

DGAP POLICY BRIEF

The EU's Role in Addressing Lebanon's Multiple Crises



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The Beirut Port blast (BPB) has revealed the fundamental failure of the Lebanese political system, but deep democratic reforms will take time and are fraught with risks. Given the US withdrawal and the extreme tensions in the region, the EU has a critical role to play in addressing the short-term humanitarian crisis, responding to the economic and financial situation, and providing a forum for civil society empowerment. If it fails to do so, the price is further geopolitical destabilization.

- Lebanon's current economic crisis has its roots planted deep in the post-civil war political settlement. The Taif Agreement of 1989 secured peace but established a clan- and religion-based political system that needs to be overhauled. This will be a long process and requires civil society empowerment.
- The EU can play a critical role by rapidly launching an EU trust fund to collect and channel international support to civil society organizations and ensure the highest level of transparency and accountability.
- Addressing the economic and financial crises requires: (i) a large financial assistance program; (ii) a far-reaching sovereign debt restructuring, and (iii) a profound restructuring of the domestic banking system. The EU should be actively engaged in all three.

Introduction

The blast in the port of Beirut has provoked a humanitarian crisis and highlighted a state failure that is at the heart of overlapping financial, economic, and political crises. With hundreds of deaths, thousands of injured, nearly 300,000 people made homeless, and a health system already overstretched by the COVID-19 pandemic, Beirut requires enormous humanitarian assistance and support to meet the reconstruction needs¹.

Stabilizing the situation in Lebanon is of crucial importance to Europe. The recent flaring up of tensions in Eastern Mediterranean Sea and the quagmires in Syria and Libya should motivate the EU to do everything it can to keep Lebanon's financial, economic, and political crisis from escalating into an explosive geopolitical situation.

THE EU CAN PLAY A CRITICAL ROLE IN THREE AREAS

So far, only a modest amount of humanitarian aid has been provided, a small fraction of the true cost of repairing the damages done by the BPB. Channeling large sums rapidly will require the EU to set up an EU trust fund, work closely with civil society organizations, and devise new ways of delivering aid that can ensure transparency and accountability. This is particularly important given the doubts surrounding the current Lebanese government.

Lebanon's humanitarian situation is made worse by an ongoing economic and financial crisis. The EU should support and lead the IMF's efforts for a large debt restructuring operation, a substantial restructuring and recapitalization of the banking system, and a significant external adjustment program. In addition to an IMF program, multilateral development banks (including the EIB and the EBRD) as well as the EU's own Macro Financial Assistance program will need to contribute.

Finally, this crisis cannot be resolved without addressing the domestic political root causes of the problem. This represents a tall order and entails huge risks. The entire political settlement that has governed Lebanon's economic and political settlement needs to be revisited. This is a long process that requires intense dialogue with civil society organizations and civic movements with the ambition of creating a real political dialogue leading up to new elections. The powers (Saudi-Arabia, the US) that helped broker the Taif Agreement in 1989 cannot be counted on to do the same today, and the EU therefore needs to be more involved.

20 YEARS OF FAILURE

For nearly 20 years, Lebanon has been on life support from the international community. Between 2001 and 2018, the country received more than \$23 billion in the form of humanitarian assistance and development aid (Paris I, Paris II, Paris III, Stockholm international donors' conference, CEDRE conference)². Yet none of these donors' conferences – mostly spearheaded by France – have enabled a stable and sustainable economy to emerge. They were too small and too captive of the existing political system to make a difference, and the Lebanese commitment to reform was too weak. This is part of the reason why the last donors' conference, which took place after the terrible explosion at the Beirut port, produced such modest international support. Donor fatigue has set in, and a new approach is needed that delivers more profound change.

