CARROTS AND STICKS:
HOW SANCTIONS AND PRINCIPLED AID CAN BRING LEBANON'S POLITICIANS TO THE TABLE

SANCTIONS AND PRINCIPLED AID CAN PULL LEBANON BACK FROM THE ABYSS – BUT ONLY BY TARGETING THE BANKING SECTOR AND CAREFULLY MONITORING THE STATE'S ROLE IN AID DISTRIBUTION.

ALEXANDER RAY

As the anniversary of last year's Beirut blast approaches, the Lebanese people are facing yet more of the same political unaccountability and criminal negligence. The country's socio-economic decline is verging towards state failure, with virtually no response from political elites. The latest Prime Minister Designate, Najib Mikati, is more old than new. Charged with embezzlement of public funds, Mikati has twice served as prime minister and is one of the country's wealthiest businessmen.

Wary of preventing another failed state and migration crisis in the Eastern Mediterranean, the European Union has launched a sanctions framework which lays out criteria to target Lebanese politicians.[1] The proposed sanctions will target individual politicians central to the entrenched ruling class by imposing travel bans and freezes on their European assets — and the US may well follow suit.

Both sanctions and aid are designed to shift the trajectory of Lebanon's record-making economic catastrophe.[2] To date, the Lebanese Lira has lost nearly 90% of its value, while the Lebanese people face soaring poverty, civil unrest, and shortages of basic items like medicine and fuel. Again, there is talk of more aid conferences to "respond to the needs of the Lebanese, whose situation is deteriorating every day," according to French foreign ministry.[3] Humanitarian aid is likely to become more and more critical for the Lebanese and the one-million odd Syrian refugees in the country, regardless of the effectiveness of sanctions.

Yet individual sanctions on politicians, levelled for obstructing reforms and/or obstructing government formation, miss the core of Lebanese political and economic power—the banking sector. Since October 2019, Lebanon's politically connected banking sector has violated Lebanese and international law by imposing illegal multiple exchange rates, as well as selective, informal capital controls on almost all deposits inside Lebanon. These unlawful acts of Lebanon's bankers provide a clear basis for prosecution and sanctions. Moreover, they also offer an especially sensitive pressure point for political change.

When considering aid delivery, the international community must account for the untrustworthiness of Lebanon's political leaders, who will view aid as a short-term solution for their eroding legitimacy. Donors, UN agencies and humanitarian organisations have largely sidestepped the government in their response to the Syrian refugee crisis and, more recently, the Beirut blast – and they should continue to do so. But responding to Lebanon's economic crisis is not the same as responding to a refugee influx.

While immediate and acute, Lebanon's humanitarian needs stem from systemic, deep rooted and long-standing institutional arrangements. Agencies and donors need to be careful not to replace broken state institutions with yet more parallel bureaucracies. They must also remain wary of the Lebanese government's long track record of trying to manipulate and cajole foreign aid. Wily Lebanese elites have likely learnt lessons from Syria in terms of avoiding sanctions and manipulating aid flows.[4]

Thus, to be effective, the international community must develop firm links between the structure and intended effects of aid and sanctions. It will not be easy to construct these policies in tandem, but it remains the most appropriate course of action available. This "carrot-and-stick" approach stands the best chance of bringing Lebanon's intransigent political and banking class to the table, so that a realistic solution to the economic crisis can finally be agreed.

WILL SANCTIONS WORK FOR LEBANON?

Sanctions have become a common tool for developed nations to achieve foreign policy outcomes from individuals and/or weaker states by limiting their access to financial markets and assets. However, they are often blunt instruments that can harm public access to essential goods, impoverish a nation, empower the black market, and even cost lives—all while the targeted elites avoid sanctions themselves, by using administrative workarounds.[5]

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Lebanon fits most of the criteria for imposing effective targeted sanctions. The Lebanese state is both politically and economically unstable, which reduces the capacity of elites to operate on a "business-as-usual" basis. Lebanon does not wish to become a pariah state, nor can it afford to become one—its economic recovery, for example, is likely to rely heavily on significant amounts of international aid. It helps further that there are no major trade relations that will impact domestic interests in either country, and that Lebanon's elites have significant assets abroad.[6]

The case for imposing sanctions grows stronger when considering the dwindling political capital of Lebanon's ruling class, which could otherwise render sanctions ineffective. In theory, the Lebanese public or civil society could galvanise defensively behind the state against threatened sanctions. As Lebanese political leaders see their popularity nosedive however, this seems unlikely. Indeed, most Lebanese would likely support sanctions grounded in obstructing the democratic process, undermining plans approved by the Lebanese government and international community, and serious misconduct of public funds.[7]

The EU sanctions being mulled—with their modest objective of forming a government capable of passing economic reforms—are only a first step toward political change in Lebanon. Lest they lead to merely another shuffling of cabinet seats, the sanctions must also target the banking sector, which is the true locus of the ruling class' political and economic clout.

