Dissecting The Recent Economic Developments

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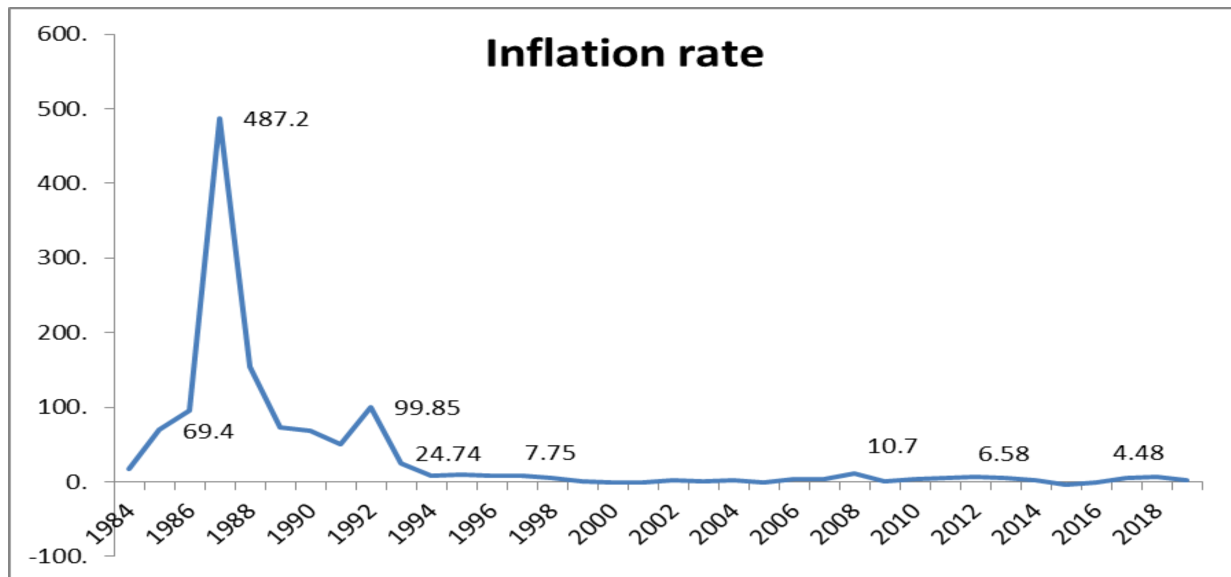
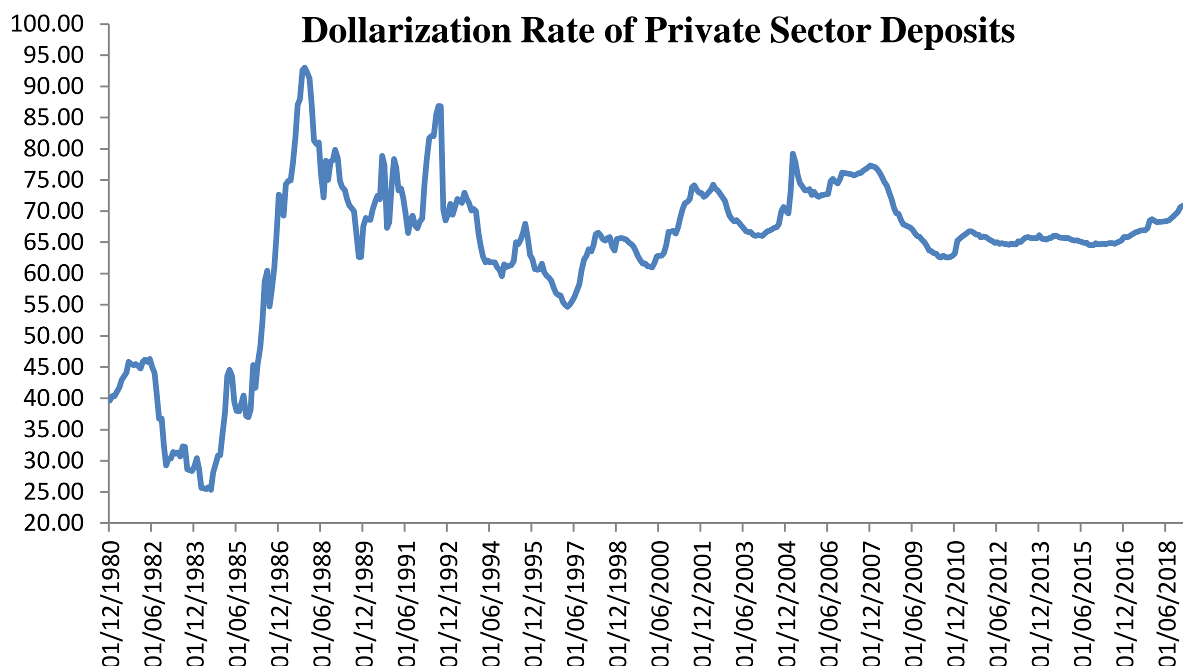
A lot of rumors have been circulating lately regarding the economic situation in Lebanon. Every citizen, whether an economic expert or not, is worried about the liquidity in the system and is trying to analyze the different scenarios and probabilities of occurrence of an economic and/or financial crisis.