Instead of a new donors' conference, the EU should establish a trust fund and create a new framework to deliver financial assistance on the ground. This requires innovation: The EU will need a comprehensive map of effective civil society organizations on the ground and an intelligent way to distribute funds to them while taking into account the payment restrictions affecting the domestic banking system. It will also have to introduce a process of accountability and transparency that has been missing from previous assistance and reconstruction efforts, including those led by the EU. This should lead

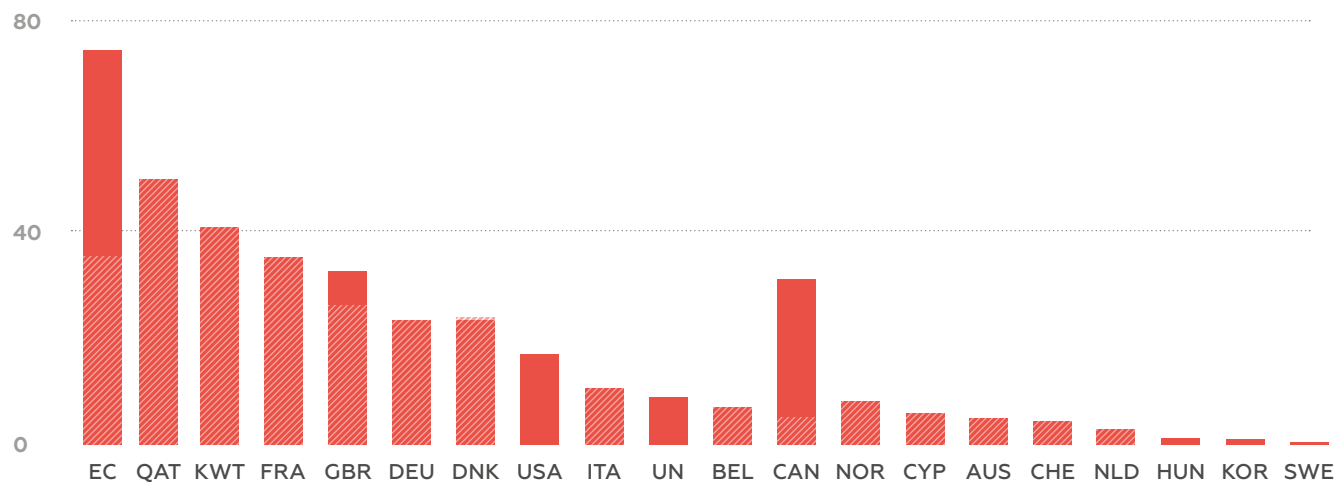
¹ BBC, "Beirut reconstruction could cost up to \$15bn", <https://www.bbc.co.uk/programmes/p08my9q9> (accessed August 23, 2020)
SIDA, "Sida ger stöd till de hårt drabbade i Beirut", <https://www.sida.se/Svenska/aktuellt-och-press/Medieservice-och-presskontakt/pressmeddelanden/2020/sida-ger-stod-till-de-hart-drabbade-i-beirut/> (accessed August 28, 2020)

Government of Canada, "Canada's response to the crisis in Lebanon", https://www.international.gc.ca/world-monde/issues_developpement/developpement/response_conflict-reponse_confits/crisis-crisis/lebanon-liban.aspx?lang=eng (accessed August 28, 2020)

² For a summary of Paris I and II see: David Schenker, "Lebanon goes to Paris," The Washington Institute, January 24, 2007, <https://www.washingtoninstitute.org/policy-analysis/view/lebanon-goes-to-paris-iii-high-stakes-in-france-and-beirut>, accessed August 23, 2020

PLEDGES BY DONOR, IN MILLION USD

- TOTAL ANNOUNCED PLEDGES
- ▨ PLEDGES AGREED AT INTERNATIONAL DONORS' CONFERENCE



European Commission	35.3	74.2
Qatar	50.0	50
Kuwait	41.0	41
France	35.3	35.3
UK	26.1	32.6
Germany	23.5	23.5
Denmark	24	23.5
US		17
Italy	10.6	10.6
UN		9
Belgium	7.1	7.1
Canada	6.5	30
Norway	8.2	8.2
Cyprus	5.9	5.9
Australia	5	5
Switzerland	4.4	4.4
Netherlands	3	3
Hungary		1.2
South Korea		1
Sweden		0.5
Total	286	383

source: news agencies¹

international and European donors toward the most decentralized support possible, bypassing as much as possible governmental structures until confidence in their delivery capacity is restored. But this requires a precise mapping and assessment of local civil society organizations and therefore a great degree of devolution of the aid distribution process to aid agencies and personnel on the ground. The EU also needs to ensure traceability and accountability of the funds it distributes but without relying on a new bureaucracy of consultants and aid specialists.

