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BUILDING a BETTER LEBANON

Report

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Executive Summary

Lebanon is reeling from a compound balance-sheet crisis that the World Bank has described as the country's worst since the 1850s. This once-in-a-century disaster was precipitated by the final breakdown of an economy akin to a Ponzi scheme, in which political elites enriched themselves with financial inflows to the country's banking system while neglecting national development priorities. The breakdown in public trust in the government was on spectacular display during the political upheaval of the October 2019 "revolution," which unsuccessfully called for the replacement of political leaders. As COVID-19 seeped into the country and lockdowns precipitated a recession, the crumbling superstructure of Lebanon's political economy was violently exposed by the August 2020 Beirut port explosion, as authorities abdicated their role in the repair and restoration of this critical economic lifeline.

Now with every month of inaction and political deadlock, a snowballing balance of payments, financial, currency, and economic crisis threatens to derail Lebanon's development and erase gains in living standards for the population. This dire economic situation will take decades to repair, with more than 55 percent of the population already in poverty, and an unemployment rate that has skyrocketed to 40 percent. Women's labor force participation has fallen to a dismal 23 percent and is expected to decrease further. Unemployed and skilled youth are fleeing the country, contributing to an already acute brain drain that will cause permanent damage to the country's productivity. Adding to Lebanon's economic woes is yet another demographic challenge: hosting the highest per capita refugee population worldwide. In juxtaposition to these stark statistics, members of the well-connected elites were able to withdraw their funds from banks and send them abroad as capital flight before bank deposits were de facto frozen in 2020.

In this report, the co-authors explore the best way out of this crisis. Against a general backdrop of weak institutional capacity and growing instability, the authors argue that any reform program for Lebanon should be simple, transparent, and most importantly managed by a credible government of reform. Advocating a combination of measures, they highlight immediate steps needed to stop the financial hemorrhaging of the Lebanese banking system before embarking on a gradual journey toward structural transformation and reform. In the heat of the present crisis, Lebanon must maneuver toward a productive economy away from the dominant financial sector through initiatives supporting business capacity, entrepreneurs, and skills development. If these steps are taken immediately, and throughout the coming political cycle, Lebanon may yet be rescued and put on a path to recovery. The key provisions presented by the four authors are as follows:

Part One:
Restoring Confidence, Restructuring the Financial Sector, and Safeguarding Society's Most Vulnerable Groups

1. **Agree on a minimal financial rescue plan**. Lebanon's sectarian leaders must agree to a minimal financial rescue plan to stabilize the financial and banking conditions that are necessary to support economic activities, buying time to negotiate an IMF-sponsored program which would bring in international assistance to assist the reconstruction and rehabilitation of the country in general. Ideally, the financial-sector restructuring should be part of a comprehensive economic-stabilization, reconstruction, and reform plan, enjoying a high degree of political commitment and ownership by the country's authorities and leadership. However, political commitment to reform is completely lacking due to the sectarian divisions in Lebanon, which are the root cause of the crisis. Consequently, waiting for the country to evolve a degree of political and social consensus to negotiate a rescue program with the IMF and the international donor community would be a lengthy process, during which time the crisis would deepen, causing more human suffering and making it more difficult and costly to repair.

2. **Develop a comprehensive cash transfer program.** Lebanon should develop a comprehensive cash transfer program to cushion the impact from subsidy reform and rising inflation on the poor and most vulnerable. Scaling up of social protection, including through direct cash transfers to beneficiaries, should be a pre-requisite to any comprehensive subsidy reform. Partnerships with the World Bank and UN agencies will be key in speeding up the delivery of emergency support to alleviate poverty, making sure those that are disproportionately impacted by the crisis—such as children and women—are protected.

3. **Establish a Lebanese Financial Rehabilitation Fund (LFRF).** The LFRF would be similar to the Hellenic Financial Stability Fund (HFSF) set up during the Greek government debt crisis in 2010 to conduct the restructuring and recapitalization of Greek commercial banks. The LFRF could be funded by a combination of proceeds from Lebanese gold sales ($5 billion) and loans from

the Gulf Cooperation Council and France ($5 billion), traditionally close friends of Lebanon. The LFRF would be given clear legal authority, political support, and competent staff, with oversight by a board of directors representing its financial contributors and representatives from civil society organizations. It would start the process of assessing the damages and then resolve, consolidate, restructure, and recapitalize the banks as well as put in competent management working under close supervision by the LFRF.

4. **Involve the IMF closely in bank restructuring efforts to provide technical assistance, but using minimal Fund resources.** This novel approach reflects the reality of strong popular opposition in Lebanon against fiscal austerity as a condition for an IMF program, which has so far helped to delay agreement between the Lebanese government and the IMF, making the situation worse by the day. A minimal program with minimum conditionality focusing on restructuring the financial sector, drawing heavily on IMF technical expertise and minimally on Fund resources would have a better chance of quick agreement. A full-fledged IMF program along traditional lines could be negotiated and hopefully adopted in a second stage of the rehabilitation process to address the needs of reconstruction, reforms, and building the basis for a new and sustainable economic model.

Part Two:
Steps to Protect Incomes, Maintain Services, and Remove Harmful Policies

1. **Request a regular standby arrangement for Lebanon with the IMF,** allowing it to get financing up to 245 percent, the maximum (which has been increased during the COVID-19 pandemic) of its IMF quota of $861 million, which would be about $2.1 billion, in line with recent IMF programs in the region (e.g., Jordan with 270 percent of its quota and Tunisia at 250 percent). The Lebanese government has requested a $10 billion IMF program, but this is unrealistic. A member country can request exceptional access subject to enhanced scrutiny and conditionality, but this is unlikely in the case of Lebanon given its weak governing institutions, and poor reform track record, which rankles several key IMF member countries. Therefore, the feasible envelope of external financial assistance is likely to be around $13.1 billion, which is much smaller than the range of financial-sector losses and recapitalization needs ($25 billion to $86 billion), let alone taking into account other needs for assistance (including the reconstruction of Beirut's port and business district, estimated to cost a few billion dollars). All together the needed financial support may total around $60 billion to $70 billion over several years.

The key elements of the program should focus on:

A. **Reducing the public-sector wage bill.** In addition to implementing hiring freezes and reductions in operational costs, there is a need for a critical revision of public spending, including a reform of the current public pension system to ensure its fiscal sustainability and long-term social protection.

B. **Enhancing tax progressivity** by introducing taxes on extreme wealth and on investments in maritime properties, vacant properties, and increased penalties for tax evasion and corruption. Such measures would reduce the distortional effects of the current tax system, raise its efficiency, and ensure a level of revenue sufficient to cover the needs of a streamlined public sector.

C. **Reforming Electricity du Liban (EdL).** Ensuring fiscal sustainability and higher rates of growth in Lebanon will not be possible without fundamental reform of the energy sector. Reforming EdL operations is a key aspect that has been outstanding for a long time. Suggested in a 2019 IMF report on Lebanon and still applicable today, any reform program should aim to "reduce nontechnical and technical losses, switch fuel to natural gas to reduce production costs at existing plants," and gradually implement a multistage subsidy-elimination plan, targeting the largest consumers first.

D. **Restructuring other state-owned enterprises.** The government should consider the gradual privatization of the activities of state enterprises, in the broader sense of the term, by contracting with the private sector to manage public assets or restructuring them so that they operate efficiently within the market. Most enterprises will require administrative and financial restructuring whether they are to be sold or not. Nevertheless, the country's prospects for short-term growth will not be significantly hindered by the continued existence of these state enterprises as long as they are managed in an efficient and economic manner.

Part Three:
Steps to Support Businesses and Build a Productive Economy

1. **Establish the Lebanon Incubator Investment Fund.** Such a fund can be sponsored by donor countries like the United States, France, and Germany, as well as regional allies such as Saudi Arabia and the United Arab Emirates. The Lebanese diaspora can play a critical role by investing capital and in-kind contributions from its considerable talent pool. The fund can be run by a board

that includes members of the diaspora, business leaders, representatives from civil society organizations, academia, and educational institutions and channel seed money as equity or loans to start-ups and entrepreneurs across Lebanon, prioritizing women and young people. A good example from the region is Oasis500 in Jordan, which was seeded in 2010 through an investment from the King Abdullah II Fund for Development and is today the country's largest start-up accelerator.

2. **Create a one-stop shop for supporting SMEs.** Small and medium-sized enterprises need more than loans; they would benefit from a suite of financial and nonfinancial services to help them improve their management, market targeting, and growth prospects. For example, such an entity could help SMEs leverage the existing free trade agreement (FTA) with the EU and provide training and capacity-building workshops to businesses. A one-stop shop could also be established as a nonprofit or cooperative with significant support from donor countries and the globally dispersed Lebanese community, thereby bypassing government deadlock. Elsewhere in the region, the Qatar Development Bank has developed a successful approach to supporting SMEs and a similar model is being tested in Tunisia.

3. **Boost female labor-force participation and support women entrepreneurs and SME owners.** As in much of the Middle East and North Africa (MENA) region, Lebanon's female labor-participation rate remains low (23 percent) despite high education rates among women. As noted earlier, less than 10 percent of Lebanon's SMEs are women owned. A plethora of United Nations agencies and other donors have traditionally provided women with mentoring support as well as capacity-building training and financial-literacy workshops. These programs are tremendously beneficial and must continue and expand. However, what many economic assessments have shown is that a key barrier facing women seeking to start a business is access to finance. Supporting aspiring women entrepreneurs with financial backing is crucial to reviving women's workforce participation and capitalizing on their untapped skills.

