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Lebanese Financial System Under Stress

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The sustainability of the Lebanese economic model and its corresponding financial system is under immense stress with multiple breaking points. On a macroeconomic level, economic growth has slowed down to 0.3% in 2018 and is expected to shrink in 2019. This adverse macro environment is a direct result of the mounting external deficit that accelerated to 9.41% of GDP, or USD 5.318Bn in the first seven months of 2019 after recording 8.52% of GDP in 2018.

Given this backdrop, BDL has become the only player in town and has engaged in unconventional monetary policies aimed at maintaining the currency peg and the attractiveness for foreign deposits into the financial system. However, they have drained liquidity from the market and diverted funding away from the government's deficit; as a result, BDL has been the government's main financer for more than two years, while maintaining profitability of the local commercial banking sector.

Furthermore, these activities have led BDL to lose USD 4.99Bn of its foreign assets as of October 15, 2019 despite large efforts to lure in reserves. If left unresolved the balance of payments crisis will accelerate and will deplete BDL's dollar reserves, the same reserves needed to pay back depositors and maintain the peg.

BDL's gap has already reached a critical level, with its reserves only capable of buying time for slightly over a year before it depletes them fully. To bring down its dollar losses, BDL recently introduced a dual rate exchange system similar to other countries facing balance of payments crises (such as Venezuela and Syria) and has placed some unofficial capital controls on importers.

Additionally, confidence in the ability of the government to pay back its debt has faded away due to the weak state of government finances coupled with political gridlock. International financial institutions are expressing continued concern over the health of our financial system due to the Government's inability to tap markets and the deterioration of the consolidated balance sheet of the financial sector.

Meanwhile, officials have been unable to commit to structural reforms and a credible deficit reduction scheme, as promised during the CEDRE donor conference. If designed and passed properly, along with a debt reduction scheme, these reforms can provide a leeway to avoid a hard landing.

Below are major red flags based on quantitative indicators from the current year.

A. Adverse Macroeconomic Environment

The economy is shrinking due to the growing balance of payments crisis and the counter cyclical monetary policies BDL had to place to win time on the expense of its own balance sheet. Meanwhile policy makers have kept fiscal policy unchanged.

Government spending has done little to boost long term growth, given the inefficient allocation of resources and lack of a clear economic vision for the country.

Debt is a major problem for the country; with both the public and private sectors characterized by excessive consumption patterns and increasing debt levels.

1. **Economy is shrinking.** Economic growth has slowed to 0.3% in 2018 and is expected to shrink in 2019 and 2020.

   Some main indicators of this include:

   - New registered vehicles, a leading indicator of consumer expenditure, are down 19.56% YoY as of 07/2019.
   - Cement deliveries are down 27.26% YoY as of 06/2019.
   - Value of cleared checks is down 13.05% YoY as of 07/2019.

2. **Inefficient public spending.** Growth has slowed down even though public spending is at all-time highs due to inefficient allocation schemes. Public funds have not been utilized to their maximum potential due to corruption and absence of strong economic development planning initiatives.

3. **High levels of indebtedness.** The economy has been reliant on debt to fuel excessive consumption. As of 07/2019, public sector declared debt stood at USD 86Bn, while loans to the private sector came in at USD 54.89Bn.

4. **Confidence in the sovereign fading.** For more than two years the Treasury hasn't been able to go on the market and has been relying on the central bank for financing; as a result, confidence in the sovereign has been reduced: Financial institutions see investments in the country as increasingly risky.

5. **Investment discouraged by high interest rates.** The Beirut reference rate on LBP rose from 8.68% to 13.49% between September 2017 and 2019 meanwhile the reference rate on USD rose from 6.74% to 10.14% over the same period. This rise in interest rates has led to a drop in private sector investment.

B. External Balance Deficit

Lebanon runs twin deficits: it imports more than it exports and spends more than it collects in tax revenues. To finance these deficits, the country is dependent on money inflows coming from outside the country.

2019 was characterized by key indicators that threaten economic stability: increased cost of imports, decreasing inflows (FDI, remittances, & foreign deposits), and a rise in outflows of capital from Lebanon to other countries due to eroding trust in the financial situation.

These factors have drained dollars out from the country, forcing BDL to use its reserves and cover the resulting USD shortage to maintain the currency peg.