A NEW FINANCIAL SUPPORT PACKAGE LED BY THE EU

Lebanon's domestic crisis started just under a year ago. Prime Minister Saad Hariri resigned on October 29, 2019, after two weeks of massive protests against corruption and nepotism in his government. The result was profound political uncertainty which aggravated an already fragile economic situation. Lebanon is now hit by a combination of a banking crisis, a balance of payment crisis, and a sovereign debt crisis. For years, the country's banking system relied on large inflows of foreign deposits. When they stopped, a large current account deficit and capital outflows drained a large part of the foreign exchange reserves. Finally, the government cannot service its debt anymore. This situation cannot be addressed without substantial external assistance and an IMF program, but talks have stalled.

In February 2020, given the lack of liquidity in US dollars, the Lebanese government was forced to announce a moratorium on its external debt. The next step, in late April, was the presentation of an ambitious recovery plan³, which has the merit of clearly setting out the need for reform and adjustment. Yet its implementation has been held back due to the difficulty of agreeing on a critical mass of "prior actions" required by the International Monetary Fund (IMF). These include a law guaranteeing the independence of the judiciary, the appointment of a new regulatory authority and a new board of directors for the electricity sector, and a law on public procurement.

The recovery plan is also facing substantial internal opposition. Critics have pointed out that the recovery plan sets highly unrealistic goals for the government's fiscal policy. Indeed, few countries of this income level would be able to sustain a primary surplus of 3.8 percent of GDP in the midst of a profound recession for years. This means that a program should attempt to be more gradual and therefore longer. As a result, however, the financing needs of Lebanon would in fact be much larger than the government and the IMF are prepared to contemplate. Indeed, given Lebanon's quota at the IMF, the Fund would normally not be willing to lend it more than \$4 billion to \$5 billion. However, the IMF has a framework to allow exceptional access which could mean doubling Lebanon's credit line. But such a step would require a very strong level of international political support which seems hard to come by at the moment.

IMF and MFA

The government has conducted more than a dozen meetings with the IMF to negotiate financial support since March 2020. The realization that international financial assistance is unavoidable has sunk in even with those elements of the Lebanese government which were initially strongly opposed. But any final agreement with the IMF will require the support of the US administration, and there are a number of voices in the administration as well as in Congress that are reluctant at best and opposed at worst. For example, the Republican Study Committee, a caucus of conservative members of the Republican Party in the House of Representatives, has recently recommended sanctions against key political figures in Lebanon⁴, which could make an IMF Board approval more challenging. On the Lebanese side, disagreements between the central bank, the government, and the banking sector have hampered the negotiations and caused delays to the voting of the prior actions in the parliament.

Notwithstanding the necessary technical expertise of the IMF, it would be useful for the EU to be strongly involved in the international financial assistance. While regional institutions like the Arab Monetary Fund could in principle be useful, they seem too weak and probably too politically divided to in-

³ Mike Azar, "Analyzing the Government Plan & Comparing it with the Draft," May 4, 2020. Provides links to the final version of the plan as well as an earlier leak and analyses the evolution of the government's position. <https://finance4lebanon.com/analyzing-the-final-government-plan-comparing-it-with-the-draft/>, accessed August 23, 2020

⁴ Gino Raidy, "How Draft Bills in the US Congress Influence the Lebanese Sulta," June 11, 2020, <https://ginosblog.com/how-draft-bills-in-the-us-congress-influence-the-lebanese-sulta-b98178ecbbbb>, accessed August 23, 2020

tervene successfully⁵. However, the EU has a facility designed to assist countries in its neighborhood as they undertake an IMF program. Such Macro Financial Assistance (MFA) programs have recently been used in Ukraine and Jordan. Some €3 billion were granted to eight countries in the EU's neighborhood in response to their greater needs and the COVID-19 crisis⁶. There was also an earlier MFA program for Lebanon⁷, too, which proved useful⁸.

