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Unraveling the 2019 Lebanese Financial Crisis: Analyzing the Applicability of Hyman Minsky's Financial Instability Hypothesis

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Declaration of Authorship:

1. I hereby declare that I have compiled this thesis using the listed literature and resources only.
2. I hereby declare that my thesis has not been used to gain any other academic title.
3. I fully agree to my work being used for study and scientific purposes.

In Prague on 26/07/2024 **Jason El Murr**

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Abstract

This thesis attempts to analyze the 2019 Lebanese financial crisis through the lens of the Financial Instability Hypothesis (FIH) that was developed by the 20th century economist Hyman Minsky. The study offers insight into how an economy develops internal financial fragility which eventually renders it susceptible to crises due to speculative and Ponzi financing. In Lebanon's case specifically, there is noticeable elements that pinpoint a potential application of Minsky's theory prior to the crisis. In this regard, the goal of this paper is to understand whether the FIH shows a clear trend that the Lebanese economy was headed towards the state it is in today i.e. experienced a "Minsky Moment". However, the FIH does not cover all potential elements that could lead an economy to crash and while the factors elaborated by Minsky are extremely relevant, the case at hand offers other unique characteristics that cannot be ignored. The paper shall therefore also cover some financial variables that are not a part of the FIH as well as examine the country's political, social and cultural history which played a crucial role in leading to the crisis. The paper then tries to suggest some potential policies such as reforms and structural adjustments to prevail over the current situation that the country is in.

The crisis in question is relatively recent and is still ongoing therefore, this research not only contributes to the global discourse on financial instability and ways to minimize their severity but also offers a unique view on the Lebanese financial crisis as there is currently no paper discussing the application of Minsky's theory to this case and most people do not realize the root causes that led to this financial meltdown.

By analyzing the stages of financial instability as well as elements that contributed to the Minsky Moment and are apparent in the case at hand, the research's main takeaways are that Minsky's framework can indeed be applied to the Lebanese financial crisis and is a fair way to try and pinpoint the reasons that led to it. However, the paper also goes through some economic factors not mentioned by Minsky as well as the fact that the country's political, social and cultural situation contributed to the crash.

Keywords

#Lebanon #FinancialCrisis #HymanMinsky #FinancialInstabilityHypothesis #MonetaryPolicy #PoliticalEconomy #Reforms #BehavioralFinance

Note from the Author

While this is an academic paper, the target audience is primarily the people of Lebanon who have had their assets and savings frozen and devalued and still to this day do not understand the cause of the financial crisis or the elements which led to its severity.

It is worth noting that when attempting to analyze a topic as complex as a financial crisis in a country such as Lebanon where economic and political factors are conflated, reliable macroeconomic data tends to be scarce. Therefore the methodology of the paper is based on a qualitative approach combined with a descriptive analysis of macroeconomic data from official sources.

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I would like to express my most sincere gratitude to my supervisor, Michal Paulus, for his support and insightful feedback throughout the entirety of this research journey. His expertise on the topic has been invaluable in shaping the quality of this thesis.

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I would like to also acknowledge the Charles University in Prague for providing the necessary resources and facilities that were essential for the completion of this thesis.

Finally, I am indebted to my country Lebanon and the resilient Lebanese people. The main motivation of this work is to understand the root cause of the crisis that left many in financial peril and add a different perspective to the works that have already been developed regarding this topic.

This work is dedicated to all those who have played a part, no matter how small, in its fruition.

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Introduction

Hyman Minsky's Financial Instability Hypothesis (FIH) showcases that financial markets are unstable by nature due to the cycles of borrowing and lending which makes them prone to crises. The theory hence revolves around the fact that long periods of economic stability ultimately lead to a rise in risk-taking behavior which results in speculative financial bubbles that eventually burst.

Minsky's FIH is one of the pioneering works that challenged the traditional economic belief of inherent market stability alongside the works of John Maynard Keynes, Charles P. Kindleberger, Friedrich Hayek and the Austrian school of economics. Those contributions to economic theory highlight the role of financial markets in leading to boom-bust cycles and underscore the importance of regulatory oversight in order to avoid financial meltdowns.

In this regard, while other works give valuable insight and a vital perspective to understand boom-bust cycles leading to financial crises, Hyman Minsky Financial Instability Hypothesis may be able to provide a more comprehensive explanation to the specific crisis that unraveled in Lebanon in the early 21st century. Hayek's ideas shed light on a specific dimension of the crisis, the policies of the central bank such as the fixing of the Lebanese currency to the US dollar at an artificially fixed exchange rate which led to an unsustainable accumulation of dollar-denominated debt and distorted price signals (Vohra, 2021). On the other hand, Minsky's theory highlights the aspect of the crisis that revolves around the buildup of financial fragility due to the period of stability and prosperity during which financial institutions engage in rather risky lending practices. Additionally, the theory highlights the importance of having strong institutional structures in order to maintain financial stability, which can be applied to the crisis at hand as the Lebanese financial system lacked institutional resilience to withstand external shocks, such as political instability and the loss of investor confidence. In this respect, we believe that integrating elements of both theories could offer a more comprehensive understanding of the crisis hence Minsky's inclusive and generally broader study could show different aspects of the situation, since the work of his forerunners is reflected in his hypothesis (Behlul, 2011).

In light of the above, this academic paper explores the application of Hyman Minsky's Financial Instability Hypothesis (FIH) to the financial crisis that occurred in Lebanon in 2019.

The main hypothesis of this paper is whether the FIH can be used to show that there are factors and elements that contributed to speculative behavior and the formation of a Minksy Moment by the late 2010s which led the Lebanese economy towards the state it is in today. Another angle will also be covered, being the fact that the country's social, cultural and political reality assisted in the creation of the crash in question.

In this regard, the main methodology that was used is a case study as it is a qualitative research method that analyzes complex issues in their real life settings and therefore avoids missing some critical aspects of a situation. Such a method proved to be insightful when trying to understand phenomena as delicate as financial crises as it allows the exploration of both financial and non-financial contributors that lead to a crash. Looking into the situation solely from a financial lens cannot fully cover the intricacy of the matter, the case study published by the journal of business ethics on the 2007–2009 global financial crisis is a great example of such an application (Schoen, 2017).

This paper goes through Minsky's theory and highlights some contributing factors to the economic boom-bust cycle then uses data retrieved from official sources such as the Central Bank of Lebanon (BDL) or the World Bank to analyze if these factors can be reflected in our case at hand and whether the FIH can show that a Minsky Moment did indeed occur in 2019.

As mentioned previously, economies of countries are very complex and finding a textbook example of a quantitative method on such a large scale economy can be very tough, especially when taking into account other vital angles such as the social, cultural and political ones. In this regard, while Minsky's theory could prove helpful to analyze the Lebanese financial crisis of 2019, one cannot ignore the structural and political situation of the country which was a major factor that led to the gravity of the situation.

The study is hence structured into the following chapters:

Starting with the literature review which is divided into five sub-chapters. This part will got through a quick introduction of financial crises as well as Hyman Minsky's predecessors. Following that, Minsky's Financial Instability Hypothesis will be examined in depth. The chapter continues with a summary of the history of Lebanon, it highlights the key events that shaped both the nation's financial and political reality as well as tackles the current situation in the country in terms of the changes that occurred in its recent past. The chapter concludes with a statement of the hypothesis and the contributions that this paper hopes to provide.

The second chapter of this paper goes through the methodology that has been used to analyze the topic. The method in question is a case study, and the section explains why it has been chosen for this specific subject.

The following chapter is when the analytical part of the paper starts. Having showcased all the information that has been gathered, this segment applies the framework of the FIH to the Lebanese financial crisis of 2019. It begins with a decomposition of the timeline focusing on identifying the stages of financial fragility in Lebanon leading up to the crisis. Following that step, the variables mentioned in previous chapters will be applied to the case at hand, explaining how the interest rate on loans, the credit growth and other elements of the FIH demonstrate how it could be a way to explain the crisis in question and demonstrate the occurrence of a Minsky Moment. The second part of this chapter will explore some financial variables that are not a part of the FIH but are nonetheless relevant to our case. Finally, we will focus on the consequences of the crash to highlight the "bust" part of the cycle.

The fourth section of the research gathers the findings from previous chapters by discussing the applicability of Minsky's FIH to the case in subject. It follows up by going through the strengths and limitations of using Minsky's theory in this context and explores other contributing factors to the crisis, i.e. the political, social and cultural landscape.

The final chapter provides potential policy recommendations aimed at preventing future financial instability in the country, drawing lessons from the analysis to propose measures for enhancing reform.

1. Literature Review

1.1 Financial crises and Minsky´s predecessors

Financial crises are a severe disruption in the functioning of a financial system. One of the main triggers behind such crashes are when moral hazards are aggravated to a point where the economy is driven away from the equilibrium (Mishkin, 1992). The latter definition makes it is very tricky to exactly pinpoint what could and could not be considered a financial crisis. They could manifest in various forms, including banking crises, currency crises, debt crises or asset price crises. Key features of such crises include asset price collapse, banking instability, loss of confidence among investors, economic contractions, and policy responses (Mishkin, 1992).

The history of financial crises dates back to the creation of the monetary system itself however pinpointing the exact first financial crisis in history is challenging. We have limited availability of historical records depicting such matters as the economic system has an evolving nature hence what could have been classified as a crash then may be seen in a completely different way nowadays.

One early event that could be considered as one of the oldest recorded financial crises is the one of the Athenian Grain Supply in the 5th century BC. During the Peloponnesian War between Athens and Sparta, Athens faced severe disruptions to its grain supply, which was mainly sourced from its Black Sea colonies, due to the blockade of trade routes which eventually led to food shortages and skyrocketing grain prices in the capital. In response to the crisis, the government put emergency measures into place, they not only started distributing grain from state reserves but they also implemented price controls and grain subsidies. It unfortunately had the opposite effect as the treasury was severely strained by these initiatives, which led to further economic instability. While the Crisis of the Athenian Grain Supply may not fit the modern definition of a financial crisis involving banking and financial markets, it serves as an early example of economic instability driven by disruptions in the financial model of a country and government intervention. Finally, it highlights the relevance of looking into historical events of financial turmoil as it showcases the dynamics of economic crises and the responses of governments and societies to such challenges (Garnsey, 1985).

Nowadays, financials crises are mainly represented by bubbles and crashes. A more modern event that could better represent such events would be the Dutch Tulip Mania of the 17th century. Tulips, imported from the Ottoman Empire, became highly coveted luxury items in Dutch society, leading to a surge in demand and consequently the prices. As the popularity of tulips grew, so did speculation in the tulip bulb market, with prices skyrocketing to extreme levels. Investors started purchasing tulip bulbs with the expectation of selling them later at a profit. However as tulip prices continued to rise, investors increasingly relied on borrowing to finance their tulip bulb purchases, often using the bulbs themselves as collateral for loans. This speculative frenzy created a cycle of rising prices, attracting more investors eager to get involved in this apparently endless appreciation of the value of tulip bulb. Eventually, the market reached a point of unsustainable speculation, and when prices far exceeded the intrinsic value of the bulbs to a point of absurdity, investors found themselves unable to repay their loans or find buyers willing to purchase bulbs at such inflated prices. This triggered a cascade of selling, leading to a rapid collapse in the prices, causing the widespread financial distress and economic repercussions that we read about in books nowadays (Öztürk, 2022).

The above mentioned two examples are good representations to show that, contrary to popular belief, financial crises have been happening throughout history and are an integral part of our economy. Many academics have tried studying this cycle of bubble emergence and bursts by analyzing such historical events, the factors that led to their creation and their repercussions.

In the exploration of financial instability theories, it is essential to recognize that the pursuit of the understanding of crises and crashes is a discipline that has been going on for a few centuries. Before tackling Minsky, one should acknowledge the importance of the foundation established by Charles Kindleberger and the Austrian School of Economics. While Kindleberger's research gave valuable insights into speculative bubbles and financial crises, the Austrian School emphasized on monetary policy and market dynamics. Both works, alongside many others, created a pipeline for the future works on financial instability.

Charles Kindleberger, a distinguished economic historian, was one of the earliest contributors to the understanding of financial crises mainly through his work, "Manias, Panics, and Crashes: A History of Financial Crises". He spent time analyzing centuries of financial history in order to identify recurring patterns of speculative behavior that led to crashes. He emphasized the role of psychological factors such as herd behavior in driving financial instability which later became a pillar in Behavioral Economic studies. Kindleberger argued that speculative bubbles emerge when investors manifest irrational optimism, leading to an inflation of an asset price regardless of its intrinsic value (Kindleberger et. al, 2005). These price bubbles ultimately burst, resulting in economic downturns. His framework provides an important understanding of the dynamics of speculative behavior and the mechanism through which financial crises emerge. He highlighted the relevance of looking into historical events in order to properly navigate contemporary financial markets as the lessons we can learn from experience are far more valuable than theories noting the irrationality of human behavior (Kindleberger, 1991).

The Austrian school of economic thought is another body that tried to analyze the instability of our financial system and come up with a concrete explanation to those cycles. Famous names such as Ludwig von Mises, Friedrich Hayek and Murray Rothbard offer a distinctive perspective on economic theory and policy. The Austrian school's analysis of financial instability capitalized on the fact that monetary expansion by central banks which lead to artificially designed lower interest rates can only encourage distorted investments. This misallocation of resources is steered towards a bust, as unsustainable investments unravel and the economy undergoes a corrective phase (Adak, 2019). Hayek, one of the greatest minds of this school of thought centered his work on this same economic boom and explained how it would be mainly the result of credit manipulation by central banks. In his framework, the conclusion of the expansionary phase of the business cycle typically occurs when interest rates rise following an increase in business profits. In this scenario, investments that fail to yield returns exceeding the new interest rate would need to be scaled back or terminated. Hayek also recognized that interest rate increases could be prevented by a flexible supply of credit, primarily from the central bank. In this scenario, the conclusion of the expansionary phase of the economic cycle would result from what Hayek termed the "Ricardo Effect." This effect suggests that the rise in consumer goods prices would elicit a shift away from production processes with longer durations towards investing in less capital-intensive processes with shorter durations. This adjustment's goal is to slow down the multiplier-accelerator process. In summary, Hayek's "Ricardo Effect" would eliminate investment in capital-intensive production processes, therefore ending the expansionary stage of the economic cycle (Rallo, 2023).

As economic theory is always being fine-tuned, Minsky's financial instability hypothesis builds upon the works of his predecessors. Many see Hayek and Minsky as disagreeing on the catalyst of credit expansion as the former focused on the central bank being its amplifier and the latter believed it was due to the speculative tendencies of financial markets. However, Minsky characterized central banks as mechanisms enabling the extension of credit supply virtually without limit. The two theories are actually way closer than they seem as ultimately, Hayek believed that the elasticity of bank credit, which is usually manipulated by central bank policies, created a disparity between the market interest rate and the equilibrium interest rate. This discrepancy is ultimately what drives the growth of credit demand. Therefore, Hayek's process of bank credit expansion is essentially the use of speculative or Ponzi finance by the banking system which is what Minsky's financial instability theory tries to explain. The main argument that skeptics use to refute Minsky's hypothesis is that it fails to incorporate Hayek's Ricardo effect in his model. However, it is important to understand that ultimately, despite discrepancies, both authors describe the mechanism which puts an end to the economic boom in a very similar manner (Rallo, 2023).

It is important to mention here that there are also newer and much more mathematically complex models that link credits, assets prices and cycles such as the paper by Pedro Bordalo, Nicola Gennaioli, Andrei Shleifer, and Stephen J. Terry, "Real Credit Cycles" (2021). They describe mathematically how periods of economic prosperity basically predict disappointment, low bond returns and decreased investment using micro data from US firms forecasts. What is interesting in their study is that they tried to generate the size of spread increases observed during the 2008-2009 financial crisis and the sole addition of a "disappointment of overoptimistic beliefs" factor into their model was enough to reach the point of crisis, there was no need for large negative shocks. The latter shows the relevance of the speculative behavior of financial institutions which was Minsky's main point of interest (Bordalo et al, 2021).

1.2 Minsky’s Financial Instability Hypothesis

Origin of the Theory

When discussing influential economists of the Post-Keynesian school of thought, Hyman P. Minsky is usually recognized as one of its central players. The Harvard graduate started his research on the Financial Instability Hypothesis in the mid-1900s when the United States was experiencing a period of relative stability hence his theory was largely overlooked by the mainstream economists at the time as it was apparent that markets were intrinsically self-correcting and steady. It was not until the 70s and 80s that his hypothesis started attracting some attention as the US economy experienced a series of financial crises, especially the loan crisis of the 1980s which cost the US government billions of dollars and brought major highlight to Minsky’s work. During the last few years of his life, Minsky refined the Financial Instability Hypothesis by publishing several books and articles on the matter with his most prominent work “Stabilizing an Unstable Economy” – published in 1986 presenting a detailed analysis of the groundbreaking financial theory of investment which was influenced by Keynes and focused on the hidden mechanisms that lead to financial instability and economic cycles (Wray, 2011).

It is worth mentioning that Minsky’s theory is to this day one of the leading works to help explain the fragility of the capitalistic financial system and was used to explain several major recessions such as the Great Recession or the Eurozone crisis in the late-2000s (Riley, 2019).

In light of the above, to fully grasp Minsky’s financial instability hypothesis, we should first tackle the original theory of investment that was developed by John Maynard Keynes.

What is the Financial Instability Hypothesis?

The Theory of Investment - Keynes

The main idea of John Maynard Keynes' theory of investment is that investment decisions are driven by expectations of future profitability, and that these expectations can be influenced by a wide range of factors such as:

- <u>The level of interest rates</u>: The latter can strongly impact the cost of borrowing and the return on investment.

- Market sentiment: The theory emphasized the role of animal spirits, or the emotional and psychological mood of investors that influence economic decision-making.
- Technological developments: Investment opportunities can be created through technological advancement. A change of profitability of current investments can also be crucial in this section.
- Political Environment: Political instability or changes in governmental policies can heavily impact certain industries.
- International Economic Condition: Naturally, the state of the global economy as well as international trade relations are crucial factors that impact the expectations of profitability of investors.

Keynes was adamant that investment choices were mostly dependent on subjective assessments and were susceptible to sudden shifts in reaction to changes in expectations or other unforeseen circumstances. He believed that these variations may result in economic downturns and depressions (Weatherson, 2002).

