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Monetary Policy in Lebanon: Structural Challenges, Central Bank Interventions, and Economic Implications

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Abstract

This study examines the trajectory of monetary policy in Lebanon over the past three decades, highlighting its role in maintaining financial stability amidst recurrent political and security shocks. Further, the study examines the relationship between monetary policy, fiscal imbalances, and the banking sector's behavior in Lebanon, highlighting the structural weaknesses that have undermined the country's long-term sustainability. The study also highlights the BDL's unconventional monetary tools, such as financial engineering operations, subsidized loans, and foreign reserves, which temporarily alleviated liquidity pressures and supported economic activity, but also deepened systemic vulnerabilities. Further, the study proposes a comprehensive economic reform agenda that aligns monetary and fiscal policies, reduces short-term capital inflows, and strengthens institutional governance for sustainable growth.

Keywords: Monetary policy, Lebanon, Banque du Liban, financial engineering, dollarization, economic reform.

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السياسة النقدية في لبنان: التحديات الهيكلية، تدخلات المصرف المركزي، والآثار الاقتصادية

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المُلخّص

تتناول هذه الدّراسة مسار السّياسة النقديّة اللبنانيّة على مدار العقود الثلاثة الماضية، مع التركيز على دورها في تحقيق الإستقرار الماليّ في مواجهة الأزمات السياسيّة والأمنيّة المتكرّرة. وعلى الرّغم من نجاح مصرف لبنان في تثبيت سعر الصرف والسّيطرة على التضخم لفترات طويلة، إلاّ أنّ العيوب الهيكليّة في الإقتصاد اللبنانيّ، قد قوّضت تحقيق نمو مستدام على المدى الطويل. لذا، تتطرّق الدّراسة إلى العلاقة بين السّياسة النقديّة والاختلالات الماليّة وسلوك القطاع المصرفيّ في لبنان، مستندةً إلى تحليل دقيق للمؤشرات الكليّة، والوثائق السياساتيّة، والبيانات الماليّة. كذلك، تركّز على الأدوات النقديّة غير التقليديّة التي اتبعها مصرف لبنان، بما في ذلك الهندسة الماليّة، والقروض المدعومة، والتدخلات التي تعمل على دعم احتياطيّات النّقد الأجنبيّ. وعليه، تخلص النّتائج إلى أنّ هذه الإجراءات، رغم فعاليّتها المؤقتة في تخفيف أزمات السّيولة وتحفيز النشاط الاقتصاديّ، قد فاقمت في الواقع من العيوب الهيكليّة. كما ساهمت في زيادة الانكشاف على الدّين العام، وتعزيز "الدّولرة"، وأتاحت المجال أمام ممارسات الريع. وعلى هذا الأساس، تختتم الدّراسة بتوصيّات يبنى عليها أجندة إصلاح إقتصاديّ شامل تهدف إلى إستعادة الثّقة وتحقيق نمو إقتصاديّ مستدام.

الكلمات المفتاحيّة: السّياسة النقديّة، لبنان، بنك لبنان، الهندسة الماليّة، الدّولرة، الإصلاح الإقتصاديّ.

Introduction

Monetary policy represents a central pillar of macroeconomic management, complementing fiscal and structural policies in achieving economic stability and sustainable growth. In Lebanon, the Banque du Liban (BDL) has been the primary institution responsible for safeguarding monetary and financial stability, a role it has maintained despite decades of political instability, regional conflicts, and repeated economic shocks. For nearly thirty years, the BDL, under the leadership of Governor Riad Salameh, upheld a fixed exchange rate regime, preserved relatively low inflation, and maintained confidence among both domestic and international observers.

However, beneath this apparent stability, Lebanon's economic structure has been characterized by deep-seated vulnerabilities. The country's growth model has been dominated by low-productivity services, excessive reliance on remittances and capital inflows, a rentier-oriented real estate sector, and persistent fiscal deficits. Structural constraints, such as poor infrastructure, weak governance, and limited competitiveness, have hindered inclusive growth and job creation, leaving the economy susceptible to external shocks.

