

Lebanon's Economy

An analysis and some recommendations

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Esther Baroudy and hady Farah are financial experts and the views expressed in this presentation reflect their personal views alone.

We will continue to present new proposals and will be pleased to receive your comments at:

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Lebanon: the time to act is now

Lebanon has lived beyond its means in recent years and we illustrate this with a series of charts in this presentation.

A pegged exchange rate coupled with high rates of overseas borrowing have maintained **an illusion** of economic strength. This has been facilitated by corrupt and inept governance which has now run out of road.

The country faces ruin without action.

A plan of emergency measures is outlined on Page 15 including:

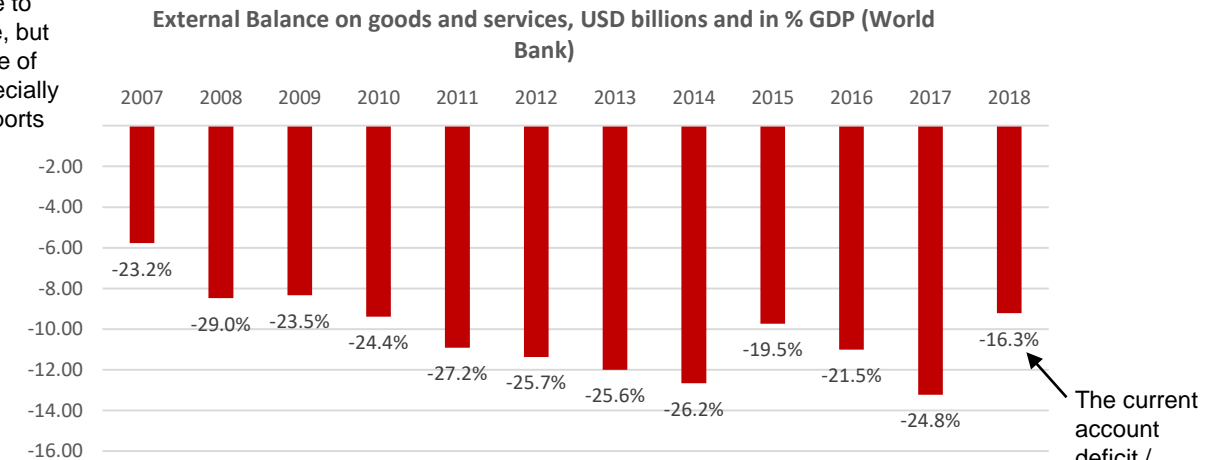
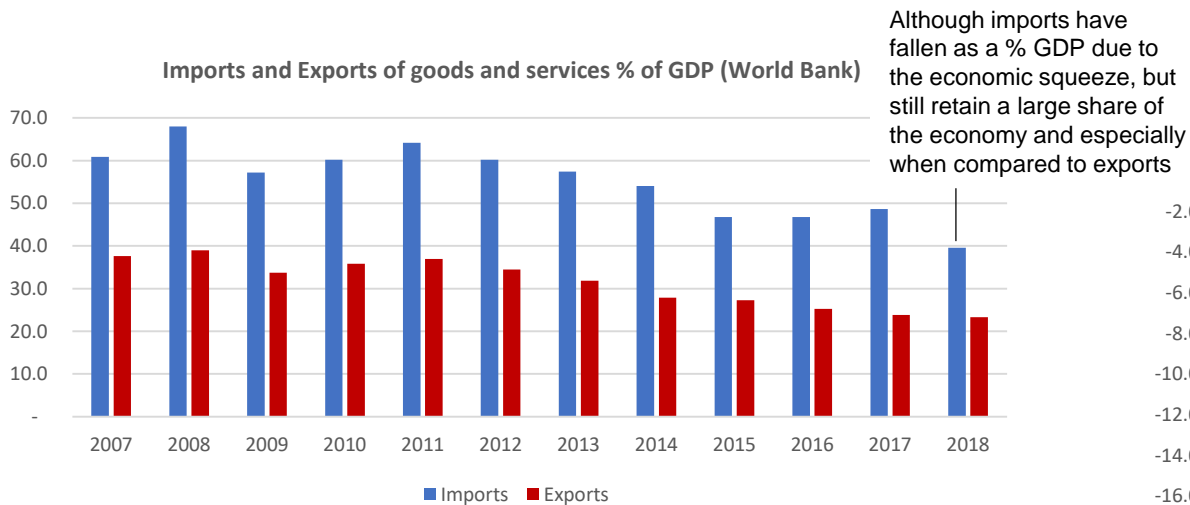
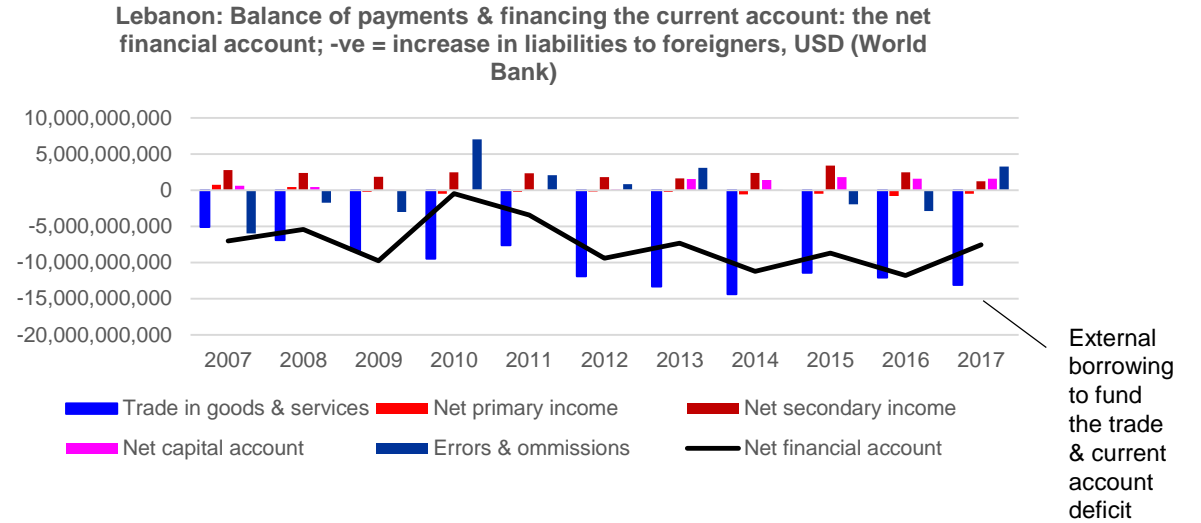
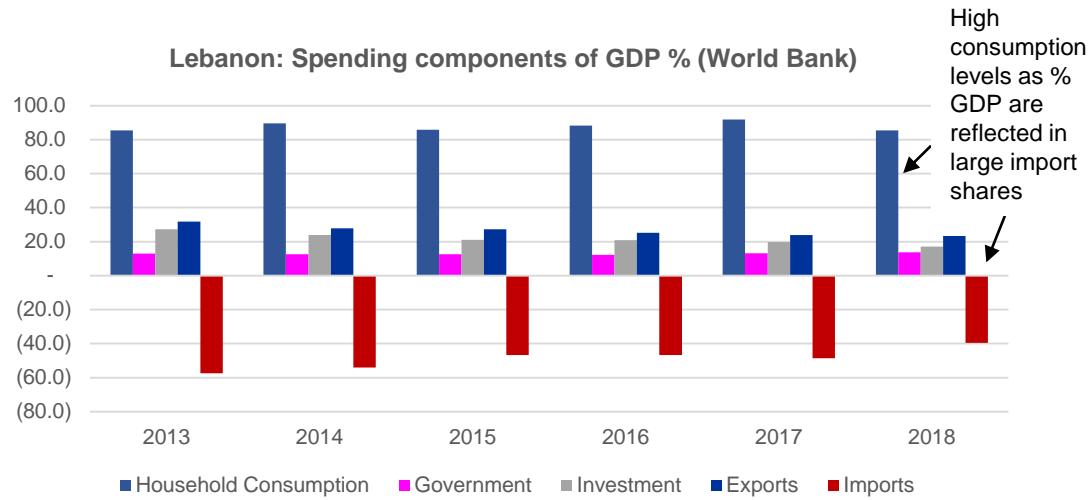
- An emergency injection of Lebanese pound liquidity to help firms facing bankruptcy.
- The return of illegally obtained assets to be redistributed to families who have been propelled into poverty in the crisis. Commercial banks' shareholders must also recapitalize their institutions.
- Lowering interest rates on all US dollar deposits and putting the Lebanese pound into a controlled float.

The country's **US Dollar debt would be renegotiated** as part of a longer-term economic recovery package.

Constitutional reform is imperative if the economy and the environment are to be put on a sound footing for future generations.

