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In countries with deficits and debt like Lebanon, what matters is not only how high these deficits and debt can get, but also how they are usually financed. Economic theory predicts that central bank financing (deficit monetization) increases the money supply and consequently inflation, whereas financing from commercial banks could dry up funds and lead to higher interest rates. Foreign financing, on the other hand, relieves the economy from these two adverse consequences, but only at the expense of exposing it to external vulnerabilities. Moreover, under a fixed exchange rate regime, any deficit monetization – especially if not sterilized – could lead to loss of foreign reserves which makes it tantamount to foreign financing of budget deficits.

By any count, the year 2020 is proving to be an economic disaster to Lebanon. The country is suffering from a triple whammy – an exchange rate crisis, a banking crisis, and a debt crisis – with no end in sight in the near future. And most analysts agree that it was the debt crisis – coupled with a corrupt public sector – that had sparked the two other crises. But, surprisingly, the debt crisis has receded in relative significance these days, partly because it is not as "sexy or juicy" as the other two (banking and exchange rate), but mostly because domestic debt which constitutes close to 64% of total debt (with total debt reaching $93.5 billion in June 2020) is losing its real value with rising inflation. That leaves, of course, foreign currency debt which the government has defaulted on, and which represents a real concern especially that almost 50% of it is held by foreigners. Another concern, and this time it relates to domestic debt, is the anecdotal evidence which claims that the current monetization of the deficits is increasing the money supply and fueling more inflation and exchange rate depreciation.

USD Billion(B)	Dec19	Mar20	Change Dec19/Mar20	Jun20	Change Dec19/Jun20	Change Mar20/Jun20
Fiscal Data						
Gov't Dep at BDL	5.442	4.473	-0.969	4.218	-1.224	-0.255
Non-Bank T-Bills Portfolio	7.462	7.643	0.181	7.639	0.177	-0.004
BDL T-Bills Port	33.654	34.175	0.521	34.705	1.051	0.530
CB T-Bills Port	16.798	16.533	-0.265	16.274	-0.524	-0.259
Domestic Debt	57.915	58.351	0.436	58.619	0.704	0.268
Foreign Debt	33.755	34.096	0.341	34.810	1.055	0.714
Budget Deficit		1.655		2.224		0.569
Monetary Data						
CC Outside BDL	7.000	9.588	2.588	12.798	5.798	3.210
Deposits:	158.925	149.635	-9.29	144.552	-14.373	-5.083
LBP	38.098	32.999	-5.099	29.154	-8.944	-3.845
USD	120.827	116.636	-4.191	115.398	-5.492	-1.238

Source: BDL; ABL

What we want to do in this note is to evaluate the validity of the above observation regarding deficit monetization by looking at the sources of Lebanese deficit financing in H1 2020. We will do that by splitting the period into two quarters to see how these sources have changed over time. The table above for fiscal data is our starting point, and we see that in the first quarter the budget deficit stood at $1.655B. We also see that commercial banks (CB) had shed $265 million (M) in domestic T-Bills, while both BDL and Non-Banks (like the Social Security Fund) picked up T-Bills in the amount of $521M and $181M respectively. The sum of these changes in T-Bills is $436M (521+181-265), which is exactly equal to the increase in domestic debt. Another important source for the financing of the deficit in Q1 2020 is from government deposits at BDL which fell by $969M. The last remaining source is foreign financing in the amount of $341M. Given that the government did not issue or swap

Lebanese Eurobonds during that period, the resulting foreign debt constitutes then financing from multilateral or official sources[1]. As a result, the sum of these three sources (437+341+969) is $1.747B which is slightly higher than the fiscal deficit of $1.655B, most likely because of the normal excess issuing of T-Bills.

Moving on to the second quarter, we see that the deficit for Q2 2020 was $569M[2]. But this time there was no foreign deficit financing due to the default and the closure of official financing; and the increase in foreign debt by $714M represents accumulated accrued interest on the defaulted debt. This means that the entire financing was left to be from domestic sources. Moreover, this time round Non-Banks didn't do any financing while banks kept shedding their T-Bills by $259M, so BDL had to pick up financing by $530M in T-Bills (the sum of these sources add to $270M which is very close to the increase in domestic debt by $268M). As important, government deposits at BDL contributed $255M in financing, close to half of the deficit in Q2 2020.

