



Analysis

On the Way Out of Lebanon's Triple Crisis

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ISSAM FARES INSTITUTE FOR PUBLIC
POLICY & INTERNATIONAL AFFAIRS

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This Analysis is published by the Issam Fares Institute for Public Policy & International Affairs (IFI) at the American University of Beirut, made possible (in part) by a grant from Carnegie Corporation of New York, and is available on the following website: <http://www.aub.edu.lb/ifi>.

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Six years into the crisis, with national income now at half its potential, it is long past time to implement the decisive reforms needed to unshackle the economy and allow it to grow again. This is no easy matter as the crisis concerns the interlinked problems of restructuring the banking sector, the public debt, and the currency. Lebanon Inc. has few assets and lots of liabilities, but until its balance sheets are cleaned up, its economy will remain stuck in a low equilibrium. Moreover, it risks missing out on the opportunities of participating in the rebuilding of Lebanon, Syria, and even Palestine.

The current Government is finally addressing the challenge head on. Already, a law that lifts bank secrecy has been adopted by Parliament, and a banking restructuring law is being finalized. A third law, nick-named the “Gap Law,” the last piece of what needs to be a coherent triptych, should be sent to Parliament “before the end of the year,” to quote the PM Nawaf Salam.

The Gap Law will no doubt elicit massive reactions, as its goal is to distribute over 70 billion USD of “losses” across domestic and external creditors. It will face opposition by special interest groups, and it will give rise to misinformation and fake news. The goal of this note is to provide some information and analysis that can help structure a constructive debate on the many issues that the draft law will no doubt generate.

My main focus is on the restructuring of the banking sector, but placed within a broader approach that seeks to address the triple crises. I first restate the main policy dilemmas. I then describe the pieces of the banking sector restructuring jigsaw puzzle, which are each starting to take shape. Difficult decisions remain on how to finalize each part, but like a balloon, when one part is squeezed, another part of the balloon is pushed out. The remaining challenge is not just to finalize each piece, but also to fit them all together into a feasible overall financing plan.¹

The Huge Challenge of Cleaning Up the Mess

Before going back to the puzzle, it is useful to recall the terms of the problem at hand. Lebanon is facing three interlinked financial crises: a state in default on its sovereign debt, a bankrupt banking sector, and a severely wounded currency. The challenge in “cleaning up the mess” lies in the scarcity of national assets and the multitude of claimants. As a result, Lebanon has faced a complex bargaining game among many parties – the state (and it should not be forgotten that the central bank, BdL, is state-owned), bank owners, depositors, Eurobond holders, and pensioners. Each group wields significant lobbying power to defend its own interests. Dividing the losses is not just difficult technically, it is also very difficult politically, as they amount to around three times GDP.

Moreover, a recovery also requires fresh financing. Yet new investors – whether the IMF, donor governments, or private finance – will not commit funds until Lebanon’s balance sheets are cleaned up. This is particularly urgent for rebuilding infrastructure, especially in the energy sector, which together with banking, and security, forms the third leg of any recovery path towards a more performing economy.

To understand why cleaning up these balance sheets is essential, consider the state’s position. In default, the government cannot borrow – either domestically or internationally. It cannot engage in public-private partnerships or offer guarantees for critical projects such as electricity generation. Nor can it access IMF

¹ In doing so, I will use approximate figures, the main point being not to present a precise blueprint, but rather a framework for discussing what is feasible.

financing or concessional loans from development partners. Debt restructuring is therefore the necessary first step toward restoring the state's creditworthiness. Typically, such restructuring is designed to make debt service manageable, though not to immediately create large fiscal space for new borrowing – that comes later, through growth. Creditors, too, benefit from a growing economy and thus have an incentive to accept a deal that enables recovery, provided they are presented with a credible plan.

The same logic applies to banks and the central bank. Their balance sheets are deeply imbalanced, burdened with far more liabilities than assets. As a result, they can neither borrow nor lend, rendering them “zombie institutions.” Until their liabilities are adjusted to match their assets – in other words, until their balance sheets are cleaned – they will remain unable to perform their core financial and economic functions.