The Financial Instability Hypothesis – Hyman Minsky

Minsky's financial instability hypothesis can be seen as an extension of Keynes' theory of investment as he built on Keynes' ideas as they missed a vital component, an explicit theory dealing with boom and crises (Wray et. al, 2008). He hence emphasized on the role and the importance of institutions and financial markets and in molding economic results, as well as the tendency of financial institutions to be unstable by nature and subject to recurring crises.

According to Minsky, market players' inclination to speculative and Ponzi financing as well as the interaction between lending and borrowing are the main causes of financial instability. However in his opinion, borrowing and lending are based on safety levels which are a strong shelter against illiquidity. Therefore, banks cannot be lenders as a requirement for the latter is to have the money in the first place, and they do not, they create it (Bellofiore et. al, 2001).

The Credit Cycle, the Minsky Moment and the Two-Price Model are a couple of the important terms that he came up with to explain the fragility of our financial systems and the high likelihood of financial crises to take place (Whalen, 2008).

His famous credit cycle hence identified three stages for a capitalist economy to fall into a recession based on the theory that financial stability leads to instability (Miller, 2018):

- <u>Hedge Finance</u>: Being the most stable stage of the cycle, individuals and institutions tend to have a conservative approach to borrowing. They generally have enough income to cover principal of their debts as well as the interest that is due. In this regard, since the debt levels are relatively low and manageable, the lenders have confidence in the other party's ability to repay.
- <u>Speculative Finance</u>: Following the last stage's safe and secure environment, the economy starts expanding and asset prices rise as both the borrowing and lending part become more bullish and optimistic. The former can therefore cover their interest payment from their cash flows however they would rely on other methods such as refinancing to repay the principal part. This stage depicts an increase in the overall debt level as borrowers take on more leverage to take advantage of the ideal market conditions. This is a very tricky stage since two dangerous actors come into play based on the assumption of the continuous appreciation of asset prices, on one hand the speculative borrowers depend on it to ensure that they can repay their debts in the future, and on the other hand, the reckless lenders become less and less cautious and start providing credit to riskier parties.
- <u>Ponzi Finance</u>: This is the final stage of the cycle and it is characterized by the highest debt level yet and very risky behaviors. Borrowing parties are solely counting on profits made from selling assets at higher prices to repay both principal and interest parts of their loans. The margin to avoid insolvency becomes slimmer as the above mentioned party keep on taking higher levels of debt, often beyond their capacity to cover it from their asset value in order to pay back their previous dues. However, any slowdown in the growth of asset price leads to a severe liquidity crisis for the borrowers which then leads to financial instability.

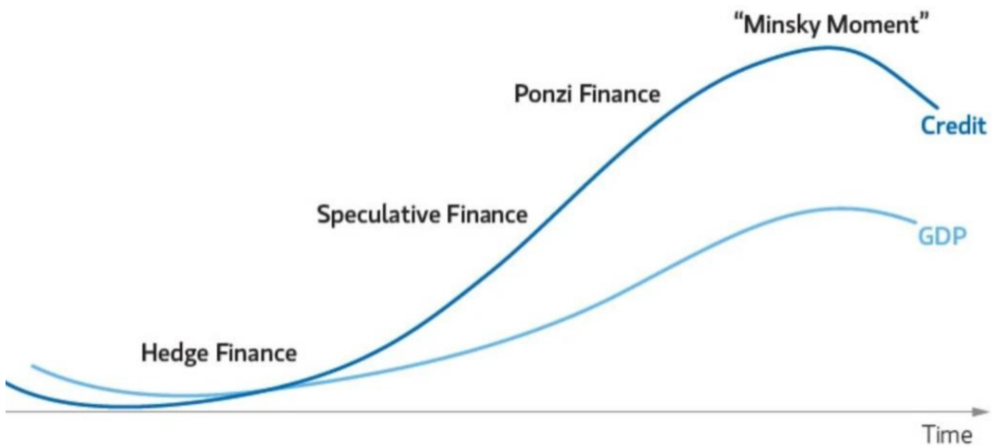

Figure 1 – The Credit Cycle

Source: MSIM Global Multi-Asset Team Analysis - Business Insider

The credit cycle is then finalized by an event titled the "Minsky Moment". It refers to a sudden extreme market collapse that was triggered by the Speculative and Ponzi finance stages followed by a decline in asset prices since borrowers and investors reach a limit to their ability to cover their debts due to a reduced cash flow. The latter leads them to having to sell assets for liquidity which further depreciates the value of those same assets. The Minsky Moment is therefore the turning point in the economy where the optimistic expectations that have been the main pillars of the asset bubbles and excessive borrowing and lending suddenly disappear leading to a major loss of faith in the financial system. Following this event, a correction of asset prices takes place and many bankruptcies often follow (Bellofiore. et al, 2011).

A vital point to make is that economies do not work in a linear manner and Minsky's credit cycle is a theoretical construct with the goal to explain that financial systems are fragile by nature. Economies are affected by various factors and the cycle may manifest differently since the model in question is rather basic since it refers to a closed small government economy where capital accumulation requires issuing debts. He stressed on the importance of interventions from the government and central bank as financial regulators can mitigate market instability. The point of this cycle is to highlight the fragility of financial markets and that risk-taking behavior leads to high levels of debts and could eventually head towards a financial crisis. He strongly believed that economic policy was unable to completely eradicate the processes that lead to instability. The best the regulators can do is to suppress and try to prevent the most harmful events that could happen as when the central banks become the lenders of last resort to try and contain a potential crisis, deep depressions often take place (Bellofiore et. al, 2001).

Regarding the two-price model, it is basically the nomenclature assigned to the phenomenon of the rising asset price between the Hedge and Ponzi stages. It revolves around the role of investor psychology and financial speculation in driving economic cycles and financial crises. It shows that as asset prices continue to rise during the Ponzi finance stage, more investors and borrowers enter the market, further driving up prices. The Two-Price Model hence highlights how a shift from the Hedge price to a Ponzi price during periods of rising asset prices can mold a financial system with a high probability of sudden downturns (Bellofiore et. al, 2001).

Variables used in the Financial Instability Hypothesis

Many variables can be analyzed to recognize Minsky's theories in economies. Some of the most influential ones are Interest Rates, Asset Prices and Debt-to-GDP Ratio. In this paper we will focus on the below:

- GDP: This factor is the most basic on to analyze the size of the economy of a country as well as spot periods of economic expansion and contraction. In case of a Minsky Moment, the FIH dictates that the GDP could suffer a decline. The GDP per capita, Puchasing Power Parity is therefore an important general measure to take into account.
- Interest Rates: It is a crucial factor to be taken into consideration as it greatly affects borrowing and lending behaviors which, in turn, affects the asset prices as mentioned previously. Central banks play a crucial role in managing interest rates through monetary policy. In times of economic growth, their objective is to maintain relatively low interest rates to encourage borrowing, and investment. However, if these low rates persist for an extended period of time, they can lead to the accumulation of financial imbalances. This occurs as borrowers accumulate more debt for speculative or Ponzi activities, thereby increasing the risk of financial instability. Consequently, asset bubbles may form while the economy becomes increasingly vulnerable to potential shocks. When central banks eventually raise interest rates to curb inflation or address financial vulnerabilities, the transition from a low interest rate environment to a higher one can be challenging for borrowers who have become accustomed to cheap credit. Rising interest rates can

increase the burden of debt service and impact the ability of borrowers to refinance their debts. This transition can trigger a Minsky moment, where borrowers who were relying on continuous refinancing find it difficult to meet their obligations, leading to a sharp market correction and financial instability (Yanamandra, 2014).
In light of the above, a relatively stable interest rate followed by a sudden rise could characterize a potential Minsky Moment.

- Credit Growth: As mentioned, this factor is a key component of Minsky's financial instability theory. The theory mentions that a period of credit growth and excessive debts in the private sector is a specification of a potential incoming Minsky Moment and thus a recession if the other factors are also present.
- Debt-to-GDP ratio: In the context of the financial instability hypothesis, the debt-to-GDP ratio serves as an important indicator of the overall health and stability of an economy's financial system and tends to be more informative than nominal credit growth value. A rapidly increasing debt-to-GDP ratio, especially driven by speculative or Ponzi finance can signal an elevated risk of financial crisis.
- Asset Prices: Another important figure that is relevant to our case is the variation in the prices of the assets. As mentioned previously, the FIH is characterized by a growth in asset prices between the hedge and Ponzi stages as per the two-price model and then a sharp drop following the Minsky moment.
- Lending/Borrowing Behavior: One of the main identifiers in Minsky's theory is the increase in speculative behavior due to the expectation of a higher return. Therefore, an increase in loans would signify an increase in speculative behavior.

Using the FIH to explain financial crises

Hyman Minsky's FIH offers a compelling explanation regarding the recurring nature of financial crises. His work about the fact that financial markets are unstable in nature and hence prone to boom-bust cycles due to speculative borrowing was extensively used by many to explain the most recent global financial collapse that occurred in the late 2000s (Troncoso, 2018). The period leading to the 2008-2009 crash was a textbook example of the FIH as it was an extended period of stability and growth driven by high private debt levels. There was a significant increase in mortgage-backed securities, derivatives and other complex financial instruments which perfectly characterizes Minsky's description of the phases of the capitalist cycle and the increase in risk-taking behavior (Charles, 2016; Shefrin, 2016).

Another direct application of the FIH is to the Greek debt crisis where Beshenov et. al (2015) analyze the public and private sectors, describing how their sample of local companies exhibited a transition to fragile financial structures between 2001 and 2014 which hence contributed to the Greek financial crisis.

Many works align with Minsky's capitalist cycle, such as Foley (1987), Gallegati et. al (1991) and Skott (1994). These models highlight the fragility of corporate balance sheets, mainly characterized by an increase in debt level. The latter leads to a congestion in the balance sheet of companies which stands in the way of investment activity and triggers an economic downturn (Palley, 2011 ; Grytten. et al, 2019).

Minsky's theory was further expanded by other economists in order to understand the broader context of explaining crashes. Thomas Palley's (2011) work on super cycles is particularly interesting. It mentions that Minsky's business cycle can be supplemented by what he calls a "super-cycle" which involves the transformation of business institutions and financial practices and the structures that govern a market which contribute to financial crisess (Palley, 2011). Super cycles can hence be used to expand the research on explaining crashes as they can be used to embed Minsky's concerns on financial innovation and regulatory change (Minsky, 2008).

Another matter that troubled Minsky was the frameworks of governance required to maintain the stability of capitalist economies as he labelled them as thwarting institutions since they prevent instability. He hence highlights the role of those financial institutions, including government agencies and banks, and indicates the sensitivity of their decisions and of the contemporary accounting practices (Ferri & Minsky, 1992 ; Palley, 2011 ; Biondi, 2013 ; Boyer, 2013).

Finally, academic works such as Bellofiore & Ferri (2001) and Minsky (1978) particularly helped to understand the financial fragility of economies and explored the fact that crises in economics are due to performance, polity and theory. The crisis in performance is due to factors such as inflation and unemployment. Policy is affected since both monetary and fiscal policy seems to be ineffective as there is a high likelihood for an expansion to become an inflationary one. Finally the crisis in economic theory is described in two aspects: the fact that conventional

theory has shown logical holes and that conventional theory has no explanation of financial crises (Minsky, 1978).
In essence, Minsky's FIH helped set up a baseline to understand crises, boom-bust cycles and the formation of speculative bubbles, as it highlighted many factors that helped explain financial collapses and was since then used by many scholars to contribute to the global understanding of financial crises.

1.3 A Brief History of Lebanon

A Consociational State

Today, Lebanon is experiencing its most dire situation ever, surpassing the several conflicts it has endured throughout its history. The latter is mainly caused by the unwillingness of public and private entities alike to relinquish the sectarian power-sharing structure that has been deeply ingrained in the thinking of Lebanese people. Both economic and social development is hence hindered because of the country's formal and informal institutions that prioritize religious requirements over any other qualification. A most notable example is the segregation of the parliamental seats which will be tackled shortly and the recruitment of public sector employees (Bogaards, 2019).
The political structure of the state is comprised of three main government roles: The President of the Republic, the Prime Minister and the Speaker of the parliament (Khatib, 2021). The nation has 18 officially recognized religious groups such as Maronite Christians or Sunni and Shia Muslims, and most governmental institutions are organized in a way that ensures representation of these many faiths (Eloubeidi, 2020). Religious affiliation is hence the key element in order to qualify for a position of judge, minister or any rank for a public position. The parliament is comprised of 128 seats, with an equal distribution of 64 seats for Christians and 64 seats for Muslims. Furthermore, the 64 seats mentioned before are allocated to certain sub-groups within Christianity (such as Maronites, Greek Catholics, Armenian Orthodox and others) and Islam (including Sunni, Shia, Druze). This division is in addition to the first layer of sectarianism

(European Committee of the Regions, n.d.). The following Figure #2 showcases the precise number of seats for each subgroup as a reference point.

The nation has been plagued by decades of sectarian influence which resulted in rampant corruption and neglect. Those in power are brought because of religious and political affiliation, rather than genuine qualifications or merit. This clearly curtails the democratic power of the general populace, since not every person has the opportunity to attain a particular government post and represent the people. Consequently, they are compelled to vote for the "most suitable candidate currently accessible" rather than the "most suitable candidate overall”. The flawed system not only gave birth to corruption in public bodies and carelessness, along with one of the most severe financial crises in history (World Bank, 2021), but also led to the emigration of the youth which will result in long term repercussions.

The following paragraphs, while a tad diverging from the main topic of the paper, are essential in order to understand the rationale for the establishment of the Lebanese power-sharing framework, the repercussions of this system as well as the path to go beyond it (Taif Agreement, 1989).

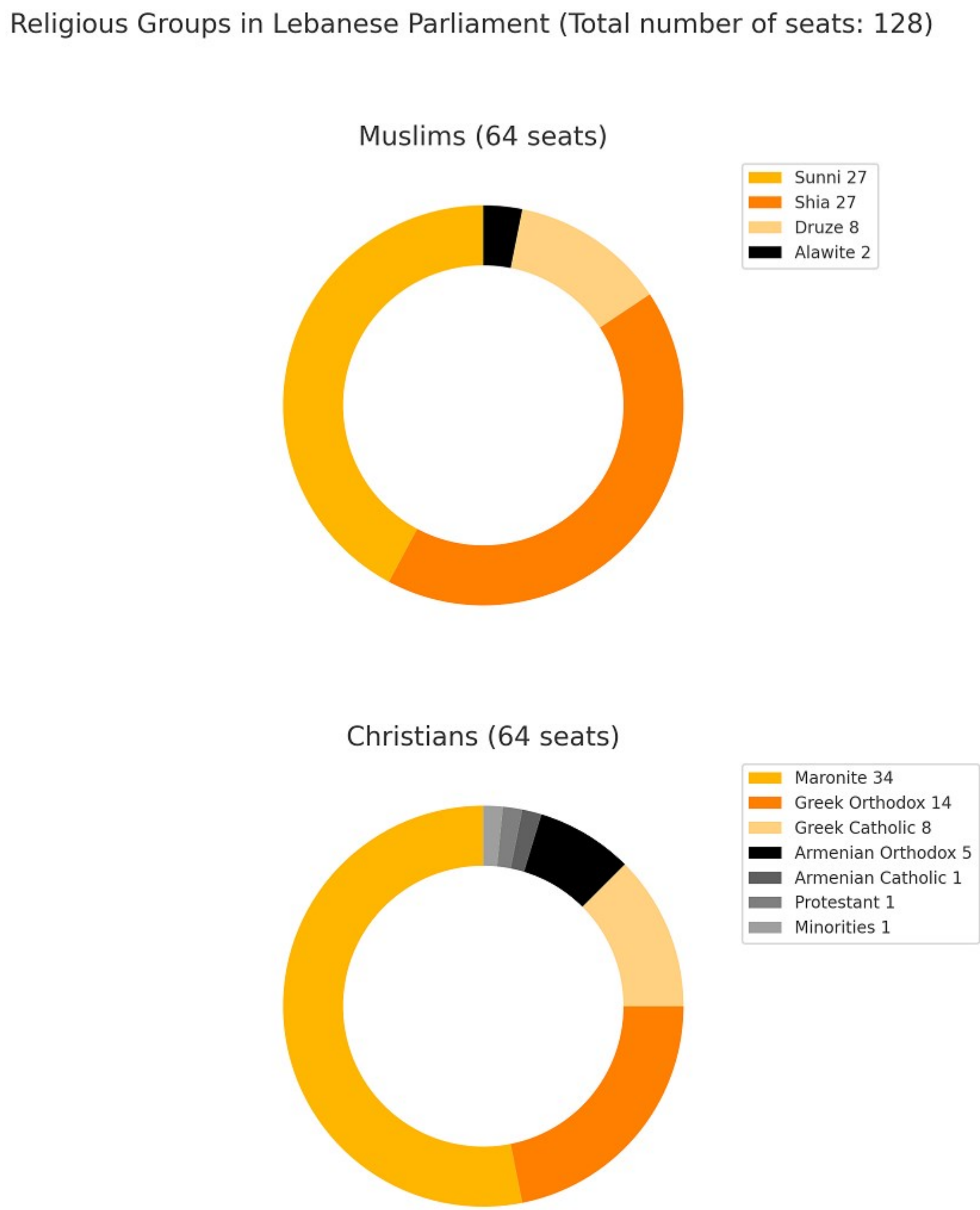

Figure 2 – Religious Groups in Lebanese Parliament

Data Source: International Foundation for Electoral Systems (2009)

Graph: Self-made

Historical Factors:

Lebanon's history has been marked by a succession of rulers that have hindered its capacity for self-governance. The latter is one of the main contributors to the legacy of political instability and civil wars that have tainted the country's recent history (Vohra, 2021). Lebanon's independence of 1943 is often dubbed as a joke by its citizens as the state never had the ability to fully exercise control its territory and population even after this major event due to internal and international political and economic pressure (Rowell, 2017).

The nation has long grappled with an identity dilemma following colonial times, as Christians resisted acknowledging their Arab background and endorsed Western influence over the region while Muslims historically sided with their Middle Eastern counterparts.

Going back in time, the exact timeline of the first settlements of the Phoenician people are blurry however the city of Byblos is believed to be one of the oldest continuously inhabited towns in the world dating back to Neolithic times. Egypt was the first empire in recorded history to expand and occupy strategic cities in the region such as Tyre and Byblos in the early 16th century (UNESCO World Heritage Convention, n.d.). Following that, many empires took over the region such as the Assyrians, the Romans and the Arabs. Recent history highlights the Ottoman rule, the French colonization and finally the Syrian administration over the territory which lasted 29 years until 2005. Nevertheless, the state's recovery was not complete, as there was a war with Israel in 2006 and has been affected by the continuing Syrian civil war since 2011. These events have had a significant influence on Lebanese politics, economics and international relations (Yassine, 2020).