If we stretch the data over the entire H1 2020 period, we see that the deficit stood at $2.224B. Of that, $1.224B was financed from government deposits at BDL; $704M was from domestic debt; and $341M was from foreign debt. And the sum of these sources adds to $2.269B, again more than the $2.224B because of the extra T-Bill issues. More important, out of this deficit of $2.224B, only $704M was net new financing by BDL (after accounting for the replacement of T-Bills shed by commercial banks), which is less than one third of the deficit[3]. Hence, deficit monetization was limited and could not have played a major role in the inflationary and exchange rate depreciation that characterized the period. A related and important question is: should not financing by government deposits at BDL be considered inflationary because it increases the monetary base and the money supply? The answer is no, simply because government deposits at BDL are not part of the money supply MS since the latter is equal to: MS = NDC + NFA, where NDC is net domestic credit (net of government deposits at BDL that is) and NFA is net foreign assets.

If the above is valid, then what did play a major role to ignite inflation and exchange rate depreciations? To answer this question, we need to consider the monetary data presented in the table. We can see that in Q1 2020, cracks to the confidence in the banking sector has caused deposits to fall by $9.290B, split almost evenly between LBP and USD. However, the extra cash liquidity that this generated was more limited as Currency in Circulation (CC) increased by $2.588B, the result of which is that at end March 2020 inflation was only 16% YOY and the exchange rate stood at about 2,800 LBP per USD. In addition, M1 increased by 31.9% to reach $14.551B, while M3 declined by 3.51% to settle at $130.354B.

In Q2 2020, however, the situation became more acute. Though deposits fell by $5.083B (more than two thirds of which in LBP), CC increased by a significant $3.210B. This increase was partially driven by BDL's Circular 151 of 21/4/2020 that allowed depositors to withdraw their allotted USD deposits at 3,900 LBP; but more importantly this higher cash liquidity reflected concerns about exchange rate viability which fueled a severe spiral of exchange rate depreciations that saw the exchange rate shoot to 8,600 LPB per USD at end June 2020 and feed into an inflation rate of 90% YOY. In terms of the entire H1 2020 period, deposit withdrawals totaled $14.373B (60% of which in LBP) and CC increased by $5.798B. This increase in cash liquidity caused M1 at end June 2020 to rise by a whopping 62.5% to $17.922B and M3 to fall by 3.3% to 4129.552B.

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1 It is pertinent to note here that historically financing through official and multilateral sources was handled by CDR whose expenditures were off-budget but payment of interest and principal on its foreign debt were not.

2 The smaller deficit in Q2 2020 is due to the stoppage in foreign debt-service payments.

3 A report issued by B of A Global Research in July 2020, Lebanon Viewpoint: The Ghost of Hyperinflation Past, argued that the reduction in government deposits at BDL could be interpreted as payments for BDL for its additional subscription in T-Bills as if it is being paid "up front". But the data does not support that view because net T-Bills issued during H1 2020 were $1.25B only.

The upshot of the above discussion is that reservations about the health of the banking system and more so the exchange rate regime – coupled with BDL's policies to contain their implications – are what ignited the rise in cash liquidity and its vicious cycle effects on currency depreciations and inflation. In other words, it wasn't so much deficit monetization that did that. It is ironic that what started as a debt crisis has receded in significance in terms of its impact on macroeconomic and financial stability, and has given way to two of its ramifications – banking and exchange rate crises – to assume the prominent role in determining the country's economic woes.

There are two important conclusions that can be obtained from this note. First, with close to two thirds of the debt in domestic debt that is losing its real value, the debt crisis is perhaps becoming increasingly less so. That is not to say that debt shouldn't be taken seriously: it should, especially when it comes to restructuring foreign debt payments. But what should be taken most seriously are the recurring budget deficits because they reflect a structural problem in Lebanese public finances that has less to do with fiscal matters and more to do with governance matters. So, fundamentally, what should underlie fiscal reforms in Lebanon are governance reforms that aim at reducing waste, corruption, nepotism, and at increasing efficiency, in public administrations and enterprises.

Second, governance reforms in the public sector take time and they are usually a medium-to long-term project. Therefore, the short-run priority should be to enact measures that restore confidence in the banking system and the exchange rate regime. In this context, it is wise to recall that, based on various country experiences, exchange rate crises do not necessarily lead to banking crises, but all banking crises lead to exchange rate crises. So reforming and fixing the banking system should be the first order of business which can then also help in ameliorating the exchange rate problem.

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