September 2020 Number 54

LCPS المركز اللبناني للدراسات
The Lebanese Center for Policy Studies

Policy Brief

Hiding Behind Disaster: How International Aid Risks Helping Elites, Not Citizens

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This policy brief is supported by the Embassy of the Netherlands in Lebanon. The opinions expressed in this brief do not necessarily reflect those of the donor.

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Executive Summary

Beirut's explosion testifies the fundamental failure of Lebanon's political settlement to provide effective governance. After decades of over-appropriation of resources to maintain extensive clientelist networks, Lebanon's system of sectarian governance not only fails to deliver services to its people. The explosion is just the latest example of how it endangers their lives. With hyperinflation and hunger looming, the magnitude of present-days' multiple crises requires immediate and decisive political action from a political elite that proved both unwilling and incapable of renewing the way it governs the country.

The August 4 disaster shook both the city and Lebanon's political landscape. By triggering the resignation of the government under Prime Minister (PM) Hassan Diab, it facilitated a realignment in the distribution of political power. The nomination of Prime Minister designate Mustafa Adib, reportedly close to major sectarian leaders and the banking sector—most notably Najib Mikati and Nabih Berri—marks the return of traditional elites to de jure political power.

This realignment marks the withdrawal of the remaining political support for the 'financial recovery plan' drafted by the outgoing government under PM Diab and financial adviser Lazard. One after another, the entire team of financial advisors that were elaborating the plan bowed out over political pressure from sectarian elites, the parliament, as well as the Association of Banks in Lebanon (ABL). Elites and the banking sector now face little domestic political resistance for pushing their own ideas for how Lebanon's financial crisis ought to be resolved.

As the Diab cabinet and its advisors resigned, so did the last defenders of the two core demands based on which the financial recovery plan has been drafted. These demands—first, a commensurate contribution of those who profited most of the fiscal policies in the past and, second, avoiding the privatization of state assets that would further exacerbate inequality—are in jeopardy more than ever, risking to protract the crisis at the expense of society at large. After months of bickering over the plan as a starting point for negotiations with the International Monetary Fund (IMF), only the international community is left to push for the plan as a departure point for recovery.

Beirut's explosion vaulted Lebanon's malaise to the attention of world leaders. As diplomats, ministers and even heads of state hurried to visit the city's port and Lebanese officials, French President Emmanuel Macron's submitted his own reform plan, coupled with open threats of sanctions against political elites in case of continued inaction. Billions of dollars of financial aid and remittances are mobilized to mitigate the devastating effects of the explosion, estimated at roughly $4 billion of physical destruction and $3.2 billion in losses of economic activity. In Lebanon's complex political economy, however, this aid risks to help elites, rather than citizens.

To avoid the abuse of Beirut's disaster by elites, international scrutiny must contribute to exposing the embarrassing depth of elites' political and economic mess and push for the preservation of the interests of citizens on the rocky road to economic recovery. In doing so, the international community must strongly condition incoming aid and financial support for the reconstruction of Beirut's public infrastructure to a credible IMF program. Such program must entail an economic and financial recovery plan that demands a fair contribution of elites and a reform program that protects citizens from undue protraction of the crisis.

A Political Standoff of Competing Visions

Assessing the risks emanating from international financial support requires an analysis of the incentives that drive domestic groups of political actors. Lebanon is mired in a political standoff between broadly two sets of interest groups that pursue fundamentally different objectives on the rocky road to

recovery, that is, the lifting of capital account restrictions by restoring deposits and the deployment of a sustainable economic growth model. This stalemate centers around one central question: How to finance and distribute the burden of accumulated losses?

These groups developed two competing visions. The first was pursued predominantly by government advisers (who have resigned since then) and was informed by financial advisory group Lazard and formalized in the outgoing government's financial recovery plan. This plan departs from two distinct tenets vis-à-vis other plans. First, it acknowledges the immediate necessity of external funding to curb inflation, to ensure the import of basic commodities, and to ease capital account restrictions for small depositors to facilitate economic activity and reduce social tensions.