The Lebanese Constitution 1926:

The Lebanese constitution, adopted in 1926, was based on a French draft and has been amended multiple times to suit the country's needs (U.S. Library of Congress, n.d.).
It brought with it two segments of consociationalism: (Bogaards, 2019)

- Segmental Autonomy which ensured respect for personal status, laws and religious orientation, and granted religious communities the right to establish their own schools.

- Proportionality, which created a ratio of parliamentary seats for Christians and Muslims for the elections to ensure fair representation of the communities in the public sector.

The ratio has been adjusted on many occasions since, while it originally allocated 17 seats to Christians and 13 to Muslims, it fluctuated to a 25:20 ratio in 1929, 14:11 in 1934 and 35:28 in 1937 (The Lebanes:e Constitution, 1997).

Although the constitution was based on the hope to unite the diverse communities into one state, it was the first planted seed of sectarianism as education, public employment and the parliament were divided and only strained the relation between sects.

The National Pact 1943

In 1943, the founders of the Lebanese republic established a National Pact with the aim being to "Lebanonize Lebanese Muslims and to Arabize Lebanon's Christians" (Bahout, 2016:7; Salibi, 1988) in order to declare independence from French colonization.

Following discussions between domestic groups and foreign mediators, the informal agreement resulted in the split of Christians to Muslims for parliamentary seats to be set at 6:5 (El Khazen, 1991). In addition to this unofficial consensus, another unwritten agreement which is still being respected today was developed; it designated a Maronite president, a Sunni Prime Minister and a Shia Parliament Speaker. The objective of the Pact was to establish a distinct Lebanese identity, whereby Christians would relinquish their affiliation with France and Muslims would refrain from assimilating into the broader Arab political scene. Following this agreement, the 6:5 formula was informally applied to most governmental positions.

The Taif Agreement 1989

In 1958, Lebanon saw a civil war triggered by Muslim forces rebelling against the government, as they believed the president was showing favoritism towards Western alliances. The conflict was resolved with the president requesting assistance from the United States to restore governmental control however this further proved that unequal amount of power in the hands of the Christians. In 1975, a 15-year civil war erupted between many political factions representing diverse religious groups however this one had influence from external players including Syria, Palestine, and Israel (Infoplease, 2017).

The Taif Agreement, which was signed in Saudi Arabia, sought to bring an end to the raging conflict. The agreement was structured based on three fundamental principles: establishing a new balance for Lebanon's political structure, shifting executive authority from the president to the Council of Ministers and guaranteeing equal representation of Muslims and Christians in the parliament, cabinet, and public service regardless of future population demographics (Taif Agreement, 1989).

Unfortunately, the implementation of this peace accord only reorganized the already failing structure, made institutions even more constitutionalized and created a reality of alienation of sects (Bahout, 2016). It hence lacked proper political reform as the structure was weak at its core and instead allowed “the defected revision of confessional power sharing arrangements; surrendering core state responsibilities to Syrian tutelage and guaranteeing power to warlords” (Karam, 2012). It only fed the seed of corruption as it made it difficult to exercise power with this new state of decision-making paralysis (Bahout, 2016).

Repercussions:

The political and religious conflicts, combined with decades of sectarian strife, have deeply fractured Lebanon's population. The lack of synergy between the politicians similarly pushed towards the same direction. It makes sense however, as those individuals got elected into their positions of power by showing that they are a good representation of a specific sect and not of the Lebanese people as a whole, a typical example is warlords from the civil war era. Following that era, the “heroes” of each sect rose into prominence and used the state as a conduit for power, financial gain and patronage distribution which consequently put the development of the country on a decelerated pace (Merhej, 2021). Potůček (1999) indicates that when a person or organization is illegitimately privileged, it tends to affect another party as the latter will be unable to receive some public goods or benefits since it would cause a disruption to the balance of the public sector.

Since each sect has a sense of comfort knowing that they are represented in the public sphere, they support their own government members without holding them responsible for being corrupt (Eloubeidi, 2020). The result of the country's decades of exposure over continuous corruption is the current situation of the country which is one of the worst socio-economic crises the world has ever seen since the mid-nineteenth century (World Bank, 2021). Research from the World Bank and the OECD indicates that "corruption is a major reason for poverty and an obstacle to development and prosperity" (Ahwash, 2018). The country's extreme disparity among its people is the most obvious result of those years of abuse: "Lebanon has been ranked in the top ten most unequal countries in the world in 2014 scoring a Gini Index of 0.848." (Dewailly, 2019:60-61).

A most recent proof of the corruption is the negligent behavior which led to the despairing Beirut Port Explosion of August 2020, the world's largest non-nuclear blast that destroyed the capital's port and devastated much of its surroundings (Al Jazeera, 2021). Despite warnings, safety protocols were ignored and tons of explosives were negligently stored for years which caused the death of hundreds and injured and displaced thousands (Eloubeidi, 2020). "The very design of the port's management structure was developed to share power between political elites; it maximized opacity and allowed corruption and mismanagement to flourish" (Fakih, 2021).

All those years of corruption led to the major protests that occurred in 2019, when citizens swarmed the streets and demanded immediate reform and the resignation of the current government. However, introducing a completely new political structure is a time-consuming procedure that would likely take years to implement, years that developing nations lack and could result in more aggravated corruption and financial instability. History, particularly in the Middle East, has shown that overthrowing systems can often result in chaos, as demonstrated in the case of Libya, which has been in complete chaos since the Gaddafi regime was overthrown (Pack, 2021). Following the resignation of the government, there were no presidential elections and Lebanon has been sitting without a leader ever since.

1.4 The Situation at Hand

Safe Haven: Banking Secrecy Law

The 60s were very generous to the newly founded Lebanese state. It was an era of political stability, cultural flourishing and tourism boom due to the country's unique climate and scenery in the region. However, the title of "Switzerland of the Middle East" was given to Lebanon not only because of its snow-capped mountains standing alongside the sea but because of its banking secrecy law. This law which was enacted in 1956 under the presidency of Camille Chamoun, established Beirut as a significant financial hub in the Middle East by guaranteeing stringent confidentiality for bank clients. The latter, inspired by Swiss banking, ensured that banks could not disclose the identities or transactions of their clients without their explicit consent (Banking Secrecy Law, 1956). This high level of privacy attracted massive foreign capital, especially from the Gulf states, boosting the country's finances and making its banking sector a main pillar of the economy. However, the same secrecy that attracted investors also facilitated financial misconduct, including money laundering and corruption (Baasiri, 2007).

Following the financial crisis of 2019 and under pressure from international institutions such as the Financial Action Task Force, Lebanon had to undergo an adjustment to its banking system with reforms introduced to lift the banking secrecy in cases of corruption, money laundering and terrorism funding (Middle East North Africa Financial Action Task Force, 2023). The goal of the latter was to try and restore both domestic and international confidence in the local banking system however despite these reforms; the history of the banking secrecy law continues to influence Lebanon's financial landscape and the appeal to foreigner investors may be lost (Gebeily, 2022). This could prove to be a fatal blow to the current structure of Beirut's economy.

Economic Policy – Fixed Exchange Rate & Capital Control

Another element that was introduced to attract foreign investment and bolster the banking system of the country is the fixed exchange rate policy which was instituted in 1997 by the central bank "Banque du Liban" and pegged the Lebanese Lira to the US dollar at a rate of 1507.5 LBP per

USD. Initially, the fixed exchange rate policy generated confidence from investors as it promoted economic stability and facilitated international trade, hence supported Lebanon's reputation as a financial hub in the region similar to the position that the countries of the Gulf such as the UAE are holding today. However, over the years, structural imbalances began to strain the sustainability of this peg (Ichrakieh, 2021).

One of the main structural challenges was the persistent current account deficit of the country which was fueled by its reliance on imports. The agricultural and industrial sectors were ignored and Finance/Services was the sole focus of the state policy-makers as highlighted in Figure #3 (US International Trade Administration, 2022). While remittances from the sizable Lebanese diaspora abroad historically played a crucial role in supporting the economy, accounting for a significant part of the GDP annually as seen in the below Figure #4, they could not offset the growing trade deficit. Additionally, as a natural step, the fixed exchange rate policy stimulated borrowing in foreign currencies, contributing to the accumulation of public and private sector dollar-denominated debt.

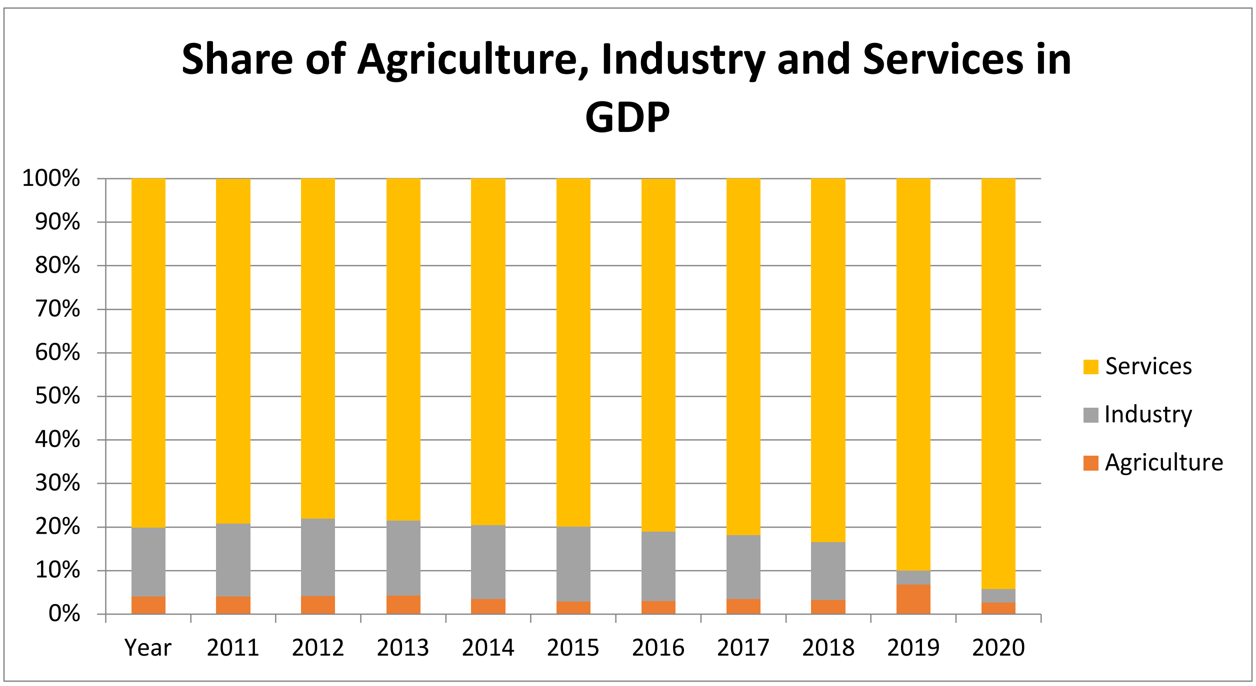

Figure 3 - Share of Agriculture, Industry and Services in GDP

Source: Statista - World Bank - World Development Indicators

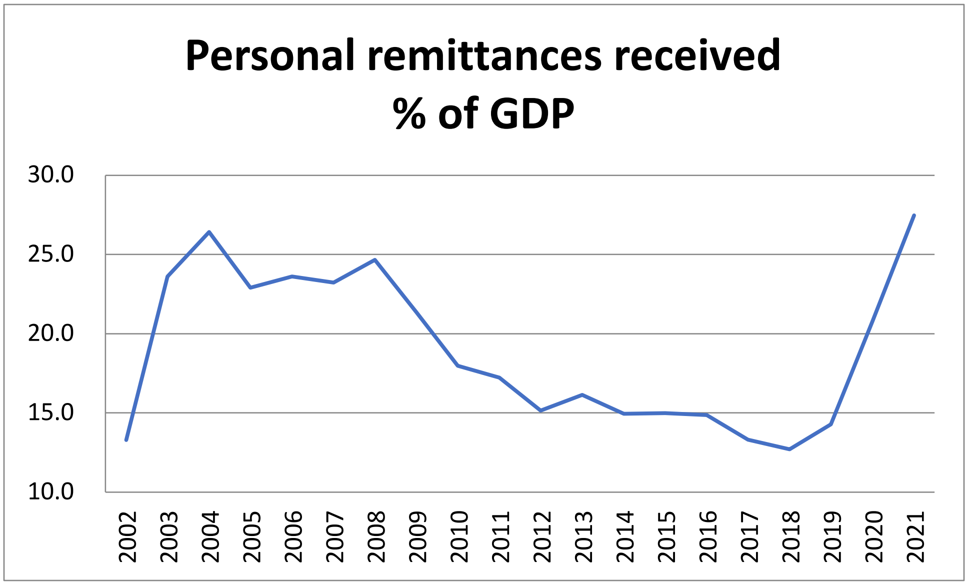

Figure 4 – Personal Remittances Received

Source: World Bank - Personal remittances, received (% of GDP) - Lebanon

As economic pressures mounted, the central bank employed various strategies to defend the peg, such as implementing temporary capital controls, restricting the majority of Lebanese citizens from making international money transfers or withdrawing dollars from their bank accounts in order to preserve foreign currency reserves, despite the fact that 75 percent of accounts in Lebanese banks are in dollar currency. The “Lollar” term was hence introduced by financial expert Dan Azzi referring to the unofficial currency that has emerged during the economic crisis, the “Lebanese Dollar”. The mock currency highlight the fact that the millions of US dollars deposited in Lebanese banks could only be accessible in local currency, rendering them as valueless as the unofficial exchange rate being traded in the black market was significantly higher than the fixed one in the banks (Burnett, 2022).

By March 2020, Lebanon made the unprecedented announcement of defaulting on and restructuring its nearly USD 31 billion debt denominated in dollars, marking the first occurrence of default in the nation's history (Perry et. al, 2020). However, these measures proved unsustainable in the face of the years of mounting fiscal deficits, political instability and especially the loss of investor confidence.

The crisis saw a rapid depletion of foreign currency reserves, amplified by a decrease in remittances amid economic uncertainty and political unrest. The inability to adjust the exchange rate to reflect economic realities increased fiscal and monetary pressures, culminating in a liquidity crunch and currency devaluation that we will explore in future chapters of this paper. The fixed exchange rate policy, once a pillar of stability, had become a focal point of Lebanon's economic turmoil (U.S. Department of State, 2020).

This example perfectly showcases the benefits and limitations of a fixed exchange rate. The United Arab Emirates and the Kingdom of Saudi Arabia currently have a fixed exchange rate to the USD (Payne, 2020) and since the GCC is considered a politically stable region with a bright economic outlook, the latter is enticing foreign investments. Lebanon was once in the position that the Gulf countries are in today a financial hub for the region however with the continually changing political landscape of the Levant region, the pegging of the exchange rate turned out to be a double edged sword as it made the economy very susceptible to external shocks and economic adjustments.

Geopolitical Landscape

Lebanon's foreign relations have always been a prominent part of its political scene, the cities of Beirut, Byblos, Tripoli or Tyre have held a strategic location for millennia as the gate to the Mediterranean sea and the Middle East. This sub-chapter will explore the country's current geopolitical complications mainly exploring the relations with its neighbors.

It is important to note that Lebanon's foreign policy prior to its independence was simply the bidding of its occupying empire. Taking the Ottoman empire for example, while there was a policy of non-intervention in the territory's domestic affairs, Turkish rule always made sure that there would never be any sort of resistance to their own interests (Danış, 2019). After World War I, the French colonization controlled Beirut's polity, again, limiting Beirut to the foreign policy of France's colonial interests (Zeidan, 2023).

Post-1943, Beirut aimed to maintain friendly relations with its neighbors and other regional powers while pursuing a policy of neutrality in disputes within the region. This, however, was short-lived as there was a spurt in Arab nationalism and then the occupation of Palestine occurred, which forced Lebanon to start adopting positions and strained relations with certain regional powers (Collelo, 1987).

Moving to Lebanon's relationship with its main neighbor Syria, it was difficult and complex since, historically, "Mount Lebanon" was a part of "Greater Syria" which included the nations that are now known as Syria, Palestine, Jordan, Lebanon and parts of other neighboring countries. As a result, Damascus regarded Lebanon as a part of its own territory and asserted territorial sovereignty over it (Yonker, 2021). As a way to influence internal politics, the Syrian Arab Republic endorsed a number of domestic Lebanese political groups and factions whose goals coincided with its own, the latter was one of the reasons that led to the Lebanese civil war of 1975 (Lawson, 1984). Syria played a significant role in the conflict, first stepping in to aid Christian forces and then forming alliances with Muslim groups. In order to bolster their position, Lebanese officials invited Syria to actively interfere in Lebanese politics and the latter allowed it to maintain control over the nation for many decades after the civil war ended (Al Jazeera, 2007). The end of the Syrian administrative control over Beirut was following major protests and international pressure over the assassination of the Lebanese Prime Minister Rafiq El Hariri in 2005, an ally of the Kingdom of Saudi Arabia, who was resisting the occupation. It is noteworthy that many Lebanese did not harbor animosity against Syria; on the contrary, they saw Damascus as a stabilizing factor that brought an end to the horrors of the civil war (Al Jazeera, 2007). Regarding more recent geopolitical issues, Lebanon's political and economic stability was severely impacted by the 2011 start of the Syrian Civil War and the millions of refugees that seeked shelter in Lebanon. Although Lebanon's official stance was to remain neutral in the conflict, some factions continued to support the Assad regime, which had dire domestic consequences (Christophersen, 2020).

Regarding Israel's occupation of Palestine, the Lebanese civil war also shaped the relationship between Beirut and Tel Aviv for decades to come. The 1982 invasion of South Lebanon which aim was to expel the fighters of the Palestinian Liberation Organization, caused an occupation of around 18 years which largely contributed to the rise in popularity of the party know as Hezbollah, the Shia armed group who has historically always been supported by the Islamic Republic of Iran (Swift, 2023). Several skirmishes have been taking place between the two alongside the southern border of the country with the most recent one happening at the time of writing this paper following the conflict happening in the Gaza Strip (United Nations, 2024 ; Kaufman, 2024). Israel has always expressed worries over Hezbollah's presence in Lebanon, labeling them as a terrorist organization however the latter received national support from other Lebanese sects following the Lebanese-Israeli war of 2006 and the invasion of Lebanon as many saw the party as the last line of defense keeping the country safe from becoming another occupied territory (Irani, 2007). Hezbollah has since made it its objective to liberate the Shebaa Farms land, which Israel is occupying and has used the latter as a pretext for attacks (Rose, 2019).