4. **Reimagine TVET to be the driver of new private-sector productivity.** Technical and vocational education and training should fully integrate technology and digital skills training, conform to internationally recognized certifications and performance standards, and customize offerings to match the needs of special economic zones. In order to make this approach a success, these schools should embrace the modular diploma, matched with

a workplace performance requirement. Successful models of consecutive diplomas are being used at Luminus Technical University in Jordan for digital communications, audiovisual design, and hospitality, as well as at Hussein Technical University in Jordan, and ESPRIT (École Supérieure Privée d'Ingénierie et de Technologie) in Tunisia for engineering.

5. **Develop training modules in collaboration with technical schools and universities,** with focus on skills in high productivity sectors such as information and communication technology and artificial intelligence, and provide them with industry certifications. Given the fast-paced technological advances underway, this approach can prepare Lebanese youth better for new business creation and also widespread digitization of production and services.

6. **Work with local and international nongovernmental organizations to focus investment on the essential and employability skills of Lebanese youth** through supplementary school programs and workshops. Both global and regional trends point to the lack of "soft" or essential skills (such as communication, team building, negotiation, problem-solving, leadership, and critical thinking), which are in high demand in emerging, especially digital, industries.

7. **Create special economic zones,** generating value and investment in various geographic and knowledge-based areas of advantage such as agriculture, fisheries, minerals, light manufacturing, digital media production, and technology.

8. **Ensure that development agencies focus investment on addressing the skills gap of Lebanese youth.** Like other countries in the region, there exists a skills mismatch, despite the prevalence of high-quality educational institutions. These institutions are mostly privately owned and, though they pass on more costs to students, they can more rapidly respond to market needs and investment. What is needed is increased dialogue between private educators and business owners, whether aspiring or recovering, in order to better prepare youth for the job market in targeted sectors.

For this reform road map to succeed, the following additional steps should be taken:

1. **Give Lebanon's SMEs a seat at the table in any recovery and rebuilding discussions.** They have the expertise and knowledge of local markets, their needs, and unique features. If they are included in the process, Lebanon is better positioned to recover and rebuild by drawing on its traditionally strong entrepreneurial foundation and vibrant business-oriented culture.

2. **Involve all stakeholders in discussions about reforming the electricity and fuel sectors in Lebanon.** As was the case in Haiti, "broad consultations with relevant stakeholders should take place in advance to better inform the analysis and design of reforms." The Lebanese parliament must weigh in on these discussions, and voices from the private sector and civil society at large should be sought out. Again, the government must be transparent about the time line of implementing these reforms and proactively introduce programs to support members of vulnerable groups who will be hit hardest by these reforms.

3. **Appoint and cultivate new competent political leadership,** especially economic policy makers. Crisis resolution requires visionary leadership and determination rather than the status quo of horse trading and compromises. Moreover, the public has lost confidence in the current political class.

4. **Educate the public about the reforms.** The Lebanese people need to understand the reforms in order to support them. Widespread public-education campaigns need to occur to prevent backlash and misinformation as well as ensure citizens can take advantage of new programs that are introduced.

Lebanon is in crisis, but the economic challenges confronting the country are a golden opportunity to adopt growth-oriented policies that are not purely based on fiscal adjustment. Such policies present the best approach to restoring economic equilibrium in the context of a growing economy and rising living standards, and the road map laid out in this report can put Lebanon on a stable and sustainable path that will eventually lead to an economy that delivers the jobs and growth that Lebanon's resourceful and vibrant population needs and deserves.

By James F. Jeffrey
Chair, Middle East Program
The Wilson Center

The World Bank's spring 2021 issue of Lebanon Economic Monitor warns that the economic and financial crisis the country is facing is "likely to rank in the top ten, possibly top three, most severe crises [sic] episodes globally since the mid-nineteenth century." The report notes that Lebanon's gross domestic product (GDP) fell from approximately $55 billion in 2018 to an estimated $33 billion in 2020. Further, according to the World Bank, the average exchange rate "depreciated by 129 percent in 2020," resulting in surging inflation at an average of "84.3 percent in 2020." Given the country's uncertain political future, real GDP is projected "to contract by a further 9.5 percent in 2021." This data presents a bleak picture of the country, one that has experienced a civil war and been part of regional conflicts with global repercussions. The question that this section attempts to address first, given the aforementioned challenges, is: why is it important to support Lebanon out of this economic and financial crisis?

The international system has several interests that justify emergency economic assistance to Lebanon. The first is working with Lebanese governmental, economic, and civil society groups to prevent a total collapse of governance and the economy, which risks creating a failed state in an already tense region. Lebanon is facing a series of separate crises: humanitarian, political, economic, banking, and financial, all at least partially the product of deep governance dysfunction as well as sectarian tensions. The second interest is keeping Lebanon from becoming involved actively in any of the larger conflicts in the immediate vicinity, which could devastate Lebanon and destabilize the entire Levant. A third reason is supporting and commending Lebanon's extraordinary efforts in providing refuge for more than two million Palestinian and Syrian refugees, thereby avoiding destabilizing, uncontrolled mass population movement within the region and across the Mediterranean Sea. A fourth interest is undergirding Lebanon's magnificent experiment in cross-ethnic and -religious communal life.

There is currently a general consensus between the US administration and European partners linking serious economic support for Lebanon with the formation of a government. Both US and European leaders have expressed dismay at the inability of the political system to form one. Commentators are careful to spread blame among all factions, but there is a general belief that major and courageous reforms will be required to attain effective governance, root out corruption, and undertake the necessary steps needed for economic recovery and rebuilding. Longer term, the international community expects Lebanon to conduct, on time, and in accordance with law, fair and free national elections in the spring of 2022.

A key entity that merits US and international community support is the Lebanese Armed Forces (LAF), and funding the LAF would set the stage for a conducive environment to address the country's economic woes. In the immediate period, such support is crucial given its impressive role in humanitarian operations since the Beirut blast in 2020. A fully supported and buttressed LAF is crucial as a key pillar for Lebanon's political stability and as an important employer. The economic crisis has severely hit security forces' salaries, forcing some to take on extra jobs.

In addition, the international community seeks to work with Lebanon to counter illicit interference in Lebanon by external actors, and to ensure that Lebanon does not become involved in new regional conflicts that would place at risk the country's economy, infrastructure, and internal stability, in accordance with relevant United Nations (UN) Security Council resolutions.

While the above is primarily the job of the state and people of Lebanon, and the international community donors supporting them, the regional environment cannot be ignored. A more stable Levant inevitably would contribute to a more stable Lebanon. As long as serious conflicts threaten, or actually explode, in Lebanon's vicinity, its own future will be endangered, potentially sidetracking political and economic reform. In contrast to Lebanon's internal political and economic difficulties, the regional situation is largely beyond Lebanon's control. More unity among the states of the region and the UN Security Council members on implementation of regional stabilization policies would contribute decisively to the environment that is necessary to allow the Lebanese people to resolve their internal issues.

By Rand Ghayad
Adjunct Professor
Harvard University
Former IMF Economist

Lebanon has been living above its means for decades and is now faced with the enormous task of tackling the accumulated problems. Decades of fiscal irresponsibility, corruption, and nepotism have resulted in Lebanon being at the verge of becoming a failed state. The increasing deterioration in social and economic conditions compounded with a lack of effective policy actions by the Lebanese authorities put the county at risk of a wider conflict and a new wave of mass migration by the very people the nation needs to rebuild its economy. Delays in addressing the crisis will increase the threat of instability and make the road to stabilization a long and daunting one. Economic reform is a gradual process that will take time, and the starting point will require coordination among reform-oriented alliances from all stakeholders in Lebanon, including civil society and the private sector. The World Bank's 2020 report on Iraq, "Breaking Out of Fragility," provided experience and evidence from countries that have successfully navigated similar transitions, including the civil society Quartet coalition in Tunisia which managed to broker a national dialogue between the government and the opposition, resulting in a road map to new elections. Similar mechanisms for dialogue will be needed in Lebanon to bring together the multitude of political and social actors, with the goal of building consensus on how to design a fair and equitable road map for recovery.

Although many agree that the economy is in a deep recession, views continue to differ on how to revitalize economic activity. One camp calls for a comprehensive fiscal—and structural—adjustment program through a policy package of fiscal austerity measures and structural reforms. Such a strategy is based on belt-tightening and the reduction of people's standards of living with a view to restoring equilibrium in the economy through downsizing aggregate demand to the level of productive capacity. Another camp calls for the adoption of a new economic-growth model that would reignite the productive sectors of the economy such as agriculture and the knowledge industry. With more than half of the population at risk of plunging into mass poverty, any front-loaded fiscal-adjustment plan is likely to result in a lot more pain and much less gain. In a country with persistent social tensions and a growing humanitarian crisis, any rapid, comprehensive adjustment—including dramatic austere policies to balance the budget—can be highly explosive, putting at risk any prospects of a reform agenda. It is better to prioritize reforms by focusing efforts on low-hanging fruit initiatives which can deliver some immediate benefits to citizens, and introducing far-reaching structural and fiscal reforms only gradually, as the evolving sociopolitical environment permits.

To understand the situation of the Lebanese economy, it is useful to recognize that there are three profound economic crises, not just one. The first, and most widely acknowledged and debated, is the financial/banking crisis. The banking system has collapsed, and the government is bankrupt and suffers from a heavy burden of foreign debt taken on by the previous governments. The second crisis, distinct from the financial crisis, and "one of the most common reasons why nations fail today," is the institutional crisis involving the politically powerful elites, who designed extractive economic institutions to benefit elites, while hurting the rest of society. The third crisis, and the one with the longest term, is a systemic crisis of structural adjustment: the need to abandon the old economic model that depends on a pegged exchange rate and the relationship between the banking sector, the central bank, and state institutions, and move toward a more sustainable and productive model. In other words, even if the government were financially solvent, and even if there were strong inclusive state institutions, there would still be a deep crisis of living standards as a result of the structural characteristics of the Lebanese economy.

