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It's a systemic crisis!

Most currently proposed remedies for the financial sector rely on liquidation approaches. The systemic nature of the crisis, while acknowledged, remains unaddressed.

This paper reiterates the elements that constitute a systemic crisis, with the aim of serving as a catalyst for confronting it through a comprehensive economic approach.

INFOPRO

It's a systemic crisis!

This paper demonstrates that the economic crisis in Lebanon is systemic in nature and that its components extend far beyond the banking sector. By international standards, the financial collapse is systemic in nature. It stems from decade-long unsustainable fiscal, monetary, and trade practices and from the interdependence between the State, BDL, and commercial banks. It was a structural failure of the entire financial model.

The collapse of the financial sector was the result of a systemic economic failure encompassing fiscal, monetary, financial, and trade dimensions. While this is acknowledged, the prevailing approach by successive governments since 2020—and by many in the international community—has been to treat the crisis as a cumulative outcome of parallel failures by individual banks.

The Lebanese crisis exhibits all the hallmarks of a systemic crisis, as defined by international financial institutions such as the International Monetary Fund (IMF), the World Bank, and the Bank for International Settlements (BIS). It represents a structural failure of a financial model that, for decades, depended on unsustainable fiscal and monetary policies—ultimately resulting in a catastrophic collapse. The crisis has impacted all institutions and sectors, leading to a widespread loss of trust in banks, the national currency, and the government's solvency.

Such a severe crisis cannot be left to resolve itself. It demands proactive intervention by the government and international donors, including bailouts, guarantees, and monetary support. Crucially, it also requires deep structural economic and fiscal reforms—far beyond mere financial sector adjustments.

Summary

1) Sector-wide insolvency
- Almost all banks are insolvent, having lost depositor money through exposure to government Eurobonds and BDL's financial engineering).
- Bank capital has been wiped out due to the default on Eurobonds.

2) Loss of confidence
- The population has lost trust in both the banking system and the central bank and **dollarization** and the use of cash have surged.

3) Contagion and structural breakdown
- The collapse has paralyzed the monetary system, public sector services, and economic output.
- Capital controls were applied in an **informal and illegal** way, affecting all sectors.

4) Failure of the central bank and government
- The **Central Bank (BDL)**, a key pillar in any financial system, was itself part of the problem—its accounting, liabilities to banks, and quasi-fiscal operations are deeply compromised.
- There was **no credible state-led resolution**, which worsened the systemic impact.

5) No orderly resolution or restructuring
- Unlike systemic crises elsewhere (Iceland 2008, Cyprus 2013), there was **no proper restructuring of banks or sovereign debt**, making the crisis **persistent and uniquely prolonged**.

Definitions of systemic Financial Crisis

IMF

“A systemic banking crisis occurs when a country’s corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time, leading to the erosion of most or all of banking system capital.”

– IMF Global Financial Stability Report

World Bank (Laeven & Valencia, 2020)

“Systemic crises are events when significant segments of the financial system lose value and functionality, often requiring large-scale government intervention.”

Bank for International Settlements (BIS)

“A systemic event is one in which financial instability in one or more institutions or markets threatens to spill over and impair the functioning of the financial system as a whole, with serious negative consequences for the real economy.”

Key characteristics of systemic crises

- **Contagion:** Problems spread across institutions and sectors.
- **Loss of confidence:** In banks, currency, or government solvency.
- **Need for government intervention:** Bailouts, guarantees, or monetary support.
- **Impact on the real economy:** Deep recessions, capital controls, inflation.

Introduction

The economic crisis has all the ingredients of a systemic crisis stemming from years of structural imbalances resulting from ill-advised fiscal, monetary, and trade policies. Its deep roots go back decades in time. It was the result of years of misguided fiscal and monetary policies, unconventional practices, and even downright wrongdoings. The government didn't address the country's chronic fiscal and current account deficits. The fiscal deficit led to a massive public debt that reached $85 billion at the end of 2018. This has increased the banks' exposure to both the State and the Central Bank which also channeled a large part of the banks' lending to the State. The current account deficit, which is mainly the result of a huge trade deficit, contributed to the erosion of BDL's foreign exchange reserves. The decline of foreign reserves was precipitated by other factors as well such as the decrease in financial inflows driven by spillovers from the Syrian war and the deterioration of relations with Gulf countries. The erosion of foreign reserves was the main reason that prompted BDL to engage in the financial engineering operations. All these factors have contributed to huge losses in the financial sector and eventually led to the collapse of the lira, the banking sector, and the economy at large.