POTENTIAL PITFALLS

While sanctions may be suitable for Lebanon, the EU must be wary of unintended political consequences and preventing elites from maintaining functionality through sanctions loopholes. Sanctions imply culpability; in Lebanon's fractious political context, this may influence Lebanon's political balance. The EUs disinclination to ostracise Western "allies" in the broader geopolitical game to counter the influence of Hezbollah and Iran in Lebanon poses a predicament. Western allies arguably bear more responsibility for the economic crisis than Hezbollah, which has less involvement in the banking sector relative to other Lebanese power blocks. At the same time, the EU will be wary of enforcing universal sanctions that allow the strongest groupings—arguably Hezbollah—to gain further relative advantage.

In the context of the 2022 elections, sanctions which label certain individuals as responsible for obstructing government formation and corruption may empower those not sanctioned. There is also fertile ground for political rivals to spin the narratives of blame related to the sanctions and link them to other issues, such as Hezbollah's weapons and/or potential involvement in the August 4th blast.

Finally, targeted persons and entities often circumvent sanctions through shell companies and substitute legal persons whose names are not linked to sanctions.[8] In Lebanon, these avoidance strategies could function through government-linked NGOs or political foundations linked to the ruling elite. Most likely though, private companies will be used as fronts by oligarchs to get around sanctions regimes. Lebanon will most likely see increased co-dependency between ruling elites and the unsanctioned business community, potentially with an increase in black market trading of scarce and essential goods, such as fuel and medicine.

BANKS' CULPABILITY

While the proposed EU sanctions take aim at Lebanon's venal political class, Lebanon's banking sector has been a key accomplice in the country's woes. Most banks—including Lebanon's central bank, Banque Du Liban (BDL)—are politically connected and played major roles in Lebanon's financial collapse. Their actions in managing the fallout also violated the Constitution of Lebanon,[9,10] Lebanon's Code of Money and Credit,[11] the Code of Commerce, and the Law of Obligations and Contracts,[12] not to mention binding international human rights conventions.[13] Yet the Lebanese government has still not held local banks accountable for these misdeeds; nor has the EU specifically identified key banking figures as targets for foreign sanctions beyond their roles in blocking reforms.

At the same time, Lebanese banks are in a unique position to enact a fair, transparent, and accountable solution to the economic crisis—and they must be pushed to do so. The banking sector constitutes a simple and effective target for Western sanctions, matching the typical requirement of effective sanctions having clear targets and objectives. Crucially, the targeted elites stand to lose a great deal from sanctions, increasing the likelihood of them taking positive steps towards financial relief.

Indeed, the banking sector faces more a clear-cut threat of legal action than Lebanese politicians do. The strong legal case for prosecuting banks comes from their original sin of failing to repay money to most Lebanese depositors. After the economic crisis began, BDL and commercial banks imposed arbitrary and illegal exchange rates on withdrawals of foreign currency.[14] At the same time, persons and entities with sufficient connections have been permitted by the same banks to withdraw at least $7 billion in capital.[15]

Due to the commercial banks' illegal and informal haircut on depositors' accounts, between October 2019 and March 2021, banks diluted their liabilities to depositors by $31.4 billion, of which an estimated $13.7 billion were in foreign currency deposits paid out at illegal exchange rates.[16,17] For its part, BDL has issued several

> ***"After the economic crisis began, BDL and commercial banks imposed arbitrary and illegal exchange rates on withdrawals of foreign currency. At the same time, persons and entities with sufficient connections have been permitted by the same banks to withdraw at least $7 billion in capital."***

circulars that contravene the Constitution and the Code of Obligations and Contracts.[18] By contrast, Lebanese politicians face comparatively loose charges related to obstructing political processes and initiatives.