Second, in an attempt to distribute the burden equitably among different stakeholders such as large, small and non-depositors, the plan demands that bank shareholders and large depositors contribute to finance losses. More specifically, bank equity would be used to cover losses incurred on banks' balance sheets. Moreover, the 2% of depositors holding the largest deposits—those who have disproportionately profited from the fiscal policies in the past—would undergo a 'bail-in,' one form of which could be a forced conversion of deposits into bank shares. This will reduce the aggregate demand on dollar notes, allow the lifting of capital account restrictions on small deposits, and curb inflation.

ABL realized that the best way to block the financial recovery plan is to seek parliament's support. However, while the plan would undermine the legitimacy and power of elites, continued inertia would eventually risk becoming costlier than concessions for reform

Powerful interest groups staged up their resistance against the financial recovery plan. Notably, the ABL presented an alternative vision of how to recover losses for which it lobbies extensively among domestic and international decision makers. By trying to minimize any losses to be borne by the banking sector, their plan calls for the privatizations of state assets—such as gold reserves—and state-owned companies—such as Middle East Airlines—to cover the losses. The proceeds of the privatized assets would feed into a 'defeasance fund' which would replenish locked-up deposits via direct revenues or, if these assets fail to pay, by being forfeited to depositors.

ABL realized that the best way to block the financial recovery plan is to seek parliament's support. The parliament's budgetary commission instated a 'fact finding committee,' comprising members of all major political parties (Ibrahim Kanaan [FPM/President], Nicolas Nahas [Azm Movement under Najib Mikati], Yassine Jaber [Amal], Ali Hassan Khalil [Amal], Samir Al-Jisr (Future

Movement), Ali Fayyad [Hezbollah], Eddy Abi Lamaa [Lebanese Forces], Michel Moawad [Independence Movement], Jihad Al-Samad [Dignity Movement], and Faysal Sayegh [Progressive Socialist Party]). While the committee was tasked to identify the 'true value' of losses incurred at the level of both the central bank and the commercial banking sector, they changed the way to calculate losses vis-à-vis the financial recovery plan.

First, they reevaluated losses for debt maturing after 2027 at the official exchange rate of LBP 1,515 to the US dollar, rather than LBP 3,500 for debt maturing before that date, in the questionable anticipation of a revaluation of the Lebanese pound over time. Second, they reduced the number and value of non-performing governmental loans. Third, the plan introduces a potential world premiere of a case in which a parliament weakens the bargaining position of its own government by proposing a lower cut on government debt (60% for an early version of the parliament's plan versus 75% in the government's plan). That way, the parliament's plan identifies the 'true value of losses' to be only $33 billion, which would effectively prevent banks from becoming insolvent as it preserves some of their equity.

The public disagreement between the parliament, ABL, and the proponents of the financial recovery plan over numbers and losses impeded a swift IMF program. Most reform measures outlined in the plan require parliamentary approval and are unlikely to pass in the current political configuration of power.

More importantly, however, the imperative for an IMF program has changed. While until the explosion no 'friendly government' was willing to provide assistance, the influx of foreign funds changes the calculus of political elites. No one less than President Michel Aoun granted insights into how elites perceive Lebanon's position vis-à-vis international donors, saying that 'the blast broke the siege [of political isolation] on Lebanon.' Outrageous in its own right by belittling the legitimate claims of millions of Lebanese for just and effective governance and reforms, accepting any reform program does not appear to be on the elites' agenda.

Why Are Political Elites Opposing the Financial Recovery Plan?

From the perspective of party elites, rejecting the financial recovery plan within an IMF program might seem rational at first sight. However, while the plan would undermine the legitimacy and power of elites, continued inertia would eventually risk becoming costlier than concessions for reform.