Beirut mostly maintains ties with Tehran via Hezbollah and its supporters. Iran provided significant assistance for Hezbollah's establishment in the 1980s when the Lebanese government failed to provide support for its Shia population. Since then, Hezbollah has grown to be a most potent political and military entity in the country, with a presence inside the government (Kane, 2018). Iran primarily supports the party in order to assert its dominance over the Levant and to offset the impact of Israel and the West. The partnership has fostered the impression of Lebanon as a proxy for Tehran in the area, resulting in heightened pressure from other regional powers, particularly the nations of the Gulf Cooperation Council, who were formerly a significant financial benefactor of the nation (Lob, 2019). Similarly to Yemen, Lebanon has been the scene of a power struggle between Riyadh and Tehran, with each seeking to influence the country's foreign and domestic policy. The latter rendered Lebanon’s originally planned “neutrality over external conflicts” impossible.

As mentioned, the Kingdom of Saudi Arabia is the other regional powerhouse that significantly affects Lebanese and regional politics. During the civil war, the Saudis first supported the government and Christian militias while also providing the nation with humanitarian aid as it saw the potential in Beirut as a strategic partner (Benoist, 2018). On a more recent note, the Kingdom has limited its investment in the country as it views Hezbollah as a risk to its regional interests. Due to its inability to rely on foreign investors and the banking system serving as its major pillar, Beirut's economy entered a state of instability mainly due to the external effort to isolate the group both politically and financially (Beyhum, 2016).

Finally, regarding Lebanon's foreign policy with the West, it has historically been backed by the Christians of the nation, which maintained close connections to the US and France after independence and frequently relied on their financial and military support. The French culture and language are widespread in the country following colonial times (Chadwick, 2020) and the United States has been financing the Lebanese Army for many years (Iskandarani, 2021).

Based on the above, we can conclude that Lebanon’s foreign policy is a very tricky one. The country was never able to maintain the stance of neutrality which was its initial goal to remain a Switzerland of the area. The region’s instability has taken Beirut in its sway and the situation we see today is a result of this political strife.

Chapter four will go in more depth as to how the political, social and cultural aspects of the country contributed to the financial crisis.

Minsky’s FIH and the Lebanese Financial System

Lebanon’s financial system was analyzed through the lens of many academic works for decades. The fact that Lebanon faced repeated currency devaluation and episodes of severe inflation during the 80s and early 90s pushed many economists to study financial crises. The period in question is characterized by a major volatility in inflation rates and the Lebanese pound's value between 1984 and 1992. Inflation surged from 6.6% in 1983 to 120% in 1992 while the exchange rate plummeted from 4.53 Lebanese pounds per dollar in 1984 to 1,838 Lebanese pounds per dollar by the end of 1992. Minsky’s work is mentioned in a paper by Dibeh, G. (2002) as his work coincides with insights gained from the FIH showcasing that in a speculative boom, “long term and lower rate of return projects get rationed out of the credit market because of high interest rates and severe competition for funds between firms which draws in both financial and non-financial institutions that ride the speculative wave” (Dibeh, 2002:41).

On a more recent note, the 2019 financial crisis has been a topic of interest to many scholars. Mora, N. (2020) highlights how balance sheets were mismatched across the government, banking system, central bank and private sector which are a clear sign of corruption. The work also mentioned the fixed exchange rate regime which made the economy vulnerable to speculative attacks and how the decade-long overvaluation of the real exchange rate further worsened the situation.

Another paper by Daher, J. (2022) analyzes how the crisis is deeply rooted in Lebanon's political economy which was shaped since the end of the Lebanese Civil War. The work covers how the contemporary policies prioritized global economic integration and the growth of the private-sector which in turn reinforced the country's finance, real estate and services sector. The latter further aggravated social inequalities and regional disparities as these policies marginalized sectors such as agriculture and industry, benefiting economic and political elites through privatization.

Finally, the World Bank (2022) analyzed the financial crisis in question by decomposing Lebanon's fiscal policy for the past few decades and elaborating an in depth analysis of the decisions of the central bank that led to them dubbing it as a "Ponzi Scheme".

There was however no mention of Minsky's FIH in any of the above cited works describing the crash of 2019.

1.5 Hypothesis & Contribution

The applicability of Minsky's FIH to the Lebanese financial crisis can be analyzed by checking whether there was a trend indicating that the Lebanese economy was on a path toward its current state of meltdown. One way of examining the latter, is by trying to identify whether a Minsky Moment occurred in 2019. As elaborated previously, the goal of the FIH is to highlight that periods of economic stability promote risk taking and financial speculation which ultimately leads to severe financial instability (Behlul, 2011 ; Vercelli, 2011).

In order to make such a claim more falsifiable, this paper formulates the following sub-hypotheses:

The following variables from Minsky's Financial Instability Hypothesis should show an upward trend in the years leading to 2019 and a crash post-Minsky Moment.

1. GDP
2. Interest Rate on Loans
3. Private Debt:
    a. Credit Growth
    b. Debt-to-GDP
4. Asset Prices
5. Lending/Borrowing Behavior

However, while this analysis shall focus on the elements mentioned in Minsky's theory, it will also tackle other factors that were not a part of the FIH but are nonetheless equally as important to mention in the case at hand. The latter will cover the following financial variables that should show an upward trend in the years leading to 2019 and a crash post-Minsky Moment.

1. Interest Rate on Deposits
2. Public Debt:
    a. Credit Growth
    a. Debt-to-GDP ratio

The "bust" stage of the cycle can be further proven by looking into the following factors that should show an upward trend post-2019:

1. Inflation
2. Currency Devaluation
3. Drainage of Foreign Currency Reserves
4. Poverty levels
5. Loss of trust of foreign investors

Finally, as described in previous chapters, Lebanon's social and political construct is rather unique and the country's longstanding political instability is characterized by sectarianism, corruption and a unique geopolitical landscape. This led to inefficient governance, policy making and a lack of supervision which may have greatly contributed to a potential Minsky Moment. In this regard, some soft parameters shall also be explored such as:

1. Decision-Making Paralysis due to sectarian governance
2. Tourism & Migration
3. Unemployment
4. Migration
5. Civil Unrest
6. Corruption
7. Geopolitical Instability

By writing this paper, I am enriching the literature on Minsky's financial instability hypothesis and its real-world application. Applying Minsky's work to the Lebanese financial crisis of 2019 provides a perspective of how Minsky's theoretical framework can be used to dissect and comprehend complex economic phenomena, especially that there is no academic paper available at the moment covering this specific case. This research not only sheds light on the specific case of Lebanon but also offers valuable perspectives for policymakers and economists worldwide. By highlighting the patterns and warning signs of financial instability, this work can give more effective regulatory measures and strategies to prevent similar crises from happening in Lebanon in the future as well as in other emerging markets. In addition to the above, a vital goal of this paper is to highlight that the FIH does not cover all potential elements that could lead an economy to crash and while the factors elaborated by Minsky are extremely relevant, the case at hand offers other unique characteristics that cannot be ignored.

Politics and Economics go hand in hand as analyzing a scenario from a financial perspective without looking into the political landscape of the country or vice versa could lead to misleading findings.

2. Methodology

The main methodology that will be used throughout the thesis will be a Case Study. The latter is an empirical inquiry which investigates a phenomenon in its real-life context. This will involve gathering and analyzing data from a various sources including official reports, news articles and academic literature (Yin, 2009). “Case Studies are a qualitative design in which the researcher explores in depth a program, event, activity, process, or one or more individuals. The case(s) are bound by time and activity, and researchers collect detailed information using a variety of data collection procedures over a sustained period of time” (Creswell, 2014). It is worth mentioning that a case study is a research strategy, and not just a method of data collection. The unit of analysis can be an individual, a community, an event or even a decision (de Vaus, 2001).

Three types of case studies can be used: *Descriptive*, its goal is to provide a detailed description of a phenomenon within its real-world context. *Exploratory*, with the aim being an investigation in order to uncover new research questions to be examined in future studies. And finally *Explanatory* which is what has been used in this paper. An *Explanatory* case study seeks to identify causal factors to explain a particular phenomenon while covering the “whys” and the “hows” that led to events happening (Priya, 2021).

To reach a more comprehensive position on whether a Minsky Moment occurred, an in-depth analysis of the crisis will be conducted focusing on identifying the contributing financial, social, cultural and political factors.

The latter will be achieved by analyzing some contributing factors that were mentioned in the theory and others that were not. Aspects of the fiscal landscape according to the FIH such as the private debt, the interest rate on loans, asset prices and lending/borrowing behavior will be explored. Followed by other contributing elements such as the public debt, the interest rate on deposits, corruption, sectarian governance, political instability, migration, poverty, civil unrest and others.

The case study method was picked to be used in this study as this is a rather qualitative analysis of a quantitative scenario. Being a student of Political Economy and having in mind that the goal is to reach an understanding of the causes that led to the crisis, it felt regrettable to solely tackle the financial aspect noting the significant political history of the Lebanese territory. The crash of the Lebanese economy ultimately came about because of specific economic, political, and social factors and the case study method can engulf all those aspects which then lead to a conclusion that quantitative methods could overlook. This research can hence explore the relevance of Minsky's work and its limitations in a real-world scenario by integrating qualitative data such as historical documents and news. The goal as a political economist is to contribute to the broader discourse by generating meaningful conclusions that are grounded in the specific realities of a scenario.

3. Case at hand – Lebanon's Financial Crisis

Decomposing the Timeline:

Minsky's Theory revolves around his hypothesis of the credit cycle. In order to differentiate the hedge, speculative and Ponzi finance stages in our case, we will try to decompose the timeline of Lebanon from the early 90s based on distinct periods leading to the financial crisis of 2019. We hence characterize four phases as per the below Figure #5 (World Bank, 2022):

- Phase 1 (1993-1997): The first phase is right after the end of the civil war, the economy had to naturally undergo increased expenditure in order to rebuild, re-staff the civil entities and invest in infrastructure. Figure #5 depicts a noticeable negative primary budget balance which led to the accumulation of debt.
- Phase 2 (1998-2001): This period marks difficult economic conditions created via measures to reduce capital expenditure, it is a period of fiscal adjustment. There was a significant reduction in infrastructure investments and higher taxation which led to a balanced primary deficit. The exception refers to a brief period of significant shortage in 2000, which might be seen as an anomaly during this era. This was mainly caused by the settlement of outstanding debts from previous years.
- Phase 3 (2002-2011): The early 2000s brought with them optimism as can be seen on the below Figure #5, a period of relief after the tough 90s. There was a major influx of capital due to an improved investor sentiment following the Paris II Conference where Lebanon secured substantial loans in order to rebuild its economy as well as surging oil prices. It is worth noting that this is the era of the global financial crisis, the instability it created led to capital flowing into Lebanon's "safe haven" bank-deposit system as they were offering attractive returns. An outlier is year 2006 as it was marked by the June 2006 war with Israel.
- Phase 4 (2012-2019): This final phase dubbed the Pre-Crisis period marked a stage of turmoil just before a crisis. This phase was kicked off by the eruption of the Syrian civil war and therefore the massive inflow of Syrian refugees which destabilized the infrastructure of the country. In addition to that, this period was marked by fluctuations in

oil prices, the closure of trade routes and a massive decline in tourism. The primary balance was fluctuating as it is physically representing the financial and political instability of Lebanon at the time. In addition to these challenges, this phase was also when the central bank engaged in extensive "financial engineering" operations to postpone a recession. Another factor was the increase in political-financial spending because of a sudden increase in recruitment of partisans into the public sphere, the military and security agencies.

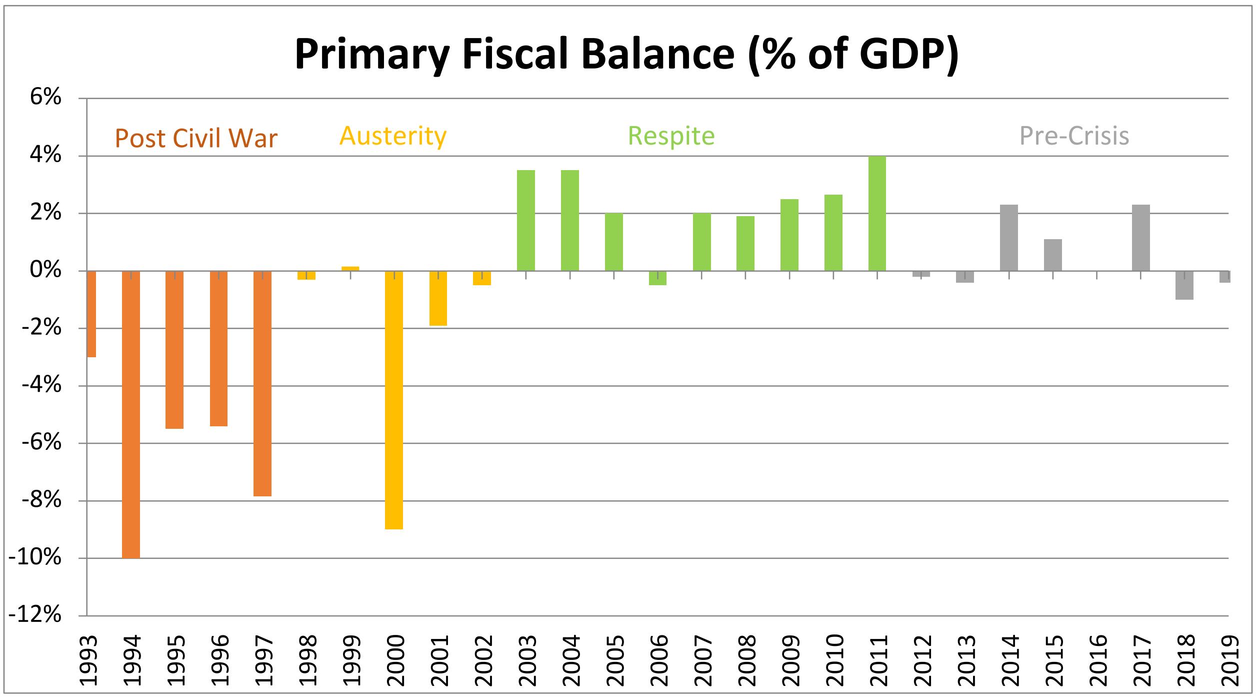

Figure 5 – Primary Fiscal Balance

Source: World Bank - Lebanon Public Finance Review: Ponzi Finance?

I - The Financial Instability Hypothesis' Variables:

- **GDP**

As per the below Figure #6, the country's GDP has been growing since the early 1990s going from USD 2.8 billion in 1990 to USD 54.9 billion in 2018. Starting in 2020, a sudden crash can be seen with the GDP reaching a value of USD 23.13 billion in 2021 putting the economy back to its size 12 years ago.

By 2022, even though the economic decline of the country relatively stabilized, its downward slope stayed persistent. The Real GDP is estimated to have contracted by 2.6% resulting in a total economic contraction of nearly 40% since in just 4 years. The state of the current account deficit is mainly due to increased imports and declining exports. It expanded to over 20% of the GDP which is similar to pre-crisis levels (Al Saeed et. al, 2023). It is worth noting that based on the World Bank data, the same trend can be observed when looking into the Real GDP per capita, PPP.

This factor hence shows a perfect representation of our assumption of an upward trend in the years leading to 2019 followed by a crash post-Minsky Moment.

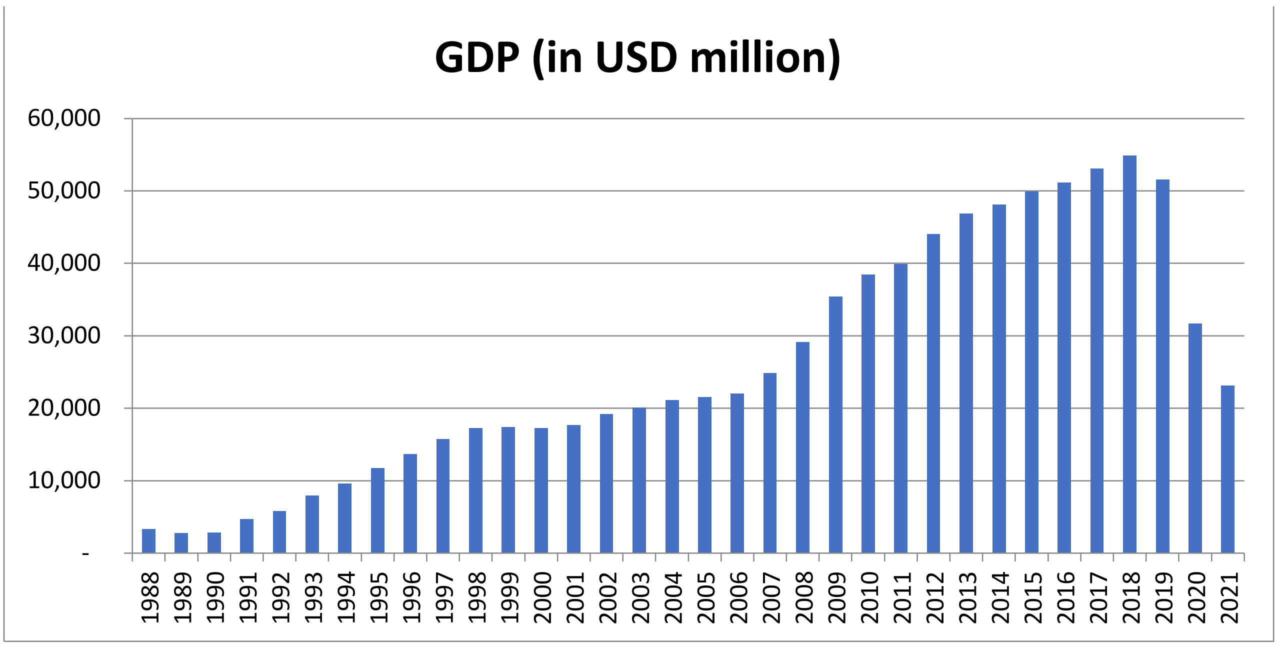

Figure 6 – GDP

Source: World Bank - GDP (current US$) - Lebanon

- **Interest Rate on Loans:**

Lebanon operates with a unique dual currency system, where both the Lebanese Pound (LBP) and the United States Dollar (USD) are commonly used in everyday transactions. Both of them are widely accepted and the banks issue loans in both currencies with different interest rate policies for each. The latter is also true for interest rate on deposits that will be covered later. The dynamics of the interest rate landscape in this particular context are entirely consistent with Minsky's framework. It is fascinating to observe the major drop of the interest rate on LBP loans between 1997 and 2011 from almost 24% to a steady and relatively low interest rate of around 7-8% that will be prevalent during 2011-2017 correspond in harmony with a period of strong economic growth marked by borrowing enthusiasm as shown in Figure #7. As mentioned, it is relatively hard to exactly pinpoint a timespan for when the hedge finance phase took place however we could assume that this is during this period.