In an ideal world, the preferred approach would be to address all three crises in parallel. However, each poses a problem with a different time horizon for a solution. Additionally, key political challenges to the implementation of a comprehensive full-fledged program remain, and thus Beirut may fail to construct a foundation that can help transform the Lebanese economy. Reforms require time to yield positive results and a traditional program based on austerity measures may lead to results contrary to its purpose in the short term. With the Lebanese population already suffering a deep recession, any unrealistic overpromising may lead not only to the deterioration of the living standards of low-income groups but also to the emergence of other vulnerable groups that are affected by measures taken in the framework of these programs.

Three Time Horizons for Strategy

Experience and evidence from countries with little capacity and fragile institutions, as discussed in "Escaping the Fragility Trap," a 2018 report, shows that for reforms to happen in a country with weak cohesiveness and capacity constraints, it is important that the agenda for policy reform should not be overloaded, and that all actions should be simple to implement within existing capacities. Building on this, it is therefore important that any program in the context of Lebanon should not be highly contractionary and should be focused in the immediate term on preventing a total social breakdown. The plan must deliver some tangible and immediate benefits to citizens, offer protection to low-income groups, and be socially acceptable. That in turn can instill confidence, and hopefully allow citizens to see some credible prospects of change and buy into the longer-term process of adjustment. The changes that would be transformational, such as comprehensive changes to the tax system and reforms to public-sector and state institutions, will usually take much longer to implement. Such objectives can be addressed more effectively in the medium term as the country become less fragile.

Against a general backdrop of weak institutional capacity and growing instability, any reform program for Lebanon should therefore be simple, transparent, and most importantly introduced in a way that does not threaten the status quo and prove detrimental to stability. We therefore propose packaging reforms into three groupings: a short-term package focused on reforming the financial sector while also implementing crucial measures of social protection for low-income groups and the most vulnerable members of society; a medium-term package focused on reforming the public sector and the tax regime to reduce the distortional effects of the current tax system and raise its efficiency while also rebuilding institutions, strengthening the regulatory framework, modernizing commercial law, and ensuring an independent judicial system; and a long-term package focusing on jobs and employment.

Phase 1: Restoring Confidence, Restructuring the Financial Sector, and Safeguarding Society's Most Vulnerable Populations

The objective of the short-term strategy is visible and "low-hanging" policy initiatives that can deliver quick benefits to ordinary citizens while also shifting the Lebanese populace's view of what policy makers can and want to do, building trust and legitimacy at home. The financial crisis is surely the most acute of the many problems facing Lebanon and the one that must be addressed immediately. Economic-reform efforts should therefore be anchored on two main themes: an immediate restructuring of the financial sector; and an enhanced social-protection strategy with the objective of providing health coverage and targeted services to low-income groups and the unemployed, particularly in light of the changing structure of the Lebanese economic model. Such a plan must be shaped around an equitable sharing of the burden, ensuring that the weight of adjustment does not fall on poor and middle-class citizens. This means the wealthiest and all of those who benefited the most from corruption and BdL's financial-engineering scheme should bear the bulk of the costs. In a country where the "top 10 percent of the adult population received almost 55 percent of total national income," any reform measure should indisputably be assessed for its disproportionate impact on the working class to avoid widening an already inflated wealth gap, leading to debilitating economic and social inequalities.

In addition to the financial-restructuring plan discussed in detail in the following section, any reform plan for Lebanon should include a comprehensive cash transfer program to cushion the impact from subsidy reform and rising inflation on the poor and most vulnerable. Scaling up of social protection, including through direct cash transfers to beneficiaries, should be a pre-requisite to any comprehensive subsidy reform. Partnerships with the World Bank and UN agencies will be key in speeding up the delivery of emergency support to alleviate poverty, making sure those that are disproportionately impacted by the crisis—such as children and women—are protected.

Phase 2: Embarking on Fiscal and Structural Reforms and Addressing the Institutional Crisis

The intent of the medium-term strategy is to coordinate and focus efforts on addressing the institutional crisis. Such a crisis has been driven by an economic system designed solely to enrich those in power, with nonexistent rule of law or an independent accountability structure that would effectively address corruption and allow for state-enterprise reform. Evidence from other countries suggests that addressing such a problem is a gradual and incremental process that can take years and will require Lebanon to embark on a series of regulatory and fiscal reforms necessary to ignite economic growth, including state-owned enterprise inefficiencies, mistargeted public spending, tax structure, a rentier private sector, and poor waste management, to name a few. However, improving the rule of law and the nation's capacity to enforce it is a necessary process needed to lay out the groundwork for other reform measures. Without these reforms, recovery cannot be sustainable, and the economic and social situation will continue to worsen.

Such reforms will involve significant legislative, administrative, and political costs, even if they can be alleviated by donor resources and technical support. Therefore, any stabilization program would need to go beyond technical economics and consider other political and capacity constraints. Not all of the issues need to be addressed simultaneously. Front-loading reforms in a country with very weak institutions and political instability would run the risk of stretching the country beyond its current capacity and disrupting its effective elements. With a gradual approach, the country can transition from the emergency to the consolidation phase without further exacerbating the country's instability. The program elements for the medium-term are to:

1. **Reduce the public-sector wage bill.** In addition to implementing hiring freezes and reductions in operational costs, there is a need for a critical revision of public spending, including a reform of the current public pension system to ensure its fiscal sustainability and long-term social protection.

2. **Enhance tax progressivity** by introducing taxes on extreme wealth and on investments in maritime properties, vacant properties, and increased penalties for tax evasion and corruption. Such measures would reduce the distortional effects of the current tax system, raise its efficiency, and ensure a level of revenue sufficient to cover the needs of a streamlined public sector.

3. **Reform Electricity du Liban (EdL).** Ensuring fiscal sustainability and higher rates of growth in Lebanon will not be possible without fundamental reform of the energy sector. Reforming EdL operations is a key aspect that has been outstanding for a long time. Suggested in a 2019 IMF report on Lebanon and still applicable today, any reform program should aim to

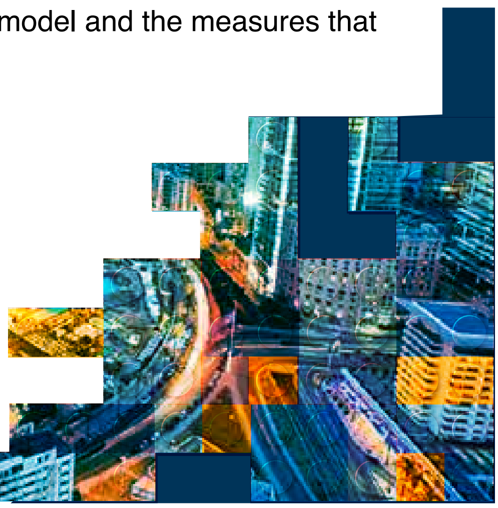
"reduce nontechnical and technical losses, switch fuel to natural gas to reduce production costs at existing plants," and gradually implement a multistage subsidy-elimination plan, targeting the largest consumers first.

4. **Restructure other state-owned enterprises.** The government should consider the gradual privatization of the activities of state enterprises, in the broader sense of the term, by contracting with the private sector to manage public assets or restructuring them so that they operate efficiently within the market. Most enterprises will require administrative and financial restructuring whether they are to be sold or not. Nevertheless, the country's prospects for short-term growth will not be significantly hindered by the continued existence of these state enterprises as long as they are managed in an efficient and economic manner.

Lebanon also needs to reinvigorate a lawmaking environment that supports cost-efficient and timely interactions between Lebanon's private sector and both Arab and global economies. The authorities should remove the various bottlenecks that the private sector faces today and thereby lower the effective cost of doing business. The government also should revamp economic regulations to ensure the public sector does not negatively impact private-sector activity, and there should be a legislative line of effort targeting corruption. On combatting corruption, including illicit enrichment, Lebanese authorities should seek support from multilateral organizations to bolster the efficacy of anti-corruption bodies and to pass legislation that would restore trust and improve public perception of corruption such as enforcing public disclosure of assets and prioritizing government spending by its importance to citizens. A transitional government could also request a Stolen Asset Recovery Initiative from the World Bank to go after those who have abused the system.

Phase 3: Building a New Economic Model and Enhancing Competitiveness

In light of the recent economic developments in Lebanon and the unprecedented economic collapse, there is a need today to examine the parameters which govern the shaping of a new economic role for Lebanon. Within Lebanon there is an active debate on the subject. The debate so far has concentrated on Lebanon's new economic model and the measures that



would help achieve it. However, one important dimension over which we have little control relates to regional and sectoral trends and the effect they have on the creation of a model for Lebanon. Can Lebanon build a new sustainable economic model that is focused less on banking and real estate and more on the productive sectors? The answer to this question is not straightforward. In many ways, Lebanon has the necessary components, yet addressing the structural crisis is not a quick task but one of a decade or so. Employees in obsolete industries will suffer the loss of their jobs, and living standards will continue to be low for years as a result of the unbalanced economic structure. With the likely impact that fiscal consolidation will have on aggregate demand, it will be crucial to improve competitiveness and increase the economy's flexibility and growth potential. Growth can be improved if, on the supply side, the economy is able to reallocate resources toward the tradable goods sector. Numerous factors can allow for this reallocation, such as the relative price adjustment associated with the fiscal effort and developments in the investment and business climate.