From 2011 onwards, the combined impact of regional turmoil—most notably the Syrian conflict—political deadlock, and the absence of structural reforms exacerbated macroeconomic imbalances. In response, the BDL implemented a series of unconventional monetary interventions, including financial engineering operations and subsidized lending schemes, to sustain foreign currency reserves and stimulate economic activity. While these measures temporarily alleviated liquidity pressures, they also entrenched systemic risks, particularly in the form of rising public debt, high dollarization rates, and an increasingly fragile banking sector.

This paper investigates the evolution of Lebanon's monetary policy, the rationale and outcomes of the BDL's interventions, and the broader macroeconomic implications. It aims to provide an analytical framework for understanding the limitations of monetary policy in a structurally imbalanced economy and offers policy recommendations for restoring stability and fostering sustainable growth.

Literature Review

The literature on Lebanon's monetary policy reveals a persistent tension between short-term stabilization measures and long-term structural challenges. Several scholars emphasize the BDL's historical success in maintaining exchange rate stability as a cornerstone of economic confidence. Labaki (2003) and Ajili (2013) note that the fixed peg of the Lebanese pound to the US dollar at 1,507.5 since 1997 provided a nominal anchor that mitigated inflationary pressures and attracted capital inflows, particularly from the Lebanese diaspora. This stability was further reinforced by strict banking regulations, high reserve requirements, and restrictions on exposure to risky financial assets, which shielded Lebanon's banking sector from global crises, including the 2008 financial meltdown.

However, other studies highlight the limitations and risks of this policy framework. Verne (2016) and Corm (2019) argue that the exchange rate peg masked underlying macroeconomic vulnerabilities, including a chronic current account deficit, low productivity, and a heavily dollarized economy. These structural weaknesses were compounded by Lebanon's dependence on volatile capital inflows to finance both fiscal and external deficits. The literature also underscores the growing role of unconventional monetary tools in Lebanon's policy mix. Moubayed (2020) describes the BDL's financial engineering operations as a form of quantitative easing adapted to a highly dollarized and fragile economy. While these operations succeeded in temporarily boosting foreign reserves and sustaining banking sector liquidity, they also entrenched a cycle of debt accumulation and rent-seeking behavior, particularly through the channeling of subsidized loans to politically connected actors (Gemayel, 2020).

Furthermore, comparative perspectives with other emerging markets, as discussed by Vloeberghs (2016) and Salloum (2019), suggest that Lebanon's exposure to global financial conditions has increased since 2016, as foreign investors began to hold a larger share of its sovereign debt. This integration heightened the economy's vulnerability to shifts in global interest rates and investor sentiment, reducing the effectiveness of domestic monetary tools in shielding the economy from external shocks.

Overall, the literature points to a dual narrative: while monetary policy in Lebanon has been effective in crisis containment and exchange rate stabilization, its structural context—characterized by fiscal dominance, weak governance, and reliance on short-term capital inflows—has constrained its capacity to deliver sustainable economic growth.

Methodology

This study adopts a descriptive and analytical research design to examine the evolution and implications of Lebanon's monetary policy. The analysis draws primarily on secondary data, including official reports from the Banque du Liban (BDL), publications from the World Bank and the International Monetary Fund (IMF), and scholarly works on Lebanon's macroeconomic structure and monetary interventions.

In this context, the methodology follows three key steps:

A- Data Collection – Relevant macroeconomic indicators were compiled from central bank statistics, Ministry of Finance reports, and international financial databases. These include GDP growth rates, fiscal and current account balances, debt-to-GDP ratios, inflation rates, and foreign reserve levels. The study also incorporates data from the provided doctoral thesis chapter, which offers historical context and detailed descriptions of policy measures.

