



February 13, 2015

Contact Information

Research Assistant: Lana Saadeh
 lana.saadeh@blominvestbank.com

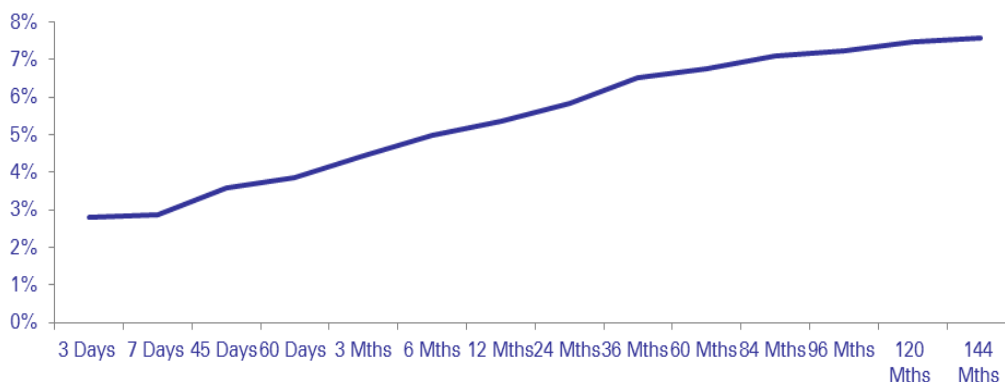
Head of Research: Marwan Mikhael
 marwan.mikhael@blominvestbank.com

Research Department
 Tel: +961 1 991 784

To support economic growth and price stability, monetary policy has remained highly accommodative during 2014. The central bank kept the interest rates stable as witnessed by T-bills rates, maintained the exchange rate peg at its current level, pumped money into the system through subsidized loans and added to its sizable holdings of government securities.

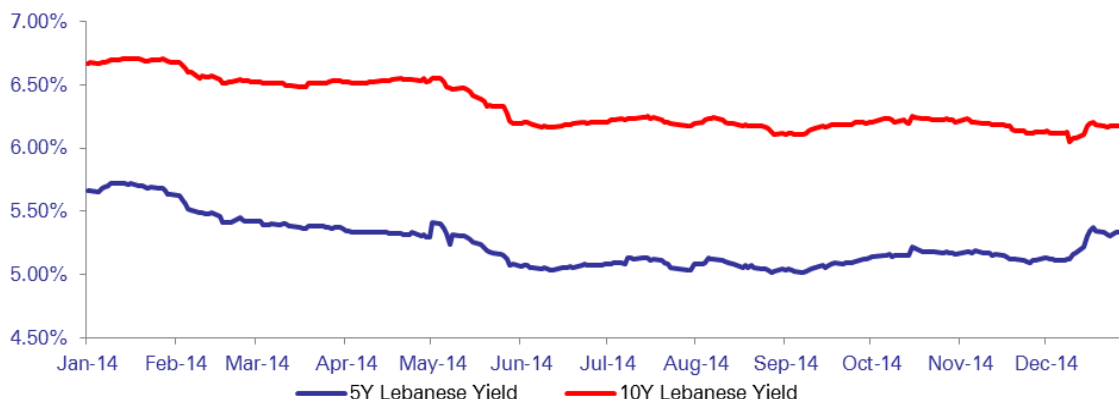
The Lebanese pound yield curve remained stable throughout the year, while that of Eurobonds fluctuated however within a small range. The central bank managed to maintain interest rates at a level that is conducive to economic growth. Interest rates on T-bills didn't change during 2014 with the average yield on the 1-year T-bills at 5.35% while the average yield on the 5-year T-notes stayed at 6.75%. On the Eurobonds level, yields on 5-year and 10-year maturities had fallen by 36 basis points and 61 basis points respectively during the year.

Lebanese Pound Yield Curve



Source: BdL

5Y and 10Y Eurobonds' Yields



Source: Bloomberg, BLOMINVEST Research Department

As security and political situations had their toll on the economy since 2011, the central bank continued to adopt an accommodative stance of monetary policy in order to support progress toward price and exchange rate stability and economic growth. In this context, the central bank implemented an \$800M economic stimulus package in 2014, which targeted start-up companies and some other sectors of the economy including housing, tourism, and manufacturing. In addition, hoping that the knowledge sector would become one of the pillars of the Lebanese Economy, BdL initiated the "Knowledge Economy"- "an economy in which information is invested to create new and improved products and services with a high added value that constitutes a main component of the production process and generation of wealth".¹ The central bank encourages banks to invest in this sector's companies, by guaranteeing 75% of the risks born of such investments, and preserving 50% of the profits stemming from the guaranteed investment.