Lebanon has a lot of weaknesses right now, but in the country and the Lebanese diaspora there is an enormous amount of human capital. The promising human capital in Lebanon and the country's interaction with international economic and technological advancements offer a glimmer of potential to strengthen the knowledge economy as a key pillar for a more diversified and private sector-led economy.

Taking a cue from the World Bank's report on Iraq, progress in Lebanon will likely remain tenuous absent changes in incentives for elites and adoption of a new, common agenda for the country. Such a vision would recognize the urgency of pivoting from the current clientelist model toward a system that transmits the gains of development to citizens. This pivot requires a change in elite behavior grounded in the acceptance that Lebanon's development model today threatens to undermine stability and progress, making it unsustainable for the future.

By Hung Tran
Nonresident Senior Fellow
Atlantic Council
Former Executive Managing Director Institute of International Finance

Introduction

The Lebanese monetary and financial system has been frozen in a de facto bankrupt state for the past two years. The interlinked balance sheets of the central bank, called Banque du Liban (BdL), and commercial banks, households, and the corporate sector have been gravely damaged by the collapse of the dollarized economic model. According to this model, Lebanon's banks (supported by the BdL) offer high interest rates to attract US dollar (USD) deposits including remittances from nonresidents (mainly among the diaspora) as well as residents—helping to finance current spending by the people and the government, and resulting in persistently large fiscal and current account deficits (of 10.5 percent and 21.2 percent of GDP, respectively, in 2019, for example).

When confidence in the banking system evaporated, nonresident USD flows turned negative in 2019 and 2020, and resident USD flows became capital flight in 2020. The turnaround in private USD flows to net outflows caused a severe imbalance in the supply and demand of USD funds in the country, rendering worthless the fixed exchange rate of the Lebanese pound (LBP) 1,507.5/USD, set in 1997 and widely used to report, in LBP terms, USD-denominated bank loans, deposits, and other financial transactions. This development has led to a freezing of USD accounts at the BdL and commercial banks, and a sharp devaluation of the LBP, currently trading on open markets at around LBP/USD 15,000. The shortage of USD also led the Lebanese government to default on its Eurobond obligations in March 2020, inflicting significant losses on the BdL and commercial banks, which hold much of the Eurobonds, as well as foreign bondholders.

With inadequate USD inflows, the country as a whole has formal access at present to USD funds held at the BdL as reserves—which are dwindling fast to what is now a tiny amount compared to the huge stock of USD claims built up over decades (which had been estimated at about five times GDP). This has produced huge losses, both in terms of flows—with an inability to settle current obligations and pay for necessary imports—as well as stocks or wealth reduction such as in the value of USD bank deposits.

This loss has to be recognized and absorbed in a financial restructuring process, with reduction in the liabilities of one sector (such as a so-called haircut on sovereign Eurobonds, which reduces the fiscal burden on the government) diminishing the assets (and wealth) of another (such as Lebanese banks holding those Eurobonds). Furthermore, the country needs to adjust to the sharply lower exchange value of the LBP, a process that will reduce wealth and redistribute it to different members of society, depending on whether they hold net USD assets or net USD liabilities.

Essentially, Lebanon has been hit by a balance sheet crisis and recession, which tends to be debilitating, long lasting, unpopular, and difficult to exit. Further fueling popular resentment is the fact that members of the well-connected elites were able to withdraw their USD funds from banks and send them abroad as capital flight before bank deposits were essentially frozen. At some point in the future, perhaps the asset holders can be persuaded to put their USD funds to work in rebuilding Lebanon; however, at sharply lower LBP exchange rates, they will become much richer than before, adding insult to injury for ordinary citizens. No matter how politically difficult it is, this reckoning is needed to set a new and realistic baseline for the economy to function again.

Specifically, it is urgent and necessary to rescue and rehabilitate Lebanon's monetary and financial system to facilitate economic transactions; otherwise, the informal economy based on cash or barter transactions will continue. This informal economy is very inefficient and incapable of supporting a recovery, though it has been crucial in helping people muddle through in the crisis.

It is thus important to begin a process to restructure and recapitalize the central bank and commercial banks, restructure the sovereign Eurobonds, and set realistic guidelines for the operations of the restructured financial institutions. Essentially, this is a matter of how to fairly and appropriately apportion the losses among the BdL, commercial banks, households, and companies, and it represents a very difficult challenge for the Lebanese government given the deep sectarian divisions in society and politics. The government has promised that only large depositors will be bailed in (i.e., required to share losses) as part of a restructuring of the banking sector, and 90 percent of depositors will be kept whole. This is an important message to assuage, at least to some extent, popular anger about widespread corruption and government mismanagement, but it is not obvious that such a promise can be honored given the scale of the losses.

Ideally, the restructuring of the sector should be part of a comprehensive plan for economic stabilization, reconstruction, and reform, and enjoy a high degree of political commitment and ownership by the country's authorities and leadership. However, political commitment to reform is completely lacking due to sectarian divisions, which are the root cause of the crisis. Consequently, waiting for the country to somehow evolve and reach a degree of political and social consensus allowing negotiation of a rescue program with the IMF and the international donor community would be a lengthy process. During such a period the crisis would deepen, causing more human suffering and making it more difficult and costly to repair eventually.

The only hope is that, realizing this danger, Lebanon's sectarian leaders can bring themselves to agree to a minimal financial rescue plan to stabilize the financial and banking conditions which are necessary to support economic activities, basically buying time to negotiate an IMF-sponsored program that would bring in international assistance for the reconstruction and rehabilitation of the country in general. The international community should be sensitive to the risk that if it does not provide some assistance to Lebanon, the country risks becoming a failed state, further destabilizing political conditions in the region and possibly the world.

However, it is important to keep in mind that while an IMF plan is very important as a condition required by the international donor community for any rescue package and will be useful in developing a coherent blueprint for economic stabilization and reconstruction, it should not be viewed as a silver bullet. The IMF failed to take note of the unsustainability of Lebanon's dollarized economy until the crisis erupted. In its October 2019 Lebanon Article IV country report, IMF executive directors noted benignly that the Banque du Liban "has continued its financial operations to facilitate banks offering high returns on USD deposits, with the aim of attracting USD deposits to the banking sector"; they also "commended the BdL for maintaining financial stability while emphasizing the need to rebuild its financial strength."

Having misdiagnosed the problem, the IMF will have to be more careful and thorough in prescribing well-targeted and efficacious policy measures to address the difficult balance sheet crisis and the recession ravaging Lebanon following the collapse of dollarization. Moreover, the IMF has to figure out a way to work with Lebanon's authorities, whose political commitment and ownership of any agreed program is inherently weak and can disappear if sectarian conflicts flare up, pushing the program off track.

Banque du Liban (BdL)

Lebanese financial institutions have not released their financial statements for some time. Audited financial reports are a rare commodity. As a result, the first order of business is an audit of BdL financial accounts conducted by an internationally reputable accounting firm—and providing reliable and timely data for the restructuring effort.

Given data limitations, the following analysis is based on information as of September 2020 contained in the BdL's, and supplemented where necessary by data compiled and assessed by James Rickards in his report, Crisis in Lebanon: Anatomy of a Financial Collapse (August 2020), as well as the Lebanese government's draft restructuring plan (2019). The following discussion aims to be illustrative only, sketching out the formidable scale and complexity of the problems, the different loss estimates, and the required restructuring and assistance efforts.

Focusing on USD-denominated items (and reported in LBP using the official peg of LBP 1,507.5/USD) on its asset side, the BdL has foreign exchange reserves of $20 billion, which had declined by about $9 billion since September 2019. The reserves have further dwindled to $16.4 billion in February 2021, according to a press article citing a Moody's report, which pointed out that only $1 billion of the reported figure is available as the rest constitutes compulsory reserves. Falling below that crucial level would cause the BdL to lose correspondent banking relations and thus access to the international clearing and payment system. Because of the precipitous decline in reserves, and the need to use them for essential imports, the BdL has not made US dollars available for the government to service its USD-denominated debt, and has not allowed commercial banks to withdraw US dollars from their USD deposits.

The BdL also has 286.8 metric tons of gold, valued at $16.4 billion at current market prices, but reported at LBP 26.2 trillion (or $17.4 billion at the official exchange rate)—or 63 percent of current GDP of $26.2 billion, as estimated in a 2020 World Bank report: this is the highest gold holding/GDP ratio among central banks throughout the world. Consequently, even though public opinion is strongly against any gold sales and current law prohibits the use of gold for any purposes, the law may need to be changed so that some of the gold can be sold, say through the Bank for International Settlements (BIS), to contribute to the recapitalization efforts in a likely situation where bailing in bank shareholders, creditors, and large depositors still falls short of the required capital infusion. Otherwise, voters in potential donor countries may question why their government would send money to recapitalize Lebanese banks when that country holds so much gold.

The BdL holds $5 billion of Lebanese sovereign Eurobonds (or LBP 7.5 trillion) and about $13.5 billion of loans to commercial banks (or LBP 20.3 trillion). Assuming a 50 percent principal haircut (it could be more) in a restructuring of Lebanon's Eurobonds, the BdL would suffer a loss of at least $2.5 billion. (The BdL could claim that a central bank's holding of its own sovereign Eurobonds should be exempt from restructuring, an argument used by European monetary institutions during the Greek government debt-restructuring negotiations in 2011-12; however, this approach would only shift the burden onto other Eurobond holders and keep the government's debt burden high). The commercial banks simply cannot repay the loans from the BdL in US dollars; if they repay the equivalent LBP amount carried on BdL's books, that would total only $1.6 billion at current open market exchange rates—representing a $11.9 billion loss to the BdL. If the loans are reconverted using current open market exchange rates, the amount would be inflated to LBP 169 trillion. It is obvious that corporate borrowers cannot generate enough income to repay that inflated amount. Consequently, some sort of restructuring has to apply to these USD loans. Again assuming a 50 percent haircut, the BdL would incur another $6.75 billion loss—for a total of at least $9.25 billion. This does not take into account the need to rebuild currently depleted reserves back to a comfortable level—say, at least $30 billion.

