

A Macroeconomic Analysis of Lebanon's Monetary and Fiscal Failure

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Abstract:

For over two decades, Lebanon maintained a fixed exchange rate sustained by unconventional Central Bank "financial engineering," a system that collapsed in 2019 and triggered a severe balance-of-payments crisis alongside widespread banking insolvency. This study investigates the historical volatility of the Lebanese Lira, examines the interlinked failures of the commercial banking sector, and evaluates the resulting monetary and fiscal policy imbalances as the state transitioned into a cash-dollarized economy. Utilizing an explanatory mixed-methods approach, the research combines quantitative macroeconomic time-series data (1997–2026)—tracking devaluation, money supply expansion, and hyperinflation—with qualitative analysis of regulatory frameworks and societal dynamics. The findings map Lebanon's macroeconomic downfall across distinct phases, culminating in a 90% official devaluation, the imposition of severe capital controls, and a shift to an unregulated cash-dollarized economy driven by the total fracture of the formal financial system. This institutional collapse notably sparked unprecedented societal responses, including "benevolent bank robberies" by depositors desperate to access their frozen savings. Navigating this new economic reality requires corporate entities to rely on hard-currency strategies and flexible pricing, while the state urgently requires IMF-mandated structural reforms and the realignment of taxation structures to match a dollarized economy. Ultimately, future recovery efforts must evaluate the feasibility of formally restructuring Lebanon's monetary architecture through a Currency Board or a full dollarization framework.

Keywords:

Lebanon economic crisis, hyperinflation, currency devaluation, banking collapse, cash-dollarization

Introduction: "The What & Why"

For over twenty years, from 1997 to 2019, Lebanon's economy operated with a fixed exchange rate. The Lebanese Lira (LBP) was pegged to the United States Dollar (USD) at a rate of 1,507.5 LBP/USD. The Central Bank of Lebanon (Banque du Liban, or BdL) managed this peg directly (Mundell, 1963). The main goals of this peg were to ensure price stability, attract foreign investments, and maintain purchasing power in an economy that heavily depended on imports. However, maintaining this fixed peg needed a constant and significant flow of foreign currency. After regional conflicts and a sharp drop in capital inflows around 2015–2016, the BdL started a series of unconventional operations called "financial engineering" (Faour et al., 2025). The central bank offered commercial banks very high interest rates to bring in USD deposits. In turn, commercial banks channeled their clients' USD savings to the central bank. The BdL then used these funds to keep the fixed peg stable and cover the government's growing fiscal deficits



(Krugman, 1979). By autumn 2019, this unsustainable system fell apart. The sudden halt of capital inflows exposed widespread insolvency in the banking sector, leaving up to 75% of commercial bank assets tied up in an illiquid central bank (World Bank, 2023). This situation led to a drastic currency devaluation, acute liquidity issues, and the indefinite freezing of trillions of liras in national savings.

1.2 Purpose of this Study

This research has three main objectives:

1. Investigate Historical Volatility: To systematically track how the purchasing power of the Lebanese Lira deteriorated as it shifted from a fixed peg to multiple exchange rates before stabilizing near 89,000 LBP/USD (Central Administration of Statistics [CAS], 2026).
2. Examine Banking Crisis Interlinkage: To look into the failures of the commercial banking sector, including the enforcement of capital controls and the mismanagement of USD deposits, assessing how these factors weakened the domestic economy (Faour et al., 2025).
3. Evaluate Monetary and Fiscal Policy Imbalances: To analyze the breakdown of economic policies and determine how a cash-dollarized economy changes national tax systems, tariff structures, and the fight against hyperinflation (International Monetary Fund [IMF], 2024). Traditional tax models depend on domestic currency, but cash-dollarization fundamentally undermines the state's ability to administer taxes, shifting the tax framework to real-value assessments.

Literature Review: "The story so far "

2.1 The Open Economy Trilemma (Mundell-Fleming)

Lebanon's monetary policy is rooted in the Mundell-Fleming Open Economy Trilemma. This theory states that an economy cannot maintain a fixed exchange rate, free capital movement, and an independent monetary policy at the same time (Mundell, 1963). For over two decades, Lebanon enforced a fixed exchange rate with absolute capital mobility, giving up its monetary policy independence. To attract the necessary USD inflows to defend the peg, domestic interest rates were kept artificially high. When macroeconomic risks increased, capital quickly left the country, leading to a severe balance-of-payments crisis. The BdL then introduced informal capital controls in October 2019, disrupting the existing Trilemma and pushing the country into a chaotic floating exchange regime, making the Lebanese economy one of the most vulnerable environment for banks around the world (Athari et al., 2023), as the stability once due to the pegging of the Lebanese currency with the U.S.D. became no more (Kamel et al., 2025).

