Understanding the Lebanese paradox

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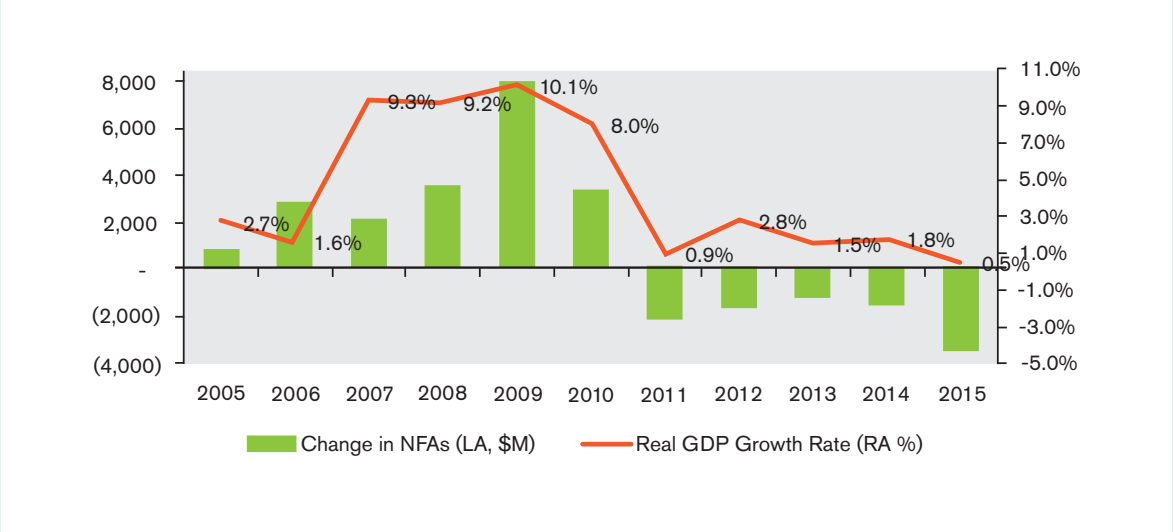
Economic indicators are giving conflicting signals on the Lebanese economic activity. However it seems that this is not exclusively a Lebanese phenomenon, as US indicators are also giving conflicting signals to policy makers, thereby establishing uncertainty on the markets regarding future interest rates' decisions by the Federal Open Market Committee. In Lebanon, several indicators showed signs of recovery in the first 6 months of the year, especially in the two major sectors that were the drivers of growth during the 2007-2010 period, namely tourism and real estate. However other indicators such as the PMI, the balance of payments, and the Beirut traders' association retail index, are showing a contraction in the private sector's economic activity. This article tries to understand what lies behind the increase in some sectorial indicators and why they are not feeding into the other sectors of the economy. The goal will be to get a real feel of the direction of economic activity in the country.

Key conclusions:

- Even with some indicators showing recovery signs, the in-depth analysis reveals that these are due to some exceptional factors and are not enough to turnaround the difficult situation that the Lebanese economy is facing.
- Low interest rates are serving the economy well. Low interest rates or even negative ones are starting to adversely impact developed economies, especially future pensioners in these economies, and a liquidity trap is starting to loom in the horizon. In contrast, the Lebanese economy continues to benefit from this environment of low rates to finance both its public and private sectors. The international low interest rates environment is helping the government to continue to pay relatively low interest rates on its debt compared to previous periods, despite the politically difficult situation. Moreover the central bank is able to adopt monetary policy easing and subsidize loans with rather limited costs on its balance sheet compared also to the previous period when interest rates used to be much higher.
- The resilience of the economy is getting slowly eroded. The resilience of the Lebanese economy has been proven over and over during

The period totaling USD9.42 billion



previous shocks, starting with the war in 1996, passing by 2001 recession, and the 2005 assassination of prime minister Rafic Hariri, and ending with the 2006 Israeli aggression on Lebanon. However this time the shock is different as it started in 2011 and extended over an unknown period of time. In addition it is a combination of a domestic political deadlock, a regional instability, a large drop in oil prices, and a sluggish growth worldwide. The continuous deficit of the BoP since 2011 is an indication that the resilience is getting thinner with time and a positive shock is needed, such as the election of a new president, to have it recharged again.