On its liability side, the BdL has deposits from commercial banks totaling LBP 155.6 trillion, about 60 percent of which is in US dollars (or about $60 billion). If the BdL does not touch these USD deposits, then the estimated loss of $9.25 billion would more than wipe out BdL's capital of $3.7 billion (when converting the reported figure of LBP 5.6 trillion at the official exchange rate; it would be much less if converted at weaker exchange rates).

Alternatively, the BdL can attempt to restructure the USD deposits as well, including by redenominating them into LBP at lower exchange rates. Yet doing so will inflict losses on the commercial banks, requiring the government to recapitalize them to keep them viable to support economic activity. How to divide the losses, and the recapitalization requirements, between the BdL and the commercial banks is a political question to be determined by the Lebanese government.

For comparison, Rickards, in his analysis, applied a 50 percent haircut to BdL's USD assets, and reconverted those assets using a more realistic exchange rate of LBP 4,000/USD, while proposing to keep depositors whole and came up with an estimated $19 billion loss that would be sustained by the BdL.

The Lebanese government draft plan, prepared by Lazard, its financial adviser, estimated that the losses to be incurred by the BdL would total $63.6 billion. The approach included immediately recognizing past accumulated losses, which have until now been hidden by financial engineering transactions and impairments of assets such as loans to banks and government bond holdings. Even if the BdL's capital of $3.7 billion is used to absorb a part of the loss, the remainder would wipe out banks' USD deposits at the central bank (at $60 billion). It is questionable if completely wiping out banks' deposits at the BdL is doable politically, but even if implemented, it would just transfer the losses from the BdL to the banking system, adding to the latter's recapitalization requirements.

The difference in estimated loss—from $9.25 billion to $19 billion to $63.6 billion—shows the huge uncertainty inherent in the restructuring exercise, depending on data, methodology, and assumptions used in calculating losses. Yet the estimates serve to illustrate the complexity and magnitude of the problem.

Commercial Banks: Consolidated Financial Conditions

According to the BdL, there are 142 commercial banks registered in Lebanon—too many for the country. Many of these are small, insolvent, and should be liquidated or consolidated to produce a far fewer number of viable banks—around a dozen or so—better positioned to serve the economy. Curing insolvency (through closure or making banks solvent) and consolidating banks could run into resistance from bank owners, who are members of the elite; however, the country's sectarian leadership should overcome this resistance to facilitate the urgent and necessary restructuring of the banking system. Bank consolidation also will create some unemployment; those adversely impacted should be given some safety-net support, including retraining for new employment opportunities.

On a consolidated basis, and again focusing on USD-denominated items, Lebanon's banking sector has about $145 billion of USD assets, composed of $112 billion in deposits with the BdL (this represents a big discrepancy with the BdL, which reports only $60 billion of USD deposits by banks, which needs to be reconciled), $20.7 billion of claims on resident customers, $2.9 billion of claims on nonresident customers, and $10 billion of Lebanese Eurobonds. (Rickards has estimated that Lebanese commercial banks hold between $16 billion and $23 billion of Eurobonds, and this amount needs to be verified before restructuring Eurobonds).

The Eurobonds will certainly be restructured, with at least a 50 percent haircut for a loss of at least $5 billion. The claims on resident customers could not be repaid in US dollars and would need to be restructured. If a 50 percent haircut is assumed, that would generate another $10.3 billion loss. Depending on how large a haircut BdL imposes on commercial banks' USD deposits, the banking sector would suffer at least a $15.3 billion loss on its USD assets and probably a lot more.

On its liability side, the banking sector has $88 billion USD deposits by resident customers and $25.2 billion by nonresident customers, $1 billion of resident financial-sector liabilities, and LBP 11.2 trillion of nonresident financial-sector liabilities—presumably mostly denominated in USD. The banks have LBP 41.5 trillion of LBP-denominated deposits as well as LBP 0.84 trillion of debt securities.

Despite promises by the government that 90 percent of customer deposits will be protected, it is clear that banks cannot repay their depositors in USD. Any write-downs of the USD deposits and liabilities, and raising larger amounts if extended to LBP deposits and liabilities as well, would offset some losses on the asset side of the banks, but at the cost of imposing losses on households and the corporate sector, which would depress consumption, investment, and growth for years to come, as well as likely trigger strong social protests. Depositors and debt holders also could be required to convert some of their balances to bank shares, reducing somewhat the need for external recapitalization, but this would also reduce domestic purchasing power somewhat similar to a write-down of their accounts (as parts of their deposits would be converted to much riskier bank shares).

On balance, the banking sector faces a loss on its USD assets of about $15.3 billion or LBP 229 trillion at current open market exchange rates, which would wipe out by several times the banks' capital account of LBP 28 trillion. Even if the exchange rate were to improve when there is an IMF program, say to LBP 4,000/USD (close to the rate the BdL uses to supply US dollars for the imports of essential food items), the loss would be LBP 61 trillion—more than twice the banks' capital. Even if current shareholders and debt holders are completely bailed in (with estimated value of around $7 billion at LBP 4,000/USD), fresh funds would need to be found to plug the remaining gap and recapitalize the banks.

Again, for comparison purposes, Rickards used a bottom-up approach, examining financial statements of fourteen important Lebanese banks, accounting for most of Lebanon's banking assets, and assuming the rest will have been liquidated or consolidated. He applied the same methodology as for the BdL: a 50 percent haircut and reconverting USD assets at LBP 4,000/USD, while keeping depositors whole, and came up with a bank recapitalization need of $67 billion.

By contrast, the Lebanese government's draft restructuring plan estimated an $82.3 billion loss for the banking system, consisting of impairments of assets at the BdL, the loan portfolios, and holdings of government debt. Bailing in banks' shareholders ($18.5 billion) and USD depositors ($113.2 billion) would mean wiping out current shareholders' equity, reducing deposits by about $65 billion to cover the remainder of the losses, and converting another $20 billion of deposits into new capital to keep the banks viable. Imposing $85 billion in losses and equity conversion to large resident and nonresident depositors—constituting the top 10 percent of depositors, estimated to account for 75 percent of USD deposits, or $85 billion—would wipe out their deposit wealth. It is doubtful if such a severe bailing-in is politically feasible, and would represent a huge negative wealth shock for those depositors, significantly curtailing their consumption and expenditure, and depressing economic growth in the future. Any reduction in the losses imposed on large depositors, to lessen the negative wealth effect, would require external assistance to fill the gap.

In early June a group of Lebanese experts released a banking sector restructuring proposal with concrete details (see link below). The plan proposes to preserve the USD deposits of small and medium depositors, at between 85 percent and 95 percent, while imposing haircuts and conversion back to LBP at an LBP 1,500/USD exchange rate on 50 percent of the remaining deposits. As shown in the analysis above, this degree of bailing-in of depositors would simply not be sufficient to deal with the losses in the banking system—as estimated by the Lebanese government.

Another serious complication is that thirteen of the more important banks in Lebanon have been named defendants in a court case, Bartlett v. Societe Generale de Banque au Liban SAL et al., filed on behalf of 350 US families in the US District Court for the Eastern District of New York, in Brooklyn, alleging that those banks provided material support to Hezbollah, including for money laundering, sanction evasion, and terrorist financing. The fact that the United States has designated Hezbollah—which has significant political control in Lebanon—a terrorist organization makes it awkward for the United States to participate enthusiastically in an international community rescue deal for Lebanon via, for example, CEDRE (a French acronym for the Economic Conference for the Development of Lebanon through Reforms with Businesses), which was held in Paris in 2018.

Restructuring Lebanon's Eurobonds

The Lebanese government has about $31 billion of Eurobonds outstanding, or 63 percent of its total bonded debt. In addition, there is another $5 billion of nonbonded debt, making for a total of $36 billion of public external debt. Lebanon's total public debt/GDP ratio is estimated by the World Bank to be 212 percent—this needs to be brought down to well below 100 percent to be sustainable. However, since practically all of the LBP-denominated government bonds are being held by the BdL and commercial banks, a haircut of that magnitude will inflict a severe loss on the banking system, requiring even more significant recapitalization.

Lebanese sovereign Eurobonds have hardly traded on secondary markets for more than a year, with the last indicated prices at around 17 cents on the dollar. This is about half the levels of other defaulted sovereign bond prices for Argentina or Ecuador, for example, and way below the average recovery value of 69 cents on the dollar for emerging-market sovereign debt in default.

As a consequence, the principal haircut needed for a restructuring of Lebanese Eurobonds would be quite steep: at least 50 percent, but likely more and up to 70 percent. Again, the deeper the haircut, the bigger the losses suffered by the BdL and Lebanese commercial banks, requiring more substantial recapitalization by the government.

In addition, none of the Lebanese Eurobond issues contain collective actions clauses (known as CAC, they allow a qualified majority of bondholders to bind the minority in changing the terms of the bond contract), making for a difficult and contentious restructuring negotiation between the sovereign debtor and private bondholders, with a distinct risk of unsettling and prolonged litigation. Reportedly, some international investment funds hold a blocking position in specific Lebanese sovereign Eurobond issues.

