BLOMINVEST BANK

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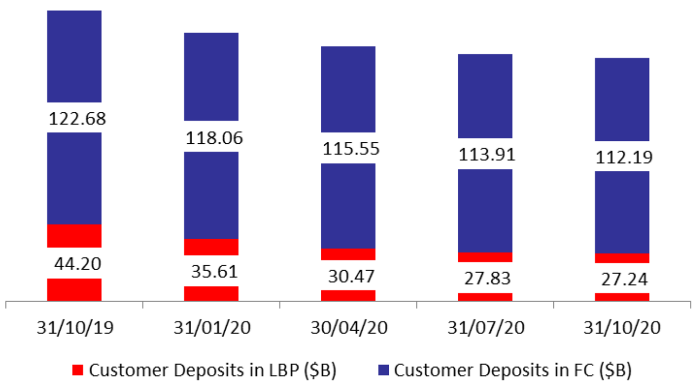
Perhaps there is no banking sector in the world that has experienced a drastic reversal of fortunes in terms of magnitude and speed as the Lebanese banking sector had. On the eve of October 17, 2019 the sector was rightly considered to be a prime pillar of the economy, enjoying solid solvency. But after two weeks of[i] banks' closure because of widespread street protests against the country's corrupt and inept political establishment, the banks experienced upon their resumption of business by early November 2019 rapid runs on their deposits that dented confidence in the sector and threatened its solvency.

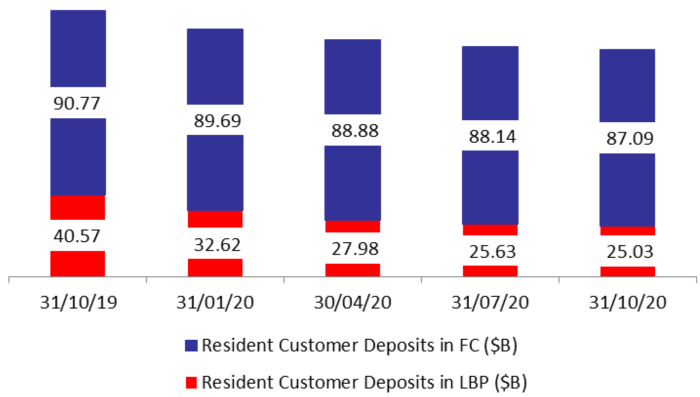
These developments that the Lebanese banking sector were subjected to point out to three important implications. First, it is not the recognition of an existing insolvency that caused the run; but rather it is the run that ignited any potential insolvency. Second, given the absence of emergency liquidity support from the monetary authorities, *formal* capital controls should have been enacted at the outset so as to protect the external positions of the banks and to reduce ailing them further. Third, since runs on deposits shrink the money supply and the credit creation process thus dampening economic activity in other sectors, the banking crisis has no doubt deepened the economic downturn in Lebanon.

What we want to do in this short note is to look at what happened to deposits at Lebanese banks in light of the controlled runs that they have gone through since October 2019. The analysis will be mostly descriptive, but we hope to draw some tentative but notable conclusions that could be useful in helping to redesign the banking system in the post-crisis period. If we restrict our analysis to an aggregate of deposits that comprises resident and non-resident deposits (constituting more than 96% of total deposits), a thorough look at Tables 1, 2, and 3 covering the period **10/2019 to 10/2020** can lead to deriving the following conclusions (all figures are valued in USD):

1. Aggregate customer deposits fell by 16.5% to $139.43 billion, the latter made up of $27.24 billion in LBP deposits and $112.19 billion in USD deposits. However, LBP deposits fell by 38.4% whereas USD deposits fell by 8.6%, thus increasing the dollarization ratio from 73.5% to 80.5%. This result is to be expected given the stricter *informal* limits placed on USD deposit withdrawals.



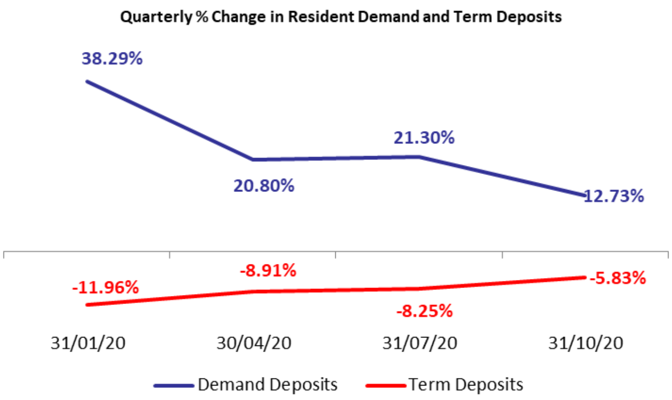
2. Resident deposits stood in 10/2020 at $112.13 billion and non-resident deposits at $27.31 billion, whereas in 10/2019 the respective values were equivalent to $131.34 and $35.53. This implies a decline in non-resident deposits at 23.2% against a decline of 14.6% for resident deposits, and a change in the shares between resident/non-resident deposits from 78.7%/21.3% to 80.4%/19.6%. And this faster decline is mostly explained by the forfeiture of formal controls on international transfers (more in item 4).