With the much greater sum needed today, however, there is a potential issue: The size of the MFA is limited by the size of the Guarantee Fund for External Actions which in turn is constrained by the resources ceiling available under the current and future Multi Annual Financial Framework. The Lebanese government's own calculation of external funding needs (described by the government as optimistic) are in the range of \$28 billion until 2024. This means that even an exceptionally large IMF program of \$10 billion would require considerable other multilateral and bilateral sources of support. The World Bank, the European Investment Bank, and the European Bank for Reconstruction and Development could probably add up to \$7 billion to \$8 billion, but this would leave as much as \$10 billion to be covered by bilateral support and the EU's MFA.

Sovereign Debt Restructuring

In calculating the country's financing needs, the Lebanese government assumed that a significant reduction of external debt could be negotiated with international creditors. In February 2020, Lebanon had declared a moratorium for all outstanding Eurobonds; the total sum amounts to \$31.3 billion. A sharp reduction in external debt would reduce the drain on foreign reserves. Yet the problem of sovereign debt concerns both external financing and domestic fiscal sustainability. It is generally accepted that roughly \$45 billion worth of domestic currency losses need to be recognized and allocated because the IMF will only agree to new loans if it considers Lebanon's public debt to "sustainable with a high probability."

Domestic Financial Stability

The Lebanese economy has operated for years with a bloated banking system (its assets amount to more than 400 percent of the country's GDP). Lebanon successfully played the role of a regional financial center but also acted as a convenient laundering system for most of the Middle East. The success of the Lebanese banking industry was built on cooperation with the central bank, the Banque du Liban: Commercial banks paid a very high premium on US Dollar deposits in order to attract foreign currency deposit from the Lebanese diaspora and from the Middle East. They were able to pay these high interest rates because the Central Bank was in turn paying high interest on Certificates of Deposits, denominated in Lebanese pounds, that the commercial banks were investing in. At the same time, the central bank maintained the exchange rate between the US dollar and the Lebanese pound stable. This strategy allowed Lebanon to finance a large current account and fiscal deficit by attracting between \$5 billion to \$10 billion in new deposits each year between 2005 and 2018⁹.

This arrangement came to an abrupt end at the end of last year when political events (the demonstrations as well as the abduction and resignation of Prime Minister Hariri) created profound political uncertainty. As a result, a massive flight of capital precipitated a banking crisis that now forces profound restructuring, consolidation, balance sheet cleanup, and recapitalization of the banking system. The key question is how to distribute the losses arising from the domestic debt restructuring. One option would be to put the burden on the Banque du Liban and spare the commercial banking system. At least in theory, the central bank could operate with negative equity and recoup its losses over a very long period of time through seigniorage revenues. The second option is to impose the loss on the commercial banking system and divide the burden between depositors and shareholders. The third option is a scheme that the Lebanese banking system is arguing

5 Barbara Fritz and Laurissa Mühlich, "Regional Financial Arrangements in the Global Financial Safety Net: The Arab and the Eurasian Fund", July 2018, https://www.lai.fu-berlin.de/homepages/fritz/publikationen/regional-financial-arrangements-in-the-global-financial-safety-net_the-arab-and-the-eurasian-fund.pdf, accessed August 25, 2020

6 EUR-Lex, "Decision (EU) 2020/701 of the European Parliament and of the Council of 25 May 2020 on providing macro-financial assistance to enlargement and neighbourhood partners in the context of the COVID 19 pandemic," May 25, 2020, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020D0701>, accessed August 23, 2020

7 EUR-Lex, "Decision (EU) 2020/701 of the European Parliament and of the Council of 25 May 2020 on providing macro-financial assistance to enlargement and neighbourhood partners in the context of the COVID 19 pandemic," May 25, 2020, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020D0701>, accessed August 23, 2020

