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Lebanon's Economic Crisis

Lebanon faces a serious economic crisis. The government defaulted on its debt in March 2020, its currency has lost 80% of its value since 2019, consumers and businesses are grappling with hyperinflation, and the banking sector is insolvent. Unemployment and poverty in the country have surged. Lebanon's economic challenges have exacerbated political turmoil, fueling nationwide protests against inequality and the perception that political elites across the spectrum have manipulated financial institutions for their own gain. Protests and political gridlock have resulted in the resignation of three prime ministers since October 2019; Lebanon has been unable to form a government since the August 2020 resignation of Prime Minister Hassan Diab. While Lebanon is urgently seeking financial assistance abroad, its current caretaker government cannot enact the reforms that the International Monetary Fund (IMF) has stated are necessary for aid negotiations to progress.

Lebanon's economic crisis has wide-ranging implications for political stability and regional security. U.S. adversaries in Lebanon—including Hezbollah and its patron Iran—could benefit from any instability in the country, including by escalating operations in Syria and/or along the Israeli border. Deteriorating economic conditions and a vacuum in state authority also could prompt refugee outflows (of both Syrians and Lebanese), renew sectarian conflict, and create a permissive operating environment for terrorist groups.

Overview of the Economic Crisis

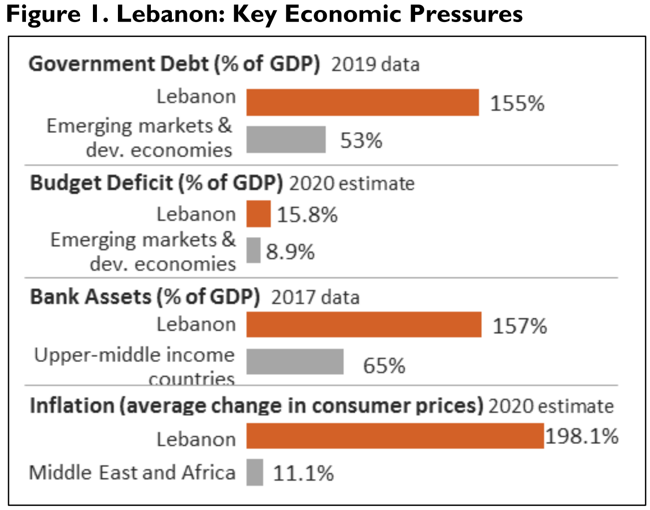
Lebanon's economic crisis combines various challenges; some analysts characterize it as simultaneous debt, fiscal, banking, and currency crises (**Figure 1**).

Debt crisis. Following Lebanon's civil war (1975-1990), successive Lebanese governments borrowed heavily to finance reconstruction, mostly from local banks, but also by selling bonds in international capital markets. The governments, however, did not always channel borrowed funds into productive investments, and repeatedly rolled over the country's debt (paying off old debts with new borrowing). Thus, Lebanon's debt burden is one of the highest in the world (roughly 155% of GDP in 2019). Investors grew increasingly concerned in 2019 about the sustainability of Lebanon's debt and that a future government would seek debt restructuring. With foreign investors increasingly unwilling to invest in Lebanon, the government in early 2020 found itself with limited foreign exchange and faced competing priorities: it could use its limited foreign exchange to make debt payments or finance critical food and fuel imports. In March 2020, Lebanon defaulted on its debt for the first time and announced that it was discontinuing payments on its foreign-currency debt.

Fiscal crisis. The Lebanese government has run large budget deficits for years, averaging 8.6% per year between 2011 and 2019. Debt service contributed to the fiscal pressures facing the government: roughly half of the government's revenue went to interest payments on the public debt. Previous attempts at closing the budget deficit gap were largely unsuccessful: efforts to raise revenue via a tax on the popular messaging system WhatsApp in October 2019 triggered vast nationwide protests against corruption and financial mismanagement, and resulted in the resignation of then-Prime Minister Saad Hariri. Unable to access new financing, Lebanon must now balance its budget by increasing revenue collection and/or cutting government spending.

Banking crisis. Lebanese banks were long-lauded as key engines of economic growth. Between 2011 and 2019, bank assets had grown by 83% to $253 billion, equal to roughly five times the country's GDP. Lebanese banks were able to attract dollar deposits from local customers and the large Lebanese diaspora abroad by offering high interest rates (up to 14%) on dollar-denominated accounts. The banks used these deposits to lend to the Lebanese government at a higher interest rate, netting sizeable profits. As investor confidence waned in late 2019, however, the banks were unable to meet customer demands for deposit withdrawals, because their deposits were tied up in longer-term loans to the government. Banks closed for weeks in late 2019 and after reopening, imposed weekly limits on cash withdrawals in dollars. Additionally, the banks are major holders of government bonds, and their financial situation has become more precarious since the government defaulted on its debt.

Figure 1. Lebanon: Key Economic Pressures



Source: IMF, World Bank, and Economist Intelligence Unit.

Currency crisis. The Lebanese pound has been pegged to the dollar since 1997. However, as investors started to pull funds out of Lebanon in 2019, demand for the pound fell. Lebanon's central bank sold foreign exchange reserves to support the value of the currency, but an informal exchange rate market developed in which the pound traded at increasingly depreciated rates and dollars became scarce. The pound has lost about 80% of its value since 2019. Lebanon is highly dependent on imports, and as the currency depreciated, the prices of most goods rose. In 2020, inflation reached over 50%, crossing the threshold into hyperinflation, depleting the value of salaries and savings and leading to shortages of consumer products.

