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THE POLITICAL ECONOMY OF GREAT DENIAL IN LEBANON

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Abstract: Rampant sectarianism, external intervention, corrupt politics, and the legacy of a devastating civil war have all contributed to generating severe political, social, and economic vulnerabilities in Lebanon. Its historical background and demographic structure, combined with extreme corruption and elite capture of the state, led the country to economic and political turmoil in 2019. Before 2019, Lebanon's financial system was based on an unsustainable scheme that required a constant inflow of foreign money. Lebanese politicians decided to protect this regime which they benefited from through their links to the banking system. The crash of the financial system ruined the welfare of ordinary citizens while the politicians have yet to suffer the consequences. Despite the election of a new Parliament in May 15, the prospects of change in the conditions of the Lebanese people seem grim amid these political and economic disruptions.

Introduction

Lebanon is currently facing one of the most severe economic crises in the world as almost eighty percent of the population is living at the poverty rate and the government continues to struggle to provide basic services to its citizens.¹ Although most people are disillusioned with the current system, this has not translated into political change due to Lebanon's political and economic idiosyncrasies and a flawed parliamentary electoral law. The country has reached the limits of an economic model heavily dependent on foreign financial flows where sectarian elites had their share of unproductive rent-seeking mechanisms. The financial system in place since 1993 has now failed spectacularly, leading to a 90% depreciation of the Lebanese pound on the black market and considerable losses in people's savings.²

The crisis in Lebanon is described aptly by the World Bank as "Great Denial."³ The country has long been financially bankrupt, but it was kept afloat for almost three decades until it suddenly crashed in 2019. The financial system was based on a "Ponzi scheme" which increased the burden on the Lebanese people and helped the elite earn vast sums of money. Although the system has failed with huge consequences for the public, political actors continue to deflect responsibility and block much needed accountability and rescue plans to address the crises in the country.⁴ The sectarian nature of politics, elite capture of state, and Hezbollah's unique position as a non-state actor also embedded in the state block a meaningful political process that can offer a vision out of the conundrum. Given these domestic circumstances, international actors could play a bigger role in Lebanon's future trajectory. More specifically, the implicit bargain between Lebanese politicians and other external forces, including Gulf countries, France, and the International Monetary Fund (IMF), will shape the reconfiguration of the economy. The new parliamentary elected on May 15 is not expected to change the domestic political stalemate, but can impact the future bargain between international actors.

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This piece focuses on the economic collapse and the Ponzi scheme led by the Lebanese central bank, the Banque du Liban (BDL), and commercial banks – and attributes political deadlock as the leading cause of the current failure. First, it provides historical background on the political economy of the crisis and investigates the economic regime, including the financial engineering operated by the central bank and commercial banks. Next, the paper discusses the recent political deadlock caused by sectarianism and foreign intervention and touches upon the political dominance of Hezbollah. It finally provides an assessment of the recent elections and their implications for the future of the Lebanese political economy.

Macroeconomic Overlook

While Lebanon saw some success as the “Switzerland of the Middle East” during the 1950s and 60s, which was temporarily reinvigorated during the 1970s due to Gulf resources, Lebanon’s sectarian political system ultimately led to elite capture, nepotism, corruption, and political dilemmas between sects.^{5,6} High levels of corruption in political and bureaucratic spheres has decreased institutional quality, which has directly and indirectly affected the country’s economy. Furthermore, the political deadlock in various parts of the government has fed the failure of internal consensus, which further exacerbated macroeconomic performance.⁷

The Beirut port explosion in 2020 created an extra burden for the entire economy. According to World Bank estimates, the explosion cost over \$8b to the Lebanese economy, which was already in dire need. The World Bank also reports that the economic crisis in Lebanon has been the most severe since the mid-19th century, and the pandemic exacerbated the conditions.⁸ For example, the pre-pandemic unemployment rate was estimated to be 20% in the IMF report, and this is expected to rise over 40% since 2019.⁹