For a start, the plan would whirl around the banking sector, for long one of the most effective tools of clientelist redistribution and elite integration.[1] As politics' long-arm, 18 of the largest 20 banks have at least one board

1 Clement Henry Moore, 'Prisoner's Financial Dilemmas: A Consociational Future for Lebanon,' *The American Political Science Review* 81, no. 1 (1987): 201–18.

member that is either a politician, a close friend, or relative of one.[2] By buying government debt at overpriced interest rates, banks provided politicians with money to finance patronage networks via procurement contracts or state employment. The bill was paid by ordinary taxpayers via high-interest rates on loans which crowded out private investment and increased the public debt even further.[3] These mechanisms were so important for elites that legislative and regulatory activity concerning banks and financial institutions proved to be the only policy area in which political polarization or even gridlock never impeded political collaboration.[4] Governments continued to produce laws, decrees, and resolutions concerning financial institutions, banks, and public finance, while all other policy areas experienced a significant drop during the years of political paralysis between 2013 and 2016.

The financial rescue plan would jeopardize these mechanisms by requiring the accounting standard of banks to be adjusted. For instance, bank assets, notably government debt, would have to be valued at market, rather than face value, in order to depreciate the losses incurred by non-performing treasury bills. That way, banks' balance sheet would reflect these assets' present-day worth rather than the original price paid. Moreover, the plan demands to ease the currency mismatch by floating the Lebanese pound to the dollar and removing the currency peg. Revalued liabilities according to a new exchange rate will largely outweigh their mostly worthless assets.

An IMF program based on the financial recovery plan, despite all the dangers and flaws an IMF program could entail, could curb the access of elites to state funds and resources

At that point, many banks would be forced to write off their equity to cover losses and file for bankruptcy. The consequences have the potential to be transformational. The whole sector would come under pressure to restructure as new appointments would be made in the boards of banks as well as potentially the ABL. Banking supervision would have to be strengthened, all of which opens a true opportunity for change.

Banks would be left with the choice to recapitalize with proceeds from sales of business shares to external investors, such as profitable international branches, or transfer ownership to depositors. This transfer would accompany a bail-in of large depositors which would eventually have to follow to cover the remaining losses—a contribution of those largest deposits of above, say, $500,000 that have disproportionately profited from past fiscal policies. This would expose board members and major shareholders of banks, including many politicians,[5] to legal persecution, while the prospect of uncertainty in the distribution of losses among elites due to the strict banking secrecy will be hardly acceptable for elites.

2
Chaaban, J. 2019. 'I've Got the Power: Mapping Connections Between Lebanon's Banking Sector and the Ruling Class,' in *Crony Capitalism in the Middle East - Business and Politics from Liberalization to the Arab Spring,* ed. Ishac Diwan, Adeel Malik, and Izak Atiyas (Oxford: Oxford University Press).

3
Salti, N. 2019. 'No Country for Poor Men: How Lebanon's Debt Has Exacerbated Inequality.' *Carnegie.* https://carnegie-mec.org/2019/09/17/no-country-for-poor-men-how-lebanon-s-debt-has-exacerbated-inequality-pub-79852.

4
Mahmalat, M. and Y. Chaitani. 2020. 'Post-Conflict Power Sharing Arrangements and the Volatility of Social Orders - The Limits of Limited Access Order in Lebanon.' (Beirut).

5
Jad Chaaban, 'I've Got the Power: Mapping Connections between Lebanon's Banking Sector and the Ruling Class,' in *Crony Capitalism in the Middle East - Business and Politics from Liberalization to the Arab Spring,* ed. Ishac Diwan, Adeel Malik, and Izak Atiyas (Oxford: Oxford University Press, 2019).

Fiscal adjustment measures would furthermore undermine elites' established mechanisms of clientelist redistribution. Austerity measures in public administration, for instance, will freeze public sector employment, while remuneration and pensions schemes would jeopardize the attractiveness and effectiveness of using formal state institutions as patronage tools. Another example is a reform of public procurement supervision and regulation, which would preclude the ability of elites to buy off constituents with inflated contracts for public construction.

And these are just the flagship reforms of what the financial recovery plan and a potential IMF program would entail. Improvements in tax compliance, higher taxes on profits, wealth and high income, as well as strengthening of accountability institutions, such as the Court of Accounts and the Public Inspection Board, could prove effective in eventually curbing corruption and the clientelist redistribution of public funds.

