2016 in Review and Outlook for 2017: Deterioration Stopped, Recovery is yet to come

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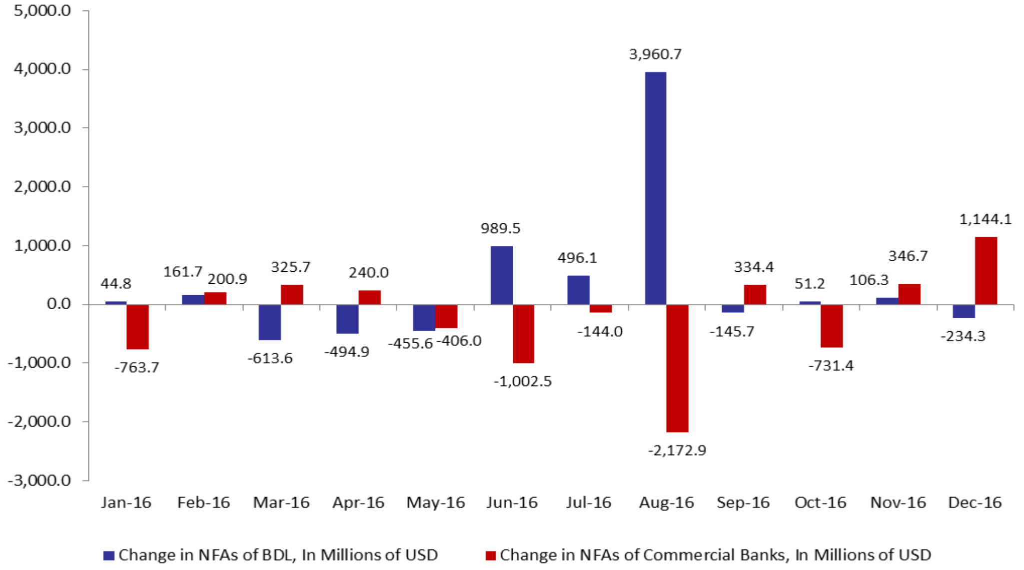
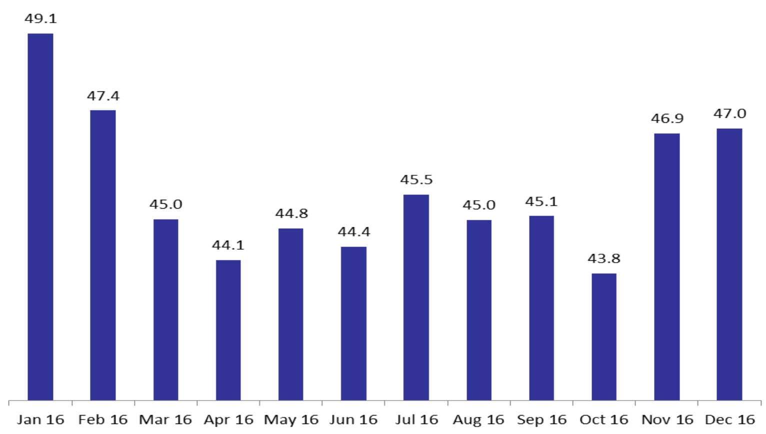
Balance of Payments in 2016: Monthly Changes in Net Foreign Assets of Central Bank and Commercial Banks



Source: Banque du Liban

BLOM Lebanon PMI in 2016



Source: Markit, Blominvest Bank

The Lebanese economy extended its stay in the tunnel during 2016 despite the election of a president and the formation of a government. These 2 events relaxed the political atmosphere that was negatively weighing on investors' confidence, and were essential to put the political stability on track. However there is still the uncertainty of getting to an agreement on the electoral law and holding the elections this year.