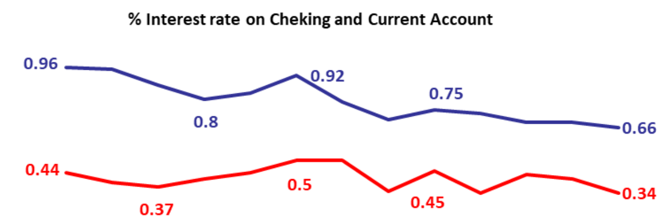
3. Resident deposits on their own saw their USD component fall from $90.77 billion to $87.09 billion, or a fall by $3.68 billion only; while the LBP component fell from $40.57 billion to $25.03 billion -- by more than $15 billion. These falls can be explained by three main reasons. First, the use of some of these deposits to write off loans, which declined by $13.3 billion during the period. Second, the buying of USD (from the parallel market) using LBP deposit withdrawals so as to retain the value of purchasing power. Third, the preference for greater liquidity for transaction and precautionary purposes, given the resulting hyperinflation arising from exchange rate depreciations and as evidenced by the rise in LBP currency in circulation (CC) by about $12 billion from $4.08 billion to $16.09 billion. Note that CC has also partly increased due to the fact that starting in April 2020 banks began exchanging limited monthly withdrawals of USD deposits at 3900 LBP per dollar instead of 1500 LBP per dollar, the difference being subsidized by BDL.

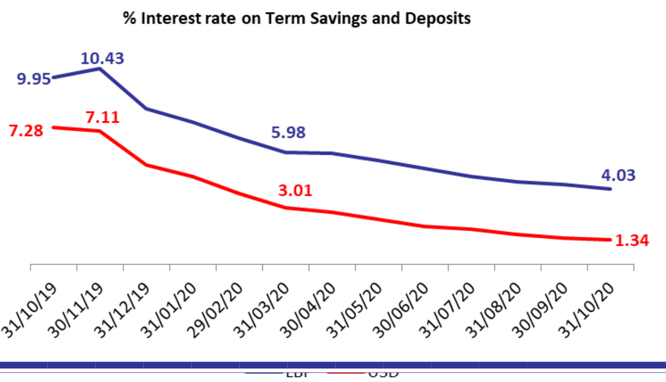
4. As to non-resident deposits, they are mostly in USD deposits, the latter constituting more than 90% of the total. It fell from $31.91 billion to $25.1 billion, or a fall of 21.4% and equal to close to $ 7 billion. With total non-resident USD deposits from all countries at only $25.1 billion, any talk about Syrian USD deposits in Lebanese banks amounting to $40 billion is simply not true. But what is true is that, in the absence of formal capital controls, a large portion of the withdrawn $7 billion was the paying back of fiduciary accounts that banks were obliged to pay to non-residents (and contributing notably to the balance of payments deficit of $9.9 billion during the period), in addition to the writing off of non-resident loans against deposits at close to $2 billion.

5. The preference for greater liquidity meant also that demand deposits are more stable than the more risk-sensitive and less sticky term deposits. And that was true regardless of deposit ownership and currency denomination: for resident deposits, total demand deposits increased from $13.27 billion to $30.31 billion, while total term deposits fell from $118.08 billion to $81.82 billion; as to non-residents, total demand deposits rose from $2.71 billion to $6.19 billion, whereas total term deposits declined from $32.83 billion to $21.12 billion. This result is not unique to Lebanon as it has been witnessed in all countries undergoing banking crises.



