

ECONOMIC and FINANCIAL REFORM: The role of the IMF DRAFT

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December 3, 2021

I. Prelude to the crisis: 3 main causes

1. Unsustainable Pegged exchange rate in
2. Large fiscal deficits
 - o/w : failed EDL – loss per year \$ 3 billion (public & private)
3. Large current account deficit-above \$10 billion
4. Rising Dollar debt to the private sector
5. Banks stopped lending the government (high risk)

6..BDL became main fiscal agent.....

- Banks deposit dollars at BDL and BDL in turn lends government
- Banks credit to the public sector (BDL & Gov) reached 70% of deposits .
- Unsustainable formula
- Down Rating of Eurobonds accelerated
- BDL losing reserves (banks' \$ deposits)

7. Results

- Higher inflation Driven by liquidity injection (interrelated) and depreciated rate
- Aside from subsidized goods :
Parallel market rate applied to most transactions
- Deep recession- absence of financing and confiscated accounts

II. Governments & BDL Response to the Crisis

- There is no reform vision
- To the contrary all measures were counter productive

1. Focus on managing overestimated losses and over estimated financing needs

- Overestimated Gross losses \$ 93 billion. Serious miscalculations of losses- major credibility issue with LAZAR Frere, the consulting firm entrusted to calculate losses.
- Massive hair cut proposed (Diab government)
- Over-estimated external financing needs at \$ 28 billion- that Can't be secured and serviced

2. Arbitrary termination of the peg in mid 2019 without reform

- without any prior reform such as in the power sector and extended wage benefits. A major mistake
- Had it been full unpeg and clean floating with reform, it could have averted the crisis
- BDL Could also have changed the peg rate temporarily instead of having multiple rates (can be a sustained rate). That's , lowered the peg to a new rate (say LBP 4000/1\$). Then it could have been maintained with the level of available reserves.

3. Introduced multiple exchange rates (6 rates)-
further depleted reserves: \$18 billion in 20-21

- At the expense of depositors
- Benefits banks and debtors
- Very damaging to trust in banks
- IMF BDL and its role while concealing the damage caused by multiple rates
- Floating is perceived to weaken role of BDL, and government control on subsidies

4. DEFAULTED on debt- Eurobonds

- Caused Losses to holders mainly Lebanese banks and citizens
- Closed access to international capital markets
- Lowered Credit rating further down to D rating

5. Introduced Extensive subsidies through quasi BDL fiscal operations (through overvalued exchange rate use)

- BDL expanded quasi-fiscal operations through multiple exchange rates
- BDL Subsidized hundreds of goods
- BDL Subsidized loan repayment at the official rate at the expense of depositors

6. Restrictions on withdrawals with massive hair cuts: 84%

- Easy solutions but very destructive-
- It implies that depositors are financing the losses of the government and the Central bank
- Several withdrawal rates distort the financial market and created mistrust

7. No fiscal reform

Fiscal deficit remained very large

- Government Considered increasing spending before revenue enhancement
- Financing of the deficit relied on monetary injection by BDL.
Government financing appears in other assets :Increased by LBP 20 trillion from October 2021 to October 2021.

8. No reform in public enterprises

- Their deficits worsened.
- KWH rate of electricity is less than 1 US cent compared to 12 -14 cents internationally.
- Same for 1 minute of mobile phone, much lower than international rates- profits of Alfa and Touch disappeared.

No reform in public enterprises.....

- The public sector was the main cause of the crisis including central government, central bank, and public enterprises.
- Public property (assets) became a main source of corruption
- It made the poor poorer and encouraged businesses to participate in corruption..

9. Current position : Unclear !
Rumors !!!

- Need to collaborate with banks, business communities, and parliament.
- Need public debate
- Secrecy is counter productive
(otherwise will have same faith as previous government)

9. Conflicting Official statements

PM announced Hair cut on deposits above \$ 70 thousand-while initial announcement in new government circular was to preserve deposits

“ spreading rumors of Lirafication” of deposits?? At market rate or what rate.