2.2 Balance of Payments Crises (First vs. Third-Generation Models)

Current economic literature describes Lebanon's economic collapse through two main models:

Krugman's First-Generation Model: shows how persistent budget deficits and expansionary fiscal policies force a central bank to print currency excessively (Krugman, 1979). This process drains foreign exchange reserves until the central bank can no longer support the currency, causing a sudden collapse of the peg, and the devaluation of the currency, causing citizens to adopt unconventional methods to perform the functions of money, such as Cryptocurrencies (El-Chaarani et al., 2025), and significantly causing crowding-out, DE prioritization of sustainable investments (Kaspard et al., 2026) and

Krugman & McKinnon's Third-Generation Model: highlights severe issues within the financial sector (Chbeir, 2020). Commercial banks borrow extensively in foreign currencies and lend them to a highly leveraged government. This situation leads to a "twin crisis," where the national currency collapses along with the banking system, making a recovery of the banking sector particularly hard (Khalife et al., 2022), and even though recent AI breakthrough enhanced firm's efficiency (Subrahmanyam & Beainy, 2027), this was not the case in Lebanon as the full collapse of the financial system rendered these breakthroughs useless for Lebanese firms.

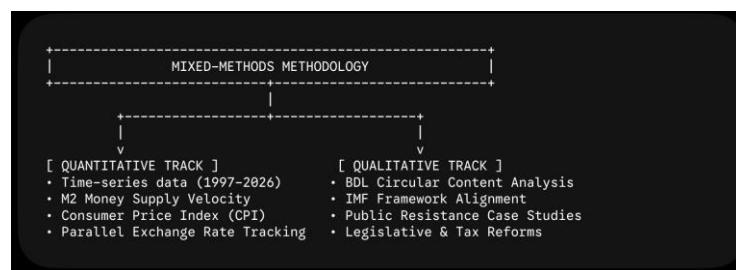
2.3 The Economics of Sovereign Ponzi Schemes

The unconventional financial operations by the BdL from 2015 to 2019 are seen as an institutional sovereign Ponzi scheme. Instead of directing funds to productive sectors of the economy, the central bank relied on a steady flow of new USD deposits to pay interest to older depositors (Faour et al., 2025). When capital inflows stopped in 2019, the growing asset-liability gap created a multi-billion-dollar deficit for the central bank and made the entire commercial banking system unsound (World Bank, 2023). Furthermore, when public entities absorb bank assets, the eventual losses wipe out private savings (Naimy, 2025).

Methodology: "The how we did it "

3.1 Research Design: Explanatory Mixed-Methods

To understand the depth of Lebanon's monetary and fiscal issues, this paper uses a mixed-methods approach. This method combines quantitative macroeconomic data with qualitative regulatory content analysis to provide a complete view of the systemic collapse.



3.2 Quantitative Data Collection & Statistical Variables

The quantitative approach collects and analyzes decades of time-series data from 1997 through mid-2026 (CAS, 2026). The key independent, mediating, and dependent variables include:

The Exchange Rate: Tracking the difference between the official fixed peg and parallel black-market rates leading up to the 2024–2026 consolidation periods (BdL, 2019-2026).

Money Supply (M2): Measuring the volume and speed of domestic currency printing as the central bank tried to manage its bank liabilities (BdL, 2019-2026).

Consumer Price Index (CPI): Monitoring hyperinflation and the loss of domestic purchasing power (CAS, 2026).

3.3 Qualitative Data Collection & Policy Matrix

The qualitative approach employs content analysis of regulatory frameworks, legal measures, and social behaviors. The main components analyzed include:

BDL Regulatory Circulars: Examining central bank directives that mandated non-market exchange rates and limited cash withdrawals (BdL, 2019-2026).

Legislative and Financial Reforms: Assessing parliamentary actions and judicial measures taken around 2024–2025 to address the fiscal crisis (IMF, 2024).

Societal Dynamics & Public Resistance Studies: Documenting public resistance and loss of institutional trust as key macroeconomic indicators. In economic theory, currency reflects a trust agreement between citizens, banks, and the government (Chbeir, 2020). When this agreement is broken, public resistance develops through different phases directly tied to the currency's decline.

Results: "The facts "

4.1 Chronological Currency Devaluation Matrix

The data shows that Lebanon's macroeconomic downfall occurred in distinct waves instead of a single drop. The following matrix integrates quantitative metrics with related policy phases:

Phase / Timeline	Parallel Rate Range (LBP/USD)	Avg. Annual Inflation	Core Macroeconomic & Institutional Status
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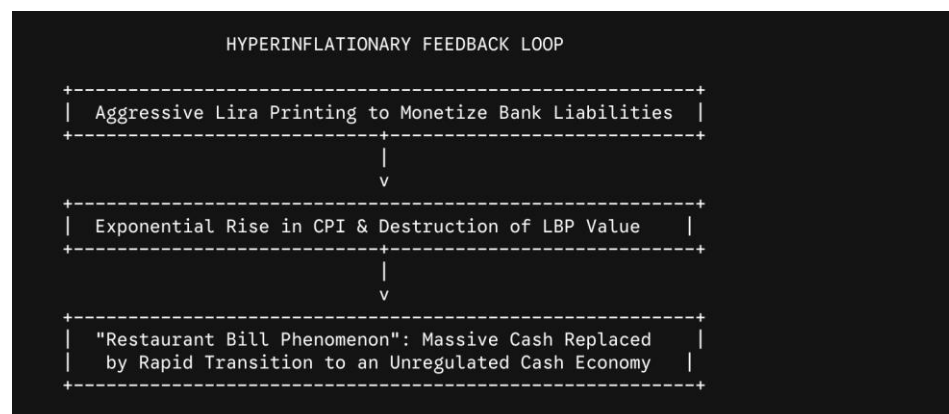
Pre-Crisis (1997-Oct 2019)	1,507.5 (Official Peg)	1.0% - 3.0%	Artificial stability sustained via aggressive financial engineering; structural deficits hidden.
Initial Fracture (2020-2022)	1,600 -> 40,000	150% - 170%	Sovereign default on Eurobonds; emergence of fragmented, multiple parallel exchange rate frameworks.
Hyperinflation Peak (2023-2024)	40,000 -> 98,000 - 221.3% > 89,000		90% official devaluation of the peg; discontinuation of Sayrafa; near-total destruction of LBP value.
Current Horizon (2025-2026)	89,000 (Constant)	45.2% (Stabilizing)	Transition to a completely dollarized cash economy; stabilization of black-market rate as Lira is marginalized.