- Reforms are crucial. As the resilience is thinning, structural reforms become even more necessary and urgent in order to improve the business environment and establish the rule of law, while pushing forward the public private partnership process. There is a need to increase investments in infrastructure to raise potential growth of the economy. As the government is constrained by its deficit and high debt, it needs to give more leeway for the private sector to finance investments and share the return.

One cannot paint a rosy picture of the economic situation in Lebanon in the current domestic political deadlock and regional turmoil. The country has been without a president for more than two years now; parliamentarians extended their mandate twice in the last 5 years. In the region, the war in Syria is still raging with all its implications on Lebanon especially with more than 1.5 million registered refugees, or 40% of the Lebanese population, for whom Lebanon has to provide support.

Lebanon is entangled with low economic growth rates since the start of the Arab spring in 2011. Following five years of outstanding performance, the Lebanese economy entered a new era of distress starting 2011. In particular, 2015 was one of the years to materialize the negative repercussions of regional and domestic political developments and instabilities on the economic performance of the country. Gross Domestic Product (GDP) growth is estimated to have reached a negligible level of 0.5% during 2015 and could have turned negative if it were not for the initiatives of the Lebanese Central Bank.

The BLOM PMI Lebanon also reflects the weakness of the private sector with the indicator remaining below the 50 benchmark for more than two years now, indicating a continuous contraction in the economic activity of the private sector. The average PMI for the first half of the year recorded 45.8 and echoes a steep decline in the new orders and output for companies.

Despite these difficult circumstances, the security situation remains under control, thus encouraging tourism. The number of tourists jumped by more than 7% in the first half of 2016. However the number of large spenders from Gulf Cooperation Council's states (GCC) declined, as the latter issued travel warnings against their nationals visiting Lebanon, triggering lower travel receipts in 2015 by almost 35% from 2010's level. Nonetheless, the number of Iraqis and Europeans increased substantially, but this was not enough to offset the decline in tourism spending, as the amount of VAT refund dropped by more than 14% in the first half of the year. Moreover, this increase in the number of tourists didn't materialize in an uptick of hotel occupancy of 4 stars and 5 stars hotels in the capital as it declined from 57% during the first half of 2015 to 54% in the first half of 2016. It is probably the case that tourists preferred 3 stars hotels and rural tourism as the characteristics of the new tourists changed.

The construction sector seems to be faring better than last year as cement deliveries increased by 10% year-on-year in the first half of 2016. However this is most probably due to the following exceptional factors: municipality elections, weather conditions, and low steel prices.

Other proofs of how the increase in cement deliveries is not reflecting better opportunities or an improvement in the whole sector are the increase in receivables' collection period and the real estate decline in prices. Receivables collection period for the cement companies has lengthened substantially during the last two years, meaning that these companies are taking more time to get paid by their clients. There are no statistics on the stock of unsold finished apartments, but it is sure that it has drastically increased over the last few years especially for large apartments in the capital Beirut. Prices also have declined between 15 and 30 percent depending on the region and apartment space.

On the external sector, the situation shows negative signs as the balance of payments (BoP) turned into negative territories starting 2011 and the deficit widened in 2015 and the first half of 2016. Primarily, in the period 2007-2010, the BoP registered sequential surpluses amounting for a cumulative USD16.72 billion. Between 2011 and 2015, the BoP recorded recurring deficits over the period totaling USD9.42 billion.

The continuous deficit in the BoP during the last 5 years is eating up the resilience of the Lebanese economy to shocks. As economic growth came close to zero in 2015, the BoP recorded a critical deficit of USD3.35 billion, the highest seen since 1980. In the first half of 2016 alone, the BoP deficit reached USD1.8 billion.

Of course, a negative BoP is reflected in the decline of the net foreign assets (NFA) of the banking sector (Central bank and commercial banks). During the last few years, Banque du Liban (BdL) was preserving its foreign currency reserves, but this was at the expense of the decline in the commercial banks' NFAs. Amid a low global interest rates environment, commercial banks were attracted by the relatively high yields on the Central Bank's CDs therefore they were repatriating their foreign assets and investing in papers issued by the Central Bank. In this context, the NFAs of BdL rose by USD18.35 billion between 2007 and

2010 while those of the commercial banks decreased by USD1.62 billion. During the period 2011-2015, the total increase of BdL NFAs slowed to USD8.04 billion amid a steeper contraction of USD17.46 billion in the NFAs of the commercial banks.

