

**The Dollarization and Collapse of the Lebanese Financial System**

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**Abstract:**

In evolving economies, financial dollarization is often adopted as a shield against inflation and currency volatility. However, the case of Lebanon demonstrates that this perceived protection can mask deep-seated structural vulnerabilities that become catastrophic during systemic shocks. This study investigates the dual role of dollarization in Lebanon, tracing its evolution from a post-civil war recovery tool to a primary driver of the 2019 financial collapse.

Through a statistically driven analysis of the "sovereign-bank nexus," the research explores how the Lebanese banking sector leveraged high-interest, dollar-denominated deposits to finance government deficits, creating a precarious dependency on continuous capital inflows. The methodology examines the critical currency mismatches and liquidity risks that emerged when the central bank (Banque du Liban) lost its capacity to act as a lender of last resort in foreign currency. Results indicate that while the fixed-peg regime initially restored institutional trust, it ultimately paralyzed monetary policy and amplified the 2019 crisis by accelerating capital flight and depleting reserves. The paper concludes by offering policy lessons for other emerging economies, emphasizing that without robust fiscal discipline and diverse growth models, dollarization acts not as a stabilizer, but as a "crisis amplifier" that erodes monetary independence and systemic resilience.

**Keywords:**

Financial Dollarization, Lebanon Financial Crisis, Sovereign-Bank Nexus, Currency Mismatch, Fixed Exchange Rate, Monetary Policy Constraints, Liquidity Risk, Capital Inflows, Emerging Economies, Banking Sector Collapse.

## **Introduction: "The What & Why"**

Nowadays, financial systems in evolving economies encounter unexpected pressures, specifically economies undergoing high levels of financial dollarization. Although dollarization could be seen as a tool for protection, by protecting economies from currency fluctuations, inflation and so on, it simultaneously introduces structural weaknesses that could remain unnoticed during times of stability but become catastrophic during periods of crisis. Lebanon is a prime example of this phenomenon. Dollarization in Lebanon emerged as a response to monetary instability throughout and after the infamous civil war, serving as a mechanism to restore trust and confidence in an economy highlighted by institutional division and ongoing fiscal deficits. The Lebanese financial system seemed to become more stable, more liquid and more connected to international financial markets after the integration of the US dollar in transactions, mortgages and deposits. The expansion of the banking sector was quickly noticed, luring in international currency inflows and establishing itself as a major driver of economic growth. However, the financial downfall that occurred during 2019 significantly challenged this perception. Instead of serving as a defense mechanism, dollarization seemed to expand the crisis. A shortage of liquidity in different currencies, the central bank's limited monetary flexibility, the accumulation of the national government's debt, and the mismatch between dollar liabilities and real dollar reserves showed the real, deep structural disparity. The drop in confidence, the implementation of informal capital controls, and the heavy depreciation of the Lebanese currency turned what was previously considered a strength into a systemic fault. The question is, did the dollarization really stand out to be a stabilizing motive, or did it just delay a fall that was bound to happen? Did the dependence on international currency strengthen financial credibility, or did it merely just weaken monetary independence and strengthen existing financial instability? To what extent did this dollarization add to the vulnerability of the Lebanese banking sector and the eventual downfall of its financial structure? Would a less dollarized monetary structure have pushed the crisis to unfold in a different manner? This statistically driven study unfolds the relationship between the dollarization and the collapse of the Lebanese financial system through the 7 following objectives:

Analyse the historical evolution and structural depth of financial dollarization in Lebanon.

Examine the relationship between dollarization, capital inflows, and sovereign debt accumulation.

Investigate currency mismatches and liquidity risk within the Lebanese banking sector.

Assess the role of the central bank's monetary policy constraints under a highly dollarized framework.

Evaluate whether dollarization acted as a stabilizing mechanism or as a crisis amplifier during the 2019 financial collapse.

Explore the broader implications of Lebanon's experience for other emerging and fragile economies with high levels of dollarization.