The same upward trend is also seen in the inflation rate. Bloomberg data finds that Lebanon has the highest year-to-year inflation rate globally, overtaking the inflation rates of Zimbabwe and Venezuela. The inflation rate increased 138% year-to-year in August 2021 compared with the previous year.¹⁰ Higher inflation combined with higher interest rates to attract foreign funds also increased the debt ratio of the Lebanese government, which is over 150%.¹¹

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High unemployment, inflation, and interest rates have also increased income inequality. The top 1% receives 25% of national income, whereas the bottom 50% receives just 10%.¹² High inequality creates an environment for illegal activities and increases corruption. According to Transparency International, the leading institute on corruption scores, Lebanon received 21 out of 100, ranking 154th among 180 countries.¹³ In fact, Lebanon's corruption score has been decreasing (that is more corrupt) since 2012 from 30 out of 100.

The following sections follow the institutionalist approach to analyze the ultimate causes of political and economic issues in Lebanon. Acemoglu et al. (2005) provide a simplified framework for understanding the relationship between the distribution of resources and political institutions, where institutions are defined as “the humanly devised constraints that structure political, economic, and social interaction.” (North 1991).^{14,15} They depict a complex relationship between political and economic institutions. Whereas “political institutions determine the distribution of de jure political power, the distribution of resources influences the distribution of de facto political power in society. The political institutions and distribution of resources then, in turn, affect how economic institutions will decide and influence the future evolution of political institutions. Economic institutions are important for determining economic outcomes, including the economy's aggregate growth rate and the distribution of resources. However, economic institutions themselves are determined by political institutions and distribution of resources in society.

In this regard, institutional framework might help explain Lebanon's current economic and political conditions. Lebanon has been dealing with institutional crisis in the political sphere with sectarian politics and its repercussions on the one hand and the economic sphere where central and commercial banks have led the country into the edge of bankruptcy on the other. Therefore, analyzing Lebanon's current crisis from institutional perspective of how Lebanese politics has transformed after post-Taif agreement and how the Ponzi scheme has created colossal economic and financial burden may provide clearer picture.

Post-Taif Agreement and The Ponzi Scheme

According to Diwan and Haidar (2019), there are three phases in the Lebanese political economy following its independence.¹⁶ The first phase was the early “merchant republic” dominated by Christian elites. The second phase was the fragmented governance during the

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civil war. The last phase was the post-Taif agreement, characterized by large multigroup coalitions with precarious macroeconomic conditions.

The economy's unique demographic and political structure produced a system where different sects bargain with each other (horizontally) and within the group (vertically). Nevertheless, the oligarchs of each group (or the so-called *Zuema*) prioritize their own interests over the interests of their group. In other words, bargaining within the group was less politically and economically important than the deals made between the oligarchs themselves. One of the reasons for this is the dominance of the war-time military groups, which decreased competition within groups, and enabled their leaders to enjoy support without strings attached.¹⁷

During the civil war, a new set of actors entered the economic scene: leaders of militias and new contractors who had close ties to Gulf countries. The banking system continued to be an important avenue for creating and distributing rents between these groups. Reconstruction and the real estate sector also became important avenues for rent-creation with the reconstruction projects of Rafik Hariri. Additionally, the government continued to distribute rents through the service ministries.

After the civil war, Rafik Hariri hired Riad Salameh, who previously managed Hariri's portfolio in Merrill Lynch, as the governor of the central bank in 1993. In 1997, under Riad Salameh's leadership, the central bank pegged the Lebanese lira to the US dollar. At the time, the idea was praised by many as stabilizing the economy. The system was implemented by offering above-market interest rates to attract foreign currency and required a constant inflow of fresh dollars to the economy. This system was kept running until 2011 with the help of remittances from the Lebanese diaspora.¹⁸

When economic problems increased with dwindling remittances and a lack of confidence in the economy, the system started to falter.¹⁹ In 2016, Salameh introduced a new financial engineering scheme which put off the actual problem and deepened the troubles ahead. The system was based on nontransparent swap agreements between the central bank and commercial banks, which increased the interest rate on the fresh dollars brought to the system by commercial banks.²⁰