A key point often missed is that the goal of cleaning up the balance sheets is not about enabling depositors to withdraw their money. The goal is to restore their confidence that they *could* withdraw – which is precisely what will convince them not to. Once banks regain solvency, they can resume functioning as real financial intermediaries: accepting new deposits and extending loans to productive firms. No economic recovery is possible until this happens.

Another way to frame the challenge is as a problem of loss distribution among creditors. Years of policy paralysis can be explained by a prolonged tug-of-war between claimants. Any chosen allocation of losses inevitably produces winners and losers. In their struggle to secure larger shares, these actors have effectively destroyed value, holding the economy hostage – without a functioning banking system or international financial links. The standoff resembles an age-old bargaining tactic: waiting for the other party to blink while the pie shrinks. But this is no way to run a country. National income has already fallen by roughly half, when it could have been by now higher had a settlement been reached in 2020, when the Diab plan was presented. The national assets were also much higher then, and the losses that need to be distributed smaller. The resulting opportunity cost – in lost income, wealth, health, talent flight, and unfinanced investment – has set Lebanon's recovery back by years.

Reasons for Guarded Optimism

There are now several reasons to believe the time for a settlement of the triple crises has come. Six core principles, which had been controversial early on, seem to have gained sufficient political and popular acceptance by now to be considered as essential parts of a national salvation plan:

1. Small depositors must be fully protected; pensions also deserve priority protection.
2. Larger depositors will be repaid *over time*, but with the Present Value of the repayment below their current claim.
3. Some deposits have “anomalies,” and they will be reduced accordingly.
4. The legal hierarchy of claims among banks' stakeholders will be respected, but efforts will be made to allow some national banks to survive.
5. Some amount of state support will be necessary while recognizing that other urgent challenges also require state support (the Eurobond restructuring, the growth process, post-war reconstruction, infrastructure).
6. The banking sector restructuring will be part of an IMF program, meaning that restructuring external debt should proceed in parallel and in a coherent way.

It is also useful to state at the outset that one central issue with no national consensus is whether parts of the gold reserves held at the BdL should be used to finance the banking sector bailout, although there seems to be widespread popular opposition in the country for doing so.

These principles bring us close to a viable overall solution. But many complex details remain to be worked out, and they will be harshly negotiated when the “Gap Law” proposed by the Government will finally reach the Parliament. Let us first look more closely at the progress made and the challenges that remain, which are mainly issues of the “right balance,” before focusing in the next section on how to fit all the pieces under a feasible financing plan.

A first positive step is the broad political consensus on protecting small depositors and guaranteeing their access to life savings. Covering up to 100,000 USD for all accounts below 1 million USD would benefit around 80% of all depositors and roughly 50% of the population. Including other small claimants, such as social security beneficiaries, and private-sector pensioners, could bring the total cost up to 20 billion USD. Prioritizing small deposits follows established international practice, and the recent decision of the constitutional court opens the way to legally enforce such a discriminatory practice in the name of supporting the public order. There are remaining discussions on whether to extend this protection to some of the larger deposits – such as those below 1 million USD, or even to extend it to all depositors (which may be more defensible legally but would also add to the cost).² There is thus here a first issue where the cabinet needs to agree with BdL on where to put the cursor, where is the agreed balance between affordability, fairness, and the strength of the legal case.³

“ One central issue with no national consensus is whether parts of the gold reserves held at the BdL should be used to finance the banking sector bailout, although there seems to be widespread popular opposition in the country for doing so. ”

A second development is the Government conviction that part of the deposits should be canceled because they possess various “anomalies.” This includes funds derived from illegal activities, and past “overpayment” of interest. These and related elements are under discussion, together with the nature of sanctions against those that have benefited unfairly during the crisis. Under optimistic considerations, these “anomalies” could add up to around 30 billion USD. This removal can considerably reduce the losses that need to be distributed, while responding to the popular demand for accountability. But it also faces headwinds relating to technical and political feasibility. There is also the important challenge of limiting legal risks, since there is a risk of legal claims creating a contingent liability on the banking system. There is also a risk that these be perceived as retroactive confiscation, thus delaying the necessary rebuilding of trust. Even more than for item 1 above, where to place the cursor will be decisive.