6. **System dependent on foreign inflows.** The Lebanese economy is dependent on capital inflows to finance its double deficit and support the indebted economy.

7. **Net outflows accelerating.** In the first seven months of 2019, the balance of payment deficit reached 9.41% of GDP,

    - **Trade Deficit** over the years has been witnessing steady increases and had seen a 12.80% YoY increase as of 07/2019; caused by a drop-in competitiveness and rising imports share of the market.

    - **Decrease in foreign inflows**. The enactment of tax information sharing agreements, such as FATCA and the CRS Multilateral Competent Authority Agreement, have contributed to decreased foreign inflows. Furthermore, financial support of political parties from foreign entities has dropped significantly.

    - **Increase in domestic outflows.** Numerous political and financial shocks have raised fears of a financial collapse caused by sovereign default, leading to an outflow of capital from the country, with Lebanese banks and financial institutions witnessing a USD 3.396Bn drop in their net foreign assets YTD as of 08/2019.

    - **Rising fuel bill.** The price of oil has risen by around 17% YoY and as a result Lebanon's oil import bill has rose.

8. **BDL supplying the deficit.** To maintain the fixed exchange rate between the dollar and the lira, BDL has to supply enough dollars to cover the balance of payments deficit, therefore weakening its balance sheet. We estimate that BDL's net FX position at negative USD 25.97Bn as of the end of September 2019 (Excluding Eurobonds). The estimate is derived based on the following data:

Table 1: Distribution of BDL's FX assets and liabilities*

Metric	Amount
BDL's Foreign Assets (excluding Eurobonds)	USD 35.31Bn
BDL's Eurobonds Holdings	USD 3.20Bn
BDL's Gold Holdings	USD 13.72Bn
BDL's FX Liabilities (to banks)	USD 75Bn Of which USD 18.62Bn in required reserves
BDL's Net FX Position (Excluding Eurobonds)	USD -25.97Bn
BDL's net FX Position (Excluding Eurobonds & Gold)	USD -39.69Bn

*All data is valid as of September 30, 2019

C. Government Incapable of Financing Fiscal Deficit

Lebanon's budget deficit reached 11.2% of GDP in2018, well above the target of 8.5%. The IMF estimates that the 2019 deficit will stand at around 9.75%, again going above government estimates of 7%. These high figures further erode the trust of financial institutions in the government's ability to engage in structural reform.

Due to this eroding trust, the government has found it increasingly difficult to finance itself on open markets whether internally or externally, thereby forcing BDL to step in and aid the government in financing assistance. This uncommon relationship between BDL and the government further erodes trust in the stability of the financial and monetary situation.

9. **High fiscal deficit.** The government cash base budget deficit rose to 11.2% of GDP in 2018. The IMF estimates a deficit of 9.75% in 2019.

10. **Extensive support from BDL.** BDL currently holds about 50% of the Treasury's LBP denominated debt and has supplied it with USD 2.152Bn in FX financing assistance during 2019.

11. **Hidden deficit.** Arrear payments are estimated at **LBP 8,900Bn as of the end August 2019.**

D. BDL Balance Sheet Weakening

BDL's foreign assets, a key indicator of the ability of the CB to maintain the fixed exchange rate, have seen a sharp decline due to its activities in avoiding a deterioration of the financial situation.

BDL's accounts show sign of an increasingly fragile institution who is suffering from dollar losses and a subsequent gap. As a result, it will be unable to maintain current policy direction for much longer.

These losses stem from the high cost of BDL policies, a large part of which are aimed at supporting the currency peg commercial banks (and providing them with high profit margins).

BDL's USD gap has reached a critical level and the institution will deplete all its accessible reserves unless the situation improves drastically. To protect itself BDL has adopted an unofficial dual exchange rate system in which it will finance key importers at the peg's level and the rest of external economic activities at a secondary rate allowed to deviate to 10%+ of the official rate according to leaks.

12. **Foreign Assets Shrinking.** BDL's foreign assets have dropped by 11.56% or USD 4.99Bn YTD as of 10/15/2019 in order to finance the balance of payments deficit, FX fiscal deficit, and unconventional monetary policies.