In effect, an IMF program based on the financial recovery plan, despite all the dangers and flaws an IMF program could entail, could curb the access of elites to state funds and resources.

Rising Costs of Ruling

The costs of rejecting the plan, despite renewed international attention, are abhorrent and deeply uncertain. The alternative proposed by the parliamentary committee and ABL is at best unsustainable and will deepen the crisis. And despite the threats the plan imposes for elites, the apparent willingness to accept these costs are not trivial to explain.

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For one, privatizations simply won't work. The often-cited estimations of the total value of state assets of $40 billion is highly unlikely to result in an equally large inflow of foreign funds.[6] Privatizations in times of crises are highly inefficient as buyers exploit the precarious positions of governments. This commonly results in the below value fire-sale of assets, further exacerbated by Lebanon's notoriously corrupt public procurement institutions that lack oversight.

Moreover, generating revenue with privatizations takes time. For sales, tenders need to be written, and bids made, and discussed in slow-working political institutions. Even revenue generated from the operations of state companies and administered by dedicated funds, such as telecom, will take many years to assemble amounts sufficient to replenish deposits. Apart from depriving the state from funds to invest into services and thereby being highly inequitable, Lebanon's ailing economy and hungry population does

6 Bank of America. 2020. 'Lebanon Viewpoint - The Ghost of Hyperinflation Past.' BofA Global Research.

not have this time. The central bank will remain the main financier for the government via seigniorage. Inflation will further devalue remaining smaller deposits, which will apply a haircut on all those who have savings in Lebanese pounds while protracting capital account restrictions on all deposits, not only large ones.

Lastly, half-solutions are simply impossible at this point. The crises became so deep that not solving the structural problems underlying them will not even benefit elites in the longer-term. Capital account restrictions and crippling austerity measures will eventually curtail many of the prevailing mechanisms that bind constituents to their elites nevertheless.

The popular narrative of ABL's and the parliament's plan was to protect depositors and to save private wealth from the government's greedy hands. In effect, however, their plan would essentially further dispossess non-depositors to the benefit of major depositors—that is, those members of society that have benefited disproportionately from the fiscal policies of the past. That way, these plans will continue to fuel discontent and further increase inequality in what is already one of the most unequal societies on the planet.[7]

The dictate of the moment turns out to be the evergreen of Lebanese politics: Buying time, leveraging the attention diverted to Beirut's disaster

But with inequality to reach new records, increasing polarization, the middle-class eroding, and life satisfaction plunging, social unrest eventually risks turning into unpredictable sectarian violence. By leaving virtually no way to restore the patronage networks that granted elites legitimacy in the past, elites' power will remain undermined regardless and forces them to maintain the loyalty of their constituents by inducing fear. This path eventually risks leaving little leeway to stay in power other than a flight forward into polarization and violence—with costs likely more devastating than concessions to reform.[8]

The Alternative: Buying Time with People's Assets

But as the option to concede power—by accepting an IMF program or only instate an independent, empowered government—appears to be off the table for the moment, so does a flight forward into open confrontation. With all factions being quick to catch the spirits of sectarian confrontation that they started to incite early June, elites appear careful to use political polarization to advance their goals at this point.

The dictate of the moment, then, turns out to be the evergreen of Lebanese politics: Buying time, leveraging the attention diverted to Beirut's disaster.

7
Alvaredo, F., L. Assouad, and T. Piketty. 2017. 'Measuring Inequality in the Middle East 1990-2016: The World's Most Unequal Region?.' *Centre for Economic Policy Research,* Discussion Paper, No. 12405.

8
Brück, T. and M. Mahmalat. 2020. 'Lebanon Needs to Learn from the Syrian Disaster.' *ERF Forum.* Discussion Paper, No. 12405.

The securitization of society will continue and make quelling of protests a constant in the months to come. With leaders prioritizing security as a precondition for political progress, force and infringements on freedom of speech have become standard measures in the toolkit of state security forces. Declaring and prolonging the state of emergency in Beirut after the explosion and conferring prerogatives over the security of the city to the army is only the most recent measure in this succession.