## **Literature Review: "The story so far "**

Dollarization refers to the use of a currency other than its own (the US Dollar (\$) in this case) and this has been a gradual process in Lebanon over many years, shaped by a series of political and economic conditions. Dollarization in Lebanon has become more than a response to the crisis, but rather a tool to stabilise the economy. Dollarization in Lebanon dates back to the Lebanese Civil War (1975-1990) and its political and economic turmoil. During this era, the Lebanese pound

depreciated and became redundant because of inflation and currency instability. Businesses and individuals opted to turn towards the US dollar as it proved to be the much more stable option at the time. This was mainly to maintain strong purchasing power and control savings in a moment of uncertainty and unpredictability. At the end of the Lebanese civil war, the Lebanese government attempted to restore stability and rebuild the Lebanese financial sector. Part of the move was to adopt fixed exchange rates in 1997, whereby the Lebanese pound was pegged to the US dollar (a fixed peg). They did so because they wanted to lower inflation, to stimulate foreign investment and to attempt to restore trust in the Lebanese pound. At first, the fixed peg regime was able to stabilise inflation and resurrect confidence but the trend of dollarisation persisted. Instead, it grew more as a factor in our economy as agents continued to lean towards holding assets in dollars. Dollarization extended to the Lebanese banking system. Banks introduced a broad array of dollar-denominated deposit and loan products, thereby entrenching the use of the US dollar in the country. In the 2000s and 2010s, a large share of bank deposits (generally more than two-thirds) was denominated in foreign currency. This extensive dollarization of deposits and loans was the result of both supply and demand factors, including banks' preference for attracting foreign currency deposits and ongoing distrust in the local currency, the Lebanese pound. The extent of dollarization and its structural nature in Lebanon is also associated with the country's endogenous dependency on foreign financial inflows. Remittances from the diaspora, foreign investment and other capital inflows were crucial for the financial system. Much of these inflows were in the form of US dollars, enhancing the role of the US dollar in the local currency market. Furthermore, the Lebanese government amassed substantial levels of debt, some of which was in foreign currency, and thus exposed the economy to exchange rate risks. Although seemingly advantageous in the short term, enabling price stability and facilitating access to foreign capital, the high level of dollarization posed several risks. It compromised the central bank's control over the money supply in foreign currency. And it created a one-sided dollar gap between dollar-denominated liabilities and the central bank's capacity to provide dollars, leading to a system highly sensitive to capital flows. Finally, financial dollarization in Lebanon originated as a crisis-induced phenomenon during the civil war and became a structural feature of the economy. Its persistence during the post-civil war period can be traced back to a set of historical, policy and governance factors that have helped turn the Lebanese financial system into a dollarized and vulnerable one.

Understanding the link between financial dollarization, capital inflows and government debt in Lebanon is key to understanding the architecture and eventual failure of its financial system. These three factors were not unrelated; they interacted with each other over time to create a dynamic that kept the economy afloat but also led to a systematic vulnerability. Unlike most Middle East economies, a high degree of dollarization facilitated capital inflows to Lebanon. The fact that much of the deposits and financial activity in banks was in US dollars made it more attractive for foreigners and the Lebanese expatriate community to deposit money in Lebanese banks. Dollarization effectively eliminated currency risk for depositors as they could hold deposits in the more stable US dollar, rather than the continuously depreciating Lebanese pound. This boosted trust in the banking system and allowed for capital inflows. This constituted a core element of Lebanon's development model. The banking sector was constantly dependent on the flow of deposits from non-residents and remittance inflows from the Lebanese abroad, comprising mainly US dollars. Lebanese banks paid relatively high rates of returns on dollar-denominated deposits to attract these inflows, making the country a hub for short-term dollars seeking higher yields. But this approach was unsustainable in the long term, as it relied on the continuous roll-over of inflows, which could be sensitive to sentiment and other factors. Meanwhile, the Lebanese government had