8 Ecorys, "Ex-post evaluation of Macro Financial Assistance operations to Lebanon," May 2, 2012, https://ec.europa.eu/dgs/economy_finance/evaluation/pdf/evaluation_lebanon_en.pdf, accessed August 23, 2020

9 Brad Setser, "Lebanon's Imminent Financial Crisis," Council on Foreign Relations, February 18, 2020, <https://www.cfr.org/blog/lebanons-imminent-financial-crisis>, accessed August 23, 2020

for, which would force the government to privatize a large number of state assets. Yet this will be difficult because external creditors will claim these assets and the IMF will need the proceeds to reduce the government's debt over the medium term.

The apportionment of losses on Lebanese depositors poses a difficult political question. Indeed, according to Bisat, Cassard and Diwan¹⁰, a bail-in to recoup all of the losses would wipe out 33 percent of all deposits, or more than 55 percent of deposits above \$500,000 (representing about two percent of all accounts), or 70 percent of deposits over \$1 million (representing about one percent of all accounts). It would constitute one of the largest bail-ins of depositors in modern economic history. Any such decision would be likely to force a much-needed audit of capital flight over the last several months, which could put the spotlight on a number of persons of high net worth and political exposure. Indeed, even after capital controls were introduced, there has been continuous leakage of foreign exchange reserves which suggests a selective application of the capital controls.

On balance, there is a case for a more gradual loss recognition and for allowing some of the losses to be placed on the central bank's balance sheet. But even if in theory, the Banque du Liban can run with substantial negative equity, its ability to sustain a given exchange rate policy would probably be undermined unless its credibility was strengthened by international/bilateral support in the form of foreign exchange swap lines, for example.

A Role for the ECB?

The Lebanese economy was extremely dollarized for historical reasons, in particular because of its role in the recycling of petrodollars from the Middle East. However, its trade with the EU represents more than 30 percent of total trade. It would be worth considering to base any new exchange rate regime on a basket of currencies that would include the euro. In this context – and in accordance with the implementation of an IMF program that would restore financial stability and the country's balance of payments – the European Central Bank could consider extending a temporary swap line to the Banque du

Liban¹¹. This would have a powerful symbolic dimension and would greatly help to restore confidence in the country and in its restructured banking system. Even though the European Central Bank has never taken this step in the context of a financial assistance package, such a temporary swap line would also go to some length in furthering the EU's objective of internationalizing the euro.

Finally, and this is rarely discussed by the IMF or the Lebanese government, the potential oil and gas revenues that could be generated from possible reserves identified off the coast of Lebanon have so far been disregarded. The intense bickering over these issues in the Eastern Mediterranean Sea should remind us both of Lebanon's strategic position for a future Eastern Mediterranean pipeline and of its long-term economic potential.

CIVIL SOCIETY BUILDING TOWARD A NEW DOMESTIC POLITICAL SETTLEMENT

These economic and financial changes will not happen without profound political reform. The Taif agreement of 1989 effectively ended Lebanon's civil war and organized the representation of all political, clan, and religious forces in Lebanon. But it also set up a predatory state marked by widespread corruption, nepotism, and crony capitalism that is largely responsible for today's economic and financial crisis.

Civil society activism started to gain momentum in 2015, when thousands of people took to the streets in Beirut in response to a garbage collection crisis. At the same time, a movement set up to support Syrian refugees started to gain ground. This civil society engagement reached a new level in the fall of 2019 and culminated with the so-called October 17th movement. It now takes the form of a myriad of organizations. Some already fielded candidates at the last general elections, while others are more focused on social issues and local activism. These movements have become incredibly vocal and powerful, and the Beirut Port blast has galvanized them. Still, this civil society opposition remains largely unstructured and somewhat decentralized, which makes it difficult to

¹⁰ Amer Bisat, Marcel Cassard, and Ishac Diwan, "A grave crisis with no silver bullet", Carnegie Middle East Center, May 2020. <https://carnegie-mec.org/2020/05/11/grave-crisis-with-no-silver-bullet-pub-81752>, accessed August 25, 2020

¹¹ With the COVID-19 crisis, the ECB has created a new facility for bilateral repo with international central banks in order to provide euro liquidity internationally. While this is far from a bilateral swap line, it shows some openness from the ECB to provide Euro liquidity to central banks in need on a temporary and emergency basis. <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200625-60373986e5.en.html>, accessed September 9, 2020

bring it into a political negotiation process. This, in turn, allows proponents of the establishment to discount the claims and demands for radical change.