Notably, the situation changed remarkably when the interest rate experienced a sudden spike, occurring between 2018 and 2020. The latter is characterized by an over 40% increase reaching a staggering rate of over 11%. A stable rate of 7-8% is considered a very good rate for loans hence it is clear that the banks were promoting loans until they could not anymore and had to suddenly increase the rates.

It is most intriguing to highlight that after the crisis occurred, there was another drop of the interest rate to the lowest point it has been in the past few decades however this is an artificial rate as offered loans are more and more scarce noting the instability of the LBP.

We can see a similar trend for the USD loans in Figure #8.

This factor also perfectly depicts the hypothesis as the interest rate on loans did in fact show an increase in the years leading to 2019 followed by a crash after the assumed Minsky Moment.

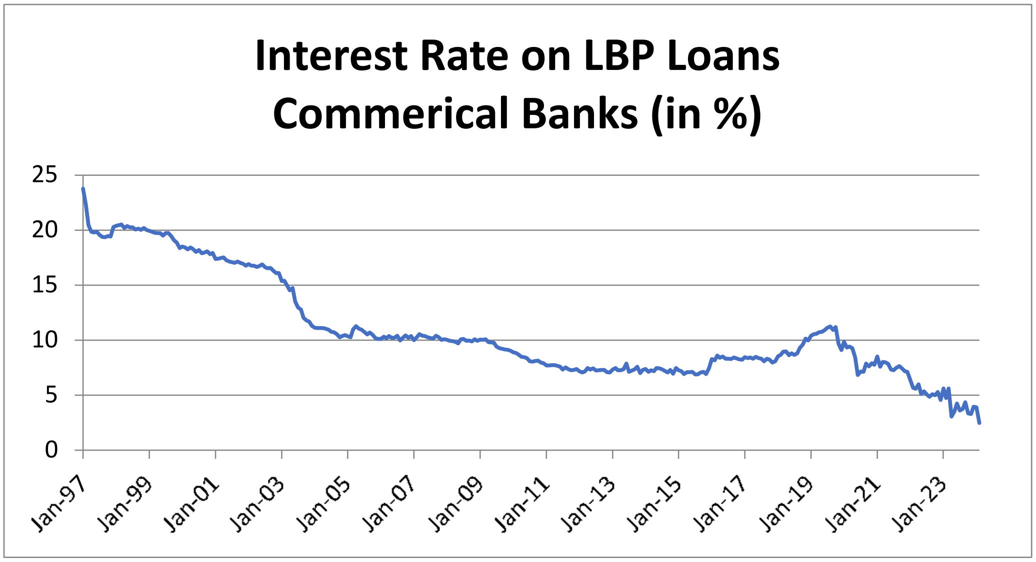

Figure 7- Interest Rate on LBP Loans

Source: Banque Du Liban – Interest Rates – Commercial Banks LBP Discount and Loans (Weighted Average)

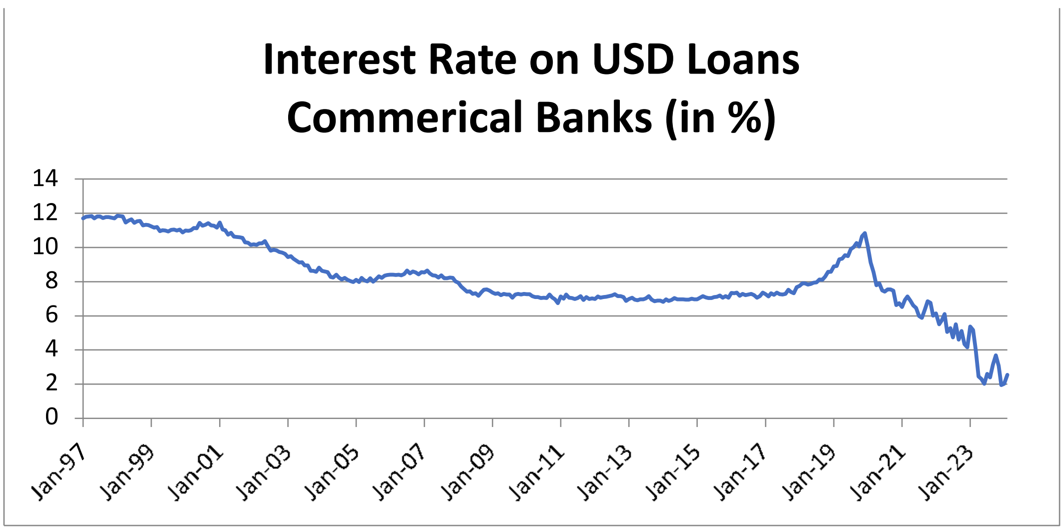

Figure 8 – Interest Rate on USD Loans

Source: Banque Du Liban – Interest Rates – Commercial Banks USD Discount and Loans (Weighted Average)

- **Private Debt:**
    - **Credit Growth – Nominal Value:**

As per Figure #9, the overall trend shows a steady increase in the local currency loans which indicates greater growing borrowing activity. The peaks in late 2019 and 2020, followed by a significant decline, suggest the possibility of a move into Ponzi finance. As described in the previous chapter, this substantial increase in borrowing could reflect an unsustainable level of debt with borrowers not being able to meet their financial obligation except by selling their assets or by continuing the cycle of borrowing. Towards 2021, we see a clear decline in loans; the latter is due to defaults and significantly tighter credit conditions implemented by the banking system.

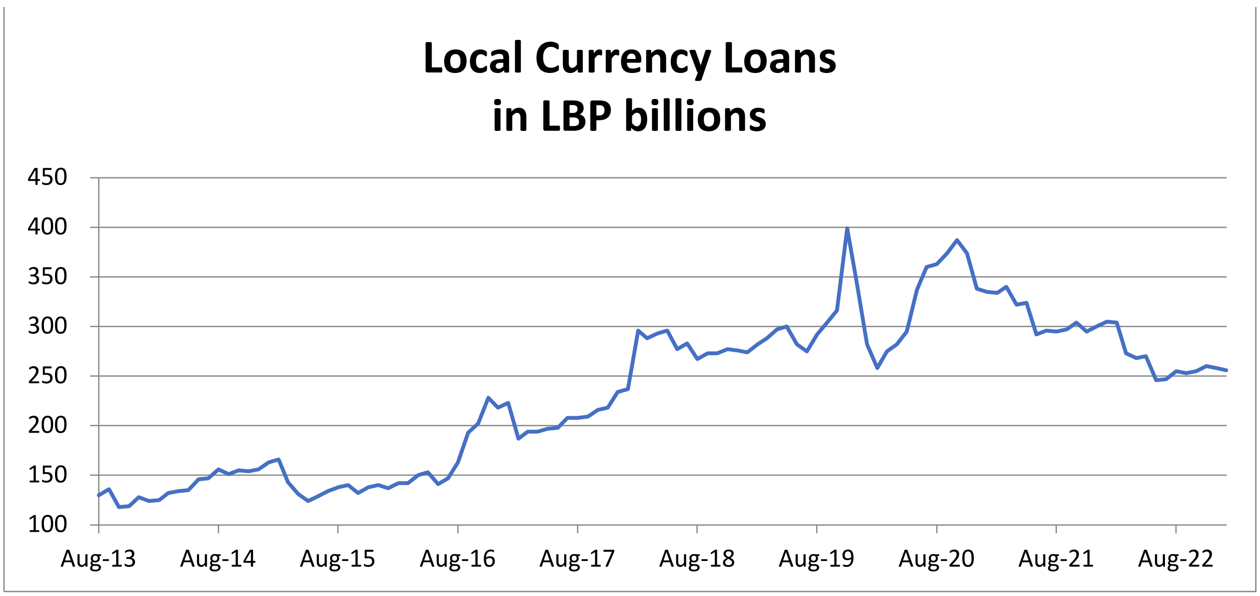

Figure 9 – Local Currency Loans

Source: Banque du Liban – Statistics & Research - Local Currency Debt by Type of Instrument – Loans

- **Debt-to-GDP ratio:**

While the credit growth in nominal terms was a valuable variable to consider when analyzing the debt level of the case at hand, one cannot ignore its limitations. In this regard, the Debt-to-GDP ratio will be examined as it is a more relevant figure to understand the realities of the situations.

The only downside is that the data available was not as extensive (limited to years 2006 - 2017) due to the fact that the Lebanese Ministry of Finance website is currently non-operational. Data from CEIC had to be resorted to.

The private debt shows a general increase which indicates a very optimistic market sentiment pre-crisis in Figure #10. The sharp increase mainly started in 2009 due to the favorable conditions issued by the Lebanese banking sector which encouraged borrowing and while it stabilized following the start of the Syrian civil war, the upward trend is nonetheless apparent until 2017. In a span of 8 years, the private debt had seen an increase of nearly 50% reaching 101.9% of the nominal GDP in 2017 which is quite an alarming figure noting that the country was not in the same state of economic contraction and relative political stability that it was in back in the early 2000s. The data for years following 2017 was not available as CEIC data had to be resorted to since the original sources of the figures, the ministry of finance website, is currently non-operational.

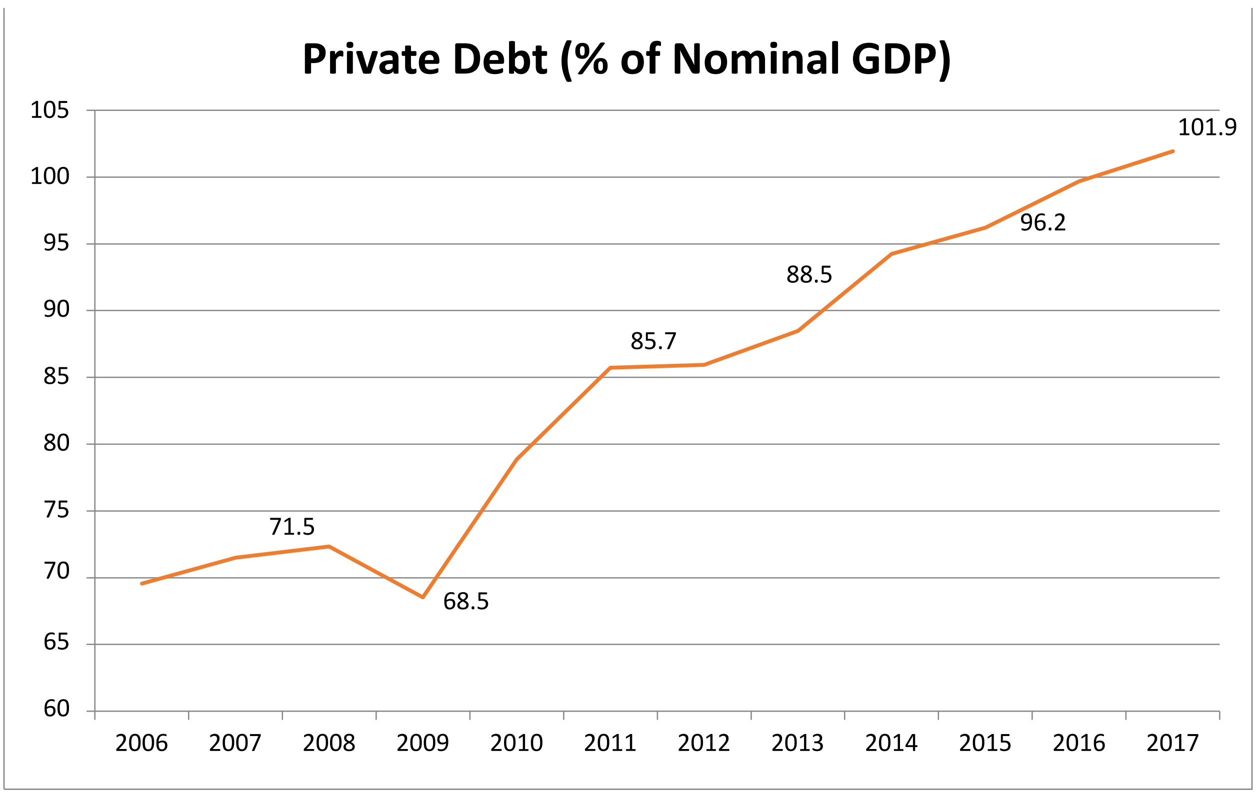

Figure 10 – Private Debt

Source: CEIC Data – Private Debt (% of Nominal GDP) - Lebanon

- **Asset Prices**:

There are not many assets which prices could be analyzed in this section in order to see the applicability of Minsky's theory due to the lack of availability of data, however, data on the real estate market is worth looking into. The Lebanese property market saw an average annual price increase of 18% between 2009 and 2013, including an impressive 48.4% increase in 2009 before slowing down due to the regional political turmoil, specifically the start of the Syrian civil war in this case, as seen in the below Figure #11 (De Guzman, 2019). In this regard, the boom-bust cycle does not follow the same historical trend as other factors when looking into the real estate market.

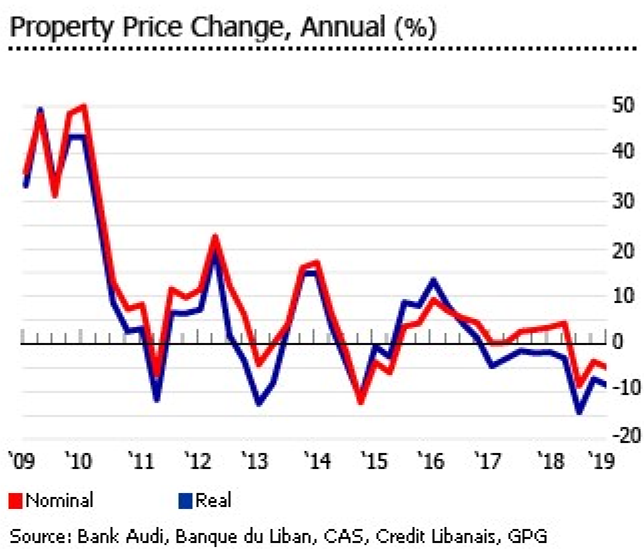

Figure 11 – Property Price Change

Source: Global Property Guide, Bank Audi, Banque du Liban, Credit Libanais

Another factor that could have been worth analyzing would have been the stock market. However since Lebanon does not have a significant stock market and is limited to either "SOLIDERE", the Lebanese Company for Development and Reconstruction of Beirut Central District or bank stocks, this factor could not be taken into account in our study as in order to analyze the overall stock prices it is generally preferred to look at indices.

Based on the above, it is safe to say that asset prices is not a textbook application of Minsky's

FIH as while we see a growth prior to the Ponzi stage and as per Figure #12, the drop happened between 2017 and 2019 and the property sales transactions value then increased following the crash due to Lebanese expatriates taking advantage of the devaluation of the local currency and the high demand for USD in the country (Bank Audi, 2023).

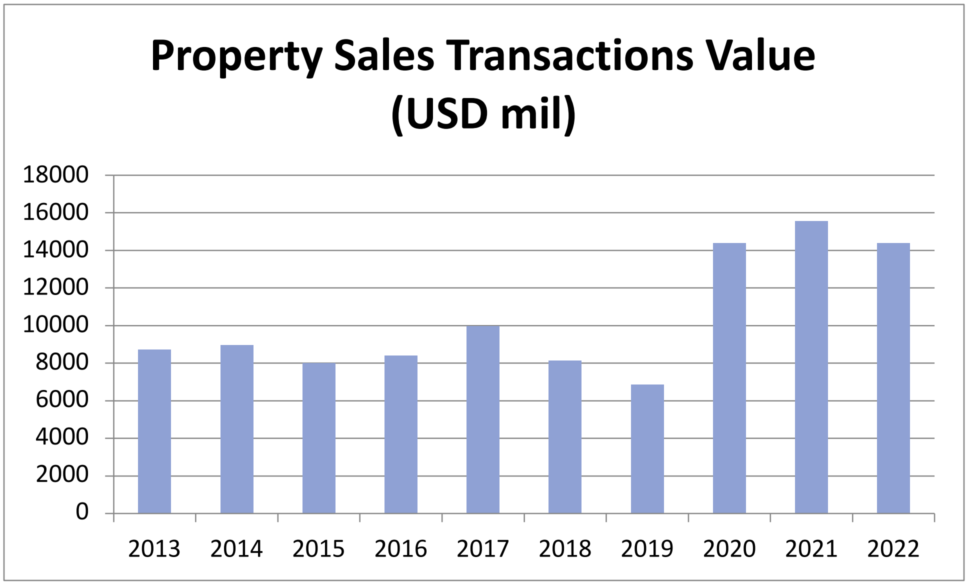

Figure 12 – Property Sales Transactions Value

Source: General Directorate of Land Registry and Cadastre, Bank Audi’s Group Research Department – Bank Audi Report (2023)

- **Lending/Borrowing Behavior:**

In 1997, the Banque du Liban introduced many initiatives to promote medium/long term lending to the private sector. Specifically in 2001, it allowed a reduction in the reserves requirements of commercial banks with the goal being to increase lending in the IT, agriculture and tourism sectors. This reduction was further expanded in reaching a deduction ceiling of 90% in early 2011 due to the success of these incentives. As part of this subsidy, the central bank ended up lending a total of USD 3.37 billion over the 2013-2015 period which was around double the net profit after tax of commercial banks in 2015 or 29% of the consolidated income of those banks. In fact, 76% of this subsidized lending went to the housing sector as shown in the below Figure #13 (World Bank, 2022).

The role of the central bank is hence highlighted here as this massive subsidy, in comparison to the revenues and profits of commercial banks, clearly shows the involvement of the Banque du Liban in their operations as well as the sensitivity of the implementation of such a public policy. It is worth noting that this policy not only increased the national debt but also created an even greater reliance on the inflow of USD deposits, in order to maintain the central bank's sacred dollar peg at low interest rates (World Bank, 2022). This factor further reinforces Minsky's credit cycle and the direction towards Ponzi finance.