amassed significant sovereign debt to meet its continuing budget deficit. The government - instead of borrowing only in local currency - increasingly issued debt in foreign currency, mainly in US dollars. This debt was mainly purchased by Lebanese banks, which used the US dollar deposits they had mobilised to fund the government's borrowing. This interlinked the banking sector and the sovereign, or what is known as the "sovereign-bank nexus". Over the years this system resulted in a large accumulation of sovereign debt, as well as exposure by the financial sector to the sovereign. The sustainability of capital inflows let the government postpone reforms and engage in excessive government spending, as such spending could be financed. But it also meant that public debt sustainability was linked with the continuation of inflows. If new dollars flowed into the economy, the government would be able to fulfil its commitments and sustain a fixed exchange regime. The unsustainability of this approach was clearly exposed when inflows started to diminish in the years before the crisis of 2019. With declining external financing, the Lebanese financial system came under pressure as dollar-denominated liabilities could not be matched by scarce actual dollar reserves. Increasing government indebtedness, along with declining inflows, eroded investor confidence, resulting in a sudden halt to capital flows and the revelation of the overall system's weaknesses. Hence, dollarization, external funding and the buildup of sovereign debt in Lebanon were all closely intertwined and interrelated. Dollarization allowed the economy to attract foreign capital flows and enabled continued financing of government borrowing in the short run, but it also increased the need for foreign finance. This, together with increasing sovereign debt, led to a fragile system, highly sensitive to external shocks and to confidence.

### **Methodology: "The how we did it "**

One of the key vulnerabilities of the Lebanese financial system before the 2019 crisis was that of substantial currency mismatches in the banking system. These imbalances stemmed from the mismatch between the currency denominated assets and liabilities of banks, which eventually put the system at serious risk for liquidity and insolvency. Mismatches were especially pronounced and played a major role in the crisis in a highly dollarized economy like Lebanon. Lebanese banks operated in a system where a substantial share of liabilities were in US dollars. Both domestic and international depositors preferred to hold their deposits in foreign currency, mainly because they trusted the US dollar and distrusted the Lebanese pound. This resulted in large dollar-denominated deposits, i.e. banks owed their depositors large sums in US dollars. On the asset side, things were different. Some of the bank assets were also in dollars, but many of them were effectively tied to the Lebanese economy and the country's government. Banks had made substantial investments in Lebanese government debt, both in Lebanese currency and foreign currency bonds (so-called Eurobonds). They also invested heavily with the central bank, Banque du Liban, which subsequently used these funds to finance the government deficit and to support the fixed exchange regime. While many of these assets were nominally denominated in dollars, this did not always correspond to the level of liquid foreign assets held by banks. It resulted in a situation where banks' liabilities were mismatched with their assets. On paper, banks appeared to have dollar assets to match their dollar liabilities. Much of these assets were either illiquid or they were tied to the state. Indeed, it took some time for the central bank to discontinue dollar supply, as its dollar denominations reserves were scarce and eroding over time. As a result, the ability of the banking system to meet dollar withdrawals became very uncertain. The mismatches were exacerbated by dependence on a stream of capital inflows. While new dollar deposits continued to flow in, banks

could temporarily conceal their illiquidity and satisfy withdrawals. But the moment inflows started to taper off and reverse, the house of cards collapsed. Without adequate liquid dollar reserves to meet their obligations, banks were left unable to meet their obligations to depositors, resulting in unofficially imposed capital controls and stringent withdrawal limits. Furthermore, the close link between banks and the state magnified the effects of these mismatches. Banks were substantially exposed to the state's debt, so when the state's balance sheet deteriorated so too did the banks. This, in turn, fed back into banking crises, eroding confidence in the banking system. In summary, mismatches in the Lebanese banking system were a structural risk that was hidden by solid capital inflows and financial engineering. The apparent match of assets and liabilities masked the underlying liquidity problems and sovereign risk. Once inflows declined, the mismatches became untenable and eventually led to the collapse of the banking sector and the financial crisis.