On the economic front, growth in the Lebanese economy was capped between 0% and 0.5% in the first 9 months of 2019 as indicated by the PMI level, and inflation remained subdued. The BLOM Purchasing Managers' Index (PMI) shows private sector activity stalled at an average of 46.8 by Sept. 2019, capped below the 50-mark separating contraction from growth. Meanwhile, inflation eased to 2.77% by August 2019, down from last year's 6.29% mainly owing it to a 10.7% annual downtick in oil prices to $64.8/barrel.



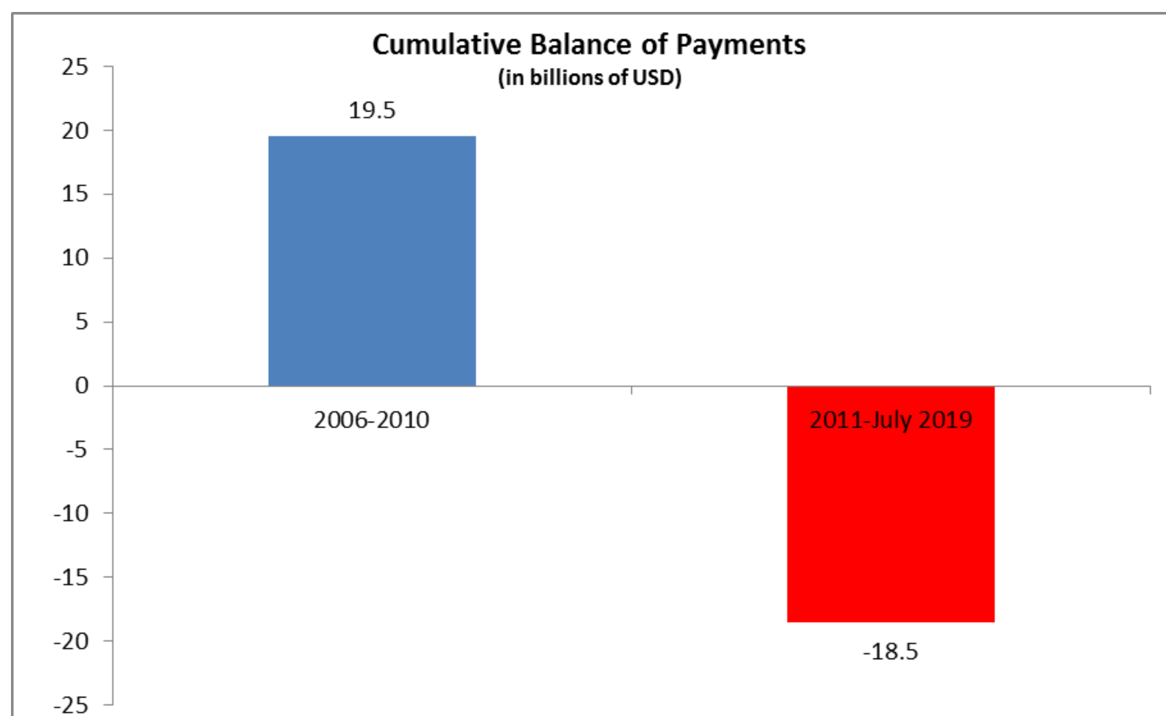
Within an environment of high interest rates and persistent slowdowns, markedly in real estate and the housing market, tourism was the only sector pulling up growth. Tourism was a bright spot in 2019 as it grew by an annual 8.3% to 923,820 tourists in H1 2019, close to 2010's highs. However, the number of real estate transactions which may include one or more realties, dropped by a yearly 18.30% to stand at 31,131 transactions by August 2019. In turn, average interest rates on loans in LBP and in USD that reached highs of 11.13% and 9.9% by July 2019, compared to 9.97% and 8.57%, respectively, in December 2018 contributed to the crowding out of the private sector of the lending market. On one hand, many projects will become unprofitable at these high rates and companies discouraged to take loans. On the other hand, banks prefer to place their money at the central bank at these rates as it is less risky than the private sector.