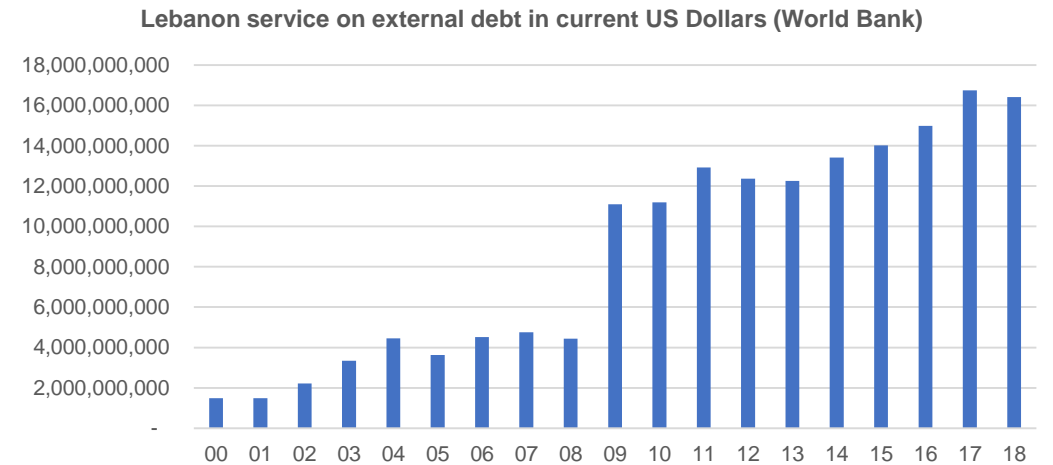
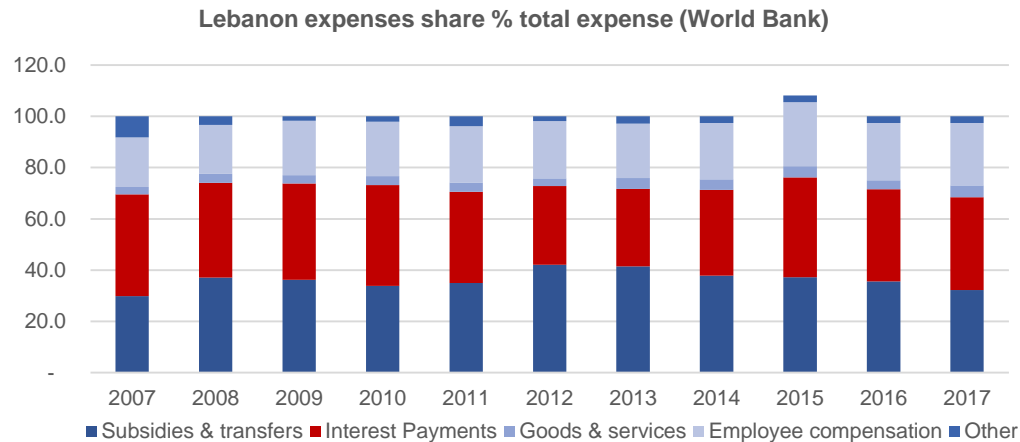
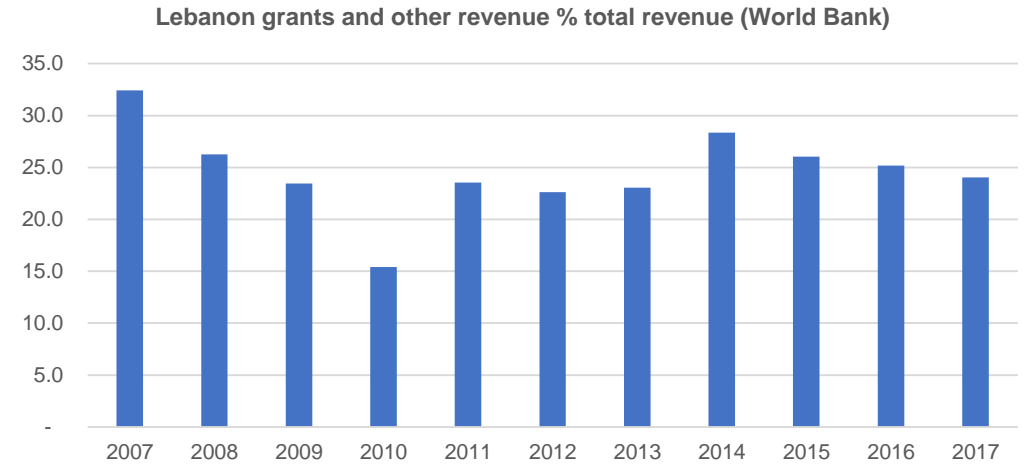
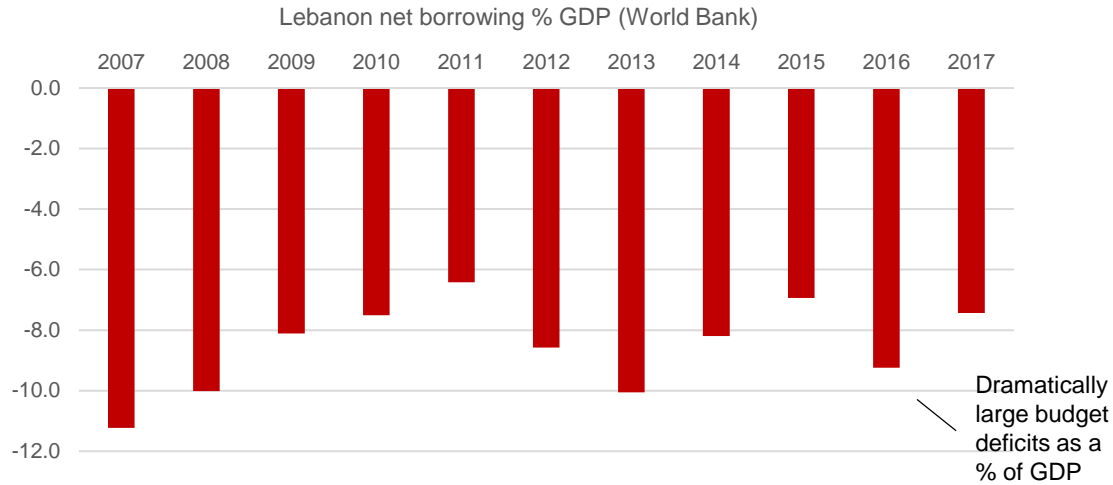
An educated, business-minded and **globally savvy population could then make Lebanon's current crisis a distant memory.**

The Lebanese economy: dangerously import and debt reliant



Household consumption makes up over 80% of GDP and is highly import-dependent. This has led to a large accumulation of external borrowing to fund the current account deficit - while shoring up the capital or financial account to enable the maintenance of a fixed exchange rate.

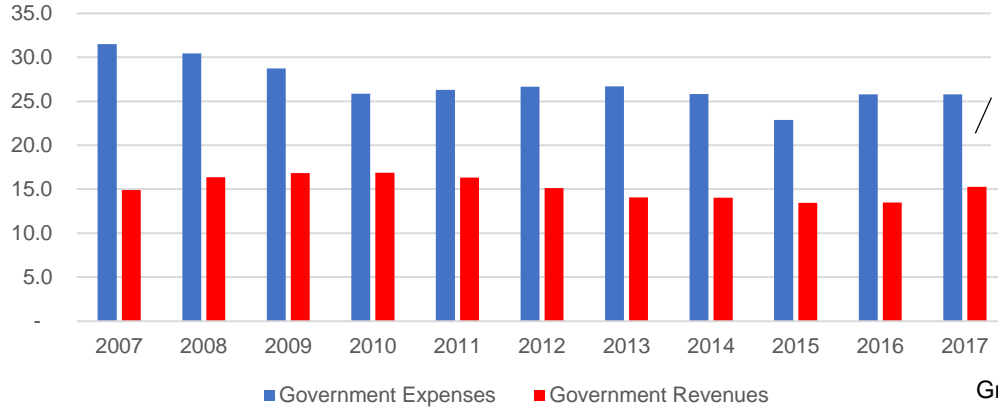
Uncontrolled fiscal policy: budget deficits averaging 8.5% of GDP 2007-2017



Mounting Lebanese government debt also comes from years of running large budget deficits – despite the government receiving generous grants from overseas. Interest payments, subsidies and transfers, employee compensation and the military have ended up taking the largest share of government spending. Spending on capital projects e.g. equipping the nation with state-of-the-art broadband, has been neglected. Meanwhile, tax revenues have not kept up with government spending.