1) Sector-wide insolvency

A **Almost all banks are insolvent, having lost depositor money through exposure to government Eurobonds and BDL's financial engineering**

B **Bank capital has been wiped out due to the default on government eurobonds**

A. Insolvency

The crisis has affected all banks. Since 2019, they have gradually imposed withdrawal restrictions and informal capital controls on their clients. In October 2019, at the onset of the crisis, the entire banking sector shut down for nearly two weeks. Banks' excess foreign currency liquidity was largely placed in long-term deposits at the Central Bank and invested in government bonds (Eurobonds). The Central Bank did not release these deposits.

The banks' exposure to BDL's risk increased considerably since they started participating in the financial engineering operations in 2015 (see below). Their deposits with BDL surged by 85 percent to $130 billion between 2015 and 2018. By the end of December 2023, these deposits represented over 73 percent of their total assets compared to 56 percent in June 2019.

Default on Eurobonds

The government defaulted on the Eurobonds leading to a sharp decline in their prices which lost 94 percent of their market value by the end of 2023. As a result, the banks became effectively insolvent and unable to meet their customers' needs—even when many still showed positive balances before factoring in their deposits held at the Central Bank.

Asset-liability maturity mismatch and exposure to government debt

The mismatch between the long-term maturity of the banks' lending to the State and placements with BDL on the one hand and the short-term maturity of their customer deposits has also contributed to their insolvency. The banks, induced by higher returns from deposits at the Central Bank, as well constrained by several BDL circulars restricting them to place their excess liquidity elsewhere, deposited a large part of their short-term foreign currency customer deposits in long-term government and Central Bank instruments (Eurobonds and placements with BDL such as certificates of deposit). This has resulted in a foreign currency asset-liability maturity mismatch in the balance sheet of the banks. The weighted average life of Treasury bills (in lira) was 4.5 years at the end of June 2019 and 3.2 years at the end of June 2023. The average maturity of foreign currency Government debt instruments was around 7.6 years at the end of June 2019 and 7.8 years at the end of February 2020.

Financial engineering

The asset-liability maturity mismatch increased drastically with the financial engineering operations which were initiated by the Central Bank in 2015 in order to attract inflows to bolster its foreign currency reserves by offering high interest rates on deposits with BDL. This allowed the banks to offer high interest rates on customer deposits amid low global interest rates. Almost every bank participated heavily in these operations. Pressured by competition and by BDL, the banks had also drawn on their dollar deposits with correspondent banks abroad which dropped by $6.8 billion (61 percent) between December 2017 and December 2023. The Central Bank's operations raised the banks' exposure to the BDL and government to 69 percent of their total assets (more than 8 times Tier 1 capital) by May 2019, up from 62 percent at the end of 2017. The increase was largely due to the rise of banks' deposits at BDL, according to IMF's 2019 Article IV Consultation.

Banks equity versus Eurobond holding (USD billion)				
	Jun-19	Dec-23	Drop	%
Equity	21	5	-15.8	-76%
Eurobonds	15.4	2.2	-13.2	-86%

B. Capital is wiped out

The foreign currency assets of the banks were severely impaired by the government's default on its foreign currency debt. Their Eurobond holdings lost 94 percent of their market value by the end of 2023 and this has contributed to the depletion of the banks' equity. Their equity was further eroded by halt of banking activity and the losses that the banks incurred as a result of many customers settling their foreign currency debt in lira at the official exchange rate when the market rate of the dollar was skyrocketing. As a result, the banks' capital was wiped out. It plummeted by 76 percent between June 2019 and December 2023 to just $5.1 billion. The heavy settlement of private sector loans and deposit withdrawals contributed further to the shrinking of commercial banks whose total assets at the end of 2023 represented just 45 percent of their pre-crisis value. The banks' outstanding loans to the resident private sector plunged by 85 percent to just $7.2 billion reducing further their income.