On the fiscal front, the government was still realizing a primary surplus up until the end of 2015, but due to the high level of public debt reaching 140% of GDP and the high interest rates paid on the public debt, this surplus was not enough to offset the debt service, and therefore government debt is still on the rise. Moreover, as the real growth rate and inflation are near zero, the ratio of debt to GDP has increased in the past few years from 135% to 140% after declining in the 2007-2011 period from 180% to 135%.

It is worth mentioning that low interest rates are helping the government lengthening the maturity of its debt at a relatively low cost. Nonetheless the high level of public debt is reinforcing the difficulty to cover the debt service with the primary surplus realized by the government, even in an environment of low interest rates. The primary surplus needed to cover the debt service and start reducing the absolute amount of public debt will exceed 7 percent of GDP.

Having said that, capital spending of the government is at a record low, and the infrastructure is getting eroded with a negative impact on the provision of public services. The 1.5 million Syrian refugees are exacerbating the problem rendering the infrastructure obsolete, which is becoming a handicap for economic activity, especially for industrials and some other sectors of the economy.

On the monetary front, the central bank (BdL) took the lead in 2015 and tried to kick-start the economic engine through monetary policy easing and the use of unconventional instruments. In 2015, BDL launched a third new stimulus package of LP 1,500 B (USD1 billion). The Central Bank provided low cost incentives to the private sector through banks to encourage investments in vital sectors such as tourism, agriculture, industry, IT, environment, housing and education.

In the same context, the central bank introduced another USD1.5 billion incentive package in 2016 and offered loans to banks with 1% interest only. In return banks will provide these loans to different sectors with special emphasis on environmental projects and housing.

These packages would have had a larger impact on the BdL balance sheet and income statement in a high interest rate environment. However with international rates at their lowest levels in decades, the impact on BdL books is much smaller.

Moreover, due to the fragile economic conditions and the slowdown in growth in Lebanon, BdL issued a new circular in October 2015, that allows the restructuring of substandard and doubtful debt portfolios (excluding all subsidized and soft loans) of banks and financial institutions upon a mutual consent between the borrower and creditor, under the oversight of the Banking Control Commission.

This extension of the monetary easing by the central bank in addition to the issuance of the debt restructuring circular indicates that the economy is not yet growing at a healthy rate and more stimuli are needed to improve growth.

As for the banking sector, indicators remained positive however at a decelerating rate compared to last year and the deceleration is much more pronounced when compared to 2010, and 2012. Consolidated assets of commercial banks grew by 5.9 percent y-o-y by 2015, and by 2.35 percent year to date by end of June 2016.

Even though deposits kept on posting positive performance, their progress seems to be slackening. In fact, private sector deposits recorded a growth of 6.0 percent by 2014, compared to a lower rate of 5.0 percent during 2015 and around 4.5 percent year-on-year in the first 6 months of 2016.

As for loans to the private sector, they edged up by a yearly 6.5 percent to USD54.22 billion by 2015 and 2.93% year to date by end June 2016, despite all BdL incentives.

The central bank kept interest rates unchanged during 2015 and 2016 and intervened in the market whenever necessary to keep the rates on the Lebanese pound stable. Therefore, interest rates on Treasury bills (T-bills) remained at their levels during 2015, with the average yield on the 1 year T-bills remaining at 5.35%, while that of the 5 year T-notes standing at 6.75%.

However on the Eurobonds level, and since there is an active secondary market, yield on 5Y and 10Y maturities reflected the uncertainty prevailing on the political front, hence surging by 80 basis points (bps) and 51 bps respectively at the end of 2015, and by another 21bps and 27bps by end June 2016 to reach 6.31 percent and 6.94 percent.

Lastly, even though the economic environment is actually in distress, recovery is still possible. This can be rendered by at least two positive developments. First, improvement in the surrounding regional conditions is essential to reestablish foreigners' confidence in the country. Second, the election of a new president could also relieve the country from its ongoing political deadlock, which will help in attracting additional capital inflows. Launching a strategy for the Lebanese oil and gas sector, so as to initiate the long-awaited exploration and production processes, will certainly be a source of external income that will help in the revival of both the external sector in specific and the economy as a whole.

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