Lebanon's current politics makes government over-reliant on spending and keeps tax collection low

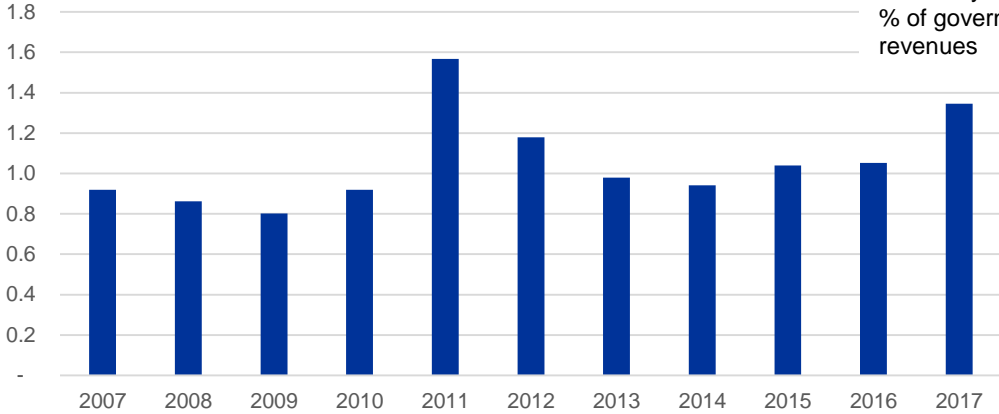
Lebanon Government spending and revenues % GDP (World Bank)



The gap between government spending and revenues is extremely large

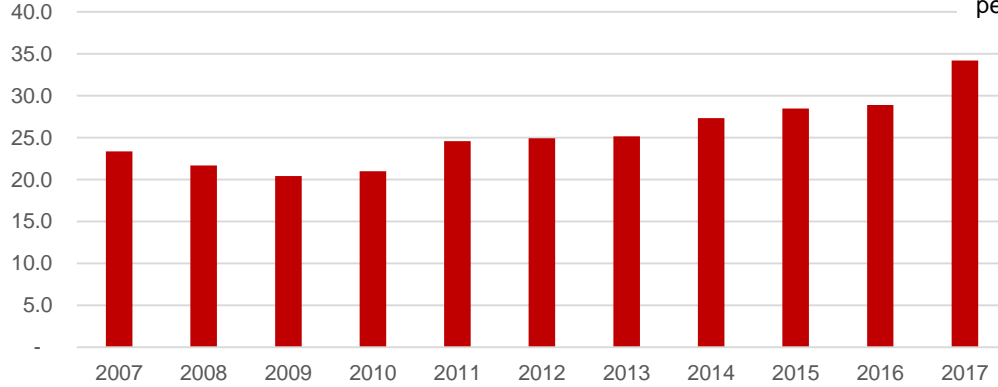
Grants occasionally make up the same share of government revenue as personal taxes.

Lebanon: Social contributions % revenue (World Bank)

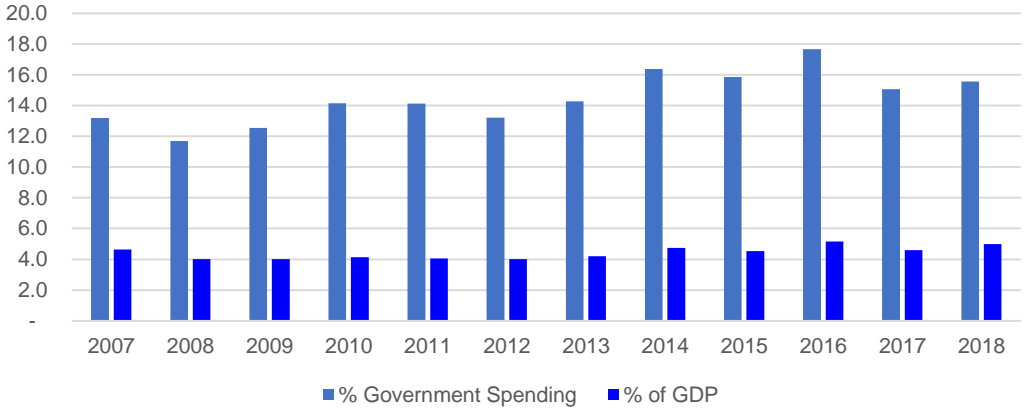


Social security contributions are extremely low as % of government revenues

Lebanon taxes on income, profits and capital gains % total revenue (World Bank)



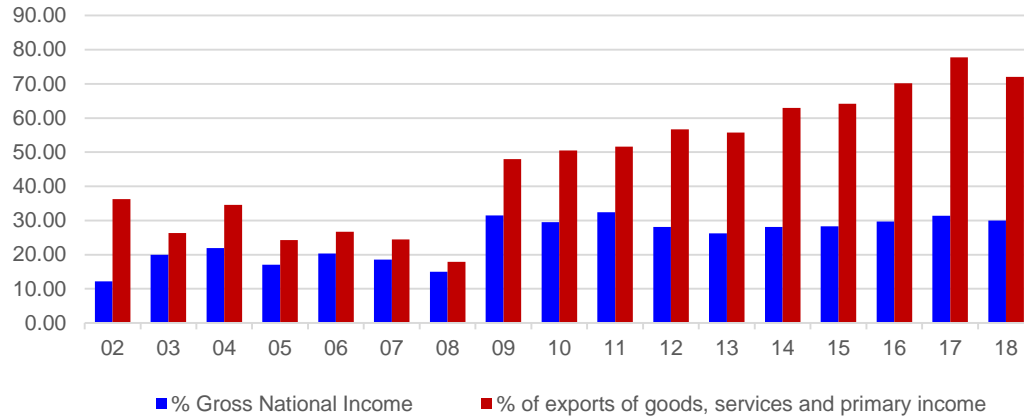
Lebanon Military Expenditure (World Bank)



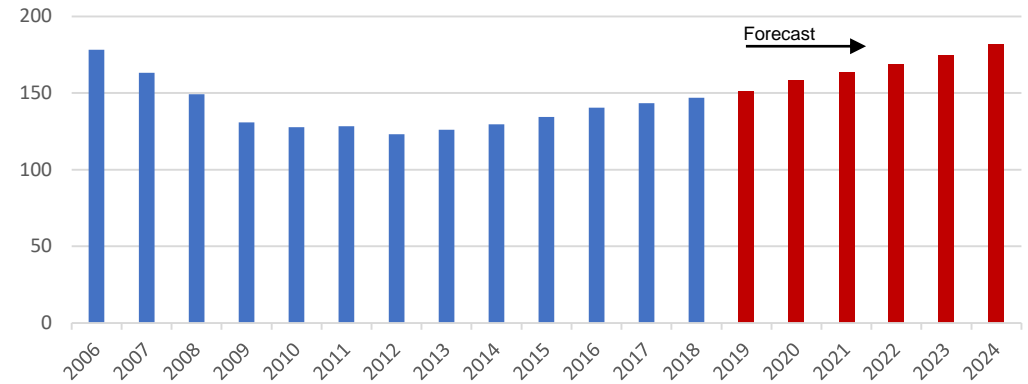
Tax evasion is rife due to mistrust in the government: poor public service provision, officials who are easily corrupted and cynicism generally regarding the use of tax revenues. A reluctance to contribute towards intercommunal redistribution of income is another factor. Politicians are also anxious to keep their constituencies happy – note how very low social security contributions are as a percentage of revenue. Military spending has also been sizeable.

Mounting debt and dangerous debt service levels: bankrupting the banking system

Total debt service % GNI & total exports earnings (World Bank)

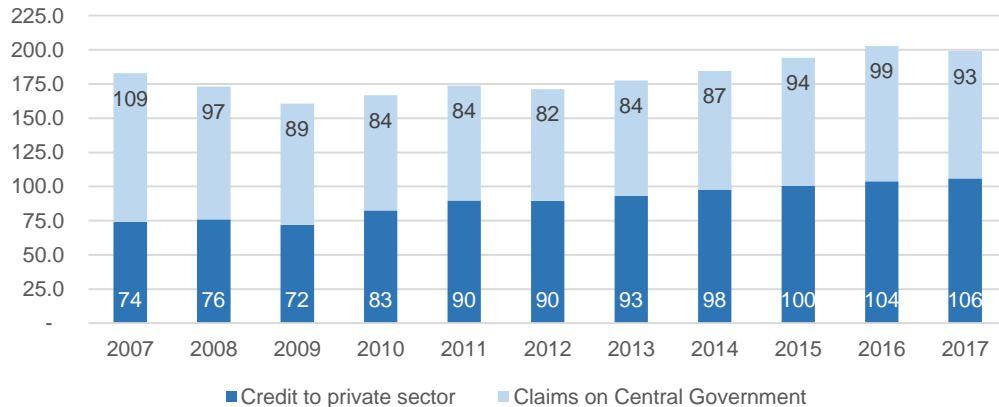


IMF: Lebanon General Government net debt % GDP, including IMF forecasts 2019-2024

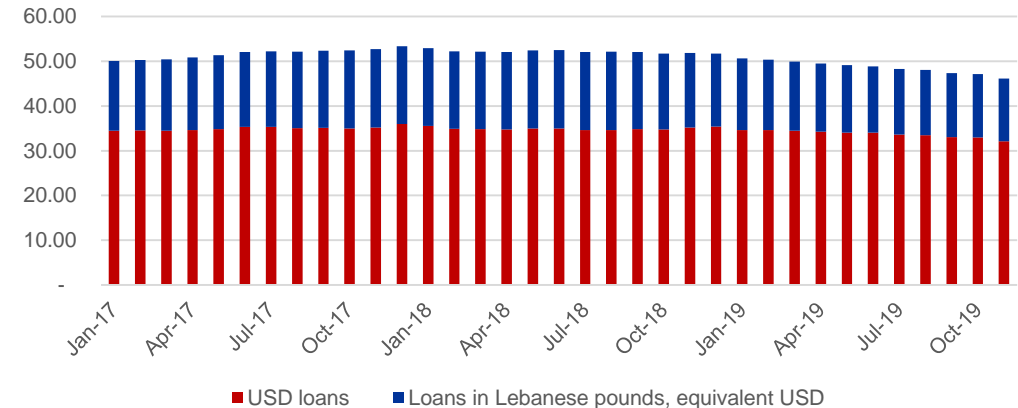


Unless action is taken on the budget deficit, debt will continue to rise

Domestic credit provided by financial sector % GDP (World Bank)