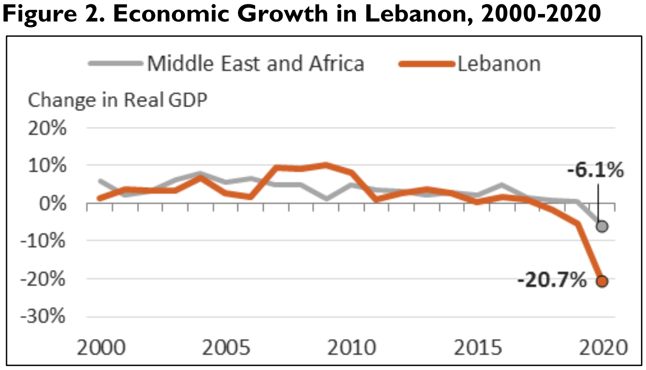
The crisis has been devastating for both Lebanese and refugees. Roughly 2.7 million of Lebanon's 5.5 million residents live below the poverty line (less than $14 a day). Extreme poverty has tripled in the past 12 months, from 8% to 23% of the population. Unemployment has risen to 30%. Fuel shortages have led to rolling blackouts, and the United Nations has cautioned that more than half of the population could face food shortages by the end of 2020.

Policy Responses and Economic Outlook

In May 2020, the Diab government formally requested a $10 billion financial assistance program from the IMF. The program would be a loan conditional on the implementation of economic reforms. The cash infusion would give the government breathing room, but negotiations have been deadlocked for months over the exchange rate, government finances, and recommended banking reforms. In April 2020, the then-government circulated a draft plan to restructure its dollar-denominated bonds, with investors facing losses of 70%; Lebanon's banking association rejected the proposal. Negotiations between the government and bondholders were put on hold after the resignation of Prime Minister Diab, following a major August 2020 explosion at the port of Beirut.

The IMF is seeking broad-based political support among the Lebanese for the economic reform program, but reforms to date have been stymied by the persistent corruption, vested interests, and system of patronage that are intertwined with the country's sectarian political system. Additionally, the resignation of the Diab government placed Lebanon's government into caretaker status with reduced authorities. Until a new government is formed, Lebanon cannot enact the called for structural reforms.

Figure 2. Economic Growth in Lebanon, 2000-2020



Source: Economist Intelligence Unit.

Notes: Forecasted data for 2020.

Lebanon's economic outlook is bleak. The Coronavirus Disease 2019 (COVID-19) pandemic has deterred tourism, a key industry. Declining global oil prices have significantly reduced remittances from Lebanese employed in the Persian Gulf, which usually account for 12% of GDP. The Economist Intelligence Unit forecasts that Lebanon's economy will contract by 20.7% in 2020 (compared to a contraction of 5.6% in 2019, **Figure 2**), and that inflation will reach 490% by the end of the year (compared to 6.9% at end-2019).

Over the long term, Lebanon will likely need to diversify its economy away from finance and towards other sectors—such as preparing its multilingual and relatively well-educated workforce for tech industries and high-end manufacturing, a lengthy process that would likely entail significant infrastructure investment. In 2018, international donors at the Conference for Economic Development and Reform through Enterprise (CEDRE), hosted by France, pledged $11 billion in loans to Lebanon to finance infrastructure modernization. However, the funds were offered contingent on as-of-yet unenacted reforms.

U.S. Interests and Policy

Lebanon's economy is small and its economic crisis is unlikely to pose a systemic threat to the global economy. However, the economic crisis poses a serious risk to domestic stability in Lebanon, potentially creating an opening for U.S. adversaries such as Hezbollah and Iran to expand their foothold in the country. U.S. policy towards Lebanon to date has sought to counter the influence of these actors by strengthening Lebanese state institutions. In the absence of support from state institutions, Lebanese may become more dependent on sectarian communal leaders. In exchange for political loyalty, these leaders provide access to job opportunities and services that the state is unable to deliver adequately, such as access to electricity, water, and health care. Hezbollah arguably maintains the most extensive communal social services network and may stand to gain the most from state weakness.

Despite U.S. interest in bolstering the Lebanese state, U.S. officials have described Lebanon as plagued by "endemic corruption," and emphasized that political leaders must implement structural economic reforms before receiving a bailout. Following the August 2020 Beirut port explosion, the United States provided $19 million in emergency aid; U.S. officials emphasized that U.S. assistance will address only the "immediate humanitarian needs caused by the explosion" and will be routed through international and nongovernmental organizations. Officials also stated that the United States will provide humanitarian relief, but emphasized that "broader assistance is conditional on fundamental change." As noted above, enactment of reform first requires the formation of a new government.

Potential Policy Questions for Congress

- What changes, if any, does Congress seek in U.S. economic assistance to Lebanon? How can the United States support reform efforts in Lebanon?
- Under what conditions would the United States support an IMF program for Lebanon?
- If the economic crisis creates further political instability in Lebanon, how might this affect patterns of U.S. assistance to Lebanon's military and security forces?

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