Can the Lebanese Government Assume More Foreign Currency Debt to Close BDL's Financial Gap?

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According to the reform plan prepared by the Lebanese Government and presumably approved by the IMF, BDL's financial losses or gap was estimated, not surprisingly, at $60 billion[1]. What is surprising, however, is that it was left to the banks' owners and depositors to shoulder the full burden of the gap, while the Government shoulders none at all. Though not mentioned in the plan, the purported reason for not allowing the government to share in the burden of the financial losses is that it would make foreign currency public debt unsustainable -- as all the losses are in USD – and the negative implications of that on Government finances and growth.

We believe that this is a good argument, but only if it is true. And what we would like to do in this brief note is to test the validity of this argument. To begin with, we note that sustainability is defined as the ability of the government to service its debt in a timely fashion *without further borrowing and without accentuating the debt burden thus maintaining the debt ratio (debt to GDP) at a reasonable or acceptable level*. So we need to find the sustainable foreign currency debt ratio for Lebanon and then check whether the Government can afford to absorb part of the financial losses without *accentuating the debt burden or without exceeding this sustainable level.* Of course, this assumes that the government is in a post-crisis mode, and is embarking or has seriously embarked on a reform and recovery program with the IMF.

To that effect, we will construct first a standard model for foreign currency debt accumulation and then apply it in numbers to the Lebanese situation. Foreign currency debt in time t will be equal to:

(1) $D_t = D_{t-1} + D_{t-1}r - NX_t$

Equation (1) postulates foreign currency debt D to be equal in time *t* to foreign currency debt in time *t-1* plus the accumulation to the latter when the servicing of foreign currency debt $D_{t-1}r$ (*r* being the interest on foreign currency debt) exceeds net exports (exports minus imports) of goods and services NX_t, as this will necessitate further foreign currency borrowing. *To be more precise, NX_t represents the current account of the balance of payments but excluding investment income, which in effect makes it equal to net exports of goods and services plus current transfers*. Equation (1) can be written as:

(2) $D_t = (1 + r) D_{t-1} - NX_t$

[1] This agrees with estimates by BLOMINVEST Bank that calculated the gap at end March 2022 to be *around $76 billion excluding gold*. So if we include gold – valued at about $16 billion – the gap would amount then to $60 billion.

Dividing equation (2) by Y_t where Y is GDP, recognizing that $Y_t = (1+ g)\ Y_{t-1}$ where g is the rate of GDP growth, and representing the ratio of D and NX to Y as the lower case d and nx respectively, we get:

(3) $d_t = \frac{1+r}{1+g} d_{t-1} - nx_t$

The condition for foreign currency debt sustainability requires that $d_t = d_{t-1}$ such that the foreign currency debt ratio stays the same. Replacing this condition in (3), we arrive at the debt ratio given by d_t^*:

(4) $d_t^* = \frac{1+g}{r-g} nx_t$

Equation (4) is very crucial as it gives the *sustainable or desired foreign currency debt ratio d* as function of r, g, and nx*[2]. To check what is the corresponding ratio for Lebanon, we have to adopt year 2020 as our base year, as it is the year where we have full balance of payments data and the year where the impact of the crisis and adjustments to it have been fully felt. The table below presents the relevant figures for equation (4)[3]:

Billion USD	Current Account	Investment Income	NX[4]	Y
Base year	-2.96	-1.04	-1.92	27.3

%	r	g	nx
Base Year	4	8	-7

The interesting thing to see is the current account, which fell to negative $2.9 billion in 2020 after it had been in excess of negative $10 billion in prior years. That is of course to be expected given the crisis, but as importantly it is akin to what a reform program would require in terms of adjustments and a depreciated LBP so as to reduce external imbalances and to build up foreign reserves once recovery is underway. It also leads to NX (including current transfers as mentioned before) of negative $1.92 billion and to nx of negative 7%. Notice, in addition, that GDP in 2020 was close to half of what it was in 2019. These figures are in fact what are to be expected for a base year. As to g, we expect going forward that the economy-cum-reform-program to recover and grow[5]. This means a real growth rate above the economy's potential of

[2] Farouk Soussa of Goldman Sachs arrives at a comparable sustainable debt ratio for *total public debt*; see *Goldman Sachs Economics Research, CEEMEA Economics Analyst, "An analysis of Lebanese debt recovery values", 4 Jan, 2019*.

[3] The GDP figure is from the IMF, *Regional Economic Outlook, Middle East and Central Asia, Statistical Appendix, April 2022;* and NX is from BDL, *Quarterly Bulletin, Q3 2021; r and g are author's estimate*

[4] The breakdown is negative $6.4 billion for net exports of goods and services and positive $4.5 billion for current transfers.

[5] For instance, Argentina was able to grow by more than 8% for several years after its default in 2001, and that was with a troubled reform program to boot!