The banking system continued to be an important avenue for creating and distributing rents between these groups

From 2019 onwards, the so-called Ponzi scheme of financial engineering collapsed, as the Lebanese government could no longer pay the interest debt to commercial banks. Moreover, due to hyperinflation, alternative exchange rates began to be utilized in the black market. While the pegged rate continued to be 1500, the black-market rates exceeded 30.000 Lebanese lira per US dollar. The government could not even afford to provide basic necessities due to hyperinflation and being in massive debt, which created a political predicament amid large street protests.

Political Impasse

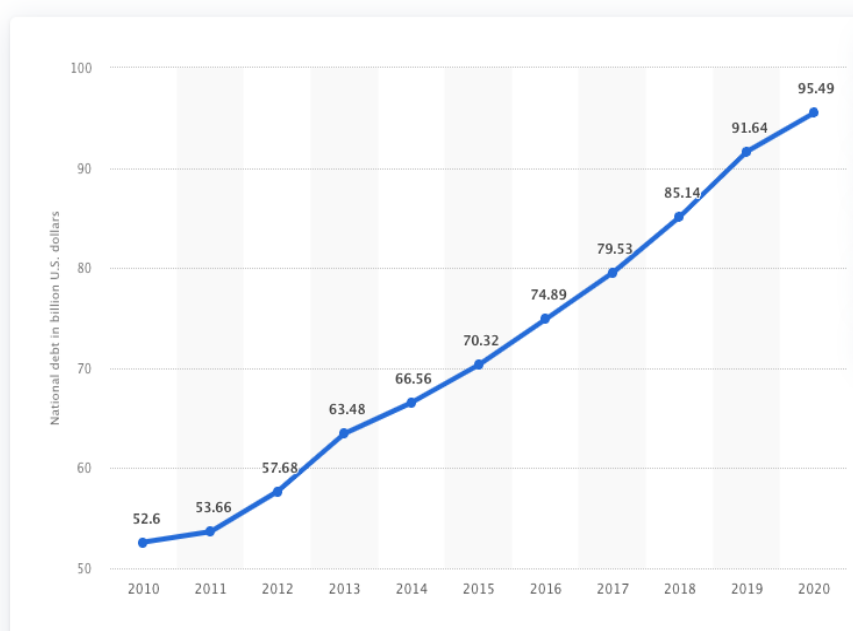
As a consequence of the frustration of the Lebanese people, the ongoing economic and political crisis, and rampant corruption, several investigations have started against Riad Salameh. Considered the mastermind of financial bankruptcy, Salameh has been accused of money laundering and illicit funding through companies owned by him and his brother.²¹ While the system was failing the Lebanese people, the banking sector amassed vast amounts of profits. The profits of the largest four banks almost doubled between 2008 and 2018.²² The political elite also secured their proceeds through their links to the banking sector. Jad Chaaban has shown that eighteen out of the 20 major banks have significant shareholders linked to politicians, and these political elites own 43% of the assets of these banks.²³

Overall, Lebanon's structural economic problems and prevalent corruption led to the current financial crisis. The civil war changed the parameters of the country as the idea of Lebanon as a tourism and banking hub could no longer be sustained, and a reconfiguration to more productive sectors was a necessity to have an economically sovereign state. Political actors did not offer any vision for the country's long-term prospects, but instead sought to increase their share of the pie. Therefore, contests in political impasse in the case of weak multigroup coalitions led the government debt to skyrocket, as seen in the figure below. The unsustainability of this economic regime was evident for an extended period, but none of the political actors objected to the system. During the tumultuous 29 years since 1993, the country's central banking chief remained the same, representing a clear agreement between the ruling elites and their vested interests tied to the banking sector

Contests in political impasse in the case of weak multigroup coalitions led the government debt to skyrocket

Lebanon: National debt from 2010 to 2020

(in billion U.S. dollars)



Source: World Economic Outlook Database October 2021, IMF

We however cannot understand Lebanon's political economy independent of the larger geopolitical picture. Lebanon's political economy, especially after the civil war, is closely related to the geopolitical balance between Syria, Iran, Israel, and the US and Gulf countries. Between 1990 and 2000s, the political scene was characterized by an implicit deal between the Syria and US-Saudi Arabia axis as embodied in the personality of Rafik Hariri. However, after the deterioration of relations between Syria and the US in the 2000s, this system has started to decay.

