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A Grave Crisis, With No Silver Bullet

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With Lebanon facing a severe financial crisis, Prime Minister Hassan Diab's government adopted an economic program and requested assistance from the International Monetary Fund (IMF). Discussions of the IMF's involvement in Lebanon have ranged from describing the organization as an evil force at the service of exploitative capitalism to being the country's ultimate savior. The reality is more nuanced and balanced. The IMF can help Lebanon if some conditions hold, but it is not a silver bullet. With negotiations set to begin, it is important to set expectations right and clarify the main points of tension. Given the gravity of the crisis, each party needs to better understand the other's constraints—and quickly.

The views below reflect the authors' several decades of experience observing IMF programs in action from various capacities at international organizations and financial institutions, including the IMF itself.

EXPECT A MODEST IMF PACKAGE

The figures that have circulated publicly in Lebanon about the size of the IMF package and international aid are, arguably, overly optimistic. For example, the Lebanese authorities have suggested a $10 billion package. Considering Lebanon's small quota at the IMF—equivalent to $861 million—and doubts that the Lebanese government will be capable of implementing what will be a very challenging program, it is unlikely the IMF will commit more than $3–$5 billion, which is four to five times Lebanon's IMF quota. By comparison, the sizes of recent programs in Egypt, Jordan, and Tunisia were 4.2, 2.7, and 2.3 times each country's IMF quota, respectively.

The Lebanese government will likely request further funding from the World Bank, from countries that pledged to help Lebanon at the CEDRE conference in Paris in April 2018, and possibly from some Gulf Cooperation Council states. By tradition, an IMF program is a prerequisite for unlocking additional funding. But the financial resources of donor countries are constrained by the recession associated with the coronavirus pandemic and the collapse in oil prices.

Once the IMF-led financial-support package for Lebanon is announced, it will likely have a headline number of $15–$20 billion ($3–$5 billion from the IMF and the rest from other international and sovereign sources). However, the actual amounts disbursed will likely be staggered over multiple years. As such, the financing of the IMF-led program will be secondary compared to the other benefits that the organization's involvement will bring to the country.

Countries, such as Lebanon, with highly complex political environments and questionable governmental commitments have a significant likelihood of IMF programs going off track and disbursements withheld. This has three implications for how the program is likely to be negotiated and monitored in the Lebanese case.

First, the negotiations will be contentious, involve multiple rounds, and risk taking months rather than weeks to be finalized. Second, even after an agreement is reached in principle, the IMF will not disburse funds until a number of "prior actions" are enacted—these form the program to which Lebanon must adhere before the first disbursement is made. And third, even after such "prior" actions have been implemented, the IMF will have a list of other measures it expects to be implemented over time. To monitor their implementation, the Fund will keep the program on a short leash, meaning quarterly (or even monthly) staff reviews tied to the implentation of those measures. Actual disbursements of loans will be linked to these reviews, and will only be provided in small amounts after each review has been successfully completed.

In terms of substance, the IMF program's elements will likely revolve around the following set of policy measures: a large devaluation of the Lebanese pound (followed by a semi-floating of the exchange rate) meant to restore economic competitiveness, narrow the current account deficit, and help rebuild reserves; an aggressive fiscal effort that generates a primary surplus over the next two to three years; deep debt reduction that achieves sustainability and ensures the country will not face difficulties servicing its debt in the future; a banking system recapitalization; and a restructuring of the Banque du Liban, Lebanon's central bank. None of these measures will be easy to implement, and the economic adjustment will be painful and lengthy. Over time, the program will increasingly focus on measures that allow Lebanon to find a new growth path.

The de facto depreciation of the Lebanese pound will likely be promptly formalized, and the central bank will probably cease supporting the currency, so as to stop the bleeding of the country's foreign currency reserves. More importantly, the depreciation will have to be large enough to swing the current account from a deficit of 25 percent of GDP to a more manageable 5–8 percent of GDP, thereby sharply lowering the country's external financing needs. Such a large swing in the current account could occur due to two factors: imports would decline during the deep recession and exports would regain competitiveness following the sharp depreciation. A current account adjustment of such magnitude would be in line with other countries that experienced similar crises, such as Iceland and Greece.