B- Thematic Analysis – The collected data and literature were organized into thematic categories, including:

1. Exchange rate stability and its implications.
2. Structural weaknesses of the Lebanese economy.
3. The role of the banking sector in monetary transmission.
4. Unconventional monetary interventions (financial engineering, subsidized loans).
5. Risks and long-term sustainability.

C- Comparative Assessment – Where relevant, Lebanon's experience is compared with similar emerging markets that rely heavily on capital inflows to finance external deficits. This comparison helps contextualize the effectiveness and limitations of Lebanon's monetary tools under global financial volatility.

By combining quantitative indicators with qualitative policy analysis, this methodology enables a comprehensive assessment of how monetary policy has interacted with fiscal imbalances, structural economic constraints, and external shocks. The approach is particularly suited to economies like Lebanon's, where institutional weaknesses and political instability influence the effectiveness of monetary interventions.

Results

The analysis of Lebanon's monetary policy trajectory reveals several key findings:

1. Economic Growth and Structural Weaknesses

Between 1993 and 2010, Lebanon's real GDP grew at an average annual rate of 6.5%, despite recurrent political and security shocks. However, growth decelerated sharply after 2011, averaging only 1–2% annually, reflecting the combined effects of the Syrian conflict, political paralysis, and the absence of structural reforms. The economy remained dominated by low-productivity services—accounting for over 70% of GDP—while industry and agriculture contributed less than 20%. This economic composition limited job creation, with most employment concentrated in low-skilled activities.

Year	Services (%)	Industry (%)	Agriculture (%)
2004.0	70.5	15.0	14.5
2008.0	71.2	14.5	14.3
2012.0	72.0	14.0	14.0
2016.0	73.5	13.0	13.5

Table 1: Sectoral Composition of GDP, 2004–2016

2. Persistent Fiscal Imbalances

Post-war public finances have been structurally weak. Between 2001 and 2010, the fiscal deficit averaged 11.7% of GDP, while public debt peaked at 180% of GDP in 2006. Temporary improvements in the debt ratio during 2006–2010 were reversed after 2011, with public debt reaching 148.5% of GDP by 2017. Rigid expenditures—particularly salaries, pensions, debt servicing, and transfers to the state electricity company (EDL)—consumed 76% of the budget, limiting fiscal space for investment.

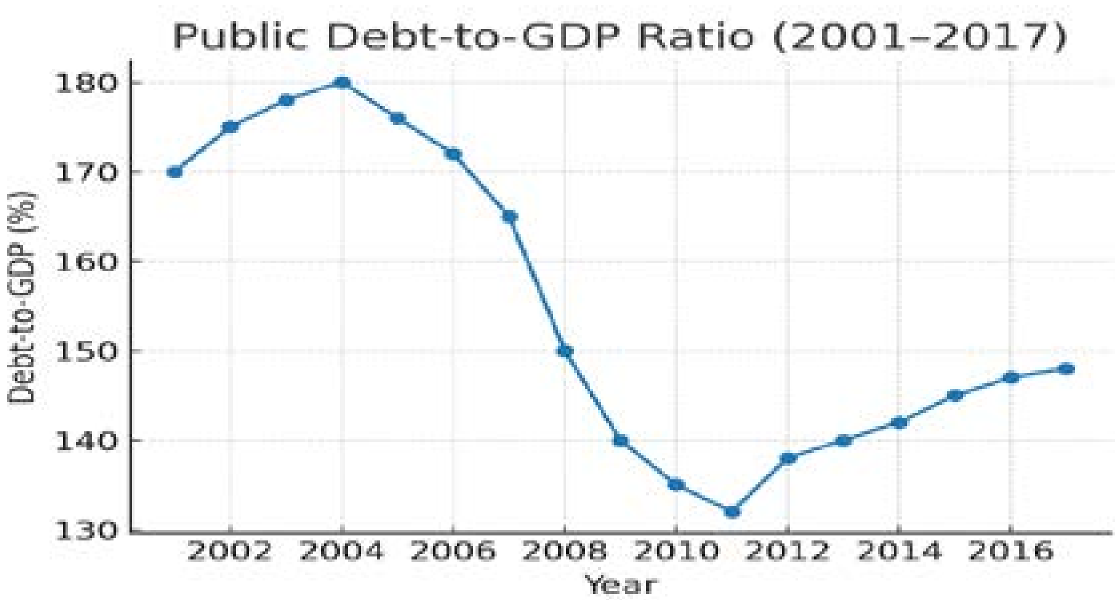

Figure 1: Public Debt-to-GDP Ratio, 2001–2017)