After the assassination of Rafik Hariri, Hezbollah created the March 8 alliance with Michel Aoun's Free Patriotic Movement (FPM) and smaller allies. After the Lebanese-Israeli war in 2006 and the 18-month long political crisis which culminated in Hezbollah's capture of Western Beirut and the Doha agreement, Hezbollah's role grew. The March 14 alliance was ineffective in stemming this trend which was further reinforced through the Doha agreement. From 2008 until 2019, Hezbollah enjoyed veto power in the cabinet through its control of more than a third plus one of all ministerial positions. On top of that, Hezbollah also took advantage of its status as a non-state actor to act beyond the bounds of the law. Therefore, Hezbollah both benefited from all the perks of being in government without paying the costs of society's dissatisfaction. In fact, it cast itself as an outsider against the clash of economic elites who exploit the Lebanese people. With the March 8 alliance at the helm of the system, the Gulf countries, headed by Saudi Arabia and the Emirates, decided to stop financially feeding a system they regarded as hostile to them and their interests. This exodus of Gulf money exposed the cracks in the established financial scheme and led to its eventual bankruptcy.

Future Implications

The parliamentary elections in May 15 brought about new dynamics that are important to follow for the future. First, the absence of a parliamentary bloc that has absolute majority will create gridlocks and complicate the formation of a new government. Following the elections, the caretaker government passed a financial recovery plan that includes several reform measures that are prerequisites to unlock a \$3 billion funds from a preliminary deal with the International Monetary Fund reached on April 7.²⁴ However, the parliament still needs to approve several laws which might not easily materialize as no political consensus to implement the necessary reforms can currently be seen.²⁵

Second is the re-engagement of Saudi Arabia and the return of several gulf ambassadors to the country after a rupture in relations.²⁶ The nature of Saudi re-involvement and its dynamics remains to be seen.²⁷

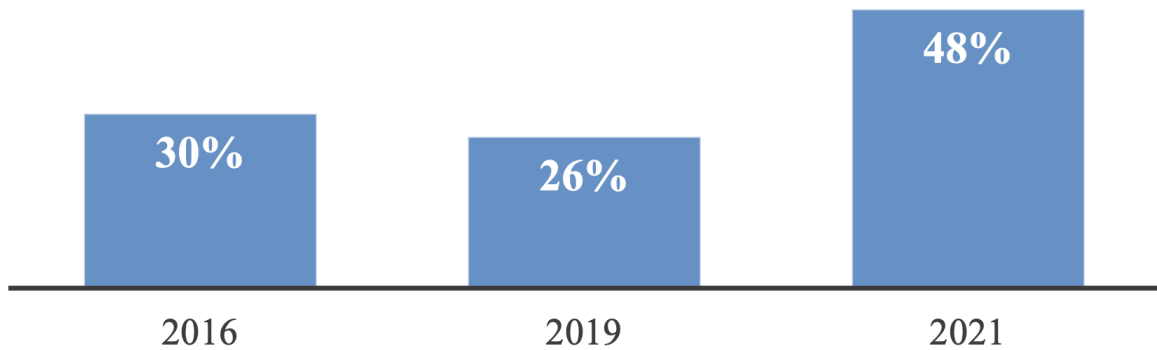
Third, the election of 15 independent candidates, which rose to prominence with the 2019 protests, suggests a considerable achievement for the movement opposing traditional party politics.²⁸ These candidates are expected to bring new dynamics to the parliament. Despite it being still a far cry from bringing about a complete change in the way the country is governed, their election represents a glimmer of hope for the Lebanese who want their rights to be protected.