- Confusion on exchange rate.
- Power from Jordan and Egypt – not clear how to cover cost

III. The solution to the crisis

- 1. float and unify the exchange rate for all transaction
 - Floating the exchange rate for all transactions
 - Lift restriction on withdrawals in LBP
 - Deposits in dollars (bank dollars) can be withdrawn in LBP at market rate
 - Limited impact on inflation, as most goods are priced at the market exchange rate except subsidized goods
 - Inflation impact of floating is overstated- will be limited to one time 16% due to customs and VAT revaluation

2. Balance the budget

- The new exchange rate applied to customs and VAT will increase fiscal revenues by multiple times
- Reform EDL & eliminate its losses and those of other public enterprises (PEs).
- First step privatize management of PEs, then corporatize through issue of shares listed on BSE.
- Limit ownership to prevent monopolizing privatized PEs.

3. Reschedule all financial assets and liabilities

- Reschedule all financial assets and liabilities including public debt, deposits and loans in line with pre-crisis set up.

4. Compensate deposits of banks lost at BDL \$ 51 billion excluding remaining required reserves \$ 14 billion.

- **Repay deposits lost at BDL without collateral**

- Refund required reserves to depositors, \$ 14 billion
- Corporatize public sector enterprises, issue equity of \$50 billion- similar to IPO process

Mobile, electricity , MEA, leasing port, lease gas and oil blocks, sell public lands to citizens (favored by current PM)

- Equity of government is transformed to equity of Lebanese citizens for those who have deposits and those who don't.
- Limit foreign investment initially until all the IPOs are sold during an initial period..
- List on BSE in dollars as all other equity shares currently are priced in dollars-limit purchases to individuals initially.
- Remainder of deposits of \$ 105 billion can be recovered overtime
- Once confidence in banks is restored- rush on deposits will end.
- Current regimes are unable to implement such reforms

Compensate deposits..

- Currently the public sector has become the main cause of the current economic collapse
- Corporatization will be to the advantage of the poor as it will create employment and growth, then they can afford to become equity holders
- Corporatization is actually giving back state property to its citizens, as the state is a very poor manager and wasteful
- Taking it away from the hands of politicians ensures its recovery. Its continued presence in the hands of politicians on the premise of being owned by all Lebanese is but an effort to maintain it as a major source of enrichment for the political class. A pretext not to introduce reform

IV. Role of the IMF

- The IMF main function is to provide financial support to countries in need of reserves (foreign exchange).
- The IMF has 2 main departments the General Resources Department (GRD) which **provides credit**, and the Special Drawing Rights Department- SDRD which **allocates SDRs to countries- considered quasi-reserves. SDRs are reversible grants that can be exchanged for reserves.**
- The SDR is also a unit of account = \$ 1.3924 (approx.)
- The IMF has several lending facilities that serve a country through the General Resources Department.

Lebanon could qualify for The IMF Extended Financing Facility (EFF)

- Withdrawal of credit over a 3 year period
- Limit of credit is at 145% annually up to a limit of 435% of quota over 3 to 4 years
- Repaid OVER 4 1/2 to 10 years
- Cost is SDR rate (0.05%) plus 100 basis points
- Lebanon's quota is SDR 633 million= \$ 878 million

IMF potential program

- The IMF will request prior action but most Lebanese parties will resist it
- The IMF can be useful by focusing on recovery rather than managing losses.
- The IMF should focus on reform and how depositors' money is saved rather than lost

Main elements of a potential IMF program----

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- The IMF should focus on balancing the budget ASAP and not within 4 years.
- Enhance revenue first
 - Customs & VAT
 - Collection
- Lower and target subsidies: Fix power
- Lower relative civil servants cost
- Reduce Interest cost through rescheduling debt instead of defaulting

Main elements.....

Achieve Current account sustainability

- Insists on floating the rate and apply all transactions at a unified one free rate.
- That by itself, could greatly reduce the BOP deficit
- And the fiscal deficit,
- IMF should focus on rescheduling debt so that its cost is sustainable rather than its ratio to GDP

Main elements

- Reschedule term financial assets and liabilities of banks
- Control liquidity through active open market operations

END