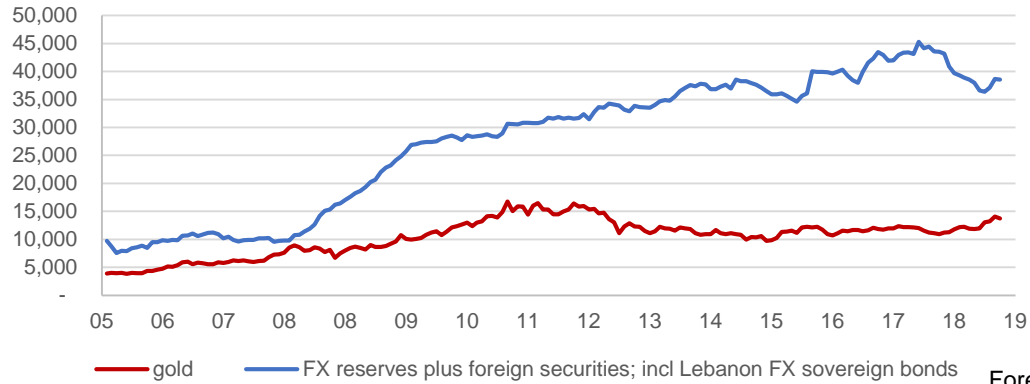
Lebanon: bank loans or claims on resident customers, USD bns (BdL)



Fiscal policy mismanagement has led to large scale government borrowing from domestic savers via the banking system - banks have bought and are holding large amounts of government debt. Sovereign risk or bank claims on the Government amount to over 100% of GDP: interest owed on US Dollar denominated government debt alone is an annual \$16 bn or 30% of GDP. The banking system is also owed around \$32 bn in US dollar debt by private residents and the latter may be unable to repay these loans should the Lira devalue significantly.

An economy in decline and mounting debt leaves the foreign exchange reserves in a precarious position

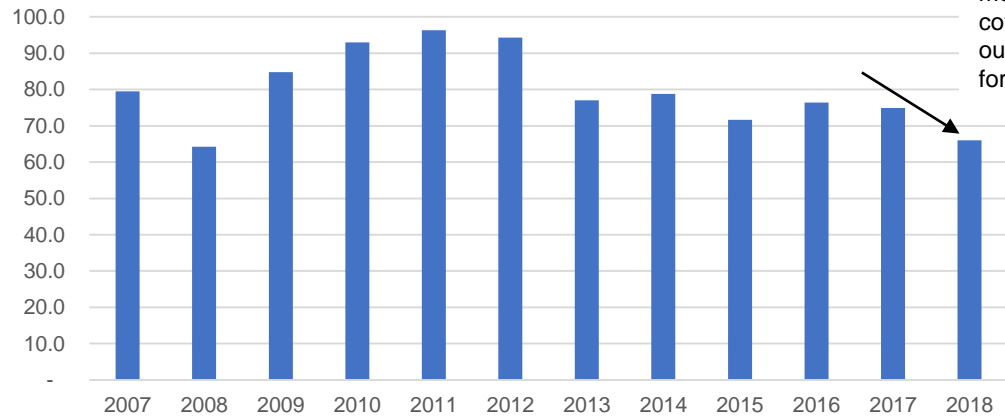
Lebanon: gold and liquid foreign exchange reserves, USD millions (BDL, Bloomberg)



— gold — FX reserves plus foreign securities; incl Lebanon FX sovereign bonds

Foreign exchange reserves no longer meaningfully cover outstanding foreign debt

Total reserves % of total external debt (World Bank)

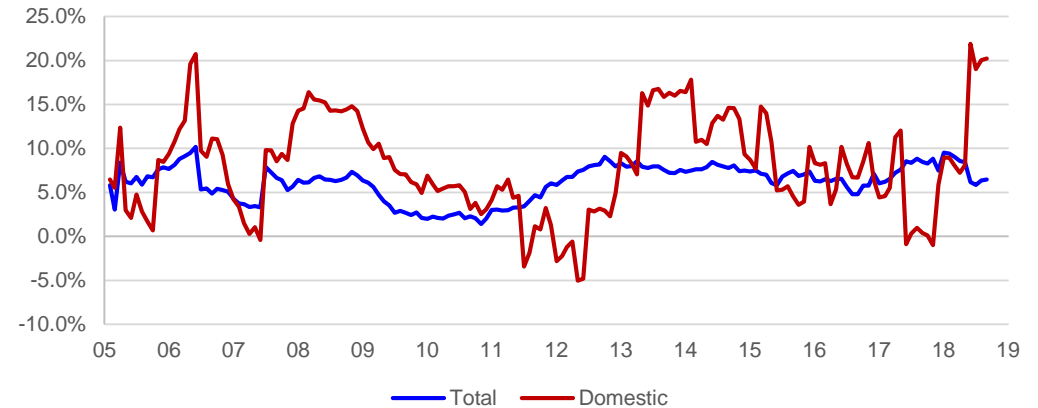


Lebanon: M3 Money supply growth % yoy (Bloomberg)



Financial squeeze induced by the central bank to retain foreign exchange reserves: Money supply growth falls while the sale of domestic debt rises

Lebanon: Government net debt % yoy (Bloomberg)

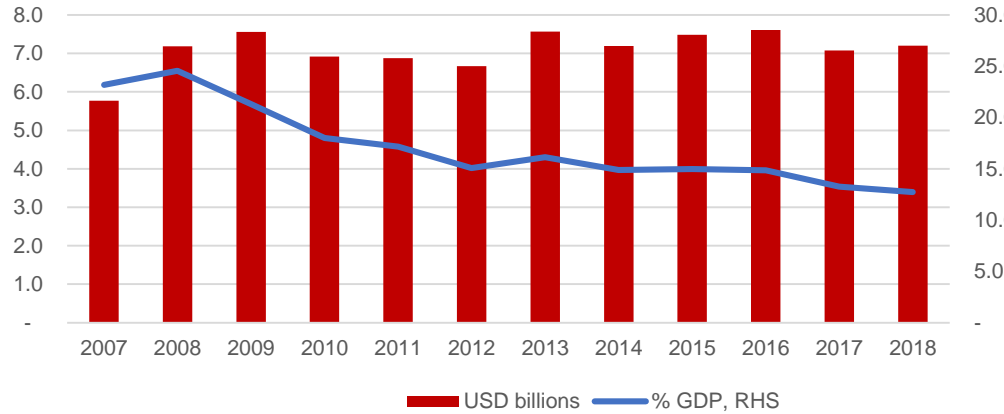


— Total — Domestic

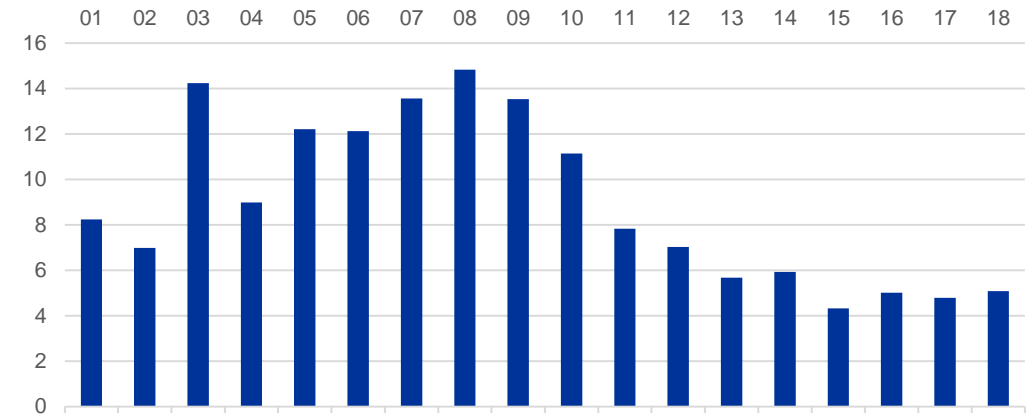
Public concern regarding the domestic economic and political situation has resulted in net capital outflows abroad, putting pressure on the Lebanese currency. A desire to maintain the Lebanese pound's exchange rate against the US dollar while conserving foreign exchange reserves has meant a sharp squeeze on credit conditions via the sale of Government debt locally.