A historical perspective on the Lebanese economy may help understand the current economic and financial situation. Since the 1960's, the partial dollarization of deposits has always existed in Lebanon, fluctuating between 25% and 30% before the 1975 war. The dollarization rate reached 93% in November 1987 following a period of hyperinflation and a deterioration of the exchange rate and stayed above 70% until 1993.



The successive governments following the civil war were never able to restore investors' confidence level to where it was before the war started. Dollarization rate never went below 50% and most of the time interest rates were much higher than their US counterpart. During the episodes of shocks like in 1995, interest rates went up to 38% while in 2005, 2006, 2008, and more recently, Credit default swaps (CDS: these are an insurance against the risk of default of the Lebanese government. When their price increased, it means that the risk of default is going up. Theoretically, the five years CDS should be equal to the difference between five years Lebanese Eurobonds and five years US bonds) crossed the 1000 basis points.

The reason why the stress is increasing in the financial markets is related to the length of the current shock that started with the war in Syria compared to the previous ones. The previous shocks had a limited time span, 3 months on average, while the current one is ongoing since 2011. The shocks that hit the economy since 1993 are many: first, the 1996 Israeli aggression called Operation Grapes of Wrath remained for several weeks. Second the assassination of prime minister Rafic Hariri in 2005 led to an outflow of capital for several months. Third the Israeli war of 2006 paralyzed the economy for more than 3 months. Finally, the global financial crisis of 2008 had very short impact on Lebanon as the Lebanese banks were not exposed to the subprime market of the United States. Hence the capacity of shock absorption of the economy was never tested for more than few months.
The Balance of Payments (BOP) surplus accumulated during the years 2006 to 2010 has been wiped out in the last 8 years. Lebanon recorded a surplus of USD19.5 billion during the period 2006-2010, while the BOP turned into negative grounds from 2011 onward, recording a cumulative deficit of USD18.5 billion by end of July 2019.