Fortunately, Lebanon has little immediate need for structural labor and product markets reforms, as these markets are relatively flexible compared to other middle-income countries. Instead, the most immediate component of the IMF package will likely be on the fiscal side. Following the collapse in tax revenues, the government is likely to post a large primary deficit in

2020. Given the depth of the recession and the impact of the coronavirus, the IMF will probably be initially lenient and not demand an immediate shift to a primary surplus. Still, even containing the budget deficit in 2020–2021 will be very challenging and a principal area of focus of the program.

In all probability, the IMF will ask immediately for a few large and high-profile fiscal reforms, such as in the electricity sector. It is also standard for an IMF program to demand a broadening of the tax base, a reduction in subsidies, and an improvement in tax and customs administration. More contentious areas such as pension reforms, anticorruption measures, and reducing the size of the civil service would likely be longer-term conditions and typically have a higher risk of failure.

On the debt side, the IMF will demand a large reduction in the country's debt, with the objective of bringing the debt stock to a more manageable 60–80 percent of GDP. The rationale behind this demand is that the IMF's internal rules prohibit it from lending to countries with an unsustainably high debt level, as it threatens a country's ability to repay its obligations to the institution. Thus, additional debt reduction will be needed to make space for the new IMF debt. Moreover, an aggressive debt effort will be seen by the IMF as giving Lebanon more fiscal space, as less debt service obligations would justify generating smaller fiscal surpluses. This could be a very contentious issue during the negotiations, as the government will want more modest debt reduction, fearing its impact on the banking sector and depositors.

The banking sector is where most of the difficult adjustments will lie. The immediate objective will be to restore banks' liquidity, allowing them to slowly unfreeze deposits. This process will not be easy and will take time, as it will require a radical restructuring and downsizing of the banking sector and recapitalization of surviving banks. The ultimate objective will be to restore the banking sector's access to foreign financing, and to reposition it toward fostering economic recovery rather than being a conduit for government financing.

With regard to the program's social dimension, the IMF will be fairly sensitive to the impact of the recession on Lebanon's most vulnerable populations. Protection of social spending and emphasis on a socially equitable distribution of the burden of adjustment have become more intrinsic to IMF programs. Over the years, the IMF has become attentive to political buy-in with respect to its programs—something it views as increasing their chance of success.

THE DIFFICULT ISSUES IN THE NEGOTIATIONS

Negotiations between Lebanon and the IMF will be complicated and protracted, especially with respect to the interrelated issues of fiscal reform, debt reduction, and bank restructuring. The government's recent reform program conservatively estimates losses that will have to be borne by depositors at $44 billion. Using the most recent estimates of total banking-sector deposits, which stand at around $134 billion after devaluation, a straight bail-in would entail wiping out 33 percent of all deposits, or more than 55 percent of deposits above $500,000 (representing about 2 percent of all accounts), or 70 percent of deposits over $1 million (representing about 1 percent of all accounts). Regardless of how the effort is implemented, it would constitute one of the largest bail-ins of depositors in modern economic history.

Despite the potential benefits of an immediate resolution of the debt overhang through a hard restructuring, its magnitude would be so large that, realistically, a fair and quick allocation of losses will be nearly impossible in the present situation. Considering that there will be little injection of new capital in the banking sector, public or foreign, absorbing such large losses at once may even exacerbate the current economic depression, delaying the prospect of a recovery.

Moreover, it is not clear what the benefits would be from an immediate cleaning up of the banks' balance sheets. Lower remittances from the Gulf following the collapse in oil prices, low tourism revenues due to the coronavirus, and unlikely capital inflows in Lebanon for the foreseeable future suggest that the benefit from an aggressive banking sector cleanup would accrue years in the future. As such, it is preferable for the IMF program to focus on short-term fiscal deliverables, competitive exchange rates, and the removal of distortions in the economy, while allowing the banking sector more time to gradually rebuild its strength.

A more realistic approach would be to start with a more modest debt reduction, and aim to achieve debt sustainability over time, with primary surpluses and economic growth gradually reducing the debt ratio to 60–80 percent of GDP in the next five to ten years. For the domestic debt (both in U.S. dollars and Lebanese pounds), a net present value reduction might be achieved by aggressively extending maturities, lowering coupons, and introducing sizable grace periods. A similar debt restructuring plan is currently being proposed in Argentina. The treatment of eurobonds would be less generous than that of domestic debt, and would include a large reduction in the principal. Such a phased and differentiated approach between domestic and external debt reduction would allow for a smaller (and politically more palatable) bail-in by depositors.

