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Thoughts on the Lebanese Economy

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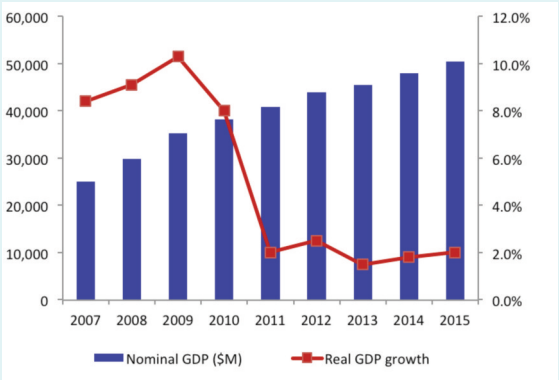
Lebanon's economic growth has been sluggish in the past few years. Growth hovered around 2% in 2013 and 2014 compared to an average rate of more than 9% between 2007 and 2010. The high growth rates of the latter period were possible due to the large output gap that existed following years of very low economic growth and episodes of wars and assassination. The closing of the output gap, the outburst of the Arab spring, and the internal political deadlock drove the economy back to low economic growth coupled with a high fiscal deficit and a high ratio of debt to GDP.

Economic growth in Lebanon



The balance of payments (BOP) deficit during the past 4 years contributed to lowering growth. The BOP registered a cumulative deficit of more than US$6bn during 2011-2014 following a cumulative surplus of more than US$16.5bn during 2007-2010. Lower capital inflows that were going into foreign direct investments mainly in the real estate sector, in addition to lower tourism receipts led to the decline in growth as both tourism and real estate were the drivers of economic growth in the previous period. Moreover the negative balance of payments meant slower growth in banks deposits as the economy is dollarized with around 65% of deposits that are denominated in US dollars.

Fiscal authorities do not have any leeway in the budget to boost economic growth. The debt to GDP ratio was about 134% at end 2014 with associated financing needs of 26% of GDP. The fiscal deficit has declined to 6% of GDP at end 2014 after reaching 8.8% in 2013. The primary balance also recorded a surplus of 2.4% last year following a deficit of 0.8% of GDP the previous year. However this improvement in fiscal performance is due to exceptional one off revenues from the telecommunication sector as both overall and primary balances are expected to register deficits of 10.1% of GDP and 1.3% of GDP respectively in 2015. Therefore it is not advisable to further increase the fiscal deficit to try to spur growth.

Hence Monetary Authorities took the initiative and implemented a series of packages to boost growth through subsidizing loans and allowing commercial banks to get a stake in start-ups belonging to the knowledge economy sector. These packages contributed 0.5 to 0.8 percentage points to the economic growth rates registered in the past few years.

Monetary Authorities have also been able to maintain financial stability. The currency peg has been preserved with the central bank accumulating more than 2 years of imports in gross foreign reserves. Interest rates remained stable in 2014 with the central bank intervening in the primary and secondary markets of government Treasury bills and Eurobonds whenever necessary to provide additional liquidity or to absorb the excess of it.

In this context of low growth, domestic political deadlock, and regional turmoil, the banking sector in Lebanon has been able to continue growing however at a decelerating rate. As commercial banks consolidated assets reach four times of GDP, their deposits were growing at a compounded annual growth rate (CAGR) of 14% during 2007-2011 before declining in 2012 – 2014 to 7%. Loans to the private sector grew at a CAGR of 18% during 2007-2011 while decelerating to 8% afterwards.

Large Lebanese banks adopted a regional expansion strategy that helped them weather the crises in neighboring countries and the difficult operating environment in Lebanon. Following the events that took place in Syria, banks had to lower their exposure to the country and concentrated on Lebanon and Iraq as the situation in Egypt was also unstable. Then Banks recorded large expansions in Egypt, Jordan, and

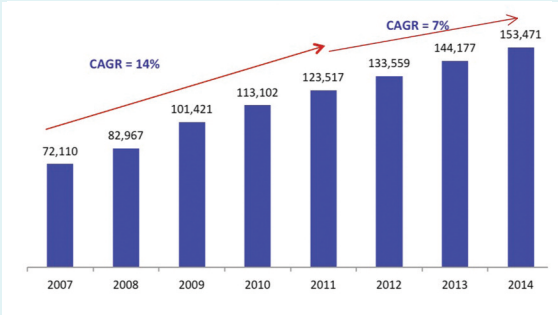
the GCC countries while their margins were squeezed in Lebanon due to the fierce competition in attracting clients.

Other than the regional turbulence, Lebanese banks faced a mounting pressure on compliance with the adoption of the Foreign Account Tax Compliance Act (FATCA) in the United States (US). Since many Lebanese citizens hold a double nationality, among which the US passport, the banks have put in a tremendous effort to segregate the clients that have an American passport to comply with the FATCA. Lebanese banks and the monetary authorities joined hands to abide by the new international requirements in a record time. It is worth mentioning that Lebanon has a banking secrecy law since 1956.