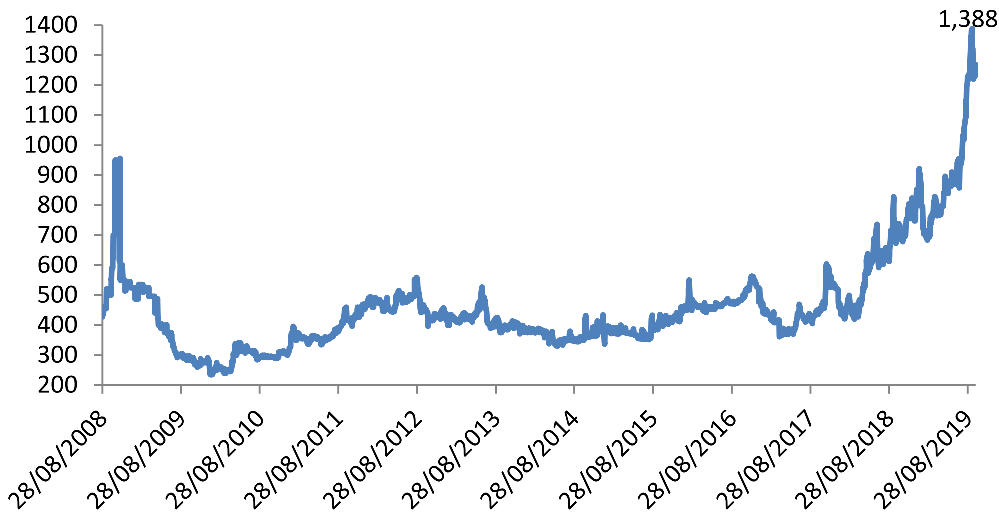


What took place since 2011 is a combination of multiple shocks that led to a progressive drying of capital inflows and investments in Lebanon. The Syrian war has cut the land routes of exports, pushed ISIS into the Lebanese territory, and instigated an unstable political and security environment. Afterwards, the economic slowdown in the GCC countries following the large decline in oil prices since 2014 and the war in Yemen exhausted the resources of implicated countries and increased the tensions in the region to levels never seen in the last decade. In addition, the vacuum created by a 2-year period without a president, and the crisis of the sudden resignation of Prime Minister Saad Hariri in November 2017 (and since rescinded) weighed heavily on investors' confidence.

The result was a deficit in the BOP and an increase in the financial stress. BOP deficit increased drastically since 2018 when it registered USD4.8 billion. It reached USD5.3 billion in the first seven months of 2019. Other financial stress indicators such as credit default swaps and spreads with international interest rates have also increased substantially, particularly following the downgrades of the Sovereign by two rating agencies.

It is worthy to note that Lebanon witnessed an inverted yield curve in 2019. In fact, the demand on the long term 10Y Lebanese Eurobonds during H1 2019 exceeded the demand on the 5Y bonds. As a result, the yields on the 5Y and 10Y Lebanese Eurobonds significantly rose from 10.80% and 10.70% by the end of 2018 to 18.30% and 13.80% by September 23rd 2019, respectively, noting that yields on the 5Y Eurobonds were higher than those on the 10Y.

Foreign investors' perception of Lebanon's default risk reached unprecedented highs in Q3 2019. Investors' perception of Lebanon's default risk is best reflected in the 5Y Credit Default Swaps (CDS) which climbed from 820 bps by the end of 2018 to 1,220 bps on September 23, 2019. Moreover, the spread between the 5Y yield on the Lebanese Eurobonds and their US comparable broadened from 362 bps at end 2014 to 430 bps by end 2015 and 503 bps at end of February 2016.



In order to preserve the peg, the central bank intervened repeatedly in the market and increased interest rates to keep on attracting capital. BDL used financial engineering schemes to boost the returns for commercial banks placements and allow them to provide higher interest rates to their customers at a time of low international interest rates.

The central bank adopted a tightening of monetary policy in order to halt the increase in money supply. The latter declined by 0.67% in the first 7 months of 2019 compared to an average increase of 5.8 per cent during the period 2013-2017. BDL tried and succeeded in sucking most of the liquidity from the market through its financial engineering schemes that started in 2016 and have been implemented repeatedly since then. In order to reduce money creation, the BDL went on terminating the subsidies program for housing loans and offering high returns to banks that place their excess reserves with him. Hence banks were not interested anymore in lending to the private sector or even to the government. Loans to the resident private sector declined by 9.5% or by more than USD5 billion between end 2017 and July 2019.