Sectoral Distribution of Utilized Credit Benefiting from Deductions in Banks' Reserve Requirements or in Banks' Liabilities (in Percent)

Sector	2012	2013	2014	2015
Deductions in Reserve Requirements				
Housing Sector	76.6	77.11	77.94	79.59
Productive Sectors	3.89	3.65	3.91	3.89
Microcredits and Microcredit Institutions	0.06	0.43	0.37	0.24
Educational Sector	1.34	1.54	1.72	1.87
Environmentally Friendly Projects	0.4	0.46	0.57	0.5
Deductions in Liabilities				
Housing Sector	12.67	16.7	19.64	22.87
Productive Sectors	4.1	4.12	2.7	1.79
Subsidized Guaranteed Loans	1.96	2.31	2.17	1.96

Figure 13 - Sectoral Distribution of Utilized Credit Benefiting from Deductions in Banks' Reserve Requirements or in Banks' Liabilities
Source: World Bank - Lebanon Public Finance Review: Ponzi Finance?

The below Figure #14 depicting the total loans clearly shows a steady nominal increase driven by loans benefitting from reductions in reserve requirements. Focusing on phases 3 and 4, we can see that speculative behavior was growing significantly. Borrowers were asking for more and more loans as they may have been expecting an increase in the nominal value of their investments. The total loans amounted to north of LBP 25K billion during years 2007-2008 and went up to LBP 70K billion by 2015. According to CEIC Data, the boom cycle kept on increasing the total loans in the country until 2019 and following the financial crisis, the total loans fell back by over 60%. The latter clearly shows that there was a phenomenon of boom-bust and a textbook example of Minsky's theory.

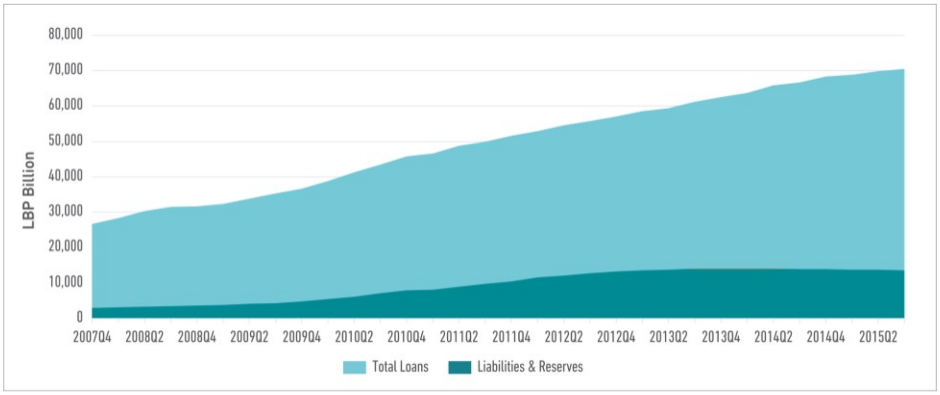

Figure 14 - Total loans in contrast to the reductions in reserve requirements
Source: World Bank - Lebanon Public Finance Review: Ponzi Finance?

II - Other Financial variables that are not a part of Minsky's Financial Instability Hypothesis:

- **Interest Rate on Deposits**

This factor could be considered a more controversial one as Hyman Minsky did not extensively focus on the specifics of it as his papers revolved around broader and more general financial market dynamics. However, his work heavily mentions the importance of savings and investments. In addition to the latter, while he did not particularly delve into central bank policies, he recognized the role of monetary authorities in influencing interest rates. Central banks use interest rates as a mean to influence inflation and economic growth hence variations in deposit interest rates are usually part of the macro monetary policy measures. In this aspect, when interest rates on deposits are higher, individuals and enterprises have an incentive to place their money in the banks, as they can earn a better return on their savings. Unlike the other factors, the impact of higher deposit interest rates on financial stability is not a straightforward one and depends on the broader economic context and the stage of the credit cycle.

In our case at hand, the interest rate on USD deposits rose from a stable 3% to more than doubling and reaching over 7%. A similar trend is seen for the LBP deposits. The latter highlights the strategy of the central bank to encourage deposits in order to increase the capital at hand of the local banking sector. Interest rates on deposits is a very sensitive factor that should be handled in the utmost delicacy as it directly affects the dynamics of the economy. The below Figures #15 and #16 are a clear depiction of a typical Ponzi scheme when after years of Hedge/Ponzi Finance and uncontrolled credit, a desperate last resort to keep the economy afloat was to reach out to any capital available by making the interest on deposits as attractive as possible to potential local and foreign investors. However as history has shown, this strategy is short-lived and was followed by a total crash with borrowing becoming unavailable. The latter is another good application of our hypothesis.

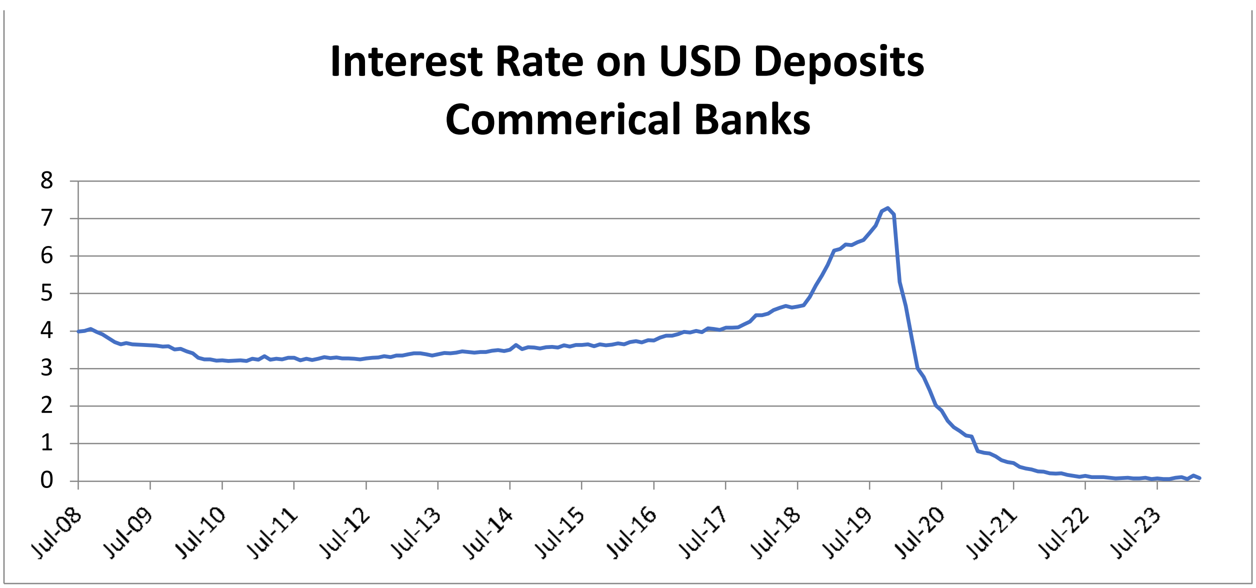

Figure 15 – Interest Rate on USD deposits

Source: Banque Du Liban – Interest Rates - Commercial Banks –USD: Term Savings and Deposits

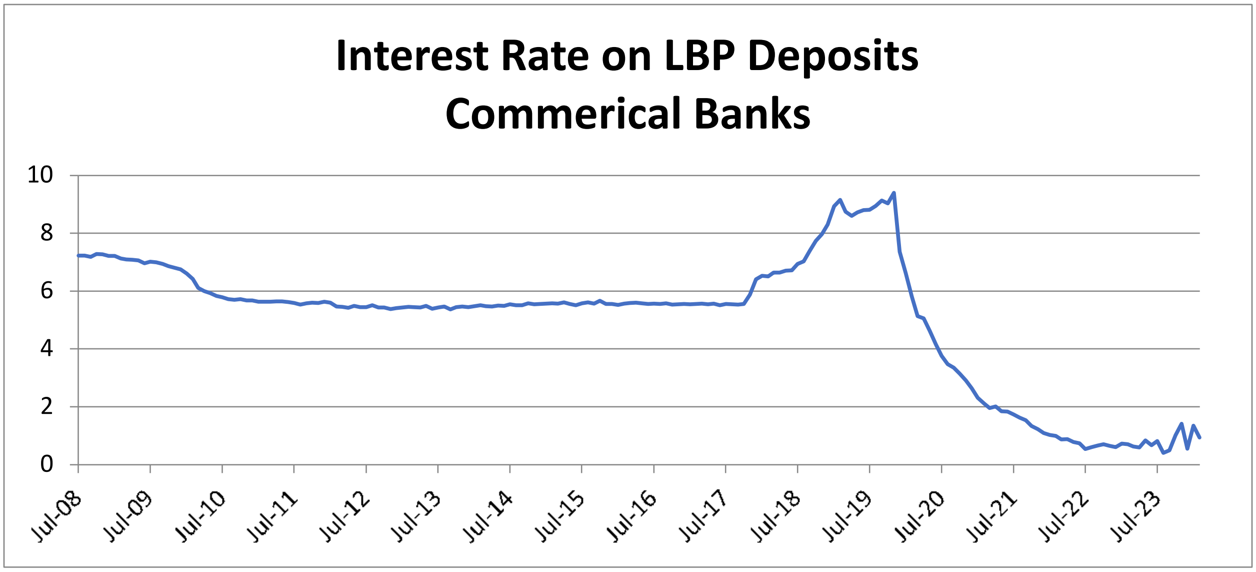

Figure 16 – Interest Rate on LBP deposits

Source: Banque Du Liban – Interest Rates - Commercial Banks –LBP: Term Savings and Deposits

- **Public Debt**
    - **Credit Growth – Nominal Value:**

While Minsky's FIH focuses on private debt, governmental credit growth can be an important indicator that the economy is switching stages from Hedge to Speculative and Ponzi. The public debt could be relevant to analyze as it points to the fact that there is excessive borrowing and that the central bank is issuing more and more bonds. Sudden spikes in public debt may be alarming as it could indicate some instability in the public balance sheets.

Generally speaking, both the Foreign and the Local currency debt graphs highlighted in Figures #17 and #18 show a clear upward trend in public debt. The latter indicates obvious fiscal challenges and a reliance on both foreign and domestic borrowing. The 2000s and early 2010s are characterized by a period of a slower growth with some fluctuations, but generally, the debt was continually rising. It is after 2015 that the debt level showed a sharper increase, with significant growth, especially noticeable after 2020. The major increase post-2020 likely reflects the impact of the COVID-19 pandemic, economic downturn and the measures taken to stabilize the economy. Looking into the LBP debt in depth, we notice that the Long Term Bonds (over 24 months) segment shows the most substantial increase, indicating that the government has leaned more towards longer-term financing. The debt composition over the years has seen a significant shift towards long-term bonds of over 24 months duration, reflecting perhaps a strategy to lock in lower interest rates for longer periods or to manage debt servicing more predictively. Therefore, this second variable also supports Minsky's theory that credit growth is indeed visible and it mirrors the capitalist cycle. The only difference here is that there is no apparent crash post-2019 which is understandable as public debt in nominal value does not operate the same way as the private one and in case of a crisis; the private debt would only grow further. The Debt-to-GDP ratio that will be covered in the next point is a better representation of our hypothesis however it lacks extensive data.

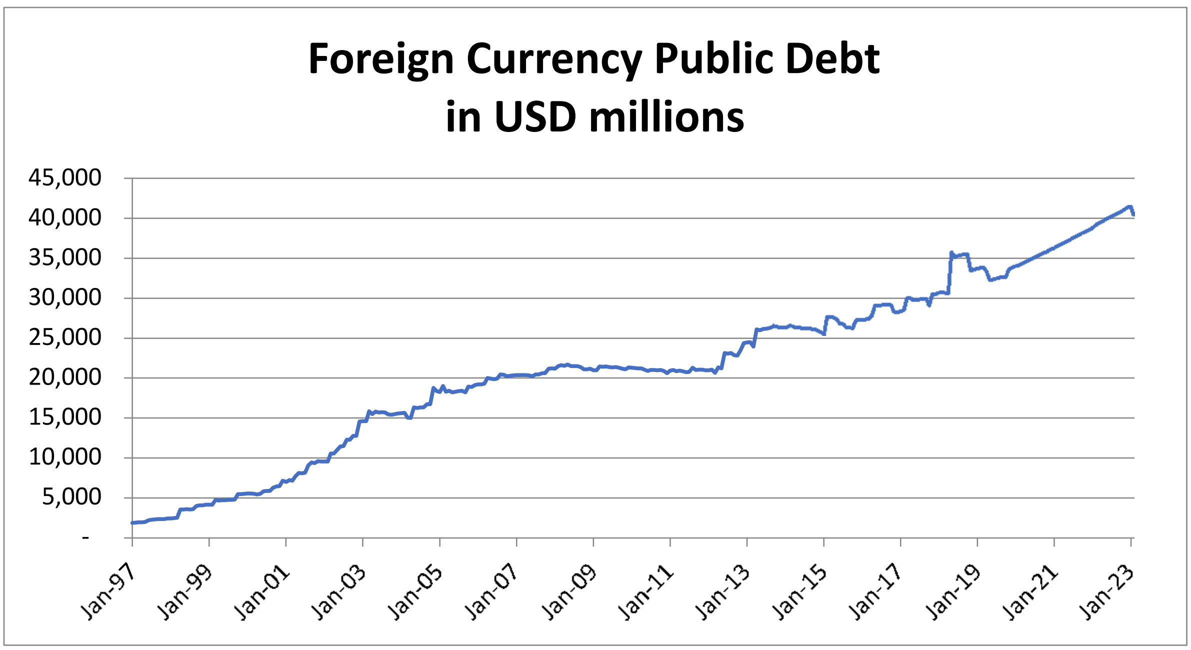

Figure 17 – Foreign Currency Public Debt

Source: Banque du Liban – Statistics & Research - Public Debt - Foreign Currency Debt

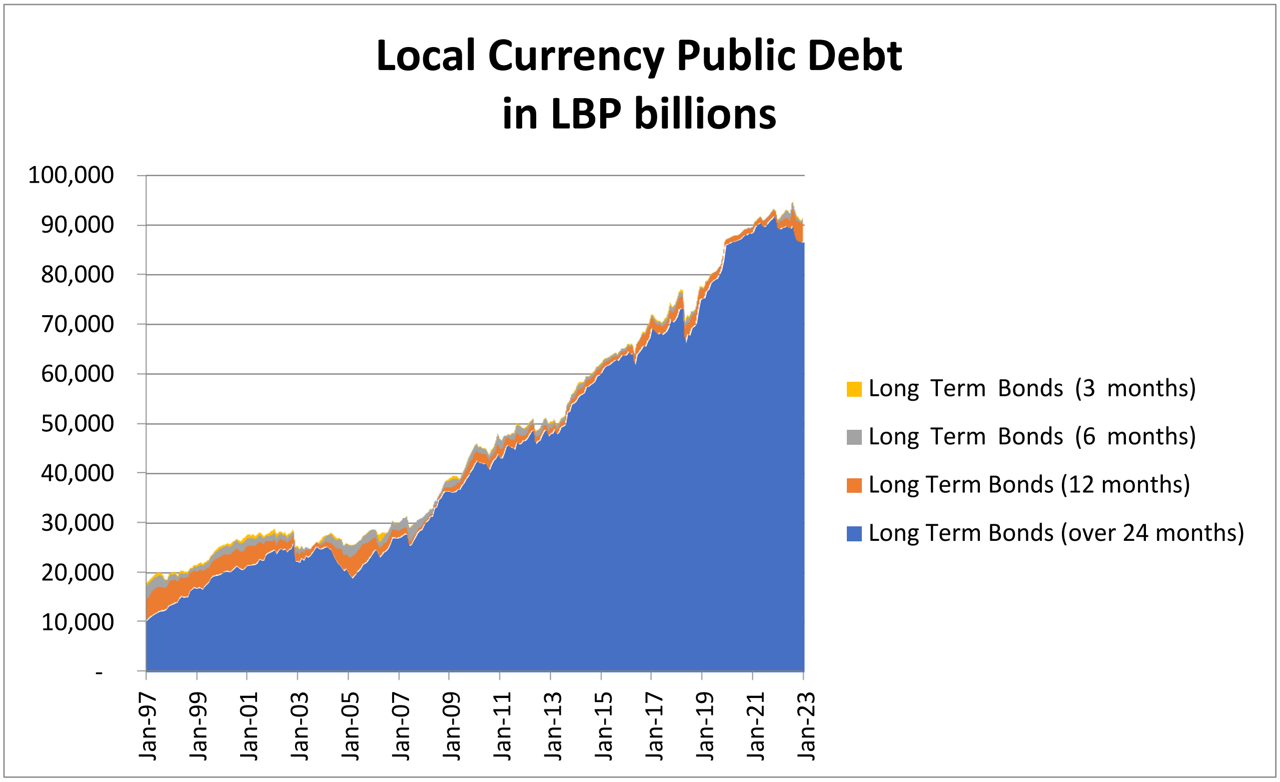

Figure 18 – Local Currency Public Debt

Source: Banque du Liban – Statistics & Research - Local Currency Debt by Type of Instrument

- **Debt-to-GDP ratio:**

Figure #19 shows that the first major phase is between 2011 and 2017 which is characterized by a noticeable upward trend in government debt from around 131% to around 150%. This gradual increase suggests that the government's borrowing continued to rise, possibly in order to finance public spending and to cover budget deficits due to culminating economic mismanagement such as desperate spending in order to maintain the currency peg and political instability such as the influx of Syrian refugees into the country.

The second phase is between 2018 and 2019 and is the last year before the start of the financial crisis and the protests. The Debt to GDP ratio experienced a sudden acceleration peaking at over 172%, nearly an 11% increase in a single year. The latter indicates severe fiscal imbalance. This dramatic rise showcases that the public sector was in a state of desperation to pay its dues and keep the economy afloat however the crash happened and 2020 shows a significant reduction to 150% due to the measures taken to restructure debt.

As benchmark, Greece experienced a severe debt crisis starting in 2009. At its peak, Greece's debt-to-GDP ratio exceeded 180%, similar to Lebanon's high ratios. Athens has to undergo significant economic reforms and austerity measures under the supervision of international financial institutions to stabilize its economy (Beshenov et. al, 2015).

The latter hence perfectly represents the hypothesis in question as we clearly see an upward trend pre-2019 and a crash following the assumed Minsky Moment.

The data for years prior to 2011 was not available as CEIC data had to be resorted to since the original sources of the figures, the ministry of finance website, is currently non-operational.