On the financial front, 2016 was marked by the swap operation between the central bank (BDL) and commercial banks. This swap operation or financial engineering helped boost the gross foreign reserves of BDL, and the tier I capital of banks ahead of the implementation of IFRS 9 standards in 2018. However it was neutral when it comes to its impact on the economy as the central bank absorbed all the increase in money supply that resulted from the operation. Therefore no inflationary pressures were felt especially that the liquidity was created in Lebanese pounds (LBP) and only 25% of banks' lending is in domestic currency.

The slowdown in private sector activity continued to hit the economy. The purchasing managers' index (PMI) remained below the 50 benchmark that separates expansion from contraction, meaning that private sector business activity was contracting during 2016. Hence economic growth rate is expected not to have exceeded 1% during the year. The election of a president and the formation of a government couldn't reverse the slowdown of the previous months, especially that they took place towards the end of the year.

Inflation returned to positive territories at the end of 2016, although the average inflation rate during the year remained negative at -0.78% compared to -3.76% in 2015. The deflation in 2015 was the result of the decline in oil prices and the depreciation of the Euro. End of period inflation (the consumer price index at end December 2016 compared to end of December 2015), reached 3.14% in 2016 following the recovery in oil prices, which pushed up transportation costs.

The two main sectors that were the drivers of economic boom during the period 2008-2010, namely tourism and real estate showed some very shy signs of revival. Tourists' number increased but their spending remained subdued, which is the result of the continuous decline in the number of tourists coming from Gulf countries. Hence the contribution of the tourism sector to GDP stagnated if not declined during 2016. The real estate and construction sector was not in a better situation as prices of apartments continued to decline even though we noticed some increase in the number of transactions.

The fiscal situation deteriorated in 2016 but kept on registering a (barely) positive primary surplus. The fiscal deficit reached around USD 5 billion or 9.5% of GDP compared to USD 4 billion in 2015 or 8% of GDP. The primary surplus fell to USD20 million compared to USD720 million in 2015. Although revenues increased by 3.6% in 2016, expenditures jumped 9.9%, thus leading to the increase in fiscal deficit. Debt service consumed 50% of revenues, an increase of 1.2 percentage points over 2015.

As a result, public debt continued its unsustainable upward trend hitting USD75 billion or 145% of GDP. The problem of Lebanon's public debt ratio is not that it is one of the highest in the world; rather it is the implicit interest rate that it is paid on this debt. This rate is around 6.6%(domestic and foreign debt combined), which is much higher than interest rates paid in developed countries with high debt and even compared to emerging markets.

In order for the debt to become sustainable, the government will have to combine two contradictory policies of boosting economic growth and at the same time keeping a restrictive fiscal policy. By sustainable debt we mean getting the public debt to GDP ratio on a downward trend. The solution cannot come only from the fiscal side as the government will have to realize a budget primary surplus in excess of 5% of GDP if economic growth remains subdued. Hence the government could aim at implementing structural reforms to improve business conditions and heading toward public private partnership agreements to fulfill its investment agenda. These reforms will increase growth which in turn will improve fiscal revenues. Another issue that may help in reducing the burden of public debt is the extraction of gas, however this will not take place before 6 to 8 years.

The balance of payments registered a surplus of USD1.24 billion in 2016 due to the financial engineering operation executed by the central bank. Up until mid-year, the balance of payments had registered a cumulative deficit of USD1.77 billion. The attractive swap operation offered by the central bank in parallel with the decline in yields in other emerging markets increased the appetite of foreign funds towards Lebanon's Eurobonds and encouraged Lebanese banks to sell these Eurobonds in order to participate in the swap operation. The combination of these two actions, in addition to high yielding products offered by banks, led to high capital inflows.

However this time, the positive balance of payments was not accompanied by an economic boom. Capital inflows resulting from the BDL swap had no impact on the economy as they were not the result of an increase in tourists spending, remittances, or foreign direct investment. These inflows were not a normal flow of capital into banks deposits that could be directed to an increase in loans and credits. Capital inflows happened in a very short time and were channeled towards the increase of central bank gross foreign reserves.

