Foreign Debt Restructuring and Sustainability: A Note on Lebanon

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Table 1: Bn USD	D	E	GNP	BDL's NFR	E/GNP%	D/GNP%
2015	27.1	25	52.8	7.2	47.3	51.3
2016	28.2	26	52.8	-0.4	49.2	53.4
2017	30.4	28.1	54	-8.5	52.0	56.3
2018	33.5	31.3	55.2	-15.4	56.7	60.7
2019	33.8	31.7	53.5	-32.4	59.3	63.2
2020	36.1	33.9	35.3	-50.7	96.0	102.3
2021	38.6	36.5	26.9	--	135.7	143.5
2022	41.3	39.2	25.9	--	151.4	159.5

Source: MOF; CAS; Alvarez and Marsal

Table 2: Bn USD	Goods	Services	Income (NFI)	Transfers (NT)	CA	CA/GNP%
2015	-13.6	2.2	-0.5	3.4	-8.5	-16.1
2016	-14	1.9	-0.8	2.5	-10.5	-19.9
2017	-14.4	1.3	-0.2	1.2	-12.1	-22.4
2018	-15.1	1.4	-1.1	1.4	-13.4	-24.3
2019	-13.4	0.4	-1.2	3.1	-11.1	-20.7
2020	-6.5	0.1	-1	4.7	-2.8	-7.9
2021	-8.2	1	-1.5	5.3	-3.4	-12.6
2022	-13.6	2.1	-0.6	5.7	-6.5	-25.1

Source: BDL; CAS

Note: D=Foreign Debt; **E**=Eurobonds; **GNP**=Gross National Product; **NFR**= Net Foreign Reserves; **CA**=Current Account; **NFI**=Net Factor Income; **NT**=Net Transfers

In an interesting article written recently[1], the ex-Minister of Labor and the eminent corporate lawyer, Mr Camille Abu Sulieman, argued that the Lebanese government (LG) needs to negotiate and come to an agreement with its foreign creditors soon, for two main reasons. First, it is high time to do so after more than four years since it has defaulted!. Second, and more important, come March 2025, or after five years since default in March 2020, the creditors will lose under the stipulations of the Eurobond issues access to their interest payments[2]; so to avert that, they will most likely take the LG to court in New York City, and any court ruling in their favor will bind the LG to paying them, irrespective of the collective action clauses[3]. As such, the LG has an incentive to strike a deal before that date. The article also argued that, as is commonly the case in these circumstances, a deal with the IMF is indispensable so as creditors will be confident that debt service will be honored after restructuring.

We think that these arguments are very serious and pertinent; and in the aim of buttressing them even further, we want to provide some crucial supporting points on Lebanese foreign debt restructuring and sustainability, covering the period 2015 onwards.

To start with, in discussions of foreign debt the essential income/output variable is not GDP but GNP, or Gross National Product, and that is because it is the variable that captures *all* foreign current transactions. Recall that GDP is expressed as follows:

$$GDP = C + I + X - M; \quad GDP = C + I + TA$$

Where C is private and public consumption, I is private and public investment, X is exports of goods and services, and M is imports of goods and services, which makes X-M equal to the trade account TA. But foreign current transactions also include transactions involving *Lebanese nationals from abroad:* these are net factor income NFI (for example, interest income and payments); and net transfers NT (for example, remittances in and out). Hence, GNP can be represented as[4]:

$$GNP = C + I + TA + NFI + NT; \quad GNP = C + I + CA$$

[1] "*Eurobonds: Time to Negotiate*", Nidaa Al-Watan, 15 March 2024. The author would like to thank Maitre Sandra Boustany for the reference and for helpful discussions.

[2] In addition, in ten years' time since default, they also will lose their claim to the principals.

[3] The Lebanese Republic is subject to the non-exclusive authority of New York courts. New York Courts will have "non-exclusive jurisdiction" over claims submitted by Eurobonds' holders (once a claim is filed in New York, the Lebanese Republic cannot remove the action to a Lebanese court). Ruling/final court's decision would then be enforced against any assets of the state overseas (if any), except those protected by immunity

[4] Modern literature now refers to GNP as Gross National Disposable Income GNDI.

Where CA is the current account of the balance of payments and it is of course equal to the sum of TA, NFI, and NT[5]. And it is the CA that is most crucial in the analysis of foreign debt; that is because if the CA is in deficit, then the balance of payments has to be balanced through transacting more foreign liabilities (positive debt) through the capital account and/or through drawing down FX reserves at BDL; and vice versa.[6]

With this in mind, we see from Table 1 above that 95% of Lebanon's foreign debt (D) is in Eurobonds (E), as the little remaining of foreign debt is mostly official multilateral loans. In 2019, the Eurobonds stood at $31.7 billion, but had reached $39.2 billion by 2022 because of interest accumulations due to default. These original $31.7 billion are estimated to be currently held as follows: $5 billion with BDL; $10 billion with local banks; and $16.7 billion with foreign creditors. Two additional observations are important. First, by 2022, *the ratio of foreign debt to GNP stood at 159.5%, against 51.3% in 2015*, or more than three times as much. Second, *in 2015 BDL's net foreign reserves (NFR) were still positive at $7.2 billion*, but they turned negative in 2016 as BDL embarked on its infamous Financial Engineering operations to shore up its gross foreign reserves, instead of changing course by adjusting the overvalued exchange rate and halting its financing of government expenditures. In retrospect, that proved disastrous, for by 2020 when BDL's NFR hit more than *negative $50 billion*, the government went into serious default and the market exchange rate went straight to the pits.