Personal remittances are no longer a strong supplement to domestic spending

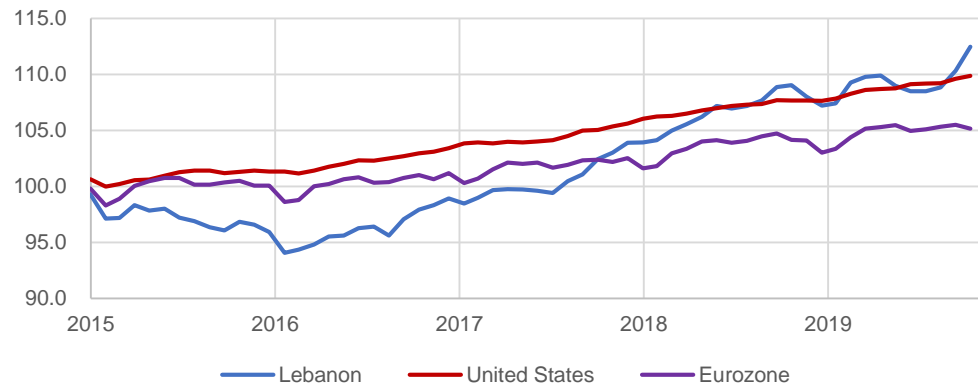
Lebanon Personal remittances in USD billions and % GDP (World Bank)



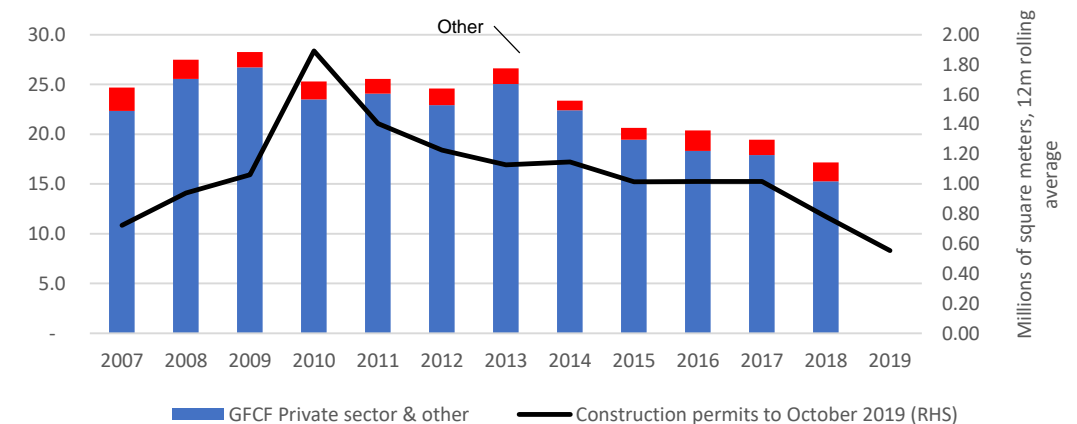
Lebanon: Foreign direct investment % GDP (World Bank, Bloomberg)



Lebanon, US & Eurozone Consumer Price Indices (Dec 2013=100, Bloomberg)



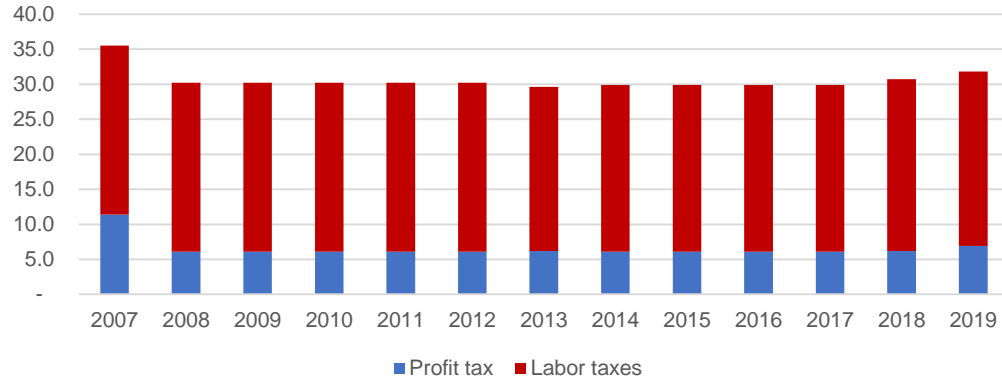
Lebanon: Gross Fixed Capital Formation % GDP (World Bank)



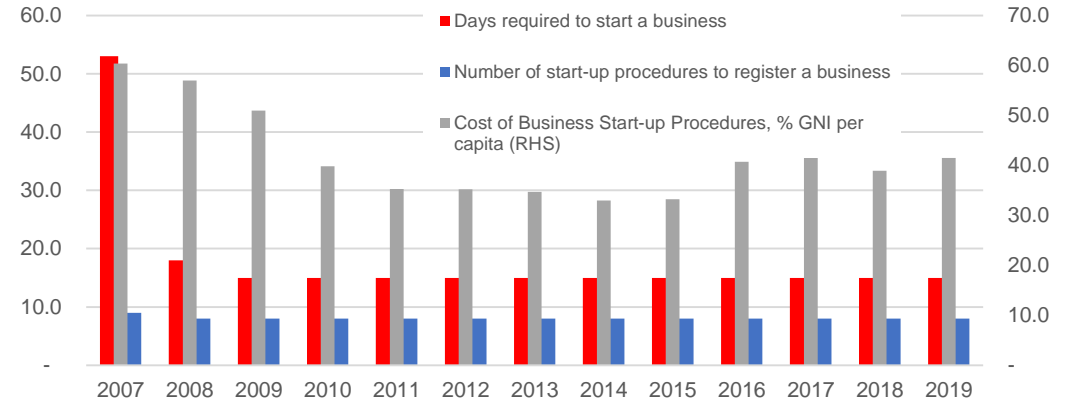
Personal remittances have helped fund the economy at a steady USD 7.0 bn per annum. However, they have steadily declined as a proportion of GDP. Meanwhile, a strong Lebanese pound coupled with rising domestic prices has made the Lebanese economy increasingly less competitive. Coupled with a decline in business confidence, this has led to falling investment.

The Lebanese Government does not score highly in terms of helping business

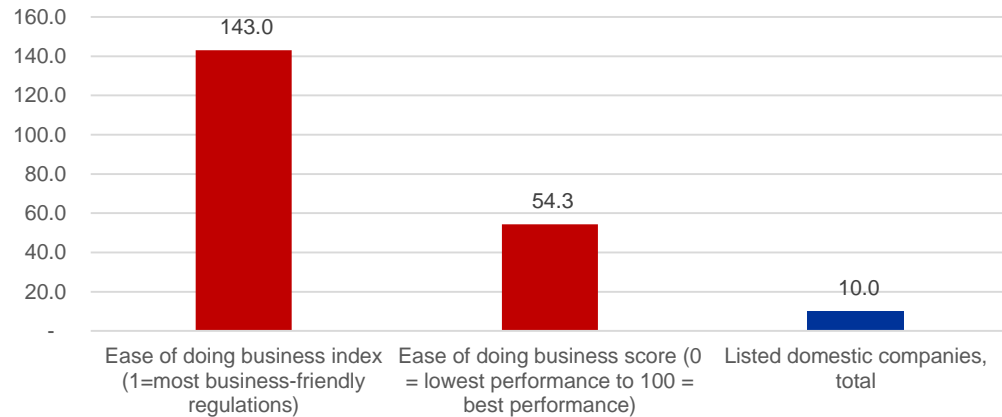
Lebanon Profit tax and Labor tax and contributions % of commercial profits (World Bank)



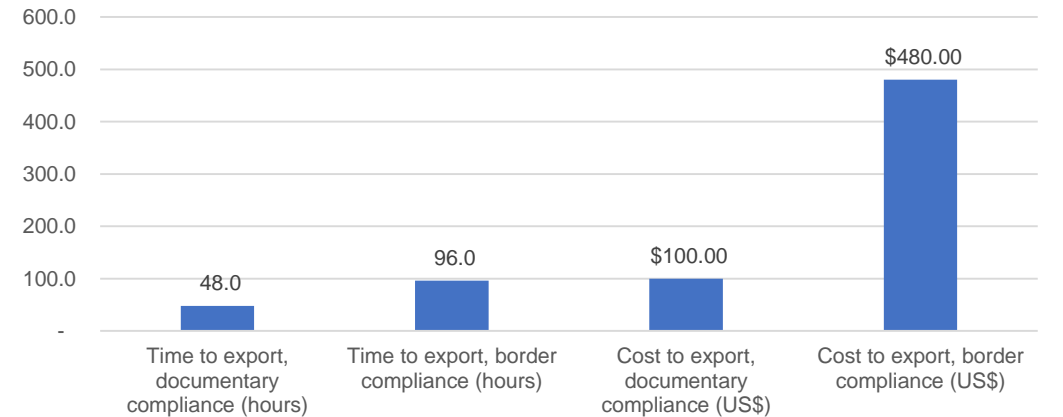
Lebanon: Starting a new business (World Bank)



Lebanon: ease of doing business and stock market (World Bank)



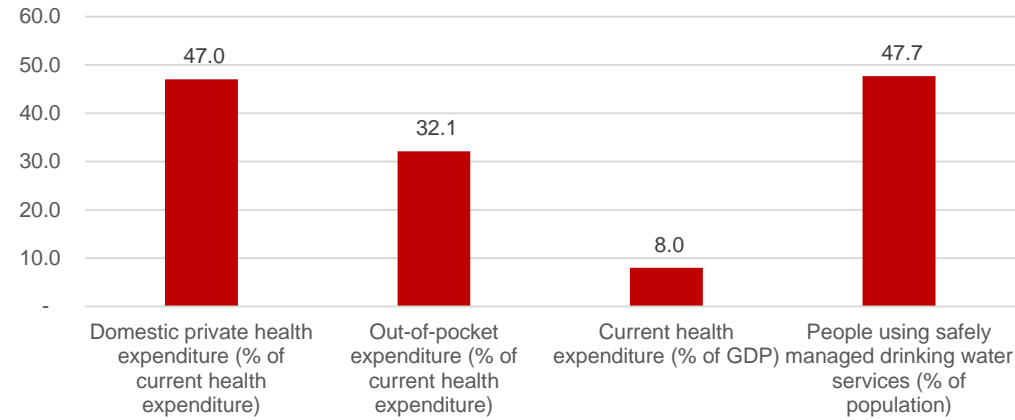
Lebanon: time and cost to export (World Bank)



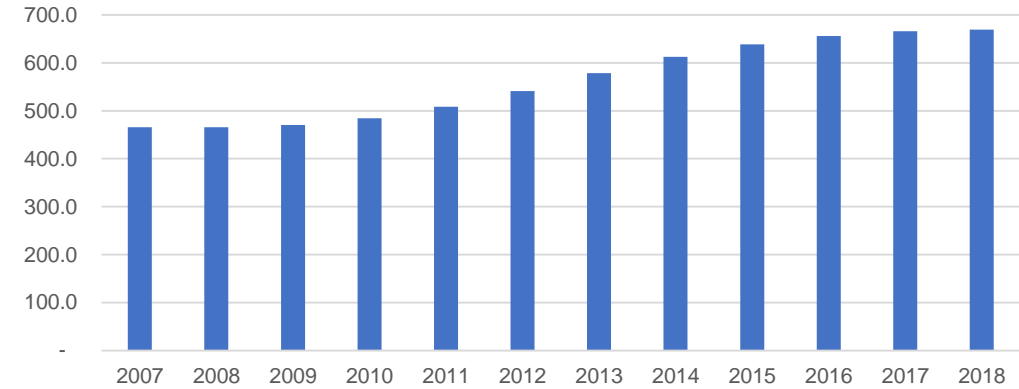
Transparency International confirms very poor government scores for corruption where 89% of the public believe corruption is a problem and this in turn hampers business prospects.