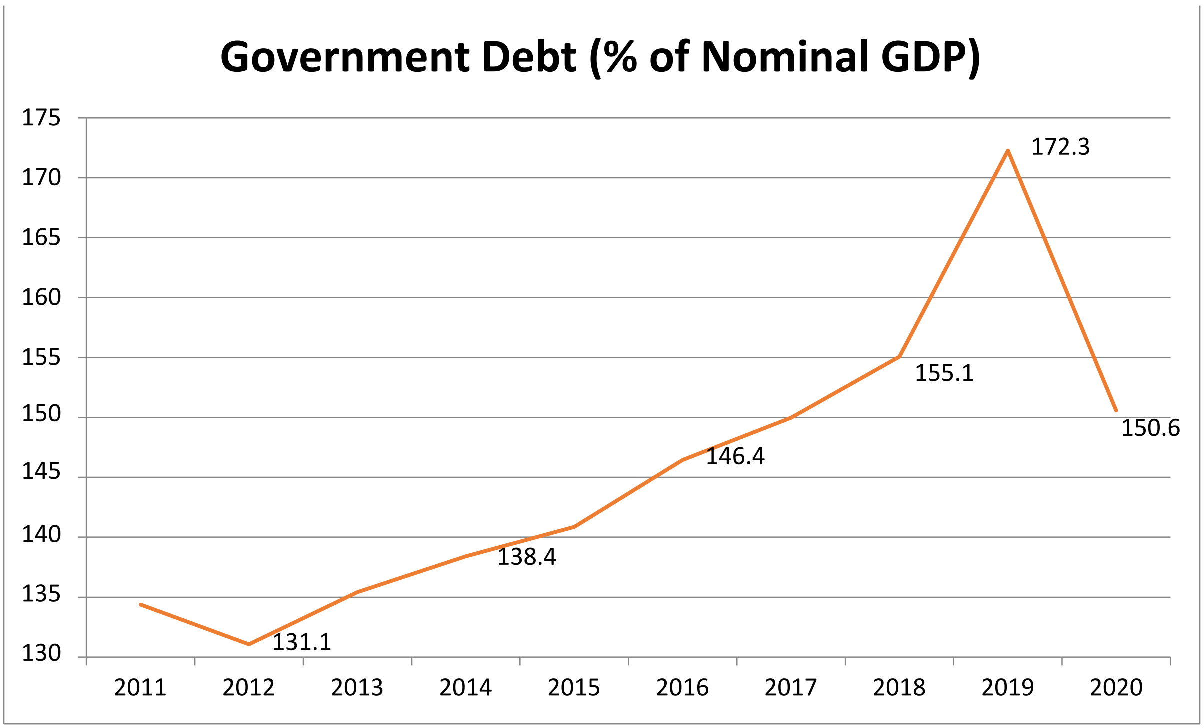

Figure 19 – Government Debt (% Nominal GDP)

Source: CEIC Data – Government Debt (% of Nominal GDP) – Lebanon

III - Consequences – "Bust" stage of the Boom-Bust Cycle:

The Lebanese Financial crisis has been ranked by the World Bank as one of the gravest internationally since the mid-1800s (World Bank, 2022). It has naturally caused many repercussions to the economy of the state but has also impacted the social and political spheres.

It is hence essential to look at the "bust" stage of the cycle to analyze whether a Minsky Moment did indeed occur.

- **Inflation**: The most apparent factor we can see is the hyperinflation that has been going on since. Lebanon's annual inflation rate has been ranked the highest of all countries tracked by Bloomberg even surpassing countries such as Venezuela and Zimbabwe who have been in dire financial meltdown for years (Goyeneche et. al, 2021). In May of 2023, it reached a record 260% marking the 35th consecutive month of hyperinflation (Trading Economics, 2023). Between 2021 and 2022, the average year-on-year inflation rate reached 157% with a corresponding food inflation rate of 328% and since the removal of subsidies, it grew even higher to reach 483% in 2022.
  Other notable sectors that have been strongly affected by the meltdown are transportation, telecommunication, recreation and culture, health as well as housing and utilities which saw extravagant numbers (World Bank, 2022). The below Figure #20 depicts the rapid growth of the mentioned inflation in the country in the past 5 years, it is clearly seen that, despite the oscillations, a major trend is present starting after the crisis of 2019.

Lebanon Year on Year Monthly Inflation Rate

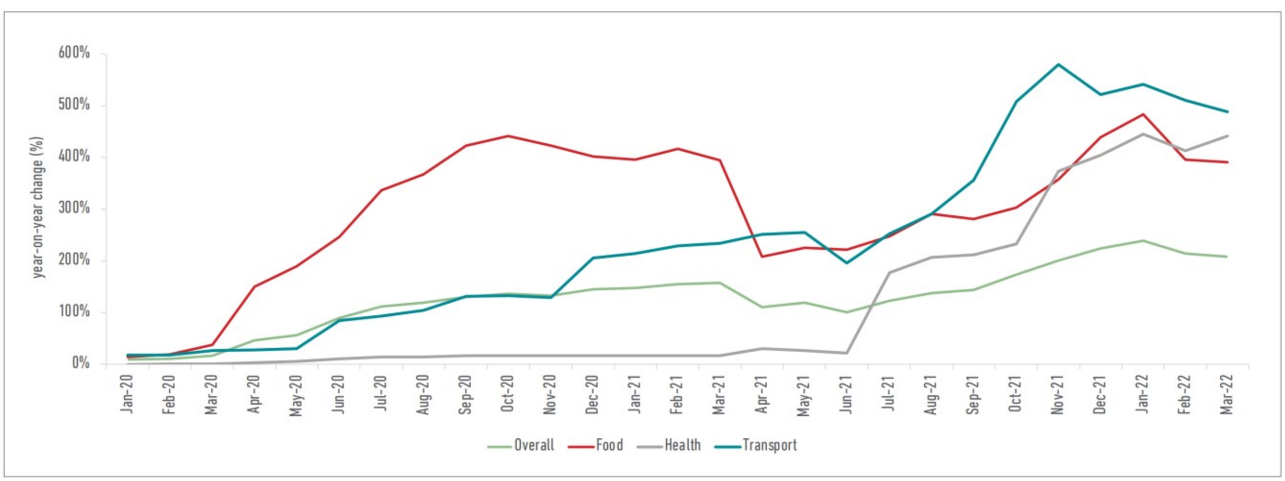

Figure 20 - Lebanon Year on Year Monthly Inflation Rate
Source: World Bank - Lebanon Public Finance Review: Ponzi Finance?

- **Currency Devaluation**: Another major factor related to the previous one is the sudden crash of the value of the Lebanese Pound as Lebanon's official currency lost some 95%

of its value post-crisis, destroying the citizens' purchasing power. For example, a Lebanese soldier's average monthly salary in Lebanese pounds amounted to USD 900 before the crisis when USD 1 was worth LBP 1,507.5. In March 2023, with USD 1 reaching a value of over LBP 100,000 a similar salary is worth north of USD 10 (Perry, 2022). There was hence a significant currency devaluation post-2019.

- **Drainage of Foreign Currency Reserves**: The latter was caused by investors and citizens moving their money out of the country. It is clear that the foreign exchange reserves have been in a state of constant growth until mid-2019 where it experienced a sudden bullish rise due to the before mentioned increase in interest rate on foreign deposits and followed by a long lasting fall in 2020 leading the reserves to value their amount back in 2008 as per Figure #21 (CEIC, 2023). In this regard, the foreign currency reserves were drained post-2019 which is a good application of our hypothesis.

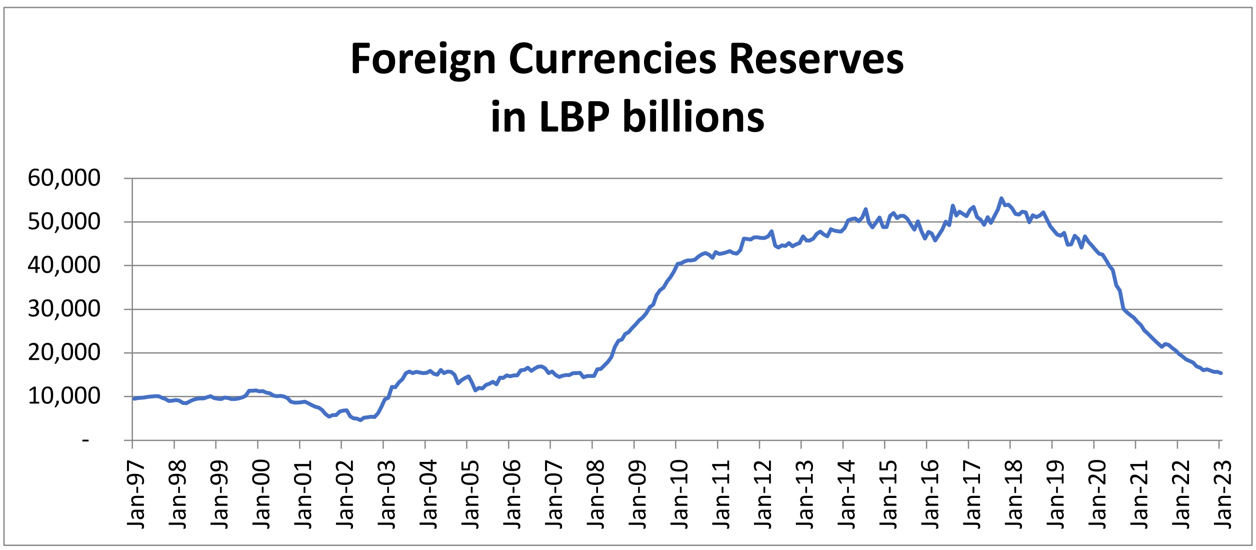

Figure 21 – Foreign Currencies Reserves

Source: Banque du Liban - Statistics & Research - Foreign Currencies

- **Poverty Levels**: The latter soared between 2018 and 2022 in Lebanon. Taking into account the most optimistic scenario, it is assumed that at least three out of every 5 citizens of the republic now live in poverty (Makdissi et.al , 2023). The below Figure #22 depicts the median monthly household income between November 2021 and January 2022 from a study conducted on over 1200 households in 5 different districts all around the country. The income in question can range as low as a mere USD 78 per month in the Beqaa valley and having an average of USD 122 for Lebanon as a whole. The Figure #23 below depicts the numbers from Figure #22 in contrast to the 20th and 90th percentiles of the population. It is important to note that inflation has continued to increase exponentially since the survey was taken therefore it is expected that the actual figures are assumed to be even more drastic. The average household size in this study is four people including one non-adult person aged below 18 and the top 1% of households were considered an outlier of the study as they do not fit the model seen below with average incomes reaching higher than USD 1450. It is hence seen that the share of the households living on extremely low incomes was overwhelming with 40% of the people earning less than USD 100 per month and 90% earning less than USD 377. According to the United Nations Economic and Social Commission for Western Asia, poverty in Lebanon has risen from 25% in 2019 to 82% in 2021 with 74% of the populace making less than $14 a day (Human Rights Watch, 2022). Poverty levels were hence worsened post-2019 further proving our claim that there was a "bust" compared to previous years.

Monthly Household Income

Mohafazat	Median monthly income (USD)	95% confidence interval
Beirut	$112	($91 - 173)
Beqaa	$78	($78 - 86)
Mount Lebanon	$157	($147 - 182)
North Lebanon	$110	($86 - 130)
South Lebanon	$120	($105 - 147)
Total Lebanon	**$122**	**($105 - 147)**

Figure 22 – Monthly Household Income

Source: Human Rights Watch survey, November 2021–January 2022, sample size: n = 1209 households.

Distribution of Households by Monthly Income

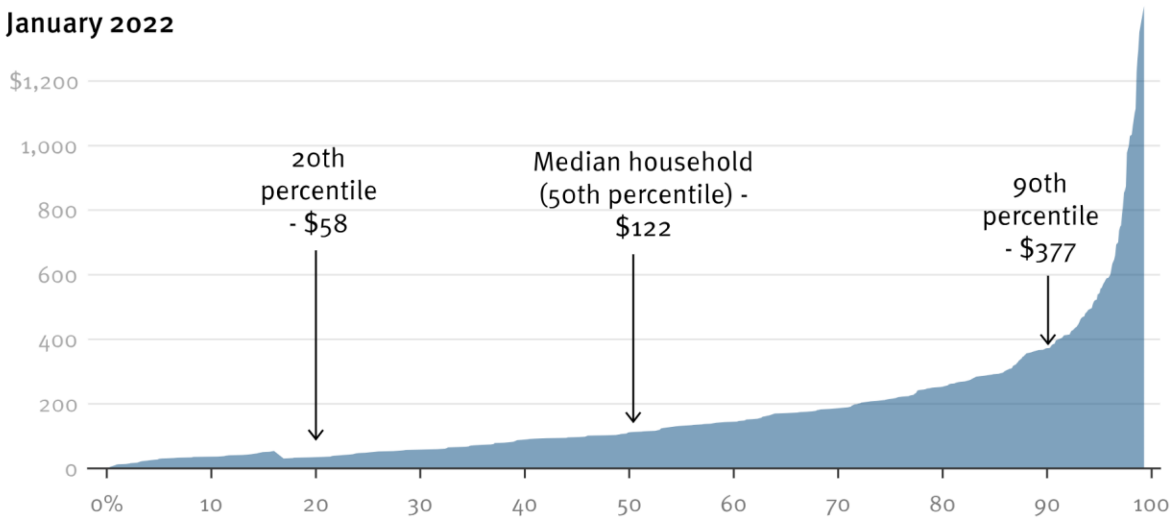

Figure 23 – Distribution of Households by Monthly Income

Source: Human Rights Watch survey, November 2021-January 2022, sample size: n = 1209 households.

For scaling purposes, the top 1% of households are not included, as monthly income is higher than USD 1,450.

- **Loss of Trust of Foreign Investors**: There was a dramatic loss of confidence from the part of investors from European and Gulf countries as well as Syria which affected diplomatic relations between those countries and Lebanon. According to Al-Khalidi (2020), Damascus mentioned that billions are trapped in the Lebanese banks with no way to withdraw them. Lebanon's banking secrecy law attracted foreign investors to deposit funds in the local banking sector. However, following the crash, both local and foreign depositors have been unable to access their savings. The Syrian president stated that the Syrian deposits range around 42 billion USD and the potential loss of such assets could be bad news for an economy like Syria's.

4. Social, Cultural & Political Contributing Factors

The findings from the previous chapters reveal that Lebanon's financial crisis can somehow be analyzed through Minsky's Financial Instability Hypothesis. The framework of his theory calls attention to the progression of financial stability turning into instability because of excessive risk-taking behavior due to a positive and optimistic market sentiment following a period of apparent economic stability. By decomposing Lebanon's contemporary timeline and analyzing key variables such as the GDP, interest rate, credit growth, debt-to-GDP ratio, lending and borrowing behaviors and the interest rates on deposits, we showcased the crisis' alignment with Minsky's stages of financial fragility and hence the possibility of having a partial Minsky Moment (even though some factors such as the asset prices did not show the same trend of a Minsky Moment occurring by 2019 as other variables). The last chapter also showcased that there was indeed a bust that reflects what the FIH stands for.

However, while the FIH provides a strong framework for understanding the financial aspect of the crisis, it cannot fully capture the bigger picture of Lebanon's unique political, social and cultural reality. The crisis is therefore not a textbook example of Minsky's theory as real-world scenarios possess some elements that the hypothesis does not cover. The below soft variables try to depict the latter:

- **Decision-Making Paralysis due to Sectarian Governance**: The consociational nature of the Lebanese state means that power is shared among different religious groups, leading to a situation of decision-making paralysis and an inefficient governance system. The latter led to corruption and patronage which further weakened economic policy implementation. An example of the latter are the Paris I, II and III conferences that offered loans to Beirut aiming to bolster the Lebanese economy but failed to achieve the announced reforms. The most recent conference was the CEDRE from 2018 which goal was to support a Capital Investment Plan in the country. The CEDRE differed from its predecessors as its financial support was contingent on the execution of budgetary and sectoral reforms in the country. Figure #24 shows that the plan was to pledge nearly USD

16 billion until 2028 which is the largest investment program Lebanon had ever witnessed in order to streamline the infrastructure of the country which was severely hit by the mass arrival of Syrian refugees. The funds were unfortunately never received as the international community expressed significant doubts about the credibility of the commitments made by the Lebanese government following the fact that the decision-making process was halted for months because of the inability of the prime minister to form a cabinet due to sectarian division (Ouazzani, 2019). The latter is only one of the many examples where corruption and the religious context of Lebanon formed an obstacle to its development.

Capital Investment Summary

(In $M, excluding land expropriation)

Sector	**"CEDRE" Investment (Cycle 1)**	Cycle 2	Grand TOTAL
Transport	**2,311**	1,964	4,275
Water and Irrigation	**2,151**	722	2,873
Wastewater	**1,309**	1,047	2,356
Electricity	**2,151**	1,441	3,592
Telecom	**700**	-	700
Solid Waste	**1,400**	-	1,400
Tourism Infrastructure	**84**	180	264
Industrial Zones Infrastructure	**0* (**Phase 1* of the 3 new industrial zones is funded by the European Investment Bank & Italian UNIDO).**	75	75
Grand TOTAL	**10,106**	5,429	15,535

Figure 24 – CEDRE Capital Investment Summary

Source: BLOMINVEST Bank. "In a Nutshell: The 'CEDRE' Conference & the Capital Investment Plan.

- **Tourism & Migration:** The sudden drop of tourism following the start of the Syrian civil war in 2011 was a major blow to the Lebanese economy as this sector comprised 7% of its GDP post-crisis (IDAL, 2019) . Based on the World Bank data on international tourism, the number of arrivals to Beirut dropped by around 40% between 2010 and 2013. The US department of state classifies Lebanon as risk level 3 out of 4 for travelling and recommends the reconsideration of travel to the country.

  Migration has also been a heavy burden on Lebanon throughout the years. After the start of the Syrian civil war, we can clearly see that the long lasting stability of the migration rate in Lebanon since the end of the Lebanese civil war in the 80s has seen some serious unsteadiness. Since 2011, a major rise in Syrian refugees entered Lebanese grounds seeking asylum. Even though Turkey hosts the most displaced Syrians in terms of nominal value followed by European countries, Lebanon's number of Syrian refugees per capita forms a staggering 20% of the population in contrast to 5% in Turkey.

  Additionally, those nations had the economic capacity and political stability to offer a helping hand, while Lebanon's already fragile economy and political structure was only further damaged by this influx of refugees, specifically from Syria, a country who has had much tensions with Lebanon in the recent past (Christophersen, 2020).