In Table 2, we can see why the CA deficit is the Achilles' heel of the Lebanese economy. Only in 2020, at the height of the financial crisis, did its ratio to GNP stay in single digits (7.9%), whereas in all other years it remained in double digits reaching a high of 25.1% in 2022. Two remarks are worth observing in terms of the components of CA. First, though the goods deficit fell to $6.5 billion in 2020, it rebounded to $13.6 billion in 2022 (no full data for 2023 is out yet); and whereas the surplus in services fell to 0.1 billion in 2020, it increased to $2.1 billion in 2022 (mostly reflecting tourism activity). Second, net transfers improved noticeably after the crisis to stand at $5.7 billion due mostly to steady in-remittances and higher public transfers. The fact remains, though, that CAs remain huge in relation to the size of the national economy and they still need to be financed through more foreign liabilities and/or loss of BDL FX reserves. What can be done? Would debt restructuring with foreign creditors help? As we will

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[5] Note that GNP is then equal to GDP + NFI + NT. And since in Lebanon the sum of NFI and NT is positive, then GNP is larger than GDP.

[6] Meaning that if the CA is in surplus, then foreign liabilities will be retired (negative debt) and/or FX reserves at BDL will accumulate.

see below, it will but only if accompanied *by structural reforms and adjustments in the economy that affect primarily CA*.

It was evident from Table 1 that up to 2015 BDL's NFR was a positive $7.2 billion – unlike all the following years -- with the corresponding Eurobonds and foreign debt to GNP ratio being 47.3% and 51.3% respectively. It is thus not unreasonable to assume that at a ratio of about 50%, the Eurobonds (foreign debt) ratio could be considered sustainable. Moreover, with 50% established as the sustainable ratio, and GNP in 2022 at about $26 billion, then the *corresponding sustainable Eurobonds value is $13 billion*. And given that Eurobonds amounted to $39.2 billion in 2022, *then this would imply a haircut of 67%.* In other words, tentative economic logic implies that the LG should *opt for a haircut of at least 67% in its Eurobonds restructuring negotiations with creditors*.

The crucial question is, can this sustainable ratio of 50% be maintained? Alternatively, what is the corresponding ratio in CA that would guarantee it? To answer these important questions, let us go through a small technical note. Let GNP be Y and let d be the ratio of foreign debt D to GNP. Hence, we have the following (with Δ being change per unit of time):

$$d = D/Y$$

$$\Delta d/d = (\Delta D/D) - (\Delta Y/Y)$$

$$\Delta d = d.(\Delta D/D) - d.(\Delta Y/Y)$$

*If d*is the constant, sustainable foreign debt to GNP ratio*, then $\Delta d = 0$; and keeping in mind that $d = D/Y$, we obtain:

$$\Delta D/Y = d^*(\Delta Y/Y)$$

And since ΔD is the change in foreign debt that would be transacted to cover the *CA deficit*, then $\Delta D = -CA$:

$$-CA/Y = d^*(\Delta Y/Y)$$

We have already established that d* is 50%. What about the growth rate of nominal GNP, ΔY/Y? *It has been shown that a plausible value for ΔY/Y is about 9%*[7] -- 6% for real GNP growth, which is reasonable given that Lebanon's potential GNP growth is about 5.5%, in addition to *the catch up in growth to re-*

[7] Bolbol, A. and Mouradian, A. "*Potential Output and Unemployment in Lebanon*", Association of Banks in Lebanon (ABL) Monthly Bulletin, No. 4/2018.

capture the loss in GNP that happened during the crisis; and 3% for the growth in the GNP deflator (or inflation), which is also reasonable given that it is close to the average inflation rate over the 1994-2018 period. Therefore, we obtain the following:

-CA/Y = 50% (0.09) = 4.5%

As a result, the sustainable CA deficit that will deliver a constant, sustainable foreign debt is 4.5%. This is a very interesting result because Lebanon has never reached such a low CA deficit ratio before (the lowest was in 2020 at 7.9%). But that is the way it should be: *it should be relatively low so as not to incite excessive foreign borrowing and so as to economize on the use of foreign exchange to be able to pay back the creditors*. And that is why creditors, as Mr Abu Sulieman had rightly argued, won't restructure the foreign debt before an IMF program becomes effective, as it is such a program that will ensure that CA will be sustainable and consequently that foreign creditors will get their restructured money back.

In closing, it is no exaggeration to say that reducing the CA deficit to a manageable, sustainable ratio is the crux of economic reform in Lebanon. It will not only involve a new economic paradigm, but it will also be the yardstick by which reforms will be assessed whether they have succeeded or not. For the CA deficit can fall through two policy measures: expenditure switching and expenditure reducing[8]. Expenditure switching involves switching from foreign goods and services to domestic goods and services; and it would entail having a reasonable exchange rate and a competitive economic base. Expenditure reducing, on the other hand, involves primarily reducing government expenditures and burdens; and it would entail having a well-governed political establishment and a restructured public sector. The alternative, however, is to have none of that, neither debt restructuring or economic reforms, as actually seems most likely. The irony, of course, is that in this case CA would most likely fall – as it did in 2020 and more – but it would fall not because of our presumed genius but because both the economy and the state have so miserably failed!

[8] Another way for implying the same thing is to increase savings for given investments, as the difference between savings and investments is equal to the current account.

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