A third emerging consensus is that any viable solution must include, in part, a state-supported bailout. Earlier in the crisis, many experts had argued for a strict *bail-in* approach – with no public funds involved. But much of the assets that could have supported such a bail-in have since vanished.⁴ At the end of the day, while blame must be shared all around, including by banks and by the central bank, the state cannot disown

² The IMF has insisted that global best practice is to protect up to 100,000 USD per account, and not per person.

³ The amount would be available within a short period, perhaps 3 years. This would require some liquidity to be made available, given that sizable withdrawals can be expected.

⁴ Roughly 40 billion USD in reserves and 40 billion USD in bank loan portfolios have shrunk to around 10 billion USD and 5 billion USD, respectively. Some of this loss stems from outright illegal acts that demand judicial follow-up; some from policy paralysis and mistakes that could still be partly corrected through retroactive legislation.

its share of responsibility. Banks' shareholders made inordinate short-term gains at the detriment of putting their depositors at great risk. The BdL is also to blame for not only coming up with very onerous "financial engineering," but also for hiding its cost. But the state is also guilty of not pushing for an earlier adjustment, when losses were much smaller. As other countries have done in comparable situations, Lebanon's government must thus contribute to the solution – while recognizing that it also has other pressing fiscal responsibilities. While the principle of a partial bailout is now accepted, its size and form remain under discussion, and it must be, in the words of the Minister of Finance, "consistent with regaining external creditworthiness."⁵ This is even more than the issues above one of the right balance, the goal here being to conserve enough fiscal space to also resolve other pressing concerns, and especially the external debt restructuring.

A fourth area of convergence is that large deposits will be exchanged with an asset of equal face value, but of lower present value – in the words of the Prime Minister, the pledge that the "notion of a haircut of deposits needs to be itself haircuted."⁶ In the past, there was a suggestion that these would be claims on a Deposit Recovery Fund (DRF).⁷ Currently, there seems to be a preference for the BdL itself to issue a security for the large depositors. Detractors of this approach argue that if BdL promises to repay more than what it can itself finance, it would end up being forced to use its gold reserves to reimburse these claims. Answers to issue #3 above – how much of a bail-out – reduce this risk, the challenge of balance here being to identify the nature and size of the assets that can back BdL's certificates and thus to protect its gold reserves.

A fifth area where progress has been made, but which remains in contention, concerns the question of the survival of the Lebanese banking system. Some of Lebanon's established banks insist on remaining in business and preserving their franchises. Maintaining some existing banks alive seems valuable, even if new banks enter the market, given their accumulated human capital and knowledge of the local market. Ultimately, the cost of helping some banks survive is relatively modest in the grand scheme of things and does not deserve the controversy the issue has generated. The size of the new banking sector would be of the order of 20 billion USD, roughly the amount owed to small depositors. There is no reason for large depositors to remain on banks' balance sheets, since banks should focus on financial intermediation, not speculative asset holding. Rebuilding the sector would therefore only require about 2 billion USD in new equity capital – 10% of deposits. With the help of some regulatory forbearance, this should not be a gargantuan task. The current debate concerns whether shareholder equity could be assessed after some types of "anomalous accounts" are removed. For a handful of banks, this may make a big difference, but in the big picture, it does not. Finding where to place the cursor here is important not so much for financial reason, but to reach a deal with the IMF.⁸

The final issue concerns the IMF. By now, all key players – the Treasury, BdL, and the PM – have publicly confirmed their attachment to an IMF program. Besides its finance, which is not inconsequential (3 billion USD over 3 years), the IMF's seal of approval is necessary to unlock donor financing, which is needed for reconstruction. Moreover, the involvement of the Fund in restructuring the banking sector would ensure

⁵ Three such proposals have been floated: that the state would recapitalize BdL by around 5 billion USD (in the Chami plan); that it repays an alleged loan of 16.5 billion USD to the BdL; or that it repays the ~8 billion USD provided by the BdL in the form of subsidized FX during the first years of the crisis.

⁶ To illustrate: a bond that pays 100 USD in 20 years, and a coupon rate of 1% a year, has a present value of 25 USD, when evaluated at a discount rate of 8% - which would be the rate provided by the market for countries at the risk level of Lebanon. Current discussion seems to favor a plan to issue securities paying a 2% interest, with maturities varying between 10 and 20 years, depending on the accounts' size.