Position with correspondent banks (USD billion)			
	Dec-17	Jun-19	Dec-23
Deposits with correspondent banks	11.3	9.8	4.5
Liabilities towards correspondent banks	7.5	9.4	2.9
Net position with correspondent banks	3.8	0.4	1.6

Total assets of commercial banks (USD billion)			
Jun-19	Dec-23	Drop	%
256.0	115.2	-140.7	-55%

2) Loss of confidence

The population has lost trust in both the banking system and the central bank and dollarization and the use of cash have surged

The difficulties that the banking system was facing made the population lose their trust which led to a bank run as panicked customers rushed to withdraw their deposits or convert their lira deposits into dollars. This snowball effect worsened further the plight of the financial sector which tried to protect itself by imposing informal capital controls. The behavior of depositors reflects a loss of confidence in the national currency and its backer BDL and in the banking sector as a whole. Total deposits plummeted by 45 percent to $93.7 billion as depositors started to stash money in their homes or buy assets that preserve their value. The distrust of depositors in the national currency is demonstrated by the surge in the dollarization ratio of deposits from 72 percent in June 2019 to 96 percent at the end of 2023. The lira lost 98 percent of its value as everyone was rushing to dump it like a hot potato. When mistrust spread to the entire financial system, people started withdrawing their foreign currency deposits which dropped by 26 percent. Mistrust in banks led to a halt of banking activity and the emergence of a cash economy estimated at about half of the country's GDP.

3) Contagion and structural breakdown

A The collapse has paralyzed the monetary system, public sector services, and economic output

B Capital controls were applied in an informal and illegal way, affecting all sectors

A. Collapse led to total paralysis

Incapacitated public sector and subdued economic output

The severe financial crisis had a disruptive ripple effect on the entire economy. It shook the foundation of the monetary system, paralyzed public administrations, and weakened further the business sector. As a result of the lack of credit, businesses became unable to expand their operations or even meet their working capital needs. This was reflected by a 40 percent cumulative GDP decline between 2019 and 2024. The financial crisis also affected the public sector with administrations beginning to experience shortages of ordinary stationery and office supplies as their budgets are in the collapsed lira. Shutdowns of public administrations became more frequent due to strikes as employees were trying to pressure the government to adjust their salaries which had been severely eroded by the collapse of the lira.

	Nominal GDP (USD billion)					
	2019	2020	2021	2022	2023	2024
World Bank	51.6	31.7	23.1	21.0	20.1	26
IMF	50.9	25.0	19.8	24.7	23.6	28.3

Note: there is a belief by this author, as well as by many leaders in the private sector, that the decline in GDP, while very severe, is being exaggerated by the calculations of the World Bank and the IMF.

A paralyzed monetary system

The Central Bank lost its ability to control the monetary system after the sharp decline in its foreign currency reserves. It squandered further its dwindling reserves in its vain attempts to stabilize the exchange rate. The market became chaotic with the emergence of multiple exchange rates. As a result, money lost its function as a measure of value and ordinary actions such as bookkeeping, business decisions and planning, or paying taxes, became a bewildering drudgery. Besides the misguided and disastrous subsidization of imports of basic goods which led to the depletion of $20 billion of reserves, the creation of the Sayrafa platform which was an attempt to control the foreign exchange market resulted in speculative currency trading. According to the World Bank, Sayrafa was an inefficient monetary tool to buy time and BDL's interventions via this platform had only achieved short-lived appreciations in the Sayrafa and the dollar banknote exchange rates at the expense of dwindling foreign reserves and a rapidly depreciating exchange rate. Depleting these reserves to temporarily prop up the lira was costly and quasi-fiscal and negatively affected Lebanon's financial position.

B. Unconstitutional capital controls amid suspect transfers

While a privileged minority was reportedly given the free rein to profit from Sayrafa, most depositors were subjected to informal and unconstitutional capital controls that prevented them from accessing their funds which were precipitously losing their value. These restrictions were also arbitrary. There were rumors that some big depositors, politicians, and bankers carried out substantial financial transfers abroad when the so-called capital controls were put into effect.

4) Failure of the central bank and government

A **The Central Bank (BDL), a key pillar in any financial system, was itself part of the problem—its accounting, liabilities to banks, and quasi-fiscal operations were deeply compromised**

B **There was no credible state-led resolution, which worsened the systemic impact**

A. BDL's unconventional accounting practices

The financial crisis was not just a sudden event that happened in 2019. Its deep roots go back decades in time. It's the result of years of misguided monetary policies, unconventional practices, and even downright wrongdoings. The Central Bank, which is supposed to be the key pillar and regulator of the financial system, was itself part of the problem. Its accounting practices, firm grip on liabilities owed to banks, and quasi-fiscal operations were deeply compromised. BDL engaged in unconventional practices such as lending to the State, the financial engineering operations, and unorthodox accounting policies. Alvarez & Marsal (AM) said in its Preliminary Forensic Audit report released in August 2023 that in order to avoid booking losses, BDL transferred costs from its profit and loss account to its balance sheet. As a result, it was able to show a profit in all years and continued to distribute around $40 million per year to the Ministry of Finance consequently eliminating the need for the Ministry to bail it out. BDL's accounting policy in respect of financial engineering involved giving personal, unscrutinized, discretion to its Governor to determine accounting estimates based on ad hominem judgment.