Moreover, as declining purchasing power makes the loyalty of constituencies cheaper, clientelist networks started to compensate the loss of state-led mechanisms of patronage with private ones. Sectarian providers simply switched from offering employment to the provision of food baskets.

In the medium-term, mass emigration will fuel the same mechanisms that kept the Ponzi-scheme alive until last year. As the educated middle-class will seek opportunities abroad to advance their career and to support their relatives back home, domestic consumption decreases and remittances alongside private and public aid might, once again, become a backbone of Lebanon's economic model. This disperses many of the most ardent and best-organized opponents of todays' party elites, whose organization in political parties and NGO's would be indispensable for enforcing concessions for great accountability of elites. Moreover, emigration will hollow out Lebanon's most important and valuable asset: Its people, their ideas and entrepreneurial spirit.

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Don't Wait for Reform, Wait for the Settlement

But when the opportunity costs of waiting are so horrendous and the costs of ruling ultimately unpredictable, what to buy time for?

The present-day political battle does not center on the resolution of technical challenges of how to distribute gains and losses of reform. The resignation of the entire team of financial advisors who drafted the financial recovery plan exemplifies that the challenge does not lie within the system. Technical solutions are available, as are the people to implement them.

It's a problem of the system.

Instead, by buying time elites were betting on opportunities to lobby internationally for political and eventually financial support. The initiative by the Maronite Patriarch to mandate Lebanon's neutrality toward neighboring conflicts, backed by international actors and local political groups, is a salient recent example of these efforts. His remarks sparked a debate that shifted public attention away from the need for immediate solutions to deteriorating

livelihoods and tied the country's economic fate to geopolitical factors. The changing geo-political environment in the aftermath of the blast prove these bets to be well placed.

For elites, the payoffs of this shift in the political settlement of the region will outweigh the payoffs of any domestic political developments. With donor money flooding exchange dealers, expat remittances to replenish banks, and the prospects of infrastructure projects reviving patronage networks, increased international attention and foreign aid risk staving off the remaining pressure for reform.

Hiding Behind Disaster

Meanwhile, once again, Lebanese citizens pay the price. With a new government, elites will continue to try bailing out the two percent of wealthy individuals with the assets owned by all Lebanese. The efforts to avoid privatizations and to demand a contribution of wealthy depositors outlined in the financial recovery plan failed to attract the necessary political and popular support among party elites. Rents accrued from years of looting will magically turn into state assets, while the majority of depositors will be unable to access their savings for many years to come.

The political elite, leveraging a ruthless banking sector, will rescue itself at the expense of both the society and the economy, as well as any government's ability to reform. Without reforms, even financial assistance other than an IMF program will only protract the crisis. Providing funds without reform is like filling water into a colander.

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Well-intended donors and sponsors must reflect these risks in any efforts to designing new or reviewing existing support programs. It is here where international donors must strongly back the financial recovery plan and the principles it entails in order to avoid squandering of donors' taxpayer money and inadvertently protracting Lebanon's malaise. Remembering that the pressure for reform largely stems from elites' need to unlock deposits in banks—both their own as well as those of their clientele—the following principles must be applied to condition financial support:

- Immediate aid relief should only be processed via independent providers, not via partisan organizations;
- No public infrastructure projects may be implemented unless elites' give credible commitments that the privatization plans of ABL and the parliament are off the table in order to avoid transferring donor financed public property into elites' assets;

- A reform program conditional for funds must be tied to a credible IMF program;
- Funding programs to give loans for reconstruction of private properties should not be channeled via commercial banks with political connections but via independent financing mechanisms;
- Given the endemic corruption in major infrastructure institutions, the Council for Development and Reconstruction in particular, public infrastructure projects must be designed and implemented by independent institutions.

Elites may not hide behind disaster. Lebanon's vibrant civil society and local media must continue to closely scrutinize the larger bargain over the country's future. Moreover, the international community must take stock of their past complicity of reproducing the status-quo and cease their support for the parties that make up the political elite.

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