In light of the cumulative progress toward its monetary policy objectives and the outlook for further progress over coming years, the BDL planned another economic stimulus package for 2015 for an amount of \$1B. The package encompasses low borrowing rates of 1% for housing and new projects, including renewable energy and environmental projects, and extended loan terms for small and medium-sized businesses.

In particular, the central bank has used large-scale bond purchases to ease financial conditions more broadly so as to promote the more rapid achievement of economic growth. BdL's holdings of T-bills and bonds increased 17% during 2014 going from \$11.19B to \$13.07B. As for BDL's portfolio of Eurobonds, it also jumped by 24% from \$4.53B to \$5.72B. In addition, the BDL decreased interest rates on certificates of deposits by 26 basis points during 2014.

While stimulating the economy the BDL managed to preserve price stability in 2014. Average inflation rate remained at 1.86%, below but close to 2%. The decline in international energy prices and reduced telecommunications tariffs helped the central bank in maintaining a low inflation rate while adopting an accommodative monetary policy. "Transportation" sub-index and "Communication" sub-index dropped 3.06% and 13.73%, respectively.

Exchange rate stability was maintained throughout 2014. The BDL was successful in keeping the exchange rate moving within the narrow band it has fixed before of 1500-1515 Lebanese pounds per US dollar. However the exchange rate remained at the higher end of the band, mainly at 1510-1514 LBP per USD, during most of the year, as regional shocks and negative domestic political and security events were always pushing investors towards dollar denominated deposits. Therefore the dollarization of deposits went up from 64.8% by end December 2013 to 65.7% at end November 2014.

¹ BdL Governor, Riad Salameh

The BDL also strengthened the regulatory framework in order to preserve the stability of the banking system and increase its resilience against shocks. The central bank issued, in 2014, new regulations (Intermediate Circular 369) concerning retail loans granted after the 1st of October, 2014. First, Intermediate Circular 369 states that a car or housing loan taken for the purchase of a car or the first house must not exceed 75% of the price i.e., the debtor should pay at least 25% of the good's price as a down-payment. Moreover, BdL restricts the cumulative monthly payments for all retail loans to a maximum of 45% of the household's monthly income, which is the husband and wife's monthly earnings. For housing loans, the cumulative monthly payments must not exceed 35% of the household's income.

As a result of the accommodative monetary policy, the balance sheet of the central bank has swollen further since the end of 2013. BdL's total assets surged 11.28% yearly, to stand at \$85.70B by the end of 2014. Similarly, its net foreign assets (excluding gold) inched up 7.28% during the same period to a high level of \$37.86B, providing it with a comfortable liquidity leeway to protect the currency peg. For comparative purposes, total assets of commercial banks posted a 4.48% increase since year start, to \$172.21B by November 2014. Also money supply registered a 5.81% year-on-year growth in 2014.

In order to get the impact of the accommodative monetary policy on GDP, we have tried in the below section to apply the quantity theory of Money ($\text{Money Supply} \times \text{Velocity} = \text{Nominal GDP}$) on Lebanon and analyze some of the results. Of course the analysis is not very accurate as we took the annual data for 9 consecutive years only. However the pertinence of the results is striking.

Year	M3 (\$M)	Nominal GDP (\$M)	V=NGDP/M3
2006	53,400	22,190	0.42
2007	59,800	24,958	0.42
2008	68,600	29,822	0.43
2009	82,077	35,229	0.43
2010	92,146	38,123	0.41
2011	97,114	40,791	0.42
2012	104,011	43,902	0.42
2013	111,158	45,451	0.41
2014	116,466	47,843	0.41

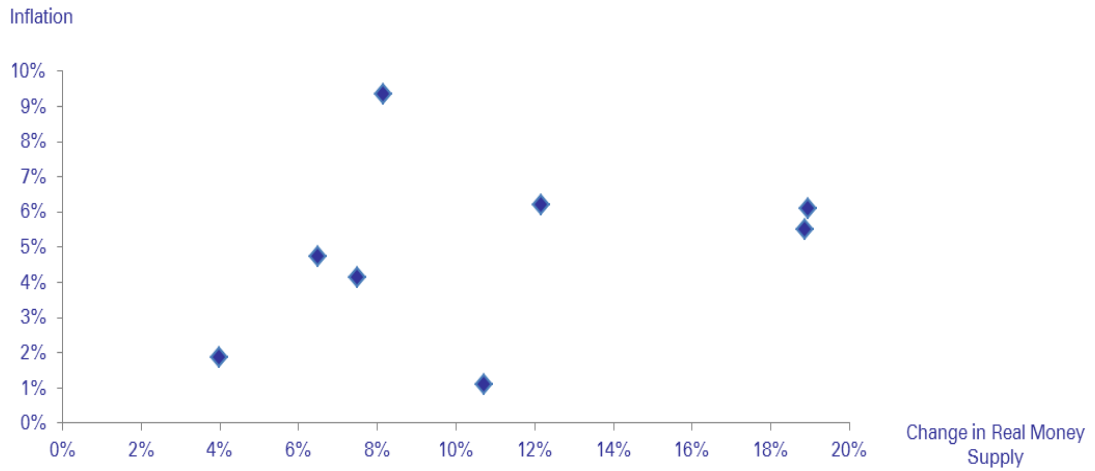
Source: BdL, BLOMINVEST Research Department