In such a gradualistic scenario, the bank resolution process will take several years to be completed. Capital controls will have to remain in place during that time to stabilize interest rates and the exchange rate. Countries with similar banking problems, such as Cyprus, Iceland, and Greece, all ended up using a measured approach to bank restructuring. In all three cases the process was protracted, despite large injections of donors' money, and capital controls and banking restrictions had to stay in place for three to eight years. Limitations placed on deposit withdrawals were phased out only gradually, and were lifted solely when the economy recovered and the public regained confidence in the banking sector. Cross-border restrictions also continued well into the life of the IMF programs in the countries, as large deposit withdrawals did not stop even after the program was in place (for example, in Cyprus, 25 percent of total deposits were withdrawn after the program was implemented). In Lebanon's case, allowing large U.S. dollar deposit withdrawls would be very taxing on the central bank's reserves, which are likely to be the only source of dollar funding for the next two years, even after IMF disbursements.

There are several ways to attentuate the losses borne by depositors. First, the central bank could provide banks with regulatory forbearance. Second, depositors could be offered incentives as the economy recovers, through GDP warrants—securities that pay when GDP grows above a certain level. Or depositors could be compensated through partial ownership of bank shares. Over time, the adjustment in the banking sector will also require the sale of bank assets and injections of fresh capital.

Some of the most politically contentious issues in Lebanon will revolve around the distribution of losses among depositors and the extent to which state assets should be used to compensate bank losses. On the first issue, the IMF will most probably push for a socially fair distribution of losses, as it did in Cyprus. On the second, the Fund is likely to take the side of those favoring privatization, as it did in Greece, arguing that, given the size of the losses that need to be covered, the state should use some of its assets to eliminate its liabilities.

ON BALANCE, AN IMF DEAL BRINGS BENEFITS

In sum, an IMF program will have pluses and minuses. On the negative side, the IMF will ask for deep debt reduction and will be slow in disbursing what will likely be relatively modest amounts. The IMF will also push for higher commitments on future primary surpluses, support privatisation, and call for realism on what can be gained from attempts to recover stolen assets or a claw-back of profits from past financial engineering measures undertaken by the central bank. Convincing the IMF that an unorthodox approach makes sense for Lebanon will not be easy. It requires the organization to be more innovative and progressive in its approach and to internalize Lebanon's idiosyncracies. It also requires tough and disciplined negotiations by a Lebanese team well versed in macroeconomic and financial affairs.

On the positive side, an important value added of an IMF package is the credibility it will bring to measures undertaken by the government, as the organization's stamp of approval will help Lebanon access other sources of funding and negotiate with its bondholders. Most importantly, such a program would provide the political cover needed to implement tough and overdue measures in ways that can command national support. In addition, the IMF's expertise in improving tax administration, and its recent experience in countries that have faced a financial crisis such as Ireland, Portugal, Greece, and Cyprus, will be extremely valuable. Contrary to a widespread belief, support from the IMF will also help ensure some level of social fairness during the adjustment.

While a program spearheaded by the IMF will be intrusive and will provide less funds than hoped for, it still offers the least painful path of adjustment for Lebanon and allows for the quickest recovery. A constructive funding mechanism, in which an IMF program could be embedded, would involve a troika of the IMF, the World Bank, and CEDRE donor countries. Such a coalition could be helpful in easing conditionality, bringing in more funding, and acting as a credible arbiter when (the inevitable) disagreements emerge in Lebanon.

However, a word of caution is in order. While an IMF program is valuable for Lebanon's future, no program has ever succeeded without the participation of a government willing to act as a serious partner in shepherding tough measures through the political system. Even though the current Lebanese government may not be, or not yet be, fully committed to the initiation of ambitious reforms, it is not at all certain that there is going to be a better time to begin. The alternative to starting such a journey at this point in time is paralysis and a gradual descent into a far worse situation, one akin to that in Venezuela.

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NOTES

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