Since banks liquidity was placed at the central bank for medium to long term, maturity mismatch between their assets and liabilities increased. Although banks were able to increase the average maturity of deposits from 45 days in the past 20 years to 6 months by end 2018, it remains far lower than the average maturity of their placements at BDL. As the economic situation deteriorated and demand for Dollars outstripped the offer because of the negative balance of payments and the erosion of confidence, banks reduced their foreign assets, particularly in the past two years to face the demand for dollars.

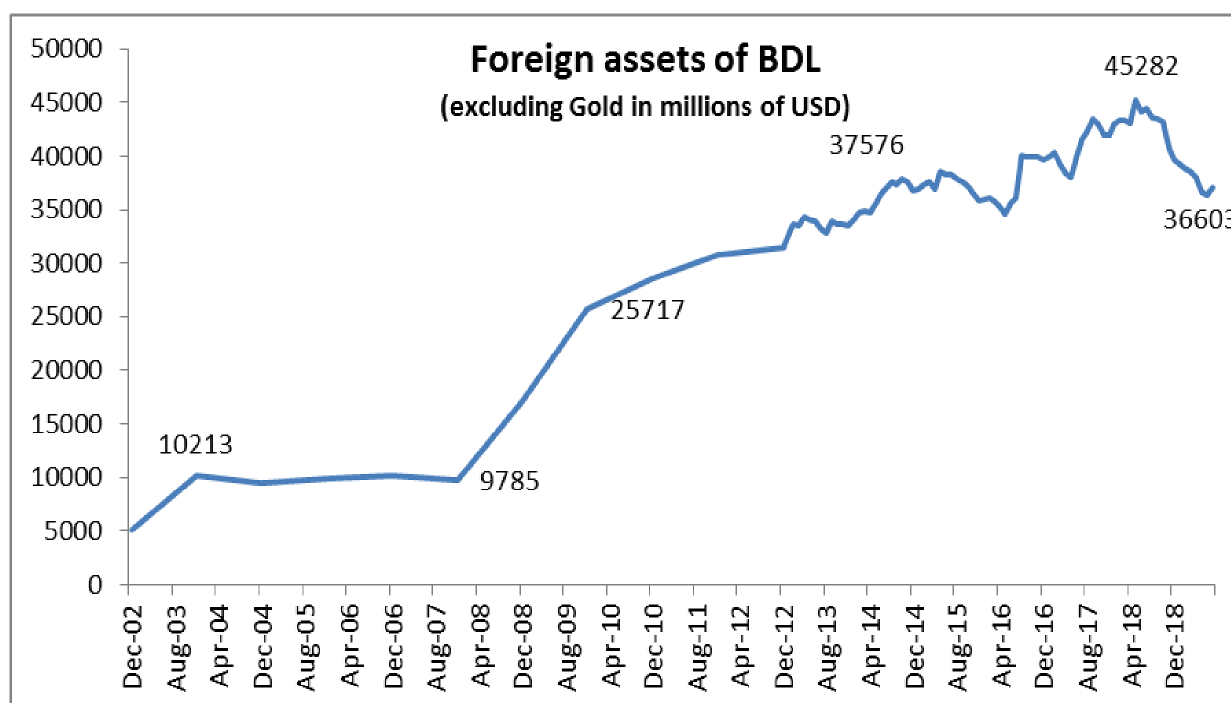
As both the central bank and commercial banks are keen to keep their foreign assets at levels that preserve confidence, some shortage in dollars appeared on the markets, which led to the creation, in the past two months, of a very thin parallel forex market. Some of the restrictive measures adopted by some banks were to counter the abuse of the system exercised by some customers that started to exploit the arbitrage opportunities presented between the official and the parallel market. The latter constitutes less than 2 percent, in size, of the official market, and the exchange rate used in this parallel market is less than 10 percent higher than the rate used in the official market.