⁷ This is not necessarily at off with the PM pledge, as a DRF could itself issue securities to compensate large depositors.

⁸ For example, erasing illegal deposits before bank equity can be more defensible legally and ethically than to do so before taking back "excess" interest payments.

that the bank-by-bank process is credible, thus improving the speed for restoring public trust in the banking system. While progress on banking sector restructuring is a pre-Board IMF condition, a key condition for its financing remains the restructuring of external debt, so that its own loans are not at risk. As we will see below, ensuring that Lebanon Inc's limited assets can finance not just its internal, but also its external liabilities, is where more work remains needed to reach a solution to the country's triple crises.

Remaining Bottlenecks

So clearly, while the approach to resolving the banking crisis is broadly defined, there are still several important balances to determine for each piece of the puzzle. Each is consequential in its own sake, but moreover, as a group, these choices also need to leave enough financial firepower available for the external debt restructuring, and for the recapitalization of the BdL. There are three types of assets available for these purposes: (i) the existing (usable) assets of the banking sector and of the BdL; (ii) the BdL gold reserves, which require special laws to become usable; and (iii) the "new" public debt that the Treasury can issue once past liabilities are erased – within the bounds of sustainable creditworthiness as per international and IMF definitions. Whether to use gold or not, and how to divide up the available assets between internal and external claimants remain issues that have not been sufficiently discussed so far.

The extent of BdL and of the banking sector remaining assets is typically estimated at around 20 billion USD, which includes liquid reserves of around 12 billion USD, with the rest in less liquid forms (e.g. national air carrier MEA, the Casino du Liban, real estate collaterals, land) which can produce revenue over time. It would make sense that a good share, if not all, of these assets be assigned to cover the cost of the repayment of the 100,000 USD deposits, because these are less risky, and most liquid, than the other classes of available assets.

One central issue concerns the treatment of the BdL's gold reserves, whose value has nearly tripled in the recent past, reaching 38 billion USD at the time of writing. All creditors covet these reserves. But such ambitions risk leading to years of political infighting, particularly as Parliament's approval is necessary to reverse the current law which prohibits the direct or indirect use of these assets, at a time when public opinion seems firmly opposed to this. But whether a part of the gold reserves is used or not to finance the banks' bailout, these reserves should be managed more actively to produce some revenue stream.

The 3rd financing item concerns the new debt that can be issued by the state in the context of the restructuring of debt issued by the Republic in exchange for extinguishing its current liabilities – its external debt, its bailout of the banking sector, and its other priority unfunded obligations. Let us sketch out the orders of magnitude involved. The IMF recommends reducing public debt levels around 50–75% of GDP by the end of its adjustment program.⁹ If Lebanon's GDP is now roughly 30 billion USD, it could optimistically reach 40 billion USD by 2030 under a fast-growth scenario. This would allow for up to 30 billion USD in debt (that should trade at about par). Of this total, an amount of the order of 10 billion USD could be reserved for senior debt (IMF plus other MDBs) and for new loans dedicated for reconstruction.¹⁰ To finance the banking and public debt restructurings, available assets amount very roughly to around 20 billions USD of BdL/banks assets; 20 billion USD of new Treasury bonds; and whatever share of gold is used. If 20 billion

⁹ An important issue to negotiate with the IMF concerns the perimeter for public debt restructuring. Typically, this includes debt issued by the Central Bank, but if Treasuries are used to back this debt, a way to avoid double counting needs to be found. An additional complication is that under the MAC-DSA, the face, rather than present value of the debt is considered.

¹⁰ It is important to note that more spending on reconstruction can benefit all involved as this can lead to faster GDP growth, and thus to a larger sustainable debt, and thus to lower haircuts.

USD is reserved for the small depositors, and assuming that gold is left untouched, around 20 billion USD (in present value) is what is left for the large depositors and the Eurobonds. One possibility is to allocate this amount in proportion to the size of their claims, a demand of the Eurobond creditor committee.