In this situation, outside help could make a big difference. The HD Center in Switzerland¹², the Berghof Foundation¹³ in Germany, and Sant'Egidio¹⁴ in Italy are organizations that could provide a forum for these civil society organizations to meet in a neutral context free of the political pressure of Lebanese or international actors. They could help them structure their demands and prepare for a possible role in the future political dialogue and reconciliation process.

This sort of civil society empowerment is necessary if one wants to envisage a political dialogue between the old and the new stakeholders in Lebanon. On the one hand, the new movements' legitimacy is rooted in their demand for radical change and a complete break with the past, while all historical political parties have been tainted by the exercise of power. On the other hand, it is unlikely that there can be a lasting political solution without a process of dialogue and compromise with all political forces. The new political movements' efforts to move away from a political life almost exclusively organized around clan-based loyalties that were set in stone with the Taif Agreement of 1989 are laudable. But this settlement served to pacify Lebanon and organize a semblance of political stability for the past 30 years. Rewriting it in view of today's democratic demands and economic reality will undoubtedly be a long process.

Indeed, it seems hard to imagine that a system so central to the organization of the entire political, social, and economic life could be uprooted as radically as the demonstrators and civil society activists demand. If the recent experience of Egypt, Libya, Syria, or Iraq is any guide, revolutions and democratization processes are long, and international meddling is often perilous. Profound political reforms are inevitable; they are also essential to stabilize the Lebanese economy.

This requires a sort of homegrown truth, dialogue, and reconciliation process which will require tremendous engagement with existing civil society

organizations to ensure their genuine representation and participation in this process. Yet precipitation would be dangerous given the current state of politics. There is also no obvious broker for a new Taif Agreement. Middle Eastern actors are probably too partisan to play a role, and many European countries are also ruled out for variety of reasons. Germany has declared the Hezbollah a terrorist organization, while France has a colonial history in Lebanon and supported previous governments to an extent that could discredit its efforts today. The question of whether an external broker would help or endanger a domestic political dialogue is therefore open, but non-governmental civil society support seems like a necessary and worthwhile effort.

CONCLUSION

The EU has an important role to play in Lebanon, both financially and politically. This assistance should at least initially take the form of patient civil society empowerment. Recent experiences of statecraft and democratization processes led by foreign governments call for extreme caution and patience. But if the EU fails to play its part, or limits its intervention to humanitarian support, it will be complicit not only in a protracted economic and political crisis. It would also carry responsibility for the possible resumption of a sectarian conflict with deep and lasting regional and geopolitical consequences.

¹² The Centre for Humanitarian Dialogue (HD) is a Swiss-based private diplomacy organisation founded on the principles of humanity, impartiality, and independence, <https://www.hdcentre.org/>

¹³ The Berghof Foundation is an independent, non-governmental, and non-profit organisation that supports efforts to prevent political and social violence and to achieve sustainable peace through conflict transformation, <https://www.berghof-foundation.org/>

¹⁴ Sant'Egidio has been involved in numerous peace negotiations as a facilitator or observer including in Albania and Algeria. The Community's most significant diplomatic achievement was the mediation of the Peace Agreement for Mozambique in 1992, <https://www.santegidio.org/>

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Publisher

Deutsche Gesellschaft für
Auswärtige Politik e.V.

ISSN 2198-5936

Editing Bettina Vestring

Layout and Info Graphics

Luise Rombach

Design Concept: WeDo

Author picture(s) © DGAP



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