The Lebanese Financial Rehabilitation Fund and the Role of the IMF

The best way to proceed is to establish a Lebanese Financial Rehabilitation Fund (LFRF) that is similar to the Hellenic Financial Stability Fund (HFSF) set up during the Greek government debt crisis in 2010 to conduct the restructuring and recapitalization of Greek commercial banks. The HFSF was endowed with a €50 billion loan from the European Financial Stability Facility (EFSF), which was later folded into the European Stability Mechanism (ESM, an institution set up by the euro area member states to assist members in financial distress).

In a similar vein, the LFRF could be funded by a combination of proceeds from Lebanese gold sales ($5 billion, for example) and another $5 billion of loans (combined) from the Gulf Cooperation Council and France, traditionally close friends of Lebanon. If gold sales are not possible due to sociopolitical opposition, the LFRF would have to rely exclusively on external funds and likely face greatly diminished chances of success.

The LFRF could be given clear legal authority, political support, and competent staff, with oversight by a board of directors representing its financial contributors and selected representatives from civil society organizations.
It would start the process of assessing the damage, and then resolve, consolidate, restructure, and recapitalize the banks. Last but not least, it would put in competent management working under the close supervision of the LFRF. By promptly implementing such confidence-building measures, the LFRF can use its $10 billion of resources to make strategic investments in equity and loans to promising banks in a catalytic way to bring in investments from other sources, both inside and outside of Lebanon, to meet the recapitalization requirements. Naturally, the more financial resources the LFRF has, the better it can carry out its tasks.
The IMF needs to be closely involved in bank restructuring efforts to provide technical assistance, but not involving Fund resources. This novel approach

reflects the reality in Lebanon of strong popular opposition to fiscal austerity as a condition for an IMF program, so far helping to delay agreement between the caretaker Lebanese government and the IMF, which makes the situation worse by the day.

A minimal program with minimum conditionality focusing on restructuring the financial sector, drawing heavily on IMF technical expertise (but not on Fund resources) would have a better chance of being agreed to more quickly. A full-fledged IMF program along traditional lines, with prior actions and conditions, could be negotiated and hopefully adopted in a second stage of the rehabilitation process, which would address the needs of reconstruction, reforms, and building the basis for a new and sustainable economic model. Ideally, both phases of restructuring and reconstruction/reform would be implemented in tandem, as they impact each other; since time is of the essence, however, it's better to move quickly with a minimal program of financial-sector restructuring and recapitalization, hoping that this will stabilize financial and economic conditions to some extent, buying time for negotiating a comprehensive program.

Conclusions and Guidelines for the Financial Sector Going Forward

To sum up, the situation in Lebanon is desperate—its economy has shrunk almost by half in the past few years and consumer-price inflation has jumped to more than 150 percent on a year-on-year basis. The longer it takes for the Lebanese government to reach agreement with the IMF and CEDRE participants to start the rescue process, the worse the situation becomes. It is much better to quickly reach agreement on a minimal program to get the rescue ball rolling, preventing Lebanon from becoming a failed state and further destabilizing the region and the world at large, rather than to conduct lengthy negotiations for a comprehensive package that would be difficult to implement in full, given the fractured nature of Lebanese society and politics.

In the 2018 CEDRE gathering, governments and international organizations pledged $11 billion in loans and grants. Going forward, perhaps China and Iran could be invited to join the conference: China because it is among the largest trading partners with Lebanon and has expressed interest in bidding for some reconstruction projects, and Iran because of its de facto influence in the country through Hezbollah, and in the context of a reported rapprochement between the state and Saudi Arabia.

The Lebanese government has requested a $10 billion IMF program, but this is unrealistic. A more feasible goal would be for Lebanon to request a regular standby arrangement, allowing it to get financing up to 245 percent (likely the maximum, given circumstances, and increases during the pandemic) of its IMF quota of $861 million—or about $2.1 billion, in line with recent IMF programs in the region; examples include Jordan, with 270 percent of its quota, and Tunisia, at 250 percent). A member country can request exceptional access, subject to enhanced scrutiny and conditionality, but this is unlikely in the case of Lebanon given its weak governing institutions, poor reform track record, and Hezbollah's influence, which rankles several key IMF member countries. Therefore, the feasible envelope of external financial assistance, given past pledging, is likely to be around $13.1 billion, which is obviously much smaller than the range of financial-sector losses and recapitalization needs indicated above (ranging from $25 billion to $86 billion), let alone taking into account other needs for assistance (including the reconstruction of Beirut's port and business district, estimated to cost a few billion US dollars—all together the financial-support need may run up to around $60 billion to $70 billion over several years). Thus it is clear that the Lebanese people—both inside and outside of the country—will have to bear a big part of the adjustment burden including contributing resources to the rehabilitation efforts. The sooner this message can be communicated to the people, the better.

In conjunction with the process of bank restructuring by the LFRF, the following minimal but necessary guidelines should be observed by Lebanon's central bank, commercial banks, and the government:

1. Legislate capital controls and adopt regulatory forbearance for a reasonable period of time to allow for the gradual adjustment of the valuation of USD assets and liabilities, which are pervasive in the economy, to the reality of sharply weaker LBP exchange values and reduced USD inflows.

The implementation of capital controls has to be transparent (compared to the current de facto, opaque, and arbitrary controls) to avoid the potential for corrupt practices, which destabilize the situation and demoralize the population.

2. Stop relying on a bankrupt, unsustainable dollarized economic model to attract USD inflows to finance spending, which builds up USD claims to astronomical levels. Given the collapse of the banking system and its loss of confidence and trust by the people, future USD inflows will be inadequate and unreliable to sustain such a dollarized economy. These are the same reasons why arrangements relying on a pegged exchange rate proposed by some economists, such as a currency board, are unworkable. Under a currency board, the central bank has no power except issuing the local currency and guaranteeing free conversion at a fixed exchange rate to the amount of US dollars on hand. This approach makes the money supply, and economic activity, quite volatile, being held hostage to uncertain USD inflows. Consequently, there is no alternative except moving to a flexible exchange-rate regime, and the BdL should only intervene to smooth out undue volatility in the foreign-exchange markets if it has sufficient reserves to do so.

3. Adopt an inflation-targeting approach as a BdL framework for monetary policy making, in the absence of an LBP/USD peg.

4. Prohibit the BdL from lending to the government through direct purchases of LBP or USD government bonds, for example, to finance government spending.

5. Allow the government to issue its LBP bonds only to the public, as part of any assistance plan or deal, and require observance of strict limits on USD debt issuance.

Part IV
Reigniting the Economy: Engaging the Diaspora and Strengthening Lebanon's Entrepreneurship Ecosystem

By Merissa Khurma
Director, Middle East Program
The Wilson Center

Introduction

The dire economic situation in Lebanon reflects the rapidly deteriorating state of employment and wages. The UN estimates that more than 55 percent of the population is in poverty. According to the World Food Programme, 49 percent of Lebanese are worried about access to food. The current unemployment rate has skyrocketed to 40 percent and women's labor force participation has fallen to 23 percent, according to the latest World Bank figures—and is expected to decrease further. Unemployed and skilled youth are fleeing the country, contributing to an already acute brain drain which will cause permanent damage to Lebanon's economy. According to MacroTrends, the net migration rate in 2021 for Lebanon has increased 32 percent from 2020, enlarging the already extensive diaspora community that is estimated at 15 million people. Adding to Lebanon's economic woes is yet another demographic challenge in hosting the highest per capita refugee population worldwide.

At the heart of Lebanon's rising poverty and failing labor market are the weakened demand-side factors facing the private sector. Micro, small, and medium-sized businesses, which comprise 95 percent of companies in the country, have been severely hit by the compounding crises, adding to rising job losses, particularly among women. Lebanon's economy is also largely informal, meaning that a large amount of transactions are made in cash and aren't deposited in banks. The devaluation of the currency will impact the wages of hundreds of thousands as they see their purchasing power precipitously decrease and the cost of imports rise. Underwriting this is the outsized role of the banking sector in the economy, which represents a majority of GDP but is unproductive in terms of employment and the real economy.

As discussed in this report, the present situation represents an urgent need for Lebanon to chart a long-term path to develop the productive sectors of the economy, generate exports, and create an environment friendly to technology and innovation. The seeds of this transformation must be planted today, despite the present crisis, and a key element must be an orchestrated workforce-development strategy that emphasizes skills and training for Lebanon's youth. This section proposes a policy of rebuilding Lebanon's economy from the ground up with measures to rescue and reinforce the productive private sector, strengthen the entrepreneurship ecosystem by making women and youth the drivers of new business development, and engage Lebanon's extensive diaspora communities for both economic stabilization and reconstruction efforts.

Strengthening SMEs and the Entrepreneurship Ecosystem

Despite its weaknesses, Lebanon is poised to rebuild through its traditionally strong entrepreneurial foundation and vibrant business-oriented culture. Lebanon's business leaders have the expertise and knowledge of local markets, their needs, and unique features. As the post-blast picture revealed, Lebanese people and businesses were at the center of the work from cleaning up streets to renovating homes and offices damaged by the explosion.

This first challenge, as outlined in an earlier section, is to stabilize the deteriorating financial sector. Small and medium enterprises (SMEs) have struggled to scale up and create jobs and they can't hope to contribute to recovery without functioning banks. However, the problem of scalability for SMEs is a widespread phenomenon across the region given the diffusion of banks and lack of access to markets. Even with an existing free trade agreement (FTA) with the EU, for example, many Lebanese businesses do not have the capacity or knowledge of import and trade regulations to export successfully. Overshadowing the lack of export savvy is the physical destruction of the port of Beirut, which is a critical entry for businesses hoping to import materials and machinery in order to export finished goods.