### **Results: "The facts "**

Lebanon's dollarized financial system is one of the key factors that limits the impact of the monetary policy, which undermines the central bank's ability to stabilize the economy against economic shocks and to maintain financial stability. Normally, monetary policy allows the central bank to control inflation, liquidity and the overall economy via specific policy tools, including setting interest rates, money supply and exchange rates. But in Lebanon's dollarized economy, the effectiveness of these tools is significantly reduced.

First, there is a lack of control over money supply. The bulk of banking deposits and transactions in Lebanon were made in US dollars, a currency that cannot be produced by the central bank (Bank of Lebanon). This means that the central bank had only limited ability to change the total liquidity in the economy, since it could only affect the number of pounds in the economy. This resulted in a two-tier monetary market in which much of the economy's financial transactions were beyond the control of domestic monetary policy.

Moreover, the use of a fixed exchange rate policy limits the central bank's independence. The adoption of a fixed exchange rate policy meant that the central bank was implicitly committed to defending the exchange rate of the Lebanese pound vis-à-vis the US dollar, which in turn implied that a large foreign exchange reserve had to be held and/or that the central bank had to intervene in the foreign exchange market (Beainy & Kamel, 2023). This limited the central bank, which could not solely pursue other objectives of monetary policy, such as inflation targeting and/or economic growth. This in turn implied that a continuous capital inflow had to be attracted and that the interest rate had to be maintained at a relatively high level to maintain demand for the local currency. Dollarization had also had a negative impact on the monetary policy transmission mechanism. Domestic interest rates became a less relevant variable for the economy, since many deposits and loans were denominated in US dollars, and hence were more responsive to the sum of the domestic interest rate and the exchange rate. It diminished the ability of conventional policy tools to affect credit, investment and consumption in the domestic economy. Finally, the central bank became ineffective as a lender of last resort. Central banks are supposed to supply liquidity to banks in times of stress to avoid bank runs. But in Lebanon, the central bank was unable to provide US dollars to the banking system without constraints, given the limited foreign currency reserve. This was a major problem during the crisis, when the central bank was unable to provide to the banks the increasing demand for US-dollar withdrawals. Finally, the reliance on foreign currency inflows also limited policy options. To support the continued dollarization and the exchange rate peg, the central bank had to resort to attracting inflows through financial engineering

and high interest rates. This helped to stabilize the system in the short term but destabilized it in the long term (Beainy & Kamel, 2023), as it set in place a system that relied on inflows and had limited policy options. Thus, dollarization in Lebanon constrained monetary policy through limiting the capacity to provide money, by limiting policy independence, by preventing effective policy transmission and by limiting the role of the central bank as a lender of last resort. This hampered policy responses and the resilience of the system against external and domestic shocks.