3. External Sector Vulnerabilities

The trade deficit, already large in the post-civil war period, had widened further after 2011. Merchandise exports fell from 78% of GDP in 2008 to 36% in 2017, partly due to the closure of Syrian transit routes. Service exports also declined, driven by contractions in tourism and financial services. Consequently, the current account deficit averaged over 20% of GDP from 2011to 2017, necessitating substantial capital inflows to finance the nation’s external imbalances.

Year	Current Account (% GDP)	Trade Deficit (% GDP)
2002.0	-15.2	-25.0
2006.0	-18.5	-27.5
2010.0	-21.0	-29.0
2014.0	-20.3	-28.0
2017.0	-21.5	-30.5

Table 2: Current Account Balance and Trade Deficit, 2002–2017

4. Dominance of the Banking Sector

Lebanon's financial system is heavily bank-centric, with commercial banks accounting for 97% of total financial assets in 2015. By 2018, the sector's balance sheet had swelled to \$234 billion—more than four times the country's GDP—primarily supported by deposits from both local and foreign clients. Additionally, the high level of dollarization has been a persistent feature, with foreign currency deposits exceeding 60% since 2000. Further, the main focus of bank investment was on sovereign assets, including treasury bills, Eurobonds, and BDL instruments, which highlighted a limited allocation of credit to the private sector.

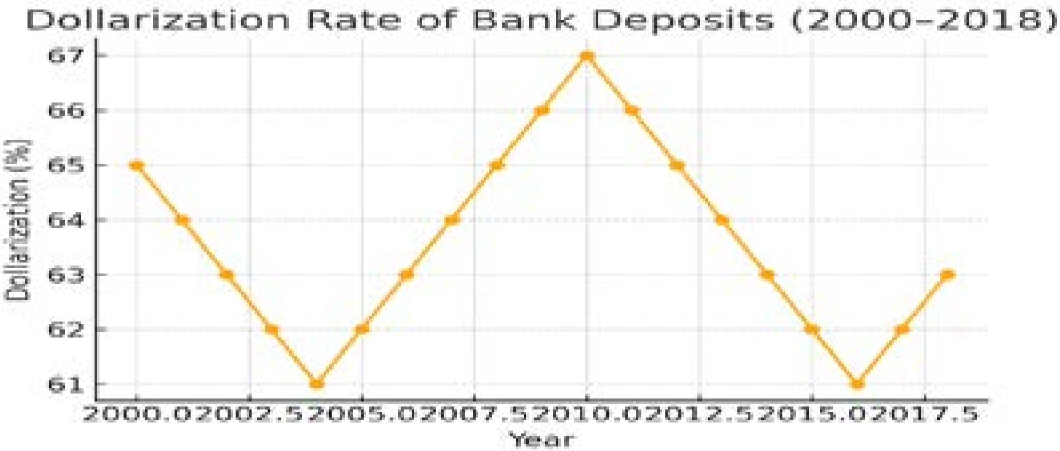

Figure 2: Dollarization Rate of Bank Deposits, 2000–2018

5. Unconventional Monetary Interventions

Facing declining deposit growth and external reserve pressures after 2011, the BDL launched a series of large-scale financial engineering operations starting in 2016. These swaps aimed to attract foreign currency, bolster reserves, and strengthen banks' capital buffers. While effective in the short term, they carried high fiscal and financial costs, deepening the BDL's exposure to public debt and increasing systemic risk.

