of the plan have failed to foresee the grave consequences of the option of defaulting on domestic debt, which normally far exceeds the repercussions of the default on external obligations, which was hastily taken by the government on March 9, 2020, without devising any plan or economic vision to pull the economy out of recession.

The main issue at stake is that the government took the easy way out by declaring the bankruptcy of the country instead of taking the difficult path of reform. The government preferred to write off its debts rather than inviting citizens to make the necessary sacrifices to put Lebanon back on the path to sustainable growth. This authority is afraid of telling the truth to the people, due to its weak popular legitimacy, as demonstrated by the Lebanese uprising in mid-October 2019.

Back to the issue of losses, the plan has decided that the size of losses is LL241 trillion, which is equivalent to $69 billion (at LL3,500 per dollar).

The plan distributes this huge amount of losses on the balance sheets of BDL and the banks. BDL's share in the losses was set at LL177 trillion, or 73 percent. The remaining LL64 trillion, or 27 percent was allocated to the banks' balance sheets. The inaccuracy of this approach lies in considering solely liabilities, without accounting for the asset side.

A careful review of the methodology used for calculating the losses shows that total losses do not actually exceed one third of the amount estimated in the plan. Indeed, the banks, while abiding by international accounting standards, can address the change in the value of some of their assets resulting from the drop in Eurobond market prices and the deterioration of the quality of their private sector loan portfolio, by using their own resources instead of the depositors' funds.

The plan's inflation of the banking sector's losses is due to three types of grave methodological errors. The first one involves the deliberate blending of the lack of liquidity and the lack of solvency. The second error consists in accounting for the liabilities without taking into consideration the entirety of the asset side of the balance sheet. This especially applies to BDL. The third methodological error pertains to banks in particular and entails overlooking the value of in-kind collaterals allocated to their loan portfolios while ignoring already created provisions whether declared or implied. This rush to declare the bankruptcy of the financial sector, both BDL and the banks, is not innocent! Lebanon is undeniably facing the most severe and most complicated crisis in its contemporary history, and we need to mobilize all concrete and real potentials in order to advance on the path of solving the crisis. We also need to tap the country's entire revenue resources in order to be able to absorb the damages and reduce the devastating repercussions on the economy and society. The solution is still possible with a mixture of directions and policies, which are detailed in ABL's paper into five points and which aim to eventually achieve an economic recovery.

The first point is restructuring the public debt which reduces as much as possible the negative repercussions on depositors and the economy at large, and avoids defaulting on internal payments, in light of its adverse effects on regaining confidence and on investing in the country's future. The ABL paper estimates the need for external financing at around $8 billion for the 5 coming years instead of the $28 billion postulated in the government's plan with a kind of optimism that seems unbelievable lest we say ludicrous.

The ABL's approach includes the creation of a Government-owned Debt Defeasance Fund (GDDF) to preserve the State's full ownership of its assets. The GDDF will also allow BDL to write off the $40 billion debt owed by the State through the allocation of part of the income of this fund. The ABL's paper also proposes that banks negotiate with the State to reschedule their debts in order to extend loan maturities and reduce their returns which would reduce the debt-to-GDP ratio from the current171 percent to 74 percent by 2030 without carrying out any haircut on debts or deposits.

The second proposal of the ABL paper is based on a financial correction that produces a reasonable primary surplus of 2.1 percent instead of 4.8 percent of GDP, so that it does not negatively affect the social conditions of the most vulnerable income segment. ABL proposes for this purpose the creation of a social safety net of at least four percent of GDP during the entire period of the financial correction.

The third point consists of a monetary policy based on the unification of the exchange rate that corrects, in a planned progression, the imbalances in the external balances and curbs the very strong inflationary pressures. It is important to adopt a 'managed floating' exchange system where BDL intervenes to mitigate sharp fluctuations.

The fourth proposal includes an organized bank restructuring, bank-by-bank, managed by the monetary and supervisory authorities, in accordance with the Code of Money and Credit and by adopting international banking standards, and within a sufficient time frame as permitted by the Basle agreements. This approach will define the structure of the market, including mergers and acquisitions.

Finally, the ABL's fifth point proposes to diversify and restructure the Lebanese economy, including structural reforms in its performance, such as fighting endemic corruption, and reducing the cost of establishing businesses, in addition to policies to reducing the size of parallel and unlicensed economic activities...

Many countries similar to Lebanon in terms of structure and population have been able to develop their productive and service infrastructure in such a way as to provide acceptable income for their people and an adequate growth for their economies, in addition to balancing at an acceptable cost their foreign trade.

Based on the above, it should not be permissible or acceptable for the government to declare the bankruptcy of the financial sector and the bankruptcy of the country on the basis of calculating assumed losses that are disconnected from reality. The parliamentary Finance and Budget, Administration and Justice, and of Economy committees did well by taking charge of the government's plan to review it in order to prevent the country's bankruptcy. The Finance and Budget Committee did well by forming a fact-finding sub-committee, and thus it cleared the way for the parties concerned, specifically to the MoF, BDL, and the ABL, to negotiate and agree on the accounting and statistical criteria, so that the government would negotiate with the IMF with a minimum of internal cohesion.

The crisis is indeed severe and dangerous. All parties should bear their responsibilities and the consequences of their actions so that we do not condemn the country to fall for decades to come. What is required is that concerted efforts be made to revitalize the economy, which is a major priority in the coming phase. In this way, the IMF, the CEDRE donor countries, and other parties will contribute to the development of the economy and upgrading the infrastructure. This could, in the short and medium term, provide liquidity in foreign currencies to import raw materials for the agricultural and industrial sectors. It also provides financing for the import of basic food commodities, in order to prevent the aggravation of poverty and destitution and consequently the dangerous security deterioration that may result.

The full cooperation of all parties would spare Lebanon an unprecedented social and economic crisis. Persisting in conflict and parochial fights is the fastest path to the great fall.