At the same time, sanctioning Lebanon's banks does not let off the political class. The banking sector has close financial ties with Lebanon's political elites, who have benefited together from Lebanon's mismanagement. In 2016, an Economic Research Forum study found that individuals closely linked to political elites controlled 43% of assets in Lebanon's commercial banking sector and that 18 out of 20 banks have major shareholders linked to political elites. The research also showed that eight families controlled 29% of the banking sector's assets, together worth more than US$7.3 billion in equity in 2016.[19] The family of Saad Hariri featured at the top of this list, with over US$2.5 billion in equity. Fellow billionaire and now PM-designate Najib Mikati, has close ties to Bank Audi (Lebanon's largest bank by assets) while his brother and business associate Taha Mikati owns a significant stake in Bank Audi through an investment company, Investment & Business Holding.[20] It is little wonder that, only a few years ago, 15 out of 20 chairmen at major banks were linked to politicians; six banks employed public officials on their board of management; and almost all boards included former government officials or parliamentarians.[21]

If influential and politically connected bank shareholders also fear impending sanctions, then the impetus to negotiate a fairer share of the financial losses can be increased. Such sanctions would be even more effective if the US and its mighty greenback followed suit. Already the US Department of Treasury has brought down two Lebanese banks with one move to forbid US correspondent banks to deal with these entities. Thus, the ripple effects of a targeted US sanctions regime on key Lebanese bankers cannot be understated. Moreover, in Lebanon's case, sanctioning banks and their shareholders will not damage the population any more than is already being done by the banks' current limits on withdrawals, exchange rate manipulation, and refusal to re-distribute losses equitably.[22]

AID CHANNELLING

The delivery of humanitarian aid will be an important complementary measure to sanctions, given the increasingly desperate needs of Lebanese and refugee populations. Over 75% of Lebanese households are now going short of food[23] due to increasing poverty, necessitating an international aid package to provide basic social protections for most of the population. As a "carrot" alongside the "stick" of sanctions, the promise of aid will incentivise the political class to stave off a complete collapse in access to basic goods and services.

The prospect of aid, however, also raises the spectre of manipulation. France's proposed donor conference must consider lessons from both Lebanon and Syria in how aid can be captured and manipulated to support ruling elites, even under sanctions. Encouragingly, aid donors and humanitarian agencies have long heeded calls for funding not to flow to or through the government, deeming the public sector an unfit partner for Lebanon's reform and reconstruction.[24] While a morally superior choice, circumventing the government risks hollowing out the state and entrenching parallel civil society bureaucracies.[25] Lebanon's socio-economic woes are now so widespread that excluding the state apparatus and relying solely on civil society may not be feasible. A balance must be struck that avoids making Lebanon more dependent on aid and stop-gap bureaucracies—specifically in social protection.

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BDL has proven itself to be a wholly untrustworthy actor but, unfortunately, will need to be engaged in the aid delivery in the management of large-scale cash and funding inflows. BDL, which has already having been caught running a 'shadow financial plan'[26] and refusing to facilitate an IMF-mandated audit, has tried to impose a 'humanitarian exchange rate' on an emergency World Bank loan. Taking a page out of the Central Bank of Syria's playbook, in early 2021 BDL sought to take advantage of a $246 million World Bank loan for emergency cash to Lebanon's poorest. It decided to disburse the US dollar loan at an arbitrary 'humanitarian exchange rate,' which was 30 percent lower than the market rate at the time.[27] This strategy would have allowed the World Bank funds to prop up critical US dollar reserves, which BDL is responsible for having mishandled in the lead-up to Lebanon's financial crisis. Correctly, the World Bank, the EU, and the UN took a principled stand not to accept the supposed humanitarian rate.[28]

The international community must also remain vigilant of the very real potential for the state to undermine effective aid delivery. The Lebanese government has previously interfered with international humanitarian actors' presence and operations in the country over the Syrian refugee crisis, by denying visas and permits as leverage in disagreements with international humanitarian standards and policies.[29] Donors and the governments behind them need to be alert to tactics of 'skimming' from multiple exchange rates which allows the government to abrogate and delay taking responsibility for its failures. Failure to do so will enrich currency traders, shell companies, and black-market intermediaries—likely in collaboration with the political elites' patronage systems.