Additionally, **subsidized lending programs** targeted housing, SMEs, and specific sectors. However, evidence indicates that these loans were often captured by politically connected actors, with 39 clients receiving 65% of total subsidized loans—undermining the intended developmental impact.

Beneficiary Group	Share of Total Loans (%)
Top 39 clients	65
Other clients	35

Table 3: Distribution of Subsidized Loans by Beneficiary, 2009–2018

6. Emerging Market Exposure and Dollarization Trends

Since 2016, foreign investors have increased their holdings of Lebanese Eurobonds, rising from less than 20% to nearly 45% of the total portfolio by 2018. This integration heightened Lebanon's exposure to global interest rate changes and capital flow volatility. Simultaneously, partial dollarization of essential goods—such as fuel and pharmaceuticals—signaled a weakening of the national currency's role, fueling inflationary pressures and eroding household purchasing power.

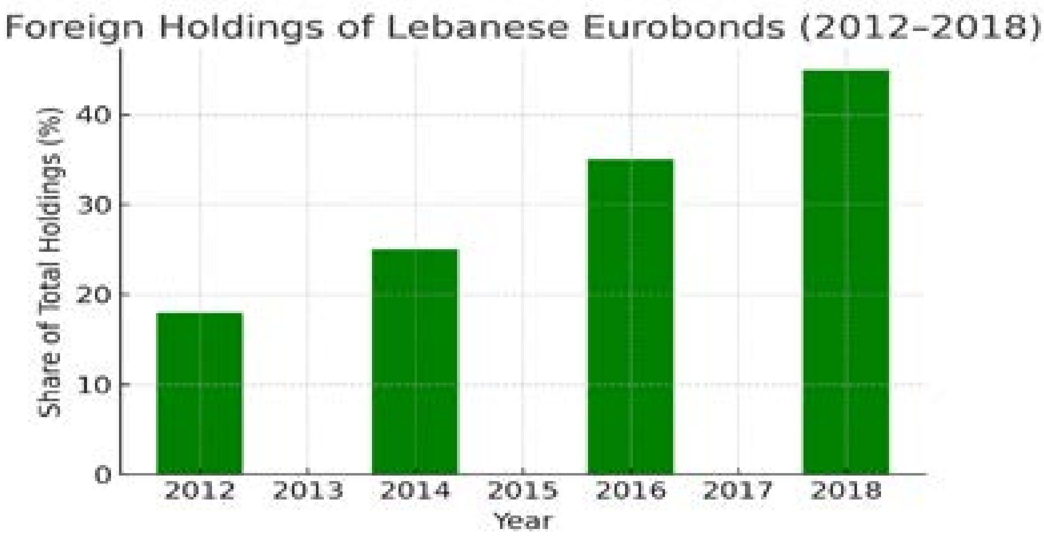

Figure 3: Foreign Holdings of Lebanese Eurobonds, 2012–2018

Discussion

The results highlight a monetary policy framework that achieved nominal stability but failed to address the structural weaknesses of Lebanon's economy. The BDL's longstanding commitment to a fixed exchange rate anchored inflation expectations and attracted capital inflows, especially from the Lebanese diaspora. However, this stability was maintained at the cost of deepening dependency on short-term foreign currency inflows to finance persistent fiscal and external deficits.

1. Fiscal Dominance and Policy Constraints

The interplay between fiscal policy and monetary policy in Lebanon reflects a condition of **fiscal dominance**, where the central bank's actions are primarily geared toward accommodating the government's financing needs. The high proportion of public debt held by domestic banks and the BDL itself limited monetary policy autonomy, as any significant shift in interest rates or exchange rate policy risked destabilizing the fiscal position. This dynamic entrenched the BDL's role as a financier of last resort for the state, crowding out private sector credit and perpetuating a rentier-oriented growth model.