5.5% so as to catch up and to make for lost grounds; we have previously estimated this rate at 8%[6]. Lastly, in case of r, we have assumed a real interest rate of 4%, as we believe that an IMF program and the support through the Cedre Conference from international donors – in addition to an equitable resolution of the banking crisis that brings back confidence in the sector – should all help in reducing funding constraints and not lead to exorbitant interest rates. More crucially, a g greater than *r* is not only a sufficient condition for debt sustainability but also for the success of any reform and adjustment program to ensure a robust recovery and growth process, as a g that is less than or equal to r will not deliver the intended expansion[7].

Given the above, inserting the relevant figures given in the table in equation (4), we get:

(5) $d_t^* = -7\% \frac{1+0.08}{0.04-0.08} = 189\%$

So the desired foreign currency debt ratio is 189%. This might seem to be on the high side; but with a strong growth rate and a strong external adjustment process that are the key to a successful reform program, perhaps the result should not be very surprising. As important, what this means is that, given a successful reform program, the country can afford to reach that sustainable level of 189%. In this respect, it is interesting to note that the foreign currency debt D (for marketable Eurobonds) on the eve of default in March 2020 was $31.6 billion[8]; and given that GDP for 2020 was $27.3 billion, *this implies a foreign currency debt ratio d of 116%, indicating that the Government can assume more foreign currency debt if need be.*

And there is a need. It is widely believed that the $60 billion in financial losses by BDL were incurred more or less as follows: $20 billion to support the exchange rate peg; $20 billion to import basic commodities; and $20 billion as loans to the Government. So if we allow the Government to shoulder at least the $20 billion it owes BDL, then total currency foreign currency debt will rise to $51.6 billion, implying a foreign currency debt ratio d of 189% -- in other words, a foreign currency debt ratio that is just sustainable!

What we have established within the framework of our standard model and its implications as applied to the Lebanese case is that the Government shouldering a share of the financial losses is *not only fair but is also feasible*. The decision not to allow for it in the Government's plan – as rumors has it -- is because of the IMF's apprehension of increasing the foreign currency debt ratio to more than 100% (it was at 116% in March 2020)[9]. But that is perhaps a statement of opinion, not a conclusion born out of objective sustainability analysis.

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[6] See Bolbol, A. and Mouradian, A. "Potential GDP and Unemployment in Lebanon: A Simple Explanatory Note", *ABL Monthly Bulletin, 4, 2018.*

[7] In economists' jargon, it is only when the economy has grown to a steady state equilibrium that g and will tend to converge towards each other.

[8] Figure is from Lebanon's MOF publication, *Debt and Debt Markets.*

[9] The view that the debt ratio should not exceed 100% was reinforced, if not established, by the work of Carmen Reinhardt and Kenneth Rogoff in their book *This Time is Different* (Princeton University Press,

Of course, our result depends fundamentally on the success and credibility of the reform program; and it is also sensitive to the choice of values assigned to r and g. *But the point of the note is that the Government should rightly assume part of BDL's financial losses, and taking on foreign currency debt for that purpose could be quite sustainable*. Besides, the actual level of foreign currency debt could be considerably less if we allow for a resolution or restructuring of the debt with foreign creditors – a process that should accompany any successful program with the IMF[10]. Also, the burden of this more foreign currency debt would be additionally ameliorated by the fact that it would be undertaken in stages to pay back depositors as part of an overall financial settlement. Perhaps more important, an alternative route to assuming more foreign debt is to liquidate Government assets and use the proceeds to fund customers' deposits. In this sense, a sound proposal adopting such a route is to earmark part of the Government's future oil and gas revenues for that purpose, especially given that these total revenues are estimated to *average* close to $700 billion[11].

What is essential is that the Government should partake in absorbing the financial losses that it was a party to, and even if that entailed carrying more foreign debt once a credible recovery gets underway. For ultimately, what matters is a just distribution of BDL's financial losses and what that means to the future confidence in and viability of the Lebanese banking sector and economy, especially as the benefits accruing from such a process would most likely outweigh any cost incurred in making it happen.

2008) who posited that debt's maximum level should be at 90%. However, it was later discovered that this result was perhaps erroneously obtained as it was based on miscalculations in the data.

[10] Although based on different assumptions, Farouk Soussa concludes that Lebanon's foreign debt could be subject to a haircut of at least 45%; see *Goldman Sachs Economics Research, CEEMEA Economics Analyst, "An analysis of Lebanese debt recovery values", 4 Jan, 2019*.

[11] This proposal was put forward by Mr Saad Azhari, Chairman and GM of BLOM Bank; for oil and gas revenue estimates, see "*Oil and Gas in Lebanon 2014", Bank Med, July 2014.* It is interesting to note, however, that these estimates are preliminary in nature and subject to indeterminate degrees of uncertainty.