4.2 The October 17 Revolution & Banking Blockades

The breaking point happened on October 17, 2019, when a proposed tax on digital services ignited a large socio-political uprising. Over one million citizens protested, blocking critical infrastructure and financial institutions against corruption and mismanagement (Chbeir, 2020). This collapse of public trust led to immediate bank runs. Fearing a total loss of liquidity, banks closed for two weeks. When they reopened, they imposed strict capital controls, freezing USD accounts. Depositors couldn't access their foreign currency savings and faced limited monthly withdrawals in a sharply devalued local currency, which cemented the crisis (Faour et al., 2025).

4.3 Hyperinflationary Realities & The Cash-Dollarized Economy

To meet commercial bank dollar debts, the central bank significantly increased the money supply by printing vast amounts of Lira notes, resulting in hyperinflation (CAS, 2026). This situation dramatically disrupted economic conditions and everyday commerce:



The Restaurant Bill Phenomenon: At the height of the currency's fall, consumers had to carry large bundles of cash. Restaurants and shops resorted to automatic currency counting machines at tables, as handling cash manually became unworkable. This situation eventually forced the entire market to stop using the national currency, pushing Lebanon into an unregulated, informal cash-dollarized economy.

4.4 The Rise of Armed Depositor Resistance

Legal channels having failed, between 2022 and 2024, “benevolent bank robberies” began to appear. Ordinary people who could not take out their own money to pay for essential cancer treatments, tuition fees or even basic food security started carrying out targeted armed raids on their bank branches (Chbeir, 2020). Rather than seeking to rob bank vaults of capital, these depositors held branches hostage so they could demand access to their own legally recorded savings. A striking case study is that of Sali Hafiz, who wielded a replica gun to withdraw \$13,000 of her locked savings to pay for her sister’s urgent cancer treatment. These actors were celebrated as folk heroes by the general public, not criminals. The formal legal institutions had collapsed along with the monetary system, a total breakdown of state legitimacy.

Discussion and conclusion: "The so what ? "

To function in this environment, the public and private sectors must make strategic adjustments: Corporate Liquidity Strategy: Lebanon-based private firms need to protect their operations fully by keeping capital only in hard foreign currency, avoiding domestic commercial banking networks for international trade settlements, and using flexible pricing models to compensate for structural infrastructure shortages.

Sovereign Fiscal Reform: From the state’s perspective, economic recovery cannot be achieved through superficial changes. The government needs to urgently implement the structural reforms required by the International Monetary Fund (IMF, 2024). This includes launching a fully transparent independent audit of commercial bank assets to ensure the equitable distribution of multi-billion-dollar losses among commercial banks, state institutions and shareholders, thus protecting small depositors (Faour et al., 2025). In addition, as discussed in Section 1.2, cash-dollarization breaks the traditional public finance. The government should cut back from the eroded tax base of the domestic currency, to the structural tariff grids, customs fees and updates to the direct taxation in dollar. Without this alignment, the state is fundamentally unable to finance basic public services, or to rebuild institutional authority.

5.3 Limitations of the Study

Contamination of the Unrecorded Cash Economy: The main analytical limitation of this study is the large unrecorded informal cash economy. About half of the national GDP has moved into cash dollars, meaning that a huge chunk of economic transactions is taking place completely outside of the formal reporting channels. Therefore, macro metrics that track consumer spending, tax evasion and velocity are statistical approximations and not absolute facts (CAS, 2026).

Opaque Financial Reporting: The lack of public, comprehensive independent audits throughout the domestic commercial banking network continues to constrain the ability to accurately track off-shore capital flight and to fully map the remaining asset base.

5.4 Future Research

Future research should investigate the structural feasibility of formally re-structuring Lebanon’s monetary architecture. The focus should be on studying the transition to an inflexible Currency Board system or a formal, full dollarization framework similar to economies such as Ecuador (Naimy, 2025). In addition, a thorough analysis is necessary to consider public-private partnership models that aim to exploit state assets in an effort to progressively restore blocked depositor savings without entirely depleting future public revenues.

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