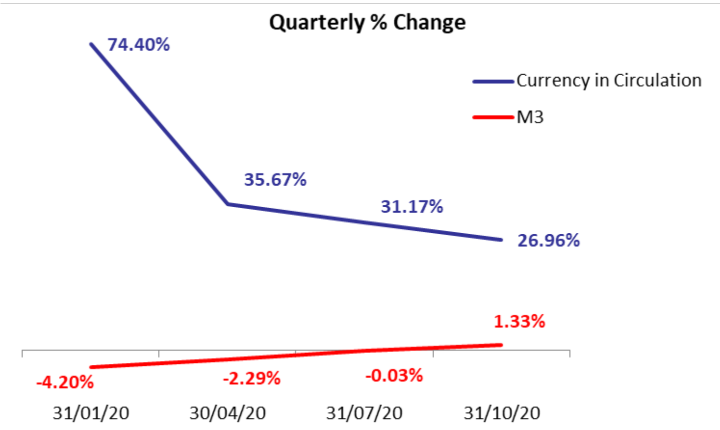
6. Perhaps more important, this preference for demand deposits happened despite the fact that term deposits commanded higher interest rates: by 10/2020, the interest rate on LBP and USD demand deposits stood at 0.66% and 0.34% respectively; while the interest rate on LBP and USD term deposits were 4.03% and 1.34% respectively. The fact that interest rates have become less or hardly effective in reversing sudden stops or regresses in deposits during a banking





crisis is nothing new; but what it does indicate is that price signals in these circumstances are almost useless in restoring a semblance of banking stability compared to quantitative restrictions, which in turn makes or should have made the enactment of formal capital control an absolute necessity.

7. An ill-fated consequence of banking crises is the reduction in the money supply. We can see that M3 fell during the period from $138.37 billion to $131 billion, a reduction that is belied or camouflaged by the rise in CC by $12 billion. The resulting resort to a more cash economy and the destruction of the money creation process denies banks their fundamental role in the economy: that is, their ability to intermediate between depositors and borrowers and to extend credit and create wealth in the process. This is perhaps the most devastating impact of the current crisis on the Lebanese economy and its growth dynamics.



Of course, now that the crisis has occurred, what matters going forward is how to restore confidence and reverse deposit outflows in the Lebanese banking system, not only for the sake of banks but also for the sake of the economy. And we want to close the note by offering some conclusions to that effect. We can only talk in retrospect because retrospect is all what we have in this case. And retrospectively, we propose the following preliminary, broad but basic suggestions that could be useful in reforming and regaining trust in the Lebanese banking system. These would include:

- Trust in banks is ultimately tied to trust in the currency, which calls for an exchange rate regime that eschews overvaluation and adopts more flexibility, so as to deter sudden stops and balance of payment deficits. This also implies that measures should be taken to increase the confidence in the use of local currency not only as a medium of exchange but also as a store of value and a vehicle for credit extension, something that would greatly ease the conduct of monetary policy and BDL's control and influence on the economy, besides making banking operations more stable and predictable. It also gives monetary policy more independence in pursuing internal stability goals;

- As important, with more exchange rate flexibility and stronger role for the local currency, BDL's main policy drive will no longer be amassing foreign exchange to protect the currency peg and what that had entailed in terms of the pressures put on banks' foreign currency position as the crisis has intensified. For that has led to more than half of Lebanese banks' USD deposits at BDL – the latter equal to about $70 billion at the outset of the crisis and rising to more than $80 billion currently -- being forced deposits in the form of legal reserves and placements against and equal in value to clients' conversions of LBP deposits to USD ones;

- The futile use of excessive interest rates as an incentive to retain and attract deposits since it is a bad substitute for healthy banking and solid bank-client relationships;

- If a smaller deposit base is desired, as is sometimes advocated, then the reduction in deposits we are currently witnessing might be a blessing in disguise, since it could be the right step – albeit a painful one – to reach a more optimal size of the Lebanese banking sector. However, this might not necessarily be the case: Switzerland and Singapore, for example, have deposits to GDP ratios that are equal or even larger than Lebanon – at more than 350% of GDP -- yet they have sound economies, and that is because they managed to have fairly well-developed sectors other than banking So the crux of the matter is not to downsize the Lebanese banking sector, but to pursue more balanced growth strategies that can lift the performance and productivity of all other sectors;

- In the end, and lest we forget, the main structural problem of the Lebanese economy and which was fundamentally behind the current deep crisis is the twin deficits. Budget deficits arising from corrupt and irresponsible fiscal policy drained resources internally; and current account deficits arising from weak competitiveness and trade performance drained resources externally, and made the country dependent on feeble capital inflows. When both deficits became unsustainable within the context of the pegged exchange rate regime, the crisis erupted on its multiple fronts. Hence, the ultimate purpose of any reform agenda should be the mitigation, if not elimination, of the twin deficits.