Other travails include expensive healthcare, rising population densities and stagnation in income per capita

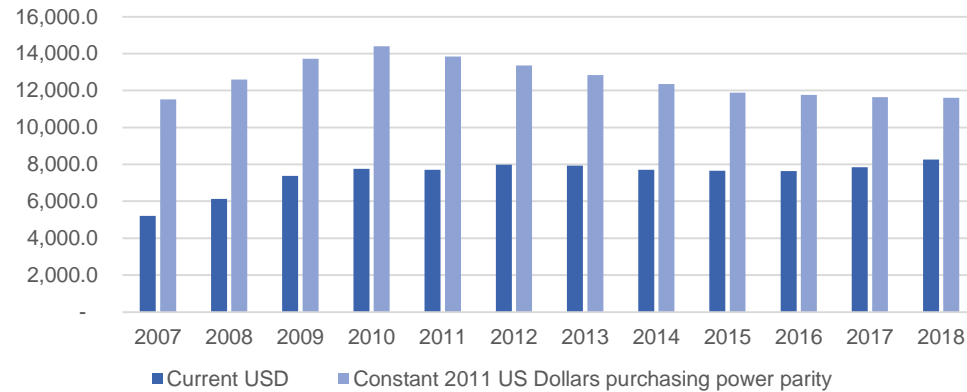
Lebanon Health Indicators (2016, World Bank)



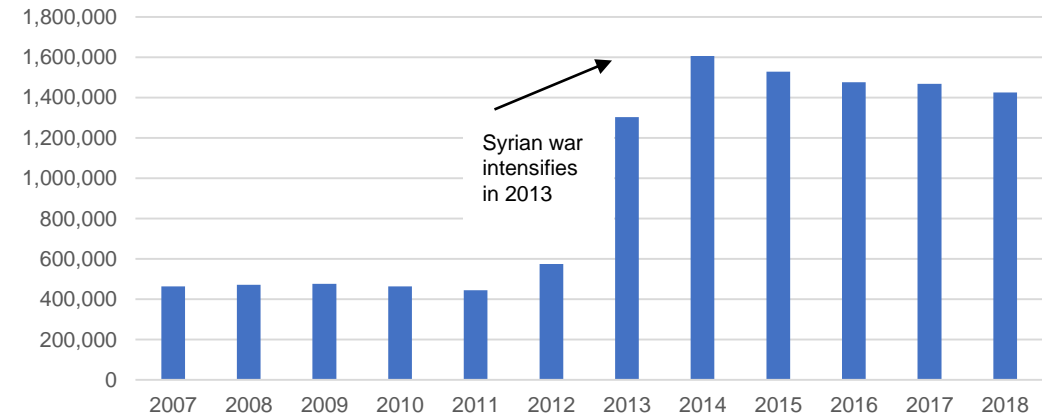
Lebanon population density, people per square kilometre of land (World Bank)



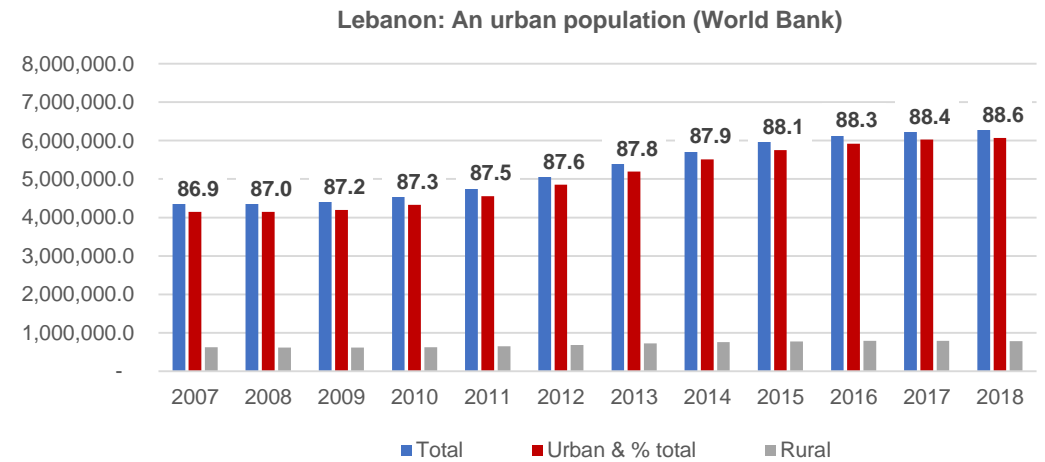
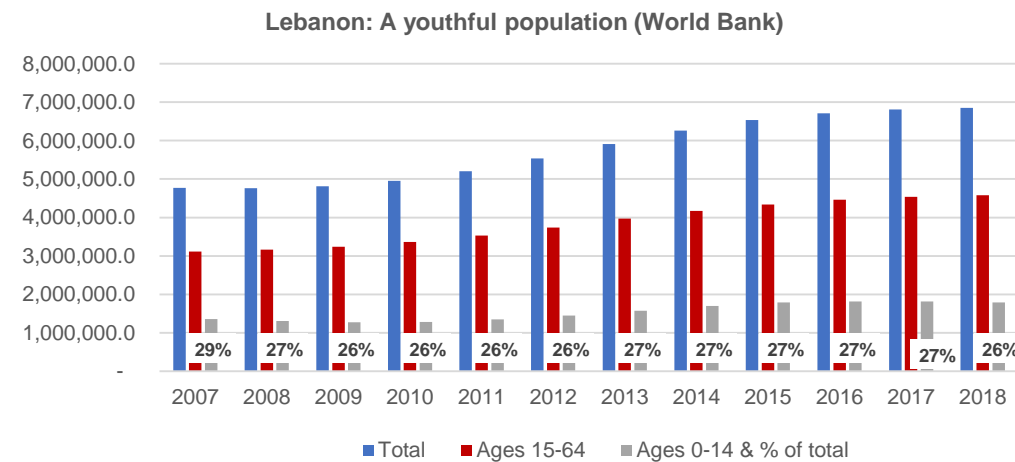
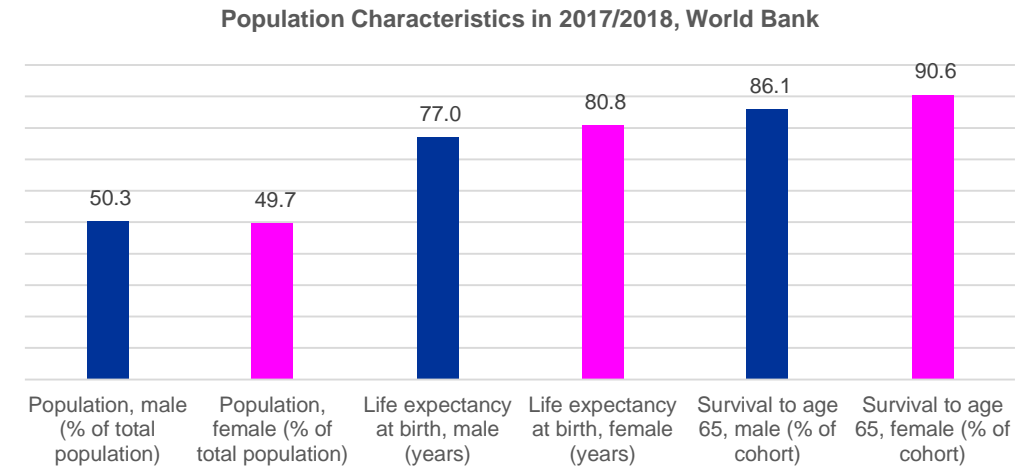
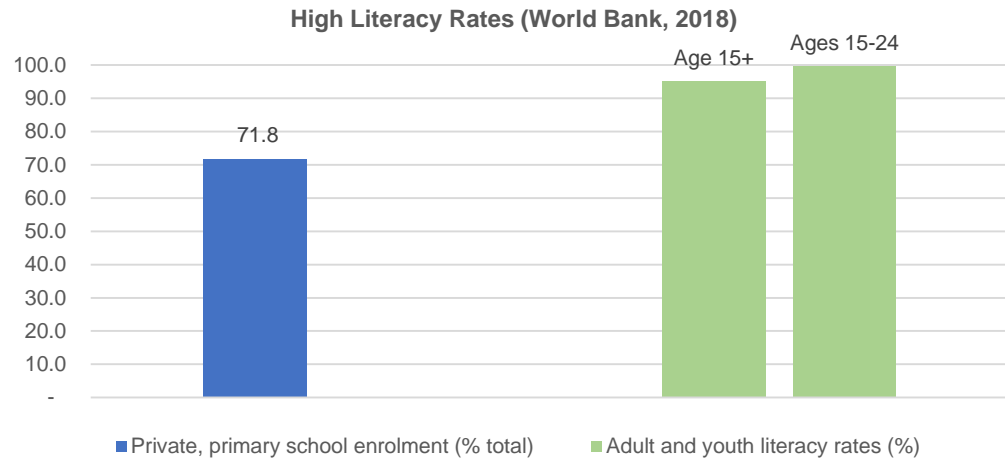
Lebanon GDP per capita: current and in constant 2011 US Dollars