Hiding losses

The deterioration in BDL's financial position from the increasing costs of financial engineering was unconventionally reported as deferred interest expense and seigniorage. "The BDL's financial position deteriorated rapidly. However, this deterioration was not reported in BDL's balance sheet presented in its annual financial statements, which were prepared using unconventional accounting policies. Those policies allowed BDL to overstate assets, equity and profits while understating liabilities – and to close each year-end in amounts specified by the Governor without explanation for the amounts chosen," AM said in its audit report. Comparing BDL figures between 2015 and 2020, the report shows that the Central Bank moved over the period from a foreign currency surplus of $7.2 billion to a deficit of $50.7 billion. BDL had a negative equity position of $51.3 billion in 2020 after restating its financial statements.

Compromised quasi-fiscal operations

Besides its unconventional accounting practices and 'malpractices', BDL went beyond its basic central bank role as a monetary authority and a regulator of the banking sector and involved itself in quasi-fiscal operations by directly lending to the State instead of focusing on monetary policy and on maintaining monetary stability. The Central Bank adopted this unorthodox policy for 30 years until it was terminated in August 2023. Its loans to the public sector reached $16.5 billion. Most of the banks' lending to the State was in fact channeled through BDL. At the end of 2023, sovereign securities accounted for 70 percent of the banks' total assets. Nearly 90 percent of these securities were in the form of deposits with BDL. The remainder consisted of government securities (Treasury bills and Eurobonds) and other claims on the public sector.

Liabilities to banks

Deposits in foreign currencies of banks with BDL surged to nearly $100 billion in 2018 following the major financial engineering operations carried out since 2016. By the end of December 2023. Their total deposits with BDL represented over 73 percent of their total assets compared to 56 percent in June 2019. BDL did not allow the banks to access these deposits. The IMF said in its Lebanon 2023 Article IV Consultation: "Starting in 2015, BDL undertook complex financial operations to attract inflows by offering unsustainable high interest rates on BDL deposits." This led banks to massively increase their foreign currency exposure to BDL. They offered high interest rates on customer deposits amid low global rates. BDL suffered losses from the incentives it was offering to the banks to encourage them to attract dollar deposits.

B. Suspect inaction

The authorities have practically done nothing to address the crisis which broke out almost six years ago and which was described by the World Bank in 2021 as one of "the top ten, possibly top three, most severe crises episodes globally since the mid-nineteenth century." Parliament didn't pass a capital control law and hasn't yet done so. Other countries that had gone through similar circumstances often ratified such law within days. The government's inaction worsened the systemic risk and many indicators deteriorated further by the end of March 2025 compared to the end of 2023 such as the equity of commercial banks which declined to $4.5 billion and their total assets which fell to $102.7 billion.

5) No orderly resolution or restructuring

Unlike systemic crises elsewhere (Iceland 2008, Cyprus 2013), there was no proper restructuring of banks or sovereign debt, making the crisis persistent and uniquely prolonged

Capital control laws were passed within days at the onset of the crisis in other countries that went through a similar predicament since such decisions don't require too much study and debates. Cyprus, for instance, imposed severe capital controls at the onset of its banking crisis in 2013 and lifted them in 2015. Likewise, Iceland implemented capital controls during the 2008 global financial after the collapse of its biggest banks. Later on, it lifted these controls when it achieved economic recovery. The Lebanese authorities have not yet addressed the issue of debt restructuring more than five years after the default on the Eurobonds. Moreover, it was just in April 2025 that the Cabinet approved a draft of the bank restructuring law which still needs to be ratified by Parliament. Such delays and apathy in the midst of the worst systemic crisis in the country's history are inexplicable. Was this inaction the result of a lack of political consensus and State failure or was it premeditated and intentional? The title given by the World Bank to its Lebanon Economic Monitor for the fall of 2020 was 'The Deliberate Depression'.