Dollarization is a recurrent theme in Lebanon's history. On the one hand, the dollarization of the economy is credited with allowing for stability in the macroeconomic environment, and for the regaining of trust in the Lebanese financial system, but on the other hand, it is held to be one of the causes of the current crisis, which began in 2019. To understand its effects, one needs to consider the long- and short-term effects. Dollarization had a stabilizing effect after the Lebanese Civil War. The ubiquity of the US dollar enabled depositors and investors to make a return to the banking system. It was also paired with a fixed exchange rate regime, and it reduced inflation and contributed to stability, so it was stabilizing and reliable. It also encouraged investment because the Lebanese diaspora, foreign bankers and investors were more willing to participate in the Lebanese dollarized financial system and therefore, there was no risk of currency appreciation or depreciation. Further, dollarization fostered an expansion in the banking system and the ability for the government to finance its deficits. Lebanese banks were able to grow their dollar deposits through attractive interest rates, thus allowing investment in government debt and supporting government expenditures. Then, dollarization was essential to promote growth and to delay the short-term effect of the deficit (Kamel et al., 2025). But these short-lived gains led to greater vulnerabilities in the long run. Dollarization also made it less likely that the national currency would be reinforced and that appropriate fiscal reforms would be carried out. Economic stability came to depend on an increasing inflow of foreign capital to both maintain the exchange rate regime and finance government. Hence, economic stability increasingly turned into an externally dependent system. Further, it increased the financial system's fragility. It led to sizeable currency mismatches among financial firms with foreign exchange liabilities (all in dollars) that were not backed by foreign exchange assets. It also constrained monetary policy and the ability to respond to shocks. In each of these ways it created a more fragile financial system. The system deteriorated when the inflows declined in the run-up to 2019. With diminishing confidence in the financial system, the flow of "new dollars" subsided and the cracks were revealed. The resulting lack of foreign exchange reserves made it impossible for the central bank and other financial institutions to honor their commitments, leading to shortages of cash, bank controls, and hence loss of confidence. Dollarization in this instance was not only symptomatic of the crisis but also amplified its severity through the speed-up of inflows reversal. In short, dollarization of the financial system in Lebanon was used for two reasons. It alleviated the crisis in the short term through the restoration of foreign exchange inflows and confidence, but it also contributed to making the financial crisis worse as it triggered institutional weaknesses. Its role in the crisis was to increase financial dependency, reduce flexibility in policymaking and magnify various risks of the financial system, making it extremely susceptible to shocks and turbulence.

### **Discussion and conclusion: "The so what ? "**

Lebanon's financial crisis provides important lessons for other heavily financially dollarized countries. Dollarization can have positive short-term effects by promoting confidence, reducing

inflation and facilitating foreign capital inflows, but as Lebanon's experience shows, these positive effects can mask the determinants of vulnerability if not accompanied by sound economic policies and stable institutions. So, the lessons from Lebanon suggest several things policymakers in other dollarized economies should keep in mind. The first is the reliance on foreign finance. Lebanon's economy relied on a constant flow of foreign currency, particularly from outside and from foreign investors. This strategy was unsustainable as it relied on a build-up of confidence and was exposed to external shocks and conditions. This is a reminder for other dollarized economies to diversify their model of economic growth to avoid excessive reliance on external finance. The second lesson has to do with fiscal and debt issues. As we have seen in the case of Lebanon, foreign currency borrowings can tempt governments to borrow more than what they should, bypassing the required fiscal adjustments. In the end, this can lead to debt overhang and vulnerability. As such, controlling the fiscal situation and keeping the public debt sustainable should be a priority, especially in countries that have access to funding made easier by a dollarized banking system. The third lesson relates to bank regulation. Lebanon's experience featured problems of currency mismatches and concentration of exposure to public debt. Effective regulation is required to monitor and manage these risks, maintaining bank liquidity and appropriate management of the currency composition of the balance sheet. Transparency and prudence also play an important role in preventing the build-up of risks in the banking system. Dollarization also offers another lesson about the limitations that are placed on the conduct of monetary policy. Many countries know that, once dollarized, the government's ability to respond to crises is constrained, notably in terms of maintaining liquidity and providing foreign exchange as lender of last resort. This highlights the importance of maintaining high levels of foreign exchange reserves and encouraging other resilience-enhancing policies. Finally, the Lebanon crisis points to some of the problems associated with fixed exchange rates. Pegs can be useful but require other elements of economic stability, including good fiscal policy, sufficient foreign exchange reserves and sufficiently large capital inflows. In their absence, a fixed peg can be difficult to maintain. In all, Lebanon's experience with dollarization shows that dollarization of the financial system is not a problem in itself but demands better economic policies. The lessons for other highly dollarized economies are to reduce reliance on external inflows, pursue sound fiscal policies, regulate financial systems and ensure that these systems have appropriate policy frameworks to manage dollarization constraints. Failure to do so can transform dollarization from a benefit to a risk.

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