13. **Sterilization of Cost.** Thought the years BDL's capital accounts grow at a steady rate because it sterilizes its costs by printing LBP to cover for losses generated from FX operations. BDL's other assets, assumed to be its sterilization cost, grew by 86.2% or USD 10.54Bn YTD as of 10/15/2019.

14. **Unconventional monetary policies at a high cost.** The top three local commercial banks derived 4.79% of GDP in interest revenues from the central bank during 2018.

15. **BDL has adopted a dual exchange rate system.** According to BDL circular 530 the central bank will cover for the USD needs of core imports and did not address how the rest of the import basket is to be financed. This circular indirectly introduced a secondary exchange market allowed to deviate from the official currency rate that most of the population will utilize. Leaks have indicated that the secondary market rate will be allowed to float 10% above the official rate and will lead to a rise in inflation and a drop-in consumers' purchasing power.[1]

[1]A composition of BDL's FX holding is in bullet 8 above.

E. Commercial Banking Sector Supported Artificially

Commercial banks have seen a large rise in their balance sheets, as opposed to other financial institutions that have seen a drop. This unusual activity in light of the weak economic situation in Lebanon points to the benefits banks have been receiving from BDL's policies.

The fundamentals of the banking sector are also on shaky ground; deposits from the private sector are shrinking, and commercial bank's liabilities are increasing due to their engagement in BDL's policies but are being hidden using accounting gimmicks.

These indicators show an increasingly risky environment, especially given how tied the commercial banking sector is to BDL and the sovereign. This relationship has created an impression that banks are too important to fail and that BDL will always step in to maintain the financial system, leading banks to limit their risk analysis.

16. **Balance sheet rising rapidly.** Total assets for the commercial banking sector rose by 9.68% YoY as of 07/2019 while that of financial institutions dropped by 5.02 YoY%.

17. **Deposits shrinking.** Private sector deposits shrank by 0.38% YoY as of 07/2019 despite weighted average interest rates recording 8.71% on LBP deposits and 5.77% on USD deposit as of 06/2019.

18. **Liabilities rising rapidly but hidden.** As part of its "financial engineering" schemes BDL has been providing USD collateralized loans to the commercial banking system. These loans recorded USD 36.88Bn on 02/28/2019, but ever since the growth of these loans cannot be traced because banks moved them to off-balance sheet items under BDL's instructions.

19. **Growing systematic risk and moral hazard.** High returns on financing the central bank and the government have created risk channels across the system, while belief that the central bank will maintain the financial system has created a risk-neutral environment.

F. Proposed Solutions Only Yield Temporary Stability

20. **Monetary policies raise risk of financial collapse.** BDL's unconventional monetary policies only increase its FX-denominated costs, leaving it further in need of hard currency while raising its cost of funds further. These operations benefit the local commercial banking sector in the short term rather than the real economy.

21. **Foreign assistance only provides short-term gains.** In the absence of structural reforms, foreign assistance from international financial institutions, given the current framework, will only delay a financial crisis.

G. Break Points are Numerous

22. **Unsustainable upward pressure on currency peg.** An overvalued lira coupled with BDL's policies have made maintaining the fixed exchange rate system much more difficult. The only sustainable way to maintain the peg in the short term would be to enact capital controls to limit outflows. But maintaining the peg at any cost will only buy time unless structural reforms are undertaken.

23. **Sovereign default avoided only by BDL's aid.** The government's unwillingness to raise rates on its debt's primary market has hindered its ability to access capital markets; as a result, BDL has been covering the greater part of government's financing needs, adding to its difficult situation.

24. **Unsustainable debt service.** Interest rates on the government's debt have risen greatly over the last three years, indeed the Lebanese government's USD denominated debt is currently one of the highest yielding of its class. Rolling over the government's debts at these rates will entail a sharp rise in both its debt servicing cost and its size. If unresolved the debt will balloon to a level were the government's total financial resources cannot service, it any further.

Kulluna Irada is a civic organization for political reform, engaged in setting the foundations for a modern, secure, efficient, sustainable and just state. It is funded exclusively by Lebanese citizens in Lebanon and abroad. Kulluna Irada believes transparency, accountability and citizen participation as major constituents of good governance. The organization's goal is to raise awareness on public issues and engage constituencies of the Lebanese society: citizens, NGOs, experts, municipalities, and members of Parliament and Government in order to find and implement sustainable solutions.

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