  Figure #25 shows that in 2013 over 700,000 individuals migrated; this huge flow of refugees destabilized the country's infrastructure and tightened its resources.

  Seeing that the situation was rapidly deteriorating, the Lebanese populace started looking for better living conditions abroad, we can see that there is a negative figure since 2015 which shows that over 200,000 Lebanese citizens have been emigrating from the country on a yearly basis until the crisis occurred in 2019 where it became harder to salvage funds to leave the country. While slower, we can nonetheless still see a solid negative trend in recent years. The major issue here is that the emigrants are mainly the wealthy, educated and generally younger generation. The latter poses a huge risk on the future of the country as those people are specifically the individuals needed to introduce reform and stabilize the situation once again. Another major setback this is setting is the fact that the emigration is altering the country's demographic balance, making the minorities majorities (e.g., Sunnis and Shiites) and majorities minorities (e.g., Christians), not taking into account the fertility rates (Mendelek, 2022).

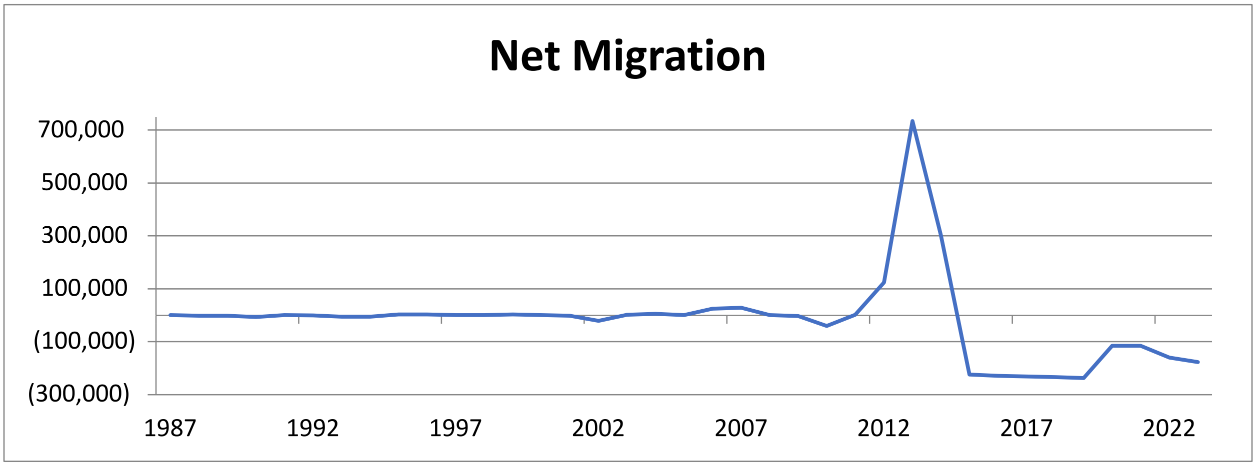

Figure 25 – Net Migration

Source: World Bank - Net migration – Lebanon

- **Unemployment:** This factor is yet another variable that is significant to show the disastrous situation that Lebanon is in as in order to put the economy back in motion. The below Figure #26 depicts that the unemployment rate has maintained a constant annual growth of around 0.5% since 2010 however a spike is highlighted in 2020 depicting over 3 times the usual growth rate value. In a matter of one decade, the unemployment rate hence increased from 6.78% in 2010 to 13.27% in 2020. The latter is due to businesses shutting down or scaling back operations amid the economic instability (MacroTrends, 2023).

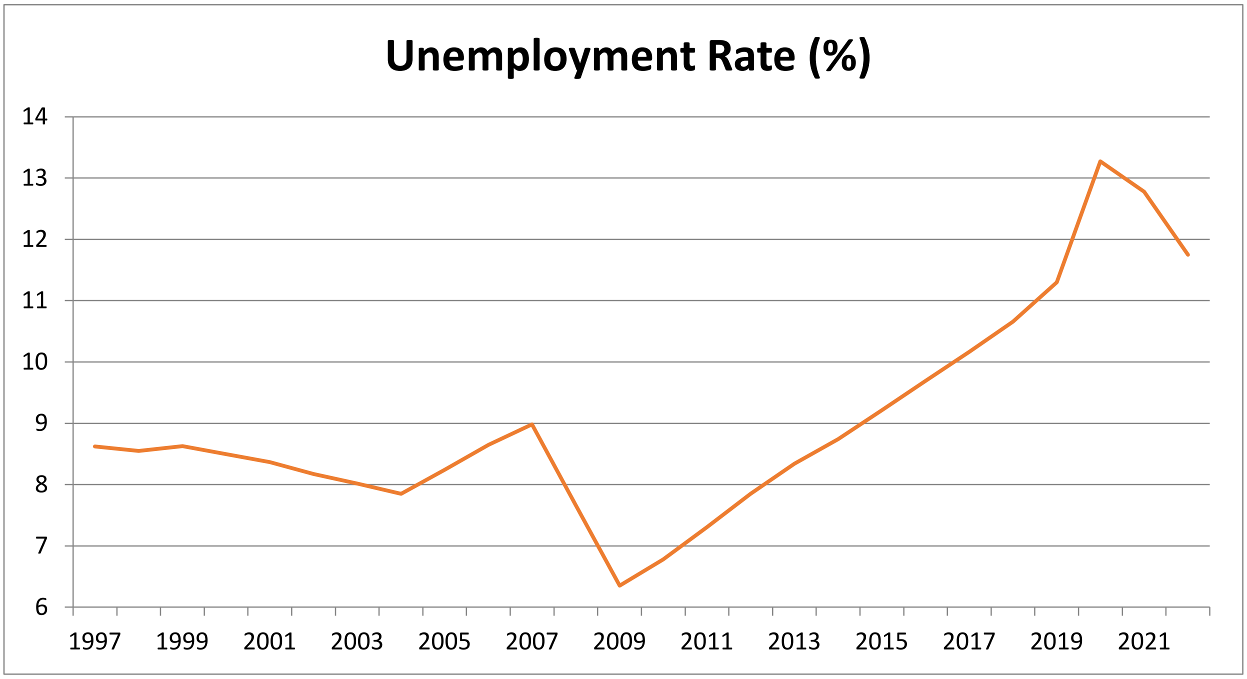

Figure 26 – Unemployment Rate

Source: MacroTrends - Lebanon Unemployment Rate 1960-2024

- **Civil Unrest:** Protests were most apparent all over the streets of Lebanon since the beginning of the crisis. The movement was dubbed the October 17th Revolution and it represented a series of protests that started that same day due to the government imposing new taxes on services like WhatsApp calls, which were seen as an additional burden on citizens already facing economic challenges. However, the protests eventually evolved into a broader movement demanding an end to political corruption, sectarianism and economic mismanagement.
- **Corruption**: The Lebanese political structure characterized by deep-seated sectarian divisions led to governance challenges and hindered necessary economic reforms. The corruption and lack of effect leadership and decision making was a main factor influencing investor confidence. An example would be the latest forensic audit into the central bank's figures which revealed years of corruption and hundreds of millions of "illegitimate commissions". Some reports have shown that the central bank had hired

"Forry Associates Ltd" a brokerage firm owned by the former governor's brother to handle government bond sales out of which the firm received USD 330 million in commissions which is the nothing less than nepotism. The latter and many other claims led several countries imposing sanctions on the former governor of the Banque du Liban who was in office for 30 years (Mroue, 2023). The forensic report can only uncover so much and solely putting the blame on the governor would not be fair, millions have been spent by the central bank financing projects of the ministries which either never took off or costed way more than they should have, the corrupt politicians are equally as guilty of the crisis and the collapse of the economy.

- **Geopolitical Instability**: The fact that Saudi Arabia, who as described previously was one of Lebanon's main financial supporters, cut billions in aid to Beirut due to its dissatisfaction with Hezbollah's influence over the country perfectly describes the dilemma that Lebanon is in (Barnard, 2016). With the weakening grasp of the West and the Gulf countries over Lebanon, the Islamic Republic of Iran saw a perfect opportunity to strengthen its role in Lebanese politics by providing aid via Hezbollah to support the affected Shia communities. Tehran's involvement could lead to greater influence in the future depending on Lebanon's internal dynamics and the perceptions of other countries in the region. The latter further reduced foreign investments in Lebanese Banks from the West and the Gulf (Ghaddar, 2022).

In this regard, while the theory indeed shows that a Minsky Moment may very well have happened by 2019, it could have been avoided or at least postponed if the social, cultural and political factors of the country did not play such a prominent role in destabilizing Beirut's development plans. The interplay between political and financial instability created a paradox where they both fueled each other. It is hence essential to note the strengths and limitations of Minsky's framework:

In summary, the FIH's stages of hedge, speculative and Ponzi finance can somehow be highlighted in the timeline of events that happened in Lebanon in the past few decades and therefore a Minsky Moment could have occurred as the elements proving the latter are in line. In this regard, the framework offers insights as to how financial stability can lead to risk accumulation and eventual crises. The FIH also showcases the importance of regulatory oversight and the sensitivity of decisions made by players such as the central bank, which are pertinent to Lebanon's financial landscape.

On the other hand, Minsky's framework does not account for political instability, corruption, and sectarian governance issues that significantly impacted Lebanon. The theory does not consider the external geopolitical pressures and their economic ramifications, which are crucial in our context. Finally, socio-economic factors such as public protests, which played a significant role in kicking off the crisis cannot be foreseen by the theory.

5. Potential Policy Suggestions

In order to enhance economic resilience and prevent future financial instability, several policy recommendations are proposed:

- **Monetary and Fiscal Reforms**: The paper highlighted the importance of the implementation of strict fiscal discipline and the improvement of transparency in order to reduce corruption. The central bank should not only be independent from political pressure, it should be a center of knowledge and work towards the policy that would best fit the current needs of the country.
- **Floating Currency Exchange Rate**: As much as the peg on the USD helped the Lebanese economy at some point to attract foreign investors and promote trade, the situation Lebanon is in today cannot support the peg anymore as it is draining its foreign exchange reserves. In addition to the latter, the central bank has limited ability to adjust monetary policy to address domestic economic conditions, as it is focusing on maintaining the peg.

  A floating currency can adjust to market conditions, helping to correct trade imbalances and respond to economic shocks more flexibly hence avoiding unexpected long-term inflation. The central bank can therefore implement independent monetary policies tailored to the domestic economic situation and not focus on using foreign exchange reserves to maintain the fixed exchange rate.

The best recommendation here would be to adopt a gradual de-pegging strategy, a step by step shift from a pegged to a more flexible exchange rate that could help manage volatility and build confidence. The latter can be done by gradually widening the band within which the currency is allowed to fluctuate. Finally, to avoid public speculation, the government and central bank should be very clear and transparent about the transition process and its benefits in order to maintain confidence among the public and investors (Bhattacharya, 2003).

- **Banking Sector Overhaul**: Strengthening regulatory oversight and enforcing banking laws to prevent risky lending practices is essential. The introduction of robust capital controls and ensuring that banks maintain adequate liquidity ratios can help stabilize the financial sector. Another strategy is the potential mergers of banks and financial institutions in order to strengthen their performance hoping to restore confidence in the banking sector, it has been proven that Lebanese banks tend to perform better post-merger taking into consideration the Audi-Saradar Group merger of 2003-2004 (Hachem et al, 2018).
- **Gold Reserves**: According to the World Gold Council, Lebanon held 286.83 tons of gold in 2023, placing it 19th globally and 2nd within the MENA region in terms of gold reserves. The estimated value of those reserves is around USD 20 billion (Gemayel, 2024). The latter could be either partially sold to improve liquidity and stabilize the economy or used as collateral in order to secure credit. However, this should be done cautiously and as part of a broader economic reform package to avoid depleting national assets without addressing underlying issues. Lebanon's gold reserves are its only reassurance keeping the country afloat and should only be used in case of emergency, which the country is currently in. Unfortunately, if the political issues are not fixed and the current sectarian power system promoting corruption is kept in place, whatever value that can be earned from the gold would be wasted and would make the already hard task

of reforming the country by the people who can actually bring about real change, an impossible one.

- **IMF Assistance**: Further engaging with the International Monetary Fund for financial assistance can provide the necessary support for economic reforms. However, similarly to the last point, this can only be tackled once reform is introduced in order not to waste any more potential future wealth.
- **Structural Reforms**: Improvements in public administration, infrastructure development and social welfare programs are needed to create a more resilient economy. Encouraging foreign investment and diversifying the economy beyond traditional sectors can also promote sustainable growth.

Going to the root of the problem, the first step to make should be letting go of the consociational system and heading towards a more secular government while keeping the religious values of the country that are maintaining the identity and traditions of the Lebanese people. The unique situation that the country is in, having so many different religions and sects has always been frowned upon and recent political debaters are even starting to engage in talks of a Federative Government which would, contrary to popular belief, further fuel the division of the tiny country. Real reform will happen when the people will let go of the patrons and political parties who are flying the banner of religion only as a means to an end in order to resonate with a specific group of people and reach their financial agenda as well as the political agenda of the external power that is sponsoring them. Lebanon should instead be using its multi-cultural identity, its massive diaspora as well as the people's ability to speak many languages to play the role of a mediator in the region. The Shia Muslims understand the values of countries such as Iran, the Sunni Muslims have very important alliances with the Sunni Muslim world, the Druze community in the country have a unique relatability to the neighboring countries with similar sects. The Armenian Christians of the country can open up new doors to the Caucasus states, the Orthodox Christians understand the traditions of the Eastern European world and the Catholic and Protestants Christians already have important ties with the West, either historically or due to the success of the Lebanese people abroad who have integrated into foreign societies. Lebanon's position should be used as strength and not be dubbed as a weakness as the small Mediterranean country has a lot of potential.

- **Political Stability**: As addressed, economic recovery can only be achieved in a politically stable environment. In this regard, the root causes of political instability should be tackled via electoral reforms and enhancing accountability. The essential step to take would be letting go of the influence of external powers and focusing on the interest of the Lebanese people in order to build a country for the Lebanese people and hopefully aim to get back the title of "Switzerland of the Middle East" by taking an overall stance of neutrality.
- **Cultural Reform**: Lebanon's history taught in schools stops around the end of the Second World War which technically means that the country's actual history post-independence is never learned by young students. The latter is due to the fact that the political parties in power were never able to agree on the version of the contemporary history of Lebanon to be taught to students as they were part of the civil war and many other horrors and they do not wish to be seen in a negative light. This led to the brainwashing of the young as they only quenched their thirst for information by listening to the generation that was part of the civil war and is hence very partial to one side, never giving both parts of the story. In order to solve the issue of new generations continuing this cycle of sectarianism, new history books should be set in place, describing the atrocities that occurred in the country's recent history, highlighting how all the warlords who are currently in positions of power have blood on their hands (Maktabi, 2012).

The above mentioned suggestions could potentially build a stronger economic baseline in order to reduce vulnerability to future crises, as well as educate the future generations to eliminate the sectarian division of the state.

Conclusion

This thesis reaffirms the relevance of Minsky's Financial Instability Hypothesis in analyzing the Lebanese financial crisis of 2019, illustrating how periods of financial stability can lead to fragility and crises due to risk-taking behaviors. The study emphasizes the necessity of robust regulatory frameworks to mitigate financial cycle risks. Minsky's framework, while valuable, does not fully capture the unique political and socio-economic complexities of Lebanon. The country's consociational state structure and political instability significantly contributed to the crisis. The political landscape, characterized by deep sectarian divisions and relationships with key regional players added layers of complexity not addressed by Minsky's hypothesis.

In the beginning of the paper, Minsky's financial instability hypothesis was introduced, going through its origin, its main constituents such as the cycle of hedge, speculative and Ponzi finance and finally the variables that can be used to check the applicability of the theory. Following chapters briefly described the history of the country in order to highlight the unique position that Lebanon is in. Going into the analytical part, the variables of the FIH were applied to the scenario in question to test whether they comply with the assumptions depicted by Minsky. The paper additionally examined other financial variables that were not explored by Minsky but were relevant to explore followed by an analysis of the consequences of the crisis to highlight the "bust" cycle. Finally, we discussed the applicability of the theory to our context and understood that while we can see that the FIH could be a framework that explains the causes of the crash and there is a partial Minsky Moment, the context is not complete without looking into the socio-political situation of the country which cannot be taken into account in the FIH. In order to contribute to the global discussion on potential ways for the country to go forward, potential recommendations were explored such as using Lebanon's gold reserves to its advantage, introducing reforms to the political and administrative sectors as well as implementing a strict fiscal discipline by establishing an independent central bank to stabilize monetary policy.

Summary

The Financial Instability Hypothesis is a theory that was developed by 20th century economist Hyman P. Minsky. The American academic was mainly influenced by John Maynard Keynes' theory of investment and significantly contributed to the global discourse on financial bubbles and crashes. Minsky's work revolved around the fragility of financial markets and the idea that they are inherently unstable and susceptible to crises through three stages "Hedge, Speculative and Ponzi". The first stage is a period of relative stability and growth, during which financial bodies have a conservative approach to borrowing and lending. Following this period and with the growing confidence of lenders that the borrowing party is in a position to repay, the speculative phase of the cycle comes into play where the market sentiment becomes rather bullish and promoting credit growth. Asset prices start to significantly inflate and with it the debt levels of borrowers. The speculative nomenclature is due to the tendency of borrowers to depend on the future value of assets in order to pay their dues and the lenders' riskier behavior due to displaced trust. The final stage comes into play when the borrowing party is only depending on profits made from selling assets at higher prices in order to repay their loans and the interest. At some point, the market value of the asset becomes way higher than its intrinsic value and the buyers become scarcer which leads to a crisis due to the inability of borrowers to repay lenders. The latter is called a Minsky moment.

This paper explores the Financial Instability Hypothesis in depth and tries to inspect its applicability to the crisis that unraveled in Lebanon by 2019. The hypothesis in question is to check whether a Minsky Moment may have occurred in 2019 and analyze the stages of Minsky's cycle that led to the latter as well as its repercussions hence highlighting the "boom-bust" bubble that occurred. In order to reach this understanding, many of Minsky's variables shall be investigated in the context of the case at hand as well as some financial factors that were not a part of the Financial Instability Hypothesis per se but are nonetheless as relevant to Lebanon's case. The paper also looks into Lebanon's unique social, cultural and political structure and reviews if it had any influence over the emergence of the financial crisis in question. Finally, some policy suggestions are introduced in order to contribute to the discourse on solving this crisis that is still ongoing.

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