The deadlock in the political system due to sectarianism, corruption, and the financial engineering scheme by the central bank have contributed to the current low levels of institutional quality in Lebanon. As mentioned in the theoretical framework, political and economic institutions distribute power and resources in the country, which then determines the institutions of the future. All these channels reinforce the vicious cycles in Lebanese politics and economy. Thus rampant corruption, political instability, de-functionalization of the government, or shortly complete institutional failure generate a grim picture for the Lebanese people.

Under any circumstances, the Lebanese people are disheartened by the current political and economic system which could further accelerate the brain-drain in a massive blow to long-term economic projections.

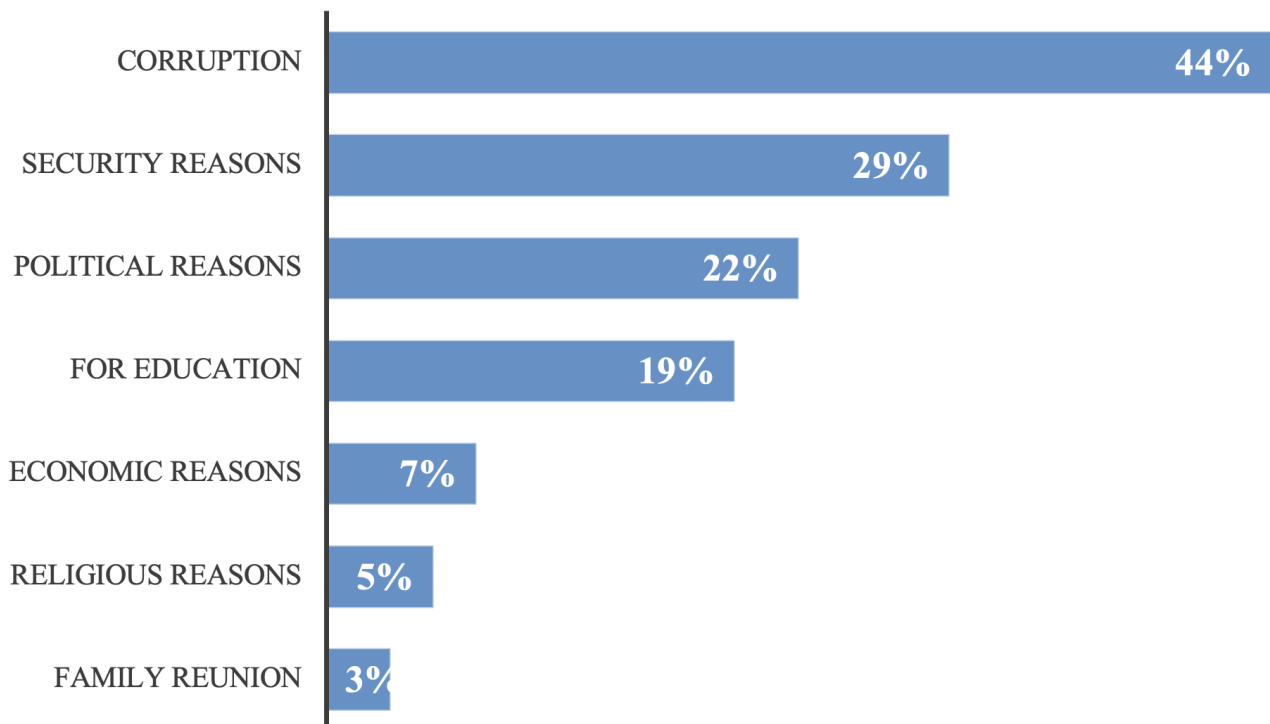
The absence of a parliamentary bloc that has absolute majority will create gridlocks and complicate the formation of a new government

Desire to Immigrate



Source: Arab Barometer Wave VI – Part III (March-April 2021), Lebanon

Reasons for Wanting to Emigrate



Source: Arab Barometer Wave VI – Part III (March-April 2021), Lebanon

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