Lebanon: Refugee Population (World Bank)

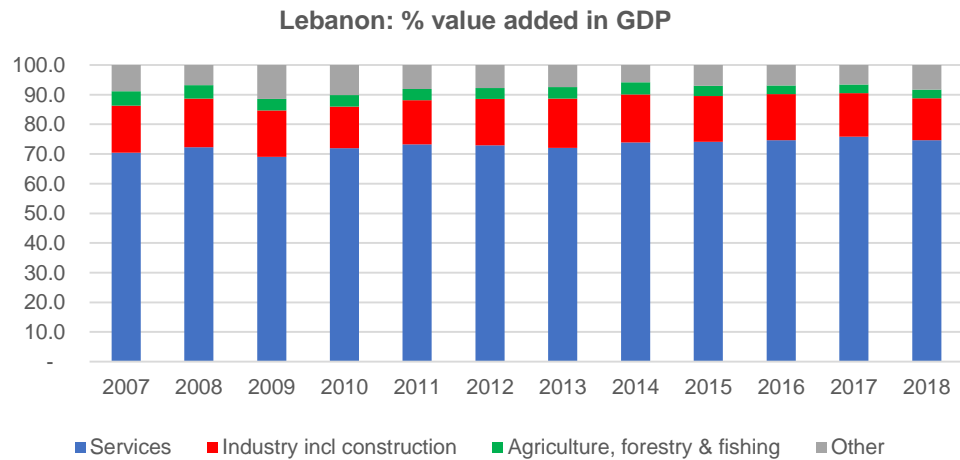
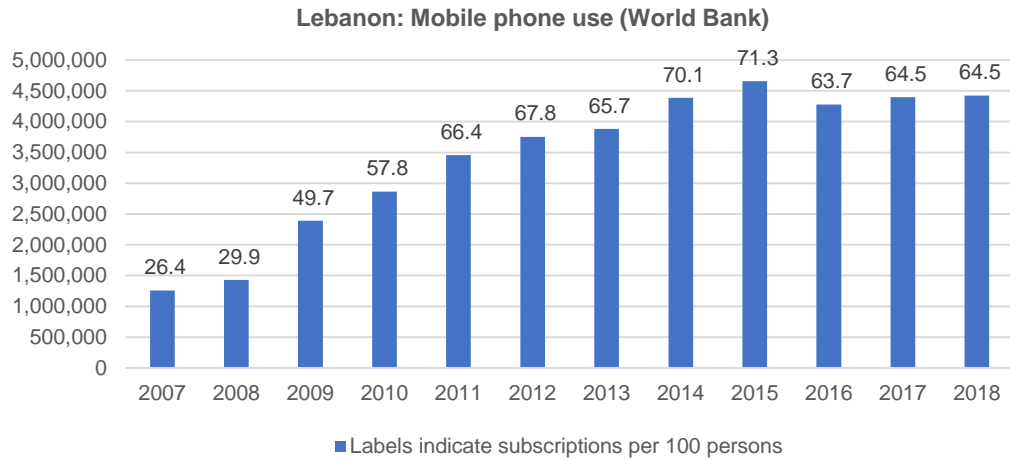


The Lebanese population has strong attributes: an educated youthful population...



If it were not for poor governance, Lebanon would score highly in terms of the United Nations Human Development Report (2019)

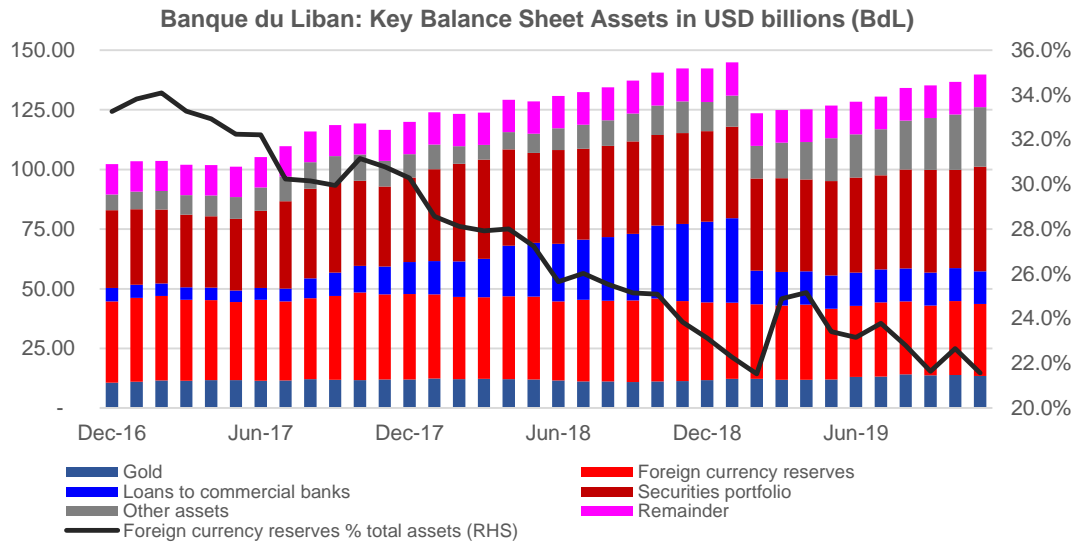
... which is tech-savvy, globally minded, and can focus on asset-light services



Some further analysis and recommendations

New methods of thinking are needed

Banque du Liban (BdL): Monetary policy operations and the Bank's balance sheet



Allowing unsustainable current account deficits to persist - in part by maintaining the US Dollar peg - and then financing the government's budget deficit in 2018 have not been judicious policy-making by the BdL.

According to the IMF, the BdL financed around $\frac{3}{4}$ of the government's budget deficit in 2018, which was a hefty 12% of GDP. And since this amounted to printing money, the counterpart to maintaining a fixed exchange rate has been to draw down liquidity in the financial system.

Unusual and large-volume monetary policy operations to support the Lebanese pound's peg against the US Dollar (IMF) have taken place:

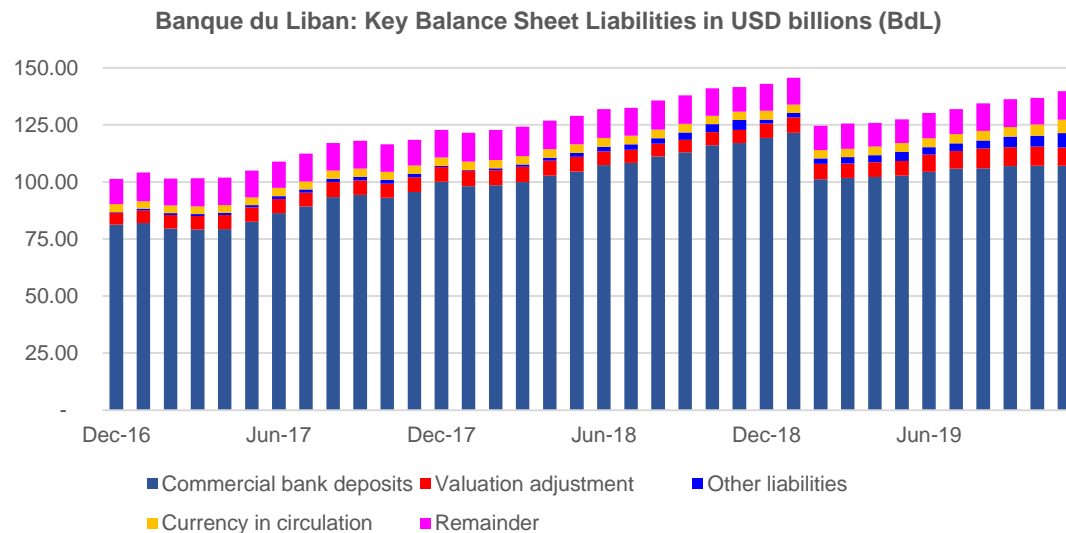
1. Commercial banks were offered 6.5% on US dollar deposits with the BdL. The same banks were also allowed corresponding but larger amounts of Lebanese pound loans at 2.0% in return for making 10-year re-deposits at 10.5% LBP with the BDL. This allowed the BdL to claim higher US dollar holdings.
2. Allowing banks to book profits from these longer-term operations with the BdL ahead of time - as long as banks held these profits as capital.