Lebanon faced several shocks in the past, following the civil war. The recent ones took place just before the global financial and economic crisis. In 2005, Prime Minister Rafik Hariri's assassination led to deposits withdrawals reaching around US$6bn in 2 months and dollarization of deposits jumping by more than 10 percentage points to reach 79% at end March 2005. As a result, gross foreign reserves of the central bank declined by US$2bn to hit US$7.6bn. The central bank responded by issuing Euro deposit certificates in an aggregate amount of US$2bn with a 10-year maturity and a coupon rate of 10 percent. In 2006, the Israeli invasion of Lebanon during the month of July led to a withdrawal of deposits at a level of US$3.5bn in two months and the dollarization of deposits increased again by 4 percentage points.

However past experience showed that monetary authorities and commercial banks were resilient to external and internal shocks. Financial stability was preserved and deposits proved to be less volatile than expected. In fact, the stability of deposits comes from two main factors: the confidence depositors have in the ability of the central bank to manage any upcoming crisis especially after the Central Bank was able to preserve the exchange rate peg since the early 90s and has adopted the right regulations to develop the banking sector and put commercial banks on a solid footing. The banking sector has high

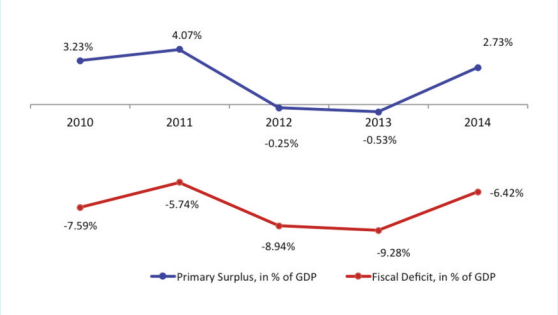
Total Deposits at Commercial banks (in US$ millions)



liquidity as the net primary liquidity ratio over total deposits stands above 30%. The shareholders equity ratio over net loans is at a high of 29% compared to a regional average of 24% and a global average of 15%. The capital adequacy ratio stands at 14%, which is higher than the minimum required and thus providing banks with the necessary buffers in case of pressures on their capital base.

Some have tried to draw on the similarities between Lebanon and Greece, but in fact any comparison with what is taking place in Greece is out of context. There are many differences between the two economies while there are only two resemblances. The latter consists of the high debt to GDP ratio that approached 133% in Lebanon at end 2013 (the year with a high debt and fiscal deficit, since 2014 contained one off factors that we had to be extracted) and was at 148% in Greece at end 2010(year when the crisis erupted); and the high budget deficit that recorded 11% of GDP in 2010 in Greece while it was at 8.8% of GDP in Lebanon at end 2013.

Fiscal Balances in % of GDP



Dissimilarities with the Greek situation are many, starting with the fact that Debt composition is different. The Greek debt is all denominated in Euros, which can be considered a foreign debt for Greece although it is in domestic currency. Why? Well because the central bank of Greece has no power over monetary policy and cannot print Euros when necessary and has to always go back to the European Central Bank (ECB) to get the needed liquidity. Thus the lender of last resort for the Greek economy is the ECB and not the Greek central bank. While in Lebanon, 60% of the debt is denominated in domestic currency and only 40% of the debt is in foreign currencies. Moreover the central bank has the ability to print domestic currency or to reduce its reserves and lend the government in foreign currencies when needed.

Second, the holders of the public debt are different. The Greek public debt was mostly held by European banks in 2010 and was transferred afterwards to the European Financial Stability Facility, the

ECB, the International Monetary Fund, and the governments of Germany and France. While in Lebanon, the debt is mostly held by Lebanese commercial banks and the central bank. The remaining is in large part held by public entities. And these investors are dedicated investors as it was proven during periods of political instability.

Third, interest rates in Lebanon are being set by the central bank, while in Greece interest rates are set by the ECB. Of course the central bank of Lebanon does not have full control over interest rates as the Lebanese pound is pegged to the US dollar but it still has a large maneuvering power.

Therefore the interest rate spread between Lebanon and the US can be managed to attract deposits and keep capital inflows from the rest of the world but mainly from the Gulf Cooperation Council countries at an adequate level that serves the economy well. Even during periods of war or instability, the increase in interest rates was able to attract deposits.

History has shown that the more the peg and financial stability are maintained, the more confidence monetary authorities are gaining and the less they have to do in periods of high tensions. In 1995, the Lebanese government had to increase interest rates on Treasury bills to 40% to lure investors as political tension was elevated, while in 2007 and the first 5 months of 2008, political tensions were extremely high but interest rates did not increase. The central bank responded through its intervention on the primary and secondary market of government bonds to keep interest rates steady and through issuing long term certificates of deposits, which was enough to maintain economic and financial stability.