The second challenge is to reassess the viable sectors that can create a more productive economy in Lebanon. Countries around the region are in a process of economic diversification, though the trend is not limited to the Gulf. Lebanon must embark on a similar course given the outsized role played by the financial sector. One solution proposed by Lebanese business leaders is to create

special economic zones, generating value and investment in various geographic and knowledge-based areas of advantage such as agriculture, fisheries, minerals, light manufacturing, digital media production, and technology.

Third, it will be critical to have a policy regarding informality. The informal economy in Lebanon, akin to other countries in the region, was severely hit by the global pandemic as lockdowns impacted cash-based, point-of-sale transactions. According to the National Statistical Institute, over 90 percent of the agriculture sector is informal, followed by construction and transport (80 percent and 70 percent, respectively), and commerce (at around 60 percent). These disruptions account for large, often unaccounted for losses in wages and employment. As discussed, stabilizing the Lebanese pound in addition to reinforcing the social safety net are first-line measures to protecting informal workers.

Facing these imbalances, the Lebanese private sector needs several policies to shift the economic balance toward productive, employment-generating sectors. Starting with the informal economy, studies have shown that around 40 percent of small informal companies see advantages to formalization, including access to finance and the ability to attract customers. Morocco used an integrated model to successfully reduce informality in its economy to 30 percent of GDP in 2018 from 40 percent in 2009 while factoring in the "particularities" of each sector. Formalization can be encouraged through fintech innovations such as the popular M-Pesa platform in Kenya, which would also reroute economic transactions through struggling banks. Numerous other incentivization packages are being tested elsewhere in Africa and the Middle East, including easy digital registration, tax filing, and training.

Though formalizing parts of the economy will add important job security and stability for millions of Lebanese, creating a more productive economy requires a policy focused on entrepreneurs and driving new business development. One intervention that is gaining traction elsewhere in the region is the one-stop shop for SMEs. Small businesses need more than loans; they benefit from a suite of financial and nonfinancial services to help them improve their management, target markets, and grow. For example, such an entity could help SMEs leverage the existing FTA with the EU and provide training and capacity-building workshops to businesses. A one-stop shop could also be established as a nonprofit or cooperative with significant support from donor countries and the Lebanese diaspora, thereby bypassing government deadlock. Elsewhere in the region, the Qatar Development Bank has developed a successful approach to supporting SMEs and a similar model is being tested in Tunisia.

Accordingly, reassessing traditionally productive economic activities is an important step to redirecting new business creation toward sectors and practices that can help Lebanon better integrate into the global economy. The country desperately needs more than an immediate economic rescue plan; GDP growth has hovered around 1 percent for the past five years or more. Refocusing on exports and value-added services will give Lebanon a more robust and resilient economy. Therefore, the country's SMEs should have a seat at the table in any recovery and rebuilding discussions.

Digitizing the Economy

Any conversation on the recovery of Lebanon's private sector must also include a dedicated discussion on the digital economy. Lebanon must exploit the global increase in digital consumption by embracing digital transformation of both traditional and emerging sectors. The advantages to this approach are manifold: creating an economy that gives youth entrepreneurs distinct advantages; enabling Lebanese to work remotely; allowing women and traditionally marginalized groups to contribute to the economy; and adopting cost-saving innovations for businesses. However, to jump-start widespread digital consumption, the country must enable the spread of digital infrastructure, encourage consumption and transactions online, and most importantly, create a system to foster and promote digital skills.

The pandemic has redefined the workplace and created a digital office for those who have access to the internet. It also boosted reliance on e-commerce for everyday needs. According to the latest estimates by the UN Conference on Trade and Development, global e-commerce hit $25.6 trillion in 2018 with 1.45 billion people shopping online that year. During the pandemic, consumers in the Middle East were nudged toward greater online consumption—a change likely to become permanent. These figures are expected to grow in the next two years given global shifts in the quality and availability of services from education to retail. For Lebanon's weakened private sector, e-commerce is an opportunity to access regional and global markets and increase exports of goods and services, facilitated by the devaluation of the currency.

However, many challenges inhibit Lebanon's digital transformation, especially in the production of electricity, as mentioned earlier in this report. The internet infrastructure also requires substantial upgrading investment to allow for greater speeds with increasing access. However, a key obstacle highlighted by the pandemic is the digital divide. Despite good mobile internet coverage figures, many consumers, especially in rural areas, are left out of the digital economy. School closures also revealed inequities in access to digital services. According to the World Bank, about "60 percent of students either do not have a computer or have to share it with at least three other family members," with recent estimates showing "only about 50 percent of students are connected to online learning." Equipping Lebanon's youth with the necessary digital skills is essential to bridging this digital divide and making them drivers of economic activity and new business development.

One pathway to strengthening the entrepreneurship ecosystem and exploiting Lebanon's existing youth skills base in technology is by establishing the proposed Lebanon Incubator Investment Fund. Such a fund can be sponsored by donor countries like the United States, France, and Germany, as well as regional allies including the United Arab Emirates and Saudi Arabia. The diaspora can play a critical role by investing capital and in-kind contributions from its considerable talent pool. The fund can be run by a board that includes members of the diaspora, business leaders, representatives from civil society organizations, academia, and educational institutions, and channel seed money as equity or loans to start-ups and entrepreneurs across Lebanon, prioritizing women and young people. A good example from the region is Oasis500 in Jordan, which was seeded in 2010 through an investment from the King Abdullah II Fund for Development and is today the country's largest start-up accelerator.

Addressing these challenges requires involving all stakeholders including the government, the private sector, civil society organizations, as well as diaspora networks. This can help bring in investments, transfer tech knowledge, create programs to upgrade digital skills, digitize businesses, and connect them to international markets.

Rebalancing Lebanon's Workforce Formula

Thus far, we have addressed the imbalances in the demand side of Lebanon's workforce formula. However, this economic transformation is impossible without an integrated policy to address workforce development and education. Some of the trends in the workforce challenge of the Middle East and North Africa (MENA) region do not apply to Lebanon, where only about 15 percent of the workforce is in the public sector, the majority of whom serve in the military. The rest are employed in the private sector, which has historically been vibrant and adaptable in the face of the country's various crises, including its fifteen-year civil war. This feature of Lebanon's workforce is a tremendous opportunity, as the road to private-sector recovery is charted out in the absence of political stability. What is needed is to capitalize and invest in skilling, reskilling, and upskilling the educated youth workforce to meet market needs.

Like other countries in the region, a skills mismatch exists despite the prevalence of high-quality educational institutions. These institutions are mostly privately owned and, though they pass on more costs to students, they can more rapidly respond to market needs and investment. What is needed is increased dialogue between these educators and business owners to better prepare youth for the job market in targeted sectors, as outlined above. However, it's important to note that Lebanon's public education system will likely face increased pressure going forward as more and more families, due to the economic crisis, will be unable to afford to send their children to better quality private schools. Therefore, development assistance should be leveraged to boost quality in the public education system, integrate technology in the classroom, and promote entrepreneurial skills. Private funds also can create opportunity scholarships to increase equitable access to private schools.

In terms of school output, both global and regional trends point to the lack of "soft" or essential skills (such as communication, team building, negotiation, problem-solving, leadership, and critical thinking), which are in high demand in emerging, especially digital industries. This presents an opportunity for development agencies and nongovernmental organizations to focus investment on the essential and employability skills of Lebanese youth through supplementary school programs and workshops. Meanwhile, donor agencies and private-sector investors must develop training modules in collaboration with technical schools and universities, focus on skills in high productivity sectors such as ICT and artificial intelligence, and provide them with industry certifications. Given the fast-paced technological advances we are witnessing, this can prepare Lebanese youth better for new business creation and also widespread digitization of production and services. Countries in the region, such as the United Arab Emirates, which has launched the One Million Arab Coders initiative, can guide Lebanon's immediate need to foster a tech savvy workforce.

Vocational and technical education, rather than remaining a last resort for students in Lebanon, should be reimagined as the driver of new private-sector productivity. Technical and vocational education and training (TVET) should fully integrate technology and digital skills training, conform to internationally recognized certifications and performance standards, and customize offerings to match the needs of special economic zones. In order to make this approach a success, these schools should embrace the modular diploma, matched with a workplace performance requirement. Successful models of consecutive diplomas are being used at Luminus Technical University in Jordan for digital communications, audiovisual design, and hospitality, as well as at Hussein Technical University in Jordan and ESPRIT (École Supérieure Privée d'Ingénierie et de Technologie) in Tunisia for engineering. With an infusion of capital, the Lebanese TVET sector can begin generating an available labor pool for recovering businesses within two or three years. Lebanese businesses must be fully involved by providing internship opportunities, defining curricula, and providing off-ramps for students to earn their diploma and enter the workforce, as well as on-ramps for them to return and upgrade their diploma and skill level.

In order for the Lebanese to accomplish this shift to a productive private sector, a people-and-skills approach must be established throughout the system. Private schools can be key partners of businesses, but the whole school system needs targeted investments to ensure skill levels meet their needs. Essential and employability skills can be enhanced for all graduates, while the TVET sector can create a skilled labor pool for expanding industries.

Unlocking the Potential of Women in the Workforce

Any workforce strategy in Lebanon must also target female labor force participation, which requires integrated solutions across the spectrum. Lebanon's female labor participation rate remains low (23 percent) despite high education rates among women—representing a loss in human capital investment. Furthermore, less than 10 percent of Lebanon's SMEs are women owned.