On the monetary front, the central bank (BDL) kept on its expansionary policy with stable interest rates and stimulus packages. The central bank tried throughout the previous years, especially in the absence of a president and a functioning government, to preserve a positive economic growth. BDL pursued the same policies in 2016 and introduced a stimulus package of USD1.5 billion while allowing banks to use a higher percentage of their capital to invest in startup companies. BDL continued also to subsidize housing loans and loans to other productive sectors.

Commercial banks boosted their profits and their capital before the upcoming implementation of IFRS 9 standards. The swap operation performed by the central bank helped the banks increasing their profits and capital. In this context, the Central Bank of Lebanon issued Intermediate Circular #446 ordering the Lebanese banks to use this surplus to meet the overall provisioning requirements in LBP, and the capital adequacy requirements in addition to the requirements that might result from the IFRS 9 regulations which will go into effect as of January 1st, 2018. The banks will also have to use the surplus realized from the swap to provision against any impairment of investments abroad. They were also required to provision against goodwill impairments resulting from merger operations. BDL added in the circular that if any surplus persists after all of the above requirements are met, no more than 70% of this surplus can be registered on the Income Statement as un-distributable profits before being allocated depending on the case as reserves for capital increase under "Common Equity Tier One".

2017 is expected to be somehow better than 2016, but growth will remain low at 2%. The reasons for not being upbeat over 2017 are many and will comprise political as well as economic developments. The first quarter has already passed without any new development. Political parties didn't yet agree on a new electoral law, and if they do soon, the elections will not take place before the end of summer. Potential growth of the Lebanese economy has declined throughout the years as the infrastructure was eroded not only due to the influx of a large number of Syrian refugees but also due to the very low investment spending done by the government during the previous 6 years. Private sector investment was also relatively low in the previous years.

The immediate challenges faced by the government are many and could be summarized in the following:

- Attracting foreign capital: negative balance of payments except for 2016 (due to the central bank financial engineering) makes it hard to finance both the private and the public sectors.

- Reduce fiscal deficit and contain the public debt: The combination of increased public debt with low growth and negative Balance of payments will soon start to crowd out the private sector.

- Face the implication of the increase in US interest rates on the cost of both public and private debts.

- Improve economic growth: GDP growth has hovered 1% in the past few years which is pushing up unemployment and pressuring the private sector. The unemployment problem will be worsened by the fact that economic growth in the GCC and African countries has slowed down. Therefore young Lebanese will find it harder to get a job in these countries.

In order to change the actual situation, the government will have to embark on a structural reform agenda to restore consumers and investors' confidence and put the economy on the road to recovery. Gaining back the confidence of investors is essential for the country to be able to achieve its potential. Confidence can be lost in a fraction of a second as it was proven during financial and economic crises all over the world. However gaining back confidence will take lots of effort and time. The more effort the government undertakes, the quicker it will gain back confidence. Making effort means taking the right decisions to implement reforms and infrastructure enhancement in order to boost potential growth.

The list of reforms has lengthened drastically as the government didn't implement any serious reform since 2006. In order to gain back investors' confidence, the government will have to embark on an action plan as soon as possible and work in parallel on a series of reforms. These include, but are not limited to, modernizing the commerce law to ease doing business in Lebanon and to allow the development of capital markets (e.g. reducing the costs and time of creating companies and closing companies), reforming the public sector in parallel with the approval of the new salary scale, fighting corruption and tax evasion.

The action plan of the government should also comprise developing the dwindling infrastructure, not only to increase potential growth but also to improve the quality of life for the citizens. The needs are immense in this regard, and the government does not have the financing required to implement all the necessary projects; hence the importance of involving the private sector to bear the cost of investments and share the profits. The government should provide a transparent legal framework. The projects comprise increasing electricity production, building dams as a milestone to have a sustainable water system, building a sewage system with sewage treatment in order not to pollute the underground and sea water, constructing waste treatment facilities, similar to the one in Saida, in order to be able to close landfills, and finally improve the transportation system especially roads infrastructure.

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