2. Unconventional Tools: Short-Term Relief, Long-Term Risk

The adoption of unconventional measures—particularly financial engineering operations—provided short-term liquidity and preserved foreign reserves. However, these interventions also inflated the BDL's balance sheet with risky sovereign assets, increased dollar liabilities, and heightened systemic risk. Subsidized lending programs, although intended to stimulate productive sectors, were often misallocated, benefiting politically connected entities rather than fostering broad-based economic development.

3. Banking Sector Concentration and Vulnerability

The Lebanese banking system's dominance in financial intermediation, combined with its exposure to sovereign debt, created a tightly interlinked state-bank-central bank nexus. While this structure facilitated the smooth financing of deficits in the short run, it also meant that any fiscal or external shock could rapidly transmit to the banking sector, undermining depositor confidence. The high and persistent dollarization rate further constrained the BDL's capacity to conduct independent monetary policy.

4. Integration with Global Financial Markets

Since 2016, Lebanon's increasing reliance on foreign investors for sovereign debt financing has exposed the economy to external financial shocks. As seen in other emerging markets, this integration magnifies vulnerability to global interest rate hikes, capital outflows, and shifts in investor sentiment. Unlike more diversified economies, Lebanon's narrow export base and weak trade agreements limit its ability to adjust through export growth, making monetary policy adjustments less effective in restoring stability.

5. Erosion of the National Currency's Role

The partial dollarization of essential goods—such as fuel, diesel, and pharmaceuticals—reflects both market adaptation to currency depreciation and the weakening of the central bank's role in preserving the Lebanese pound's value. This shift exacerbates inflationary pressures, erodes purchasing power, and signals a potential move toward full dollarization, which would further constrain policy flexibility.

In sum, Lebanon's monetary policy has been reactive rather than transformative—focused on crisis management rather than long-term structural adjustment. Without complementary fiscal reforms, institutional strengthening, and economic diversification, the BDL's capacity to sustain stability will remain limited, and the risk of recurrent crises will persist.

Conclusion and Recommendations

Conclusion

Lebanon's monetary policy over the past three decades has been marked by a paradox: it successfully preserved nominal stability, particularly through the fixed exchange rate regime, while the underlying economic structure remained fragile and highly vulnerable to shocks. The Banque du Liban's interventions—both conventional and unconventional—temporarily sustained foreign reserves, supported the banking sector, and maintained investor confidence. However, maintaining this stability came at the expense of intensifying reliance on short-term foreign currency inflows to fund ongoing fiscal and external deficits**.**

The post-2011 period revealed the limits of this policy framework. Regional instability, political paralysis, and the absence of structural reforms amplified fiscal and external imbalances, while financial engineering operations and subsidized lending schemes provided only temporary relief at high long-term costs. The resulting state-bank-central bank nexus created a systemic vulnerability, whereby shocks in one sector could rapidly spill over into the others.

Recommendations

1. **Align Monetary and Fiscal Policies**: Establish a coordinated macroeconomic framework that integrates fiscal discipline with monetary stability. Reducing fiscal deficits through targeted spending reforms and revenue mobilization would alleviate the BDL's financing burden.

2. **Gradual Exchange Rate Flexibility:** Introduce a managed float or crawling peg to allow for gradual currency adjustment, reducing pressure on foreign reserves and improving competitiveness without triggering a full-scale currency crisis.

3. **Strengthen Financial Sector Governance**: Diversify bank assets away from excessive sovereign exposure, enforce stricter lending standards, and enhance regulatory oversight to reduce systemic risk.

4. **Refocus Subsidized Lending**: Target subsidized credit toward genuinely productive sectors such as manufacturing, agriculture, and technology, with transparent eligibility criteria and regular performance monitoring.

5. **Promote Economic Diversification**: Invest in infrastructure, trade facilitation, and innovation to expand the export base, reduce reliance on volatile capital inflows, and create sustainable employment opportunities.

6. **Enhance Institutional Independence**: Strengthen the BDL's operational and financial independence from political influence, while ensuring accountability and transparency in policy implementation.

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