In both cases, commercial banks' profitability and therefore their soundness have artificially been made to look better.

The BdL's balance sheet expanded as a result and these financial operations have also meant a rise in BdL's foreign **liabilities**, implying a weakening in the foreign exchange position on the asset side and hence in the exchange rate's defenses (see upper chart for FX reserves as a percent of assets).

US Dollar squeeze: Banks are finding it difficult to honor their US dollar deposits since placements swapped into the BdL are locked in for the long term. US Dollar inflows from abroad have also dried up in response to the crisis.

Financial squeeze: Banks' lending rates have risen in response to higher rates paid by the BdL in its operations, while the BdL has been constraining lending in Lebanese pounds. This is making financing more expensive for private sector customers and is exacerbating the recession.



There is no alternative - the time to act is now

Our young generation is threatened with paying down enormous amounts of debt and this is ruinous for their future. It is our duty to work out how best to assume some of this burden as we reform.

The Banque du Liban is currently in a holding pattern, imposing a liquidity squeeze and covert capital controls while trying to hold on to its foreign exchange reserves.

Immediate emergency steps should include:

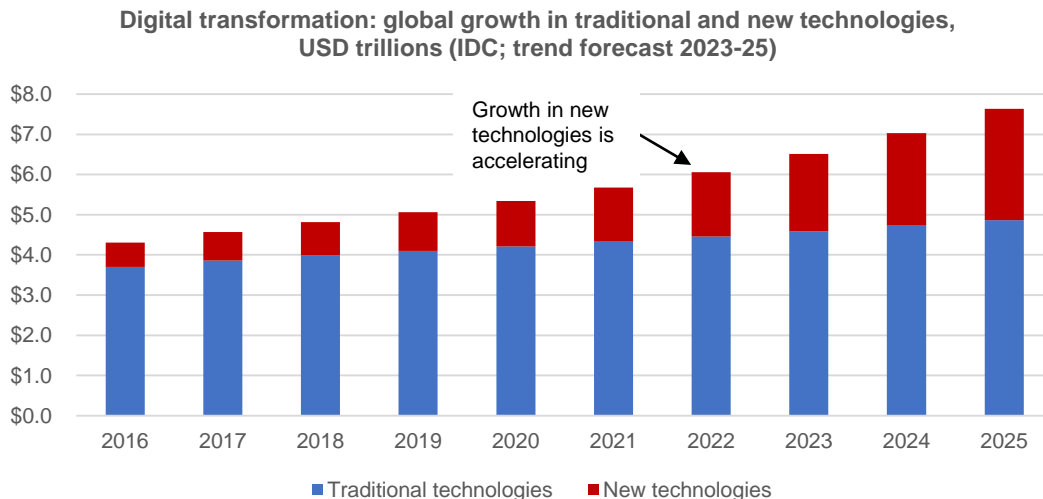
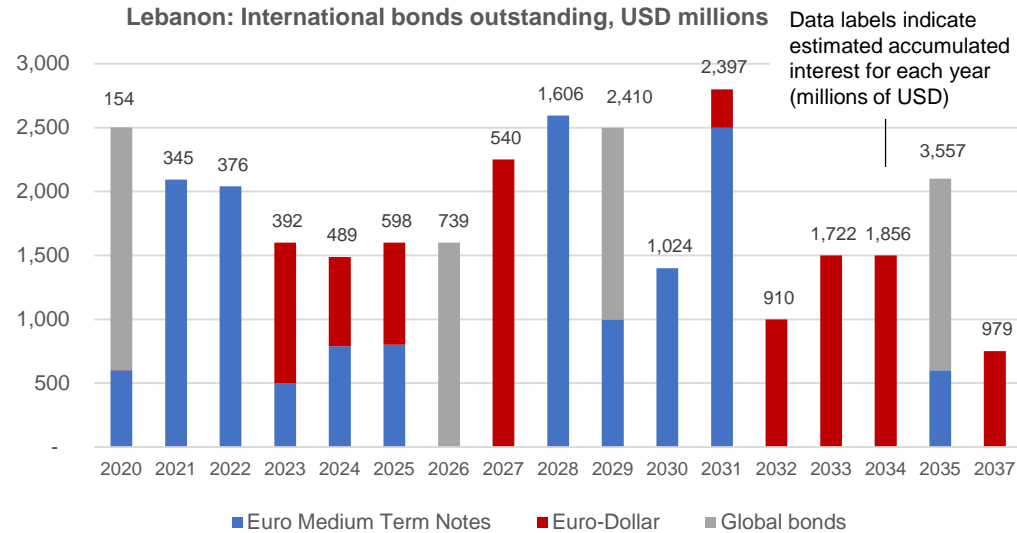
1. An **emergency injection of Lebanese pound liquidity** to help firms facing bankruptcy. This has been brought about by an abrupt monetary squeeze by the Banque du Liban and a freezing of the payments system. However, **flooding** the system with local currency liquidity should be avoided. Although this might eradicate Lebanese Government debt in local currency, it would generate inflation, trigger devaluation and would also expose Lebanese US dollar depositors to the banks defaulting on their deposits.
2. The **Lebanese pound would be put into a controlled float** as a sudden and large devaluation of the currency would force the Lebanese government and other creditors to default on **foreign** currency debt, forcing the local banking system into bankruptcy.
3. **Illegally obtained assets must be returned**; some of this could be redistributed to families who have been propelled into poverty in the crisis. 30% of the population could now be below the poverty line.
4. Commercial **banks' shareholders** - who have profited handsomely from Banque du Liban monetary operations - **should be asked to increase banks' capital by at least 50%**.
5. **Debt restructuring**, although **debt default is no answer** as it would destroy creditor confidence in Lebanon for years to come.
6. A **mandatory zero-coupon bond should be sold** to residents with greater than USD 300,000 in bank deposits. It could be issued with a 15% haircut which would then be placed in a fund to help poorer families.
7. **Interest rates on all deposits in US Dollars would be lowered.**

Carefully executed policy measures would restore household and business confidence and enable an easing in current (hidden) capital controls.

The youth and their movement are demanding a government with both technical expertise and supervision and they are right. Whatever the quality of the government is, it must have technical guidance and be rigorously scrutinized. The system of government that has developed does not have the means of supervising the executive or controlling corruption. The entire government machine must be reviewed, and a new Constitution define a new system of governance.

Multinational creditors will also want to see credible governance put in place. The measures outlined above would give a new government greater credibility in negotiating a plan for medium-term debt restructuring with responsible creditors. We note that any debt restructuring plan must be accompanied by a multi-year investment plan to put Lebanon back on its feet.

Towards an economic recovery plan



Debt restructuring is imperative but must be done in a way that forestalls speculators:

- Lebanon will have to pay down a crippling \$10bn in the next five years and \$20 bn in the next ten years.
- Interest is accumulating. Some of the debt is very expensive with certain bonds paying coupons ranging up to 12.0% over long periods.
- Lebanon's credit rating is at rock bottom, which means new borrowing on can only be done at usurious rates and longer maturity bonds trade at less than 50c on the dollar.

An investment and recovery plan should consider how Lebanon can benefit from new, fast-growing technologies:

- Artificial intelligence, big data analytics, robotics, 5G will all be **software driven** and this is asset-light, offers high and speedy payback and is perfect for Lebanon's geography.
- A highly educated, flexible and early adopter type population such as Lebanon's is ideally suited for developing software for these technologies.
- Data scientists and software programmers are already in very short supply globally and are commanding large remuneration.
- Lebanon, which is tiny, could leapfrog legacy technologies to become a test bed for 5G connectivity (while making sure it uses state of the art technology providers).
- Connectivity and technology are changing the way we work, creating an ideal backdrop for young Lebanese tech entrepreneurs and workers.
- Reliable electric power will be indispensable. Since Lebanon has plentiful sunshine, renewable energy should be considered rather than vast expenditure on out-dated power stations.
- The Lebanese should not be fooled by promises of income from gas and oil. This may be expensive to extract and the price of these commodities is highly volatile.

Towards fundamental reform

A new Lebanese government should begin with a new Constitution: “A firm bargain and a right reckoning make long friends”*. A new Constitution would put in place the **foundation** for the way forward.

And the new Constitution should outline the framework **for genuine institutional reform** as well as aim to stabilize the political system:

Our younger generation and indeed many citizens no longer want the current form of governance – a form which is out of date and out of time.

If there is no change:

- The laws will continue to be made by the present set and they will make every effort to retain the status quo. The country will therefore go bankrupt or be in a constant state of upheaval.
- Various Lebanese groups will continue to look for protection from other powers. But outside powers will always act in their own interest and foreign ‘alliances’ will only lead to more intercommunal disagreement.
- Even the best terms the present government can offer will **not be more than a temporary fix**. The state of affairs will continue to be unsettled and could be followed by even greater revolt.
- **Capital will not come back to the country** and residents will again leave. Business will suffer further and unemployment will continue to rise.
- Delay may make it **too difficult to form a unified government for Lebanon in a few years given the febrile state of the nation**.

The time to act is now, for, without change, we could be **looking at the destruction of Lebanon**.

A new vision and plan are the only way to effect recovery. Once the situation is stabilized, confidence will recover, the Lebanese themselves will quickly get back to business and capital will return.

* From Common Sense by Thomas Paine. Thomas Paine helped inspire the American Revolution.