This context means aid and development agencies will likely have to work with the government on a strong and well-developed basis of 'principled aid.' The concept of principled aid has been refined through the experiences of delivering support to countries with unsavoury regimes.

Principled aid requires that international humanitarian organisations work together under detailed operational guidelines to streamline conditionalities, bolster compliance monitoring, reduce government interference and improve their operational independence. Such an approach will require protecting donors' right to choose local partners and developing more rigorous and transparent procurement assessments. For procurement, donors should use shareholder investigations to ensure that the ultimate beneficiaries of aid and agency contracts (in much needed foreign currency) are not linked to sanctioned individuals.[30]

LOOKIND AHEAD TO MAY 2022

The timeframe of EU sanctions is important, in that the sanctions can leverage political trends within Lebanon. Lebanon's economic collapse, and the attendant decline in basic goods and services, has whittled away economic bonds of patronage that have secured support for establishment politicians. The delinking of patronage opens up political space for independent opposition groups to compete more effectively against entrenched political elites. Lebanon's emerging opposition groups still face major structural impediments; these obstacles include limited funding, a lack of media coverage, little long-term campaign experience, and unfair electoral laws.[31,32,33]

The sanctions framework, which could well be implemented from late 2021 onwards, may incentivise Lebanese elites to obstruct progress before elections—or even postpone the polls altogether—if they think the election result may weaken their grip on power.

In the event of elections going ahead, establishment political parties will likely still mobilise their private wealth to attempt to buy as many votes as possible from a desperate and impoverished population. Given such spending is rarely tracked and occurs through informal networks, extra attention will have to be given to how sanctions can prevent ruling elites from exercising their financial might in vote buying and unregulated election campaigning to stay in power. The May 2022 elections thus provide an important milestone and conditionality by which ongoing aid and sanctions decisions can be made.

RECOMMENDATIONS

To bring Lebanon's powerbrokers to the table and chart a course for Lebanon away from total state collapse, Western sanctions must target individuals in the banking sector with the financial power capable of creating real change, and those who are responsible for the damage done to everyday Lebanese' livelihoods. The main objective should be to bring Lebanese bankers towards an equitable, transparent, and accountable economic recovery plan, while also making sure that independently monitored elections are held as planned in May 2022.

Respectively, the 'carrots' and 'sticks' of aid and sanctions should learn from recent experiences in Syria. They should be as precise, traceable, and measurable as possible to chart a path out Lebanon's economic and political quagmire. That means that aid and sanctions need to follow a strict timeline; close administrative loopholes; and provide incentives for cooperation from targeted individuals.

TIMEFRAME

- Sanctions and aid must be tied to more than a new government's formation. Additional conditions should include:

- creating clear timetables for auditing the BDL and agreeing an economic recovery plan;

- resuming and continuing formal negotiations for an IMF financial relief package; and

- reforming the electoral law and holding elections in May 2022, as planned, subject to international monitoring.

SANCTIONS

- Other nations, particularly the US, should join the EU in imposing a wider sanctions framework which targets individuals in the banking sector, while keeping the option open for a sector-wide sanctions regime.

- The sanctions framework should expand to target individuals in BDL and commercial banks' governance and shareholding structures, based on charges of having breached Lebanese and international laws of financial misconduct. Impugned individuals should include:

- persons and/or entities who have significant shares, equity interests in, and/or management control of, commercial banks in Lebanon regulated by the BDL; and

- BDL officials who have management control over the BDL's Central Council or bodies which fall under the oversight of the Governor of the Central Bank and Vice Governors.[6]

AID

- Sanctions on the banking sector should allow waivers for specific transactions such as salaries, purchase of materials (by non-sanctioned entities), and pre-identified humanitarian cash transfers.

- A cooperative balance in aid delivery mechanisms must exist between state and civil society bureaucracies.

- Aid should be distributed in the currency it is provided, a core component of principled aid.

- Rigorous and independent procurement processes should be established, which are capable of conducting individual shareholder investigations.

- Humanitarian aid organisations should retain organizational independence by preventing government imposition of local staff and local partner organisations.

- Humanitarian and aid organisation staff should be guaranteed full access for field visits, needs assessment, operations, and independent monitoring and evaluation.

- Aid delivery projects should include an independent verification mechanism for security access approvals.

ENDNOTES

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