What this estimate suggests is that even without using any of the gold, a resolution is possible that provides all claimants with payoffs at least as large as current market expectations. To provide an order of magnitude of the required haircut in present value, consider that there are around 30 billion USD of Eurobond, and around 30 billion USD of large deposits (after purging deposits of “anomalies”). If, for the sake of illustration, each gets 10 billion USD of the new debt, the haircut will amount to around two thirds (or around 75 percent if past due interest is also accounted). The current market price of a “Lollar” is around 15 cents on the dollar, and Eurobonds are trading at around 20% of face. These values would be raised by the plan we outlined, even though gold is left out. In other words, the market is telling us that at this stage, it is not expecting to get a share of the gold.¹¹

“All creditors covet gold reserves. But such ambitions risk leading to years of political infighting, particularly as Parliament’s approval is necessary to reverse the current law which prohibits the direct or indirect use of these assets, at a time when public opinion seems firmly opposed to this.”

The last component of a comprehensive financial plan concerns the revitalization of the Banque du Liban (BdL). Once its balance sheet is cleansed of commercial banks’ deposits, the BdL’s net position would again turn strongly positive if the gold, or at least a large part of it, is not committed to the old claims. The BdL need for additional liquidity would be addressed in the short term through IMF financing, which should provide the foreign exchange cushion necessary to stabilize the LBP. With a sounder central bank, the Lebanese pound (LBP) could gradually regain credibility. A flexible or managed float could then be introduced to support a re-invigorated economic growth path along an export-driven mode, while enhancing the economy’s external competitiveness, and avoiding the distortions of a rigid peg. But there are also proposals to formally dollarize the economy, and to move to a currency board. This area has been explored even less than the external debt restructuring but deserves a proper analysis and informed debate.

The availability of liquidity to BdL in the medium term is a more complex issue, and it reflects also the country’s fiscal financial challenge. Lebanon would need to service around 75% GDP in internal and external debt, which cost could reach more than 5% GDP/year. The cost would be larger if BdL offered generous terms on its large shareholders certificates. Typically, the IMF restricts the fiscal Gross Borrowing Needs to no more than 6% GDP. More than the target for debt stocks, it will be this liquidity constraint that is likely to be the most difficult constraint to overcome in the IMF program.

¹¹ A security worth 25% of face would be a 15-year bullet Treasury Bond (discounted at 10%). More generous securities would require either more collateral, or the use of other types of BdL or Treasury backing.

In Sum

We seem to be nearing the end of the “war of positions” that has characterized the past six years, pitting the ABL, BdL Treasury, Parliament, and the public, all mediated by a polarizing media. Some implicit consensus seems to have emerged, which some observers are starting to call *a financial Taef*¹². Such a plan may end up involving some, but incomplete, accountability about past financial crimes and misdemeanors. It seeks to provide a fair enough way to divide up the losses, to put Lebanon on a dynamic recovery path, not unlike the post-civil war situation.

At present, there are three areas that could delay progress and which require special attention:

- The first is to build a political consensus rapidly and decisively despite entrenched divisions and ongoing political instability. The role of the ABL, and the influence of the more “progressive” banks will be crucial here.
- The second is the difficult balance around utilizing BdL’s gold reserves and the acceptance of “anomalous deposit” haircuts will be resolved in ways that avoid protracted legal or political battles. The role of Parliament will be central here.
- Finally, the third challenge is to ensure that the sequencing of external debt restructuring and banking recapitalization will be managed in a coordinated manner, despite negotiation complexities. The role of the IMF will be central there.

The challenge now is to tighten the plan rapidly, choosing the right balance” for each piece of the puzzle, while also ensuring that they add up, and that the result is within international norms and thus acceptable to the IMF. While it may be impossible to convince all stakeholders to support such a plan, it is now becoming possible to impose a solution that makes most parties better-off in a growing economy than under the low equilibrium status quo. Even after a Gap Law passes Parliament, the challenge of implementation will be lengthy. But at least, Lebanon will be finally on a road that can lead to economic recovery. This can only help the country deal concurrently with its existential challenges on the security and political reform fronts.

¹² In reference to the political agreement that led to the end of the 1975-1990 civil war, signed in 1989 in the city of Taef, Saudi Arabia.



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