(B$)	Resident Deposits			Resident Demand Deposits			Resident Term Deposits		
	Total	LBP	FC	Total	LBP	FC	Total	LBP	FC
31/10/19	131.34	40.57	90.77	13.27	4.26	9.01	118.08	36.31	81.77
30/11/19	128.03	37.28	90.75	15.58	4.54	11.05	112.45	32.74	79.71
31/12/19	125.03	34.48	90.55	16.72	4.44	12.28	108.31	30.04	78.27
31/01/20	122.30	32.62	89.69	18.35	4.89	13.45	103.96	27.72	76.23
29/02/20	119.96	30.61	89.35	19.21	4.82	14.39	100.75	25.79	74.96
31/03/20	118.53	29.82	88.71	21.13	5.56	15.57	97.40	24.26	73.14
30/04/20	116.86	27.98	88.88	22.16	4.98	17.18	94.70	22.99	71.70
31/05/20	115.65	26.88	88.77	23.23	5.34	17.90	92.42	21.54	70.87
30/06/20	114.58	26.21	88.37	25.07	5.86	19.22	89.51	20.36	69.15
31/07/20	113.77	25.63	88.14	26.88	6.12	20.77	86.88	19.51	67.37
31/08/20	113.76	25.55	88.22	28.56	6.53	22.04	85.20	19.02	66.18
30/09/20	113.14	25.31	87.83	29.47	6.73	22.75	83.66	18.58	65.08
31/10/20	112.13	25.03	87.09	30.31	6.84	23.47	81.82	18.20	63.62

(B$)	Non Resident Deposits			Non resident Demand Deposits	Non resident Term Deposits
	Total	LBP	FC		
31/10/19	35.53	3.63	31.91	2.71	32.83
30/11/19	33.17	3.38	29.79	2.71	30.46
31/12/19	32.45	3.14	29.31	3.17	29.28
31/01/20	31.36	2.99	28.37	3.64	27.72
29/02/20	30.30	2.80	27.50	4.02	26.28
31/03/20	29.63	2.64	26.99	4.44	25.19
30/04/20	29.17	2.49	26.67	4.51	24.66
31/05/20	29.07	2.39	26.69	4.79	24.28
30/06/20	28.33	2.30	26.03	5.52	22.81
31/07/20	27.98	2.21	25.77	5.36	22.62
31/08/20	27.76	2.23	25.53	5.73	22.02
30/09/20	27.43	2.21	25.22	5.93	21.50
31/10/20	27.31	2.21	25.10	6.19	21.12

(B$)	Currency in circulation	M1	M2	M3
31/10/19	4.08	8.40	45.77	138.37
30/11/19	5.41	10.01	43.82	136.44
31/12/19	6.51	11.02	42.11	134.55
31/01/20	7.12	12.21	40.82	132.56
29/02/20	7.94	12.97	39.59	130.95
31/03/20	8.76	14.55	39.59	130.31
30/04/20	9.66	14.88	38.64	129.52
31/05/20	10.89	16.47	38.78	129.67
30/06/20	11.82	17.91	39.02	129.48
31/07/20	12.67	19.02	39.25	129.48
31/08/20	13.72	20.49	40.21	130.53
30/09/20	14.68	21.66	40.94	130.92
31/10/20	16.09	23.17	42.06	131.20

Interest rate in %	-LBP: Average Rate on Deposits	-US$: Average Rate on Deposits	LBP: Checking and Current Accounts	US$: Checking and Current Accounts	LBP: Term Savings and Deposits	US$: Term Savings and Deposits
31/10/19	9.03	6.61	0.96	0.44	9.95	7.28
30/11/19	9.4	6.31	0.95	0.39	10.43	7.11
31/12/19	7.36	4.62	0.87	0.37	8.29	5.31
31/01/20	6.62	4	0.8	0.41	7.59	4.67
29/02/20	5.81	3.22	0.83	0.44	6.71	3.8
31/03/20	5.13	2.53	0.92	0.5	5.98	3.01
30/04/20	5.06	2.32	0.79	0.5	5.94	2.78
31/05/20	4.63	1.99	0.7	0.35	5.55	2.42
30/06/20	4.16	1.64	0.75	0.45	5.13	2.02
31/07/20	3.76	1.49	0.73	0.34	4.69	1.88
31/08/20	3.47	1.28	0.69	0.43	4.39	1.61
30/09/20	3.35	1.15	0.69	0.41	4.28	1.44
31/10/20	3.14	1.04	0.66	0.34	4.03	1.34

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