Fourth, the composition of the banking sector and its deposits is very different between Lebanon and Greece. Deposits in Greek banks amounted to 117% of GDP in 2010 compared to more than 300% of GDP for Lebanon at end 2014. Moreover, most of depositors are Lebanese residents in Lebanon or living in the Gulf Cooperation Council countries. These depositors are less prone to transfer their deposits out of the country when external and internal shocks hit the economy. Only foreign investors, mainly global funds, exposed to Government Eurobonds did some divestments away from Lebanon when there are negative developments taking place in the country. History shows that Lebanese banks intervened to buy government bonds from foreign investors at a discount and realized large gains afterwards when market conditions improved. Moreover Lebanon receives around US$7.7bn, more than 16% of GDP in remittances, which are countercyclical by definition as they increase when the situation in Lebanon deteriorates, thus contributing to the stability of the deposit base.

However lessons can be drawn from the Greek experience, especially when it comes to fiscal and debt issues. On the fiscal side, a pro-cyclical fiscal policy can be harmful to the economy, particularly when it sets very ambitious targets to be met in a short period of time. If fiscal austerity has to be implemented, it should be stretched over the long term and not be done in two to three years. Otherwise its implications could be disastrous on the economy as in the case of Greece. Hence Lebanon needs fiscal discipline rather than fiscal austerity in order to limit the impact on an already low growth environment.

In Lebanon, the structure of the government's expenditures reveals the marginalization of capital expenditures and automatic stabilizers. Current expenditures make up 96% of total expenditures while capital expenditures, excluding the foreign financed parts of the projects that are provided directly to the Council of Development and Reconstruction, make up only 4% of total expenditures. Automatic stabilizers are very weak as there are no unemployment benefits or other automatic increase in spending related to the slowdown in economic growth.

The importance of capital expenditures lies in the fact that they are destined for long-term investments aimed at boosting the country's infrastructure. The latter will provide the necessary platform to increase the potential gross domestic product of the economy. Building roads, airports, telecommunication networks, water networks, electricity production facilities, are becoming urgent matters after many years of low capital spending. The output gap between potential and actual GDPs has disappeared during 2007-2011 period of high economic growth. Hence potential growth is nowadays limited and infrastructure investments are necessary to spur growth and increase potential GDP.

Basically improving fiscal competitiveness, which is the impact of government spending and taxation on the competitiveness of the economy, is key to increase potential output. Indeed, a tax system may penalize economic activity, job creation, and investment if it weighs heavily on producers, in terms of, for instance, profit tax, fuel tax and social contributions. An expenditure structure that is unbalanced, with current spending crowding out productive investment in infrastructure and human capital, and hindering competitiveness and economic growth. Fiscal policy also acquires particular importance in a currency peg system, such as in the case of Lebanon, owing to the government's lack of discretion in exchange rate and monetary policy management.

Lebanon has to address the level, composition, and quality of government expenditures to improve competitiveness. To this end, the authorities will have to reduce current spending in favor of capital spending. Since the wage bill is a major component of current expenditures, it has to decline to release the necessary resources to increase domestically financed investment (this goes against the pay rise

for public employees that continues to be debated in parliament). A way of reducing the wage bill is through restructuring the public sector and especially public education. An efficient use of these resources will improve the country's infrastructure and if accompanied by satisfactory macroeconomic policies, is likely to increase Lebanon's growth prospects. This will then allow for a comprehensive revision of taxation to reduce informality and costs.

However, with a large fiscal deficit and a substantial debt burden, the government may not have the necessary resources to boost capital spending, and may not be able to reduce the wage bill. That is why it is in the government's advantage to resort to structures such as privatization, public-private partnerships (PPP) and Build-Operate-Transfer (BOT) whereby the private sector takes on the problem of lack of public funds by financing a given project in exchange for a stake in the future profits.

Fiscal discipline is of utmost importance to sustain the debt to GDP ratio, meaning to put it on a downward path. A debt sustainability analysis for Lebanon shows that the government will have to accumulate a large primary surplus, nearing 3 percent of GDP, in order to put the debt to GDP ratio on a sustainable path, particularly if economic growth remained subdued at 2-3%. It is worth noting that adopting a fiscal discipline in an already low growth environment may depress growth more. Nonetheless, if accompanied by the right structural reforms and an enlargement of the tax base, the economy will be able to achieve higher growth rates once regional conditions improve.

In this context, the government has to grasp the current dead time (domestic political deadlock and regional turmoil) to do the necessary reforms in order to be ready when regional and domestic political conditions improve and become more conducive to growth.

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Mr. Mikhael has been the Head of Equities and Economic Research at BLOMINVEST Bank (part of BLOM Bank group) since 2008. He has also worked on investment banking M&A deals since 2014. Before joining the bank, Mr. Mikhael was an Advisor to the Minister of Economy and Trade H.E. Dr. Sami Haddad for two years. Mr. Mikhael joined the International Monetary Fund in Washington DC as an economist in 2002, working in the African, Middle East and Central Asia departments, where he stayed for four years, and dealt with a number of issues including trade development, fiscal competitiveness, fiscal and debt sustainability, microfinance, and monetary and financial matters. He started his career at the Ministry of Finance dealing with public sector reforms, budget preparation, and public debt issues. Mr. Mikhael is a lecturer at the Saint Joseph University in Beirut and has published many papers on Lebanon and other countries in the region.