Consequently, many UN agencies and other donors have traditionally provided women with mentoring support as well as capacity-building training and financial-literacy workshops. These programs are tremendously beneficial and must continue and expand. However, what many economic assessments have shown is that a key barrier facing women seeking to start a business is access to finance. Supporting aspiring women entrepreneurs with financial backing is crucial to reviving women's workforce participation and capitalizing on their untapped skills.

Incoming international aid and support to Lebanon's various businesses as well as its social sector should consider conditioning support on either employing women on an equal basis as men or ensuring that at least 50 percent of their beneficiaries are women. This approach requires high-level coordination among the numerous donor agencies involved in recovery and rebuilding plans. Gender-responsive policies and budgeting should become key pillars of any proposed development or recovery fund for Lebanon. For example, addressing sexual harassment in the workplace and providing day-care services for working mothers is key to unlocking women's potential in the economy. Childcare services represent a sector in itself that supports the direct and indirect employment of women.

Engaging the Diaspora

The Beirut port explosion has galvanized the Lebanese diaspora across the world in an unprecedented manner to support the country's immediate humanitarian needs as well as midterm recovery efforts. Disenchanted and frustrated by the Lebanese government's negligence and lack of political leadership after the explosion, the diaspora turned to the private and social sectors to channel assistance and support. This experience shows how Lebanon's diaspora communities can be engaged and circumvent political indecision in the key phases of short-term recovery and medium- to long-term growth, especially in support of its workforce-development formula.

A number of initiatives focused on strengthening diaspora networks and linkages to Lebanon were launched in the last decade, representing a foundation from which to assess lessons learned. One such platform is DiasporaID, which aims to link diaspora members with not only the country but the level of the communities, towns, and villages from which their families originate. Accordingly, a Lebanese diaspora forum should be organized to engage different associations and organizations in the United States and Europe as well as the Gulf Cooperation Council. Development assistance should be directed to complement these organizations' efforts, especially in supporting the recovery of businesses and strengthening the country's entrepreneurship ecosystem, especially by bolstering the one-stop shop for SMEs and the proposed Lebanon Incubator Investment Fund.

Engaging the diaspora can take many forms including establishing platforms for the transfer of knowledge and expertise, investments, and diaspora bonds, which are currently being heavily championed by the World Bank and other international agencies.

Diaspora bonds represent an effective vehicle through which the successful Lebanese in the diaspora can support the country, especially in times of economic struggle. According to a World Bank economist, these bonds could generate about $50 billion a year in total for developing countries.

A number of countries have produced successful models in issuing diaspora bonds as a means of investment. Israel and India have raised around $40 billion from such bonds. In the case of Lebanon, restoring trust in a future government is certainly a factor, but it is important to note that diaspora bonds could be issued by a private corporation. Learning from the experiences of other countries with large diaspora communities will significantly benefit Lebanon as it charts out a means to issue these bonds to raise financing from abroad.

Conclusion

This section addresses the supply—and demand—side components of Lebanon's workforce formula. First, Lebanon's private sector must be supported and grown from the ground up. Specialized economic zones can facilitate development of certain industries, but a one-stop shop with an arsenal of financial and nonfinancial services will be critical to SMEs as they seek to overcome growth challenges. As a key sector, the digital economy also must be developed through infrastructure and especially workforce skilling. The proposed Lebanon Incubator Investment Fund would provide an excellent tool for the Lebanese diaspora to contribute investment support and technical know-how, helping to develop the local firms that will drive the digitization of the rest of the economy.

However, neither approach will be successful without a dedicated policy for people and skills. Investment in education will ensure a proper skills base in the workforce, while a renewed focus on essential skills and employability will enable more efficient workforce matching. Redeveloping a creative high-quality TVET system is a key pillar to enabling this industrial transition, increasing the quality and capacity of production. Programs targeting women also do more to ensure greater equity down the road—they create immediate benefits by capitalizing on their existing skills and potential.

Lastly, the diaspora has a role to play in supporting all the above strategies. This wider community has the expertise to allow these initiatives to succeed, and diaspora bonds can create a profitable avenue for members to redirect their investment from the struggling financial sector right into the hands involved in reconstruction and transformation of Lebanon's economy.

AUTHOR

Dr. Rand Ghayad
Adjunct Professor
Harvard University
Former IMF Economist

Dr. Ghayad has extensive experience advising governments and other sovereign entities on complex nancial and economic matters, including debt restructuring, job creation, and scal and monetary policy issues. He has more than a decade of experience as a macroeconomist including serving most recently at the International Monetary Fund where he worked on low-income countries and fragile states, participating both in bilateral discussions on macroeconomic surveillance and on negotiations of programs involving IMF nancial assistance. In addition to providing expert advice on economic policy and labor reforms to numerous governments, including most recently France, the UK, and Kuwait.

Dr. Ghayad has also advised the Federal Oversight Board of Puerto Rico and its counsel on a broad range of macroeconomic and nancial issues related to the Commonwealth's debt crisis and bankruptcy proceedings. He also worked closely with various regulatory bodies and key institutions, including the US Department of Justice and the Securities and Exchange Commission, in developing economic and nancial analyses in a variety of matters involving false claims, Ponzi schemes, nancial market fraud, and shams.

Between 2012 and 2013, he was part of an ongoing eort at the White House to develop best practices for hiring and recruiting the long-term unemployed. In 2014, Ghayad advised the Prime Minister and Employment Policy Council of France on strategies to reduce the incidence of long-term unemployment.

Dr. Ghayad began his career at the Brookings Institution working on unemployment and labor market reforms. He also served in various positions at the Federal Reserve Bank, International Labor Organization, and MIT. He holds a PhD in Economics and has held research and teaching positions at Harvard University, Massachusetts Institute of Technology, Boston University, and Northeastern University

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AUTHOR

Ms. Merissa Khurma
Program Director
Middle East Program
Wilson Center

Merissa Khurma is the program director of the Middle East Program at the Wilson Center. She was a non-resident fellow in the International Security program at New America. She has leadership experience working in a range of development projects in the Middle East that focused on economic development, the Syrian refugee crisis, education, youth, gender development, and governance. Additionally, Khurma served as director of the Office of Jordan's Prince Ali Bin Al Hussein (2010-2013) and as press attaché and director of the Information Bureau at the Embassy of Jordan in Washington, D.C. (2003-2010). Khurma has a master of public administration degree from Harvard University's Kennedy School of Government, a master of science in international security and foreign policy degree from Georgetown University, and a bachelor of art in political science degree from McGill University. She is also an adjunct professor at Georgetown University›s School of Foreign Service in leadership development.

AUTHOR

Mr. Hung Tran
Nonresident Senior Fellow
GeoEconomics Center
Atlantic Council
Former Executive
Managing Director Institute
of International Finance

Mr. Hung Q. Tran is an accomplished economist, with broad experience across the private sector, international organizations, and research institutions. Mr. Tran has produced important research and shaped policy decisions concerning advanced and emerging market economies, global capital markets, debt and capital flows, and financial stability issues. From 2007 until retirement in 2018, Mr. Tran was at the Institute of International Finance (IIF). Since 2012 he served as IIF's Executive Managing Director while simultaneously leading its Global Capital Markets Department. During 2011-2012, he played an important role coordinating the negotiations of the Private Creditor-Investor Committee for Greece with the European Commission, the Euro Group, the European Central Bank (ECB) and the International Monetary Fund (IMF). The negotiations led to the successful restructuring of €206 billion of Greek Government Bonds, the largest sovereign debt re-structuring in history. Before that, serving as Counsellor and Senior Director of the Capital Markets and Emerging Markets at the IIF, he was responsible for the Institute's highly regarded market policy research, which included multiple publications and services for its members.

Prior to his work at the IIF, Mr. Tran served for six years at the International Monetary Fund as Deputy Director for the Monetary and Capital Markets Department. His responsibilities included being the Chairman of the Editorial Committee of the Fund's semi-annual flagship publication, the Global Financial Stability Report (GFSR).

From 1998 to 2001 Mr. Tran was based in London serving as Managing Director, Chief Economist and Global Head of Research for Rabobank International, a Dutch multinational bank. He spent the previous 12 years at Deutsche Bank, serving first as Director of Global Fixed Income Research from 1987-1990 in New York, then as Co-Founding Managing Director of Deutsche Bank Research GmbH from 1991-1995 in Frankfurt, and finally as Head of Equity Business (Sales, Trading, Derivatives, Research) for the Deutsche Bank Group in Asia-Pacific, based in Singapore from 1995-1998. Earlier in his career he had served in senior positions in international fixed income research for Merrill Lynch (1984-1987) and Salomon Brothers (1979-1984) in New York.

AUTHOR

Ambassador James F. Jeffrey
Chair of the Middle East Program
Wilson Center

Ambassador James F. Jeffrey joined the Wilson Center in December 2020 as Chair of the Middle East Program. Ambassador Jeffrey served as the Secretary's Special Representative for Syria Engagement and the Special Envoy to the Global Coalition To Defeat ISIS until November 8, 2020. He is a senior American diplomat with experience in political, security, and energy issues in the Middle East, Turkey, Germany, and the Balkans. He has held senior assignments in Washington, DC, and abroad, including as Deputy National Security Advisor (2007–2008); United States Ambassador to Iraq (2010–2012); United States Ambassador to Turkey (2008–2010); and United States Ambassador to Albania (2002–2004). In 2010 Jeffrey was appointed to the highest rank in the U.S. Foreign Service, Career Ambassador. From 1969 to 1976, Jeffrey was a U.S. Army infantry officer, with service in Germany and Vietnam.

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