The table above shows that since 2006, velocity has been almost constant at an average of 0.42, entailing that money supply and nominal GDP are directly proportional. Moreover, these 2 variables are extremely related with a high correlation of 0.998. This implies that an increase in money supply would result in an increase in either prices or Real GDP or both.

Will this stimulus package result in inflation?

Calculating Real Money Supply, by taking inflationary effect out of Money Supply, and comparing its yearly change to inflation, a correlation 0.287 is obtained. This signifies that an increase in money supply would lead to a small increase in inflation rate. However, an inflation rate of 1.86% is considered low, so a small uptick in prices would not lead to a very high rate.

Inflation versus Annual Change in Money Supply

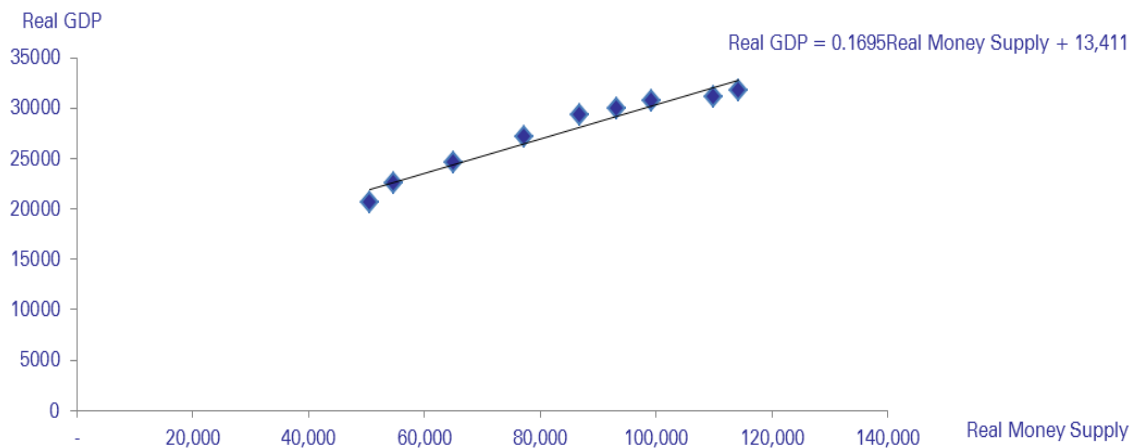


Source: BdL, BLOMINVEST Research Department

Does this mean that changes in money supply mainly impact Real GDP?

The correlation between real money supply and real GDP is 0.975, which is really close to a perfectly positive correlation.

Real GDP versus Money Supply



Moreover, if Real GDP is regressed on Real M3, we obtain a straight line with the following equation, $RGDP = 0.1695 RM3 + 13,411$, which suggests that a \$1B increase in real money supply results in a \$169.5M increase in RGDP.

Finally, the central bank has remained true to its objectives, helping the economy maintain a positive growth despite all the obstacles the country has been facing in the past couple of years. However, BdL's efforts should be accompanied by an effective fiscal policy aimed at decreasing government's debt. This would increase investor's confidence in the country.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department
Bab Idriss, Weygand Str.
POBOX 11-1540 Riad El Soloh
Beirut 1107 2080 Lebanon

Lana Saadeh
Tel: +961 1 991 784
ana.saadeh@blominvestbank.com

Marwan Mikhael, Head of Research
marwan.mikhael@blominvestbank.com
+961 1 991 782

Disclaimer

This report is published for information purposes only. The information herein has been compiled from, or based upon sources we believe to be reliable, but we do not guarantee or accept responsibility for its completeness or accuracy. This document should not be construed as a solicitation to take part in any investment, or as constituting any representation or warranty on our part. The consequences of any action taken on the basis of information contained herein are solely the responsibility of the recipient.