The problem is summarized into a vicious cycle of self-fulfilling expectations whereby the lost confidence is the starting point and people are aggravating the situation by acting, all of them, in the same direction. Individuals are afraid to lose their deposits, thus some of them are withdrawing their

money from banks and keeping it at home and others are opening accounts abroad and transferring part or the total of their deposits to Europe.

However the cushion that the banking system holds is more than sufficient in the foreseeable future. The central bank foreign assets, excluding gold, cover 75 percent of LBP deposits, and the banking system foreign assets cover more than 40 percent of USD deposits. Therefore the situation is not as bad as portrayed in the media.

The banking sector has the ammunition to defend the peg, which has served the economy well, and opinions about de-pegging the currency are misplaced. In a region full of uncertainties and shocks, any policy that insures some stability and a clearer vision for consumers and investors may have a positive effect on growth. Hence the importance of the peg is in its ability to provide a stable business environment when it comes to anchoring inflation expectations.



Moreover, evidence from economic research indicates that "floating exchange rates are far from a panacea for emerging markets and that this policy advice misses a number of important real world consideration that are crucial for developing countries" (see Guillermo A. Calvo and Carmen M. Reinhart 2000 paper at the National Bureau of Economic Research). As stated in my own research paper, co-authored with Andy Khalil last year: "Large exchange rate volatility in emerging and developing countries, such as large depreciation has a recessionary impact. when investors' confidence is lost, domestic interest rates volatility will become chronic and exchange rate swings seem to be more damaging to trade with the pass-through to inflation far higher in emerging and developing economies than in developed countries".

Hence, whatever is the cost of pegging the exchange rate; it will remain more advantageous for emerging economies when compared to a pure floating regime. In fact, "currency crises become credit crises as sovereign credit ratings often collapse following the currency collapse and access to international credit is blocked". Studies agreed that if trade consists of a large fraction of a country's

GDP, i.e. the country is small and open; the costs that come with currency instability are substantially high in the aggregate.

In order to restore investors' confidence the government has to set a clear timetable for reforms rather than just mentioning a list of projects and a 1 percent decline in fiscal deficit per year. Until now the situation is blurry for investors about the necessary reforms that, if implemented, will unlock CEDRE money pledged by international donors in April 2018, but contingent on fiscal reforms.

In this context, the government has taken some important measures, unfortunately these have passed unnoticed by investors. The parliament has approved a law that updates and modernizes the code of commerce. The government has also passed a decision to stop hiring in the public sector for the next three years. It started to tackle the pension salaries by imposing a tax on the highly paid pensioners. The authorities increased some taxes like VAT and the tax on interest income in the budget of 2019 and reduced some expenditure. Moreover the council of ministers approved the electricity plan and work has started and it is in advanced stages. Beside CEDRE money the government has approved several infrastructure projects to reduce the traffic jam problem in the eastern neighborhood of the capital. The government has filled vacancies in the judiciary sector to be able to accelerate the work related to fighting corruption in the public sector.

If these measures were outlined in a clear work program within a clear time frame, their impact on investors' confidence would have been tremendous. The reforms should have been prioritized and spelled out in a program that will show on a quarterly basis which reforms will be implemented. Hence if the government respects this schedule, donors will disburse the money and investors will be able to monitor the performance of the government on a quarterly basis.

Setting and monitoring such reform programs is the bread and butter of the International Monetary Fund (IMF) mandate. The IMF will tick the box whenever the government implements a reform and it will inform donors and investors, on a quarterly basis, about the progress achieved by the authorities. When the government is on the right track and is respecting its commitments, the IMF will give a green light for donors to disburse the money.

An important game changer will remain the drilling for oil and gas that will start before the year end, especially if oil and gas are discovered in early drilling stages. In this case, consumers' and investors' expectations will change drastically with a likely positive impact on the economy but more importantly, it will be able to turn the vicious cycle into a virtuous one.

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