

# Lebanon: Economic Developments, Monetary Policy, Dollarization & the Exchange Rate

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# Role of Central Banks: I

- Expansion of banking & financial services in modern economies  $\Rightarrow$  wider role of CBs
- Modern ICT  $\Rightarrow$   $\downarrow$  information costs &  $\downarrow$  payment costs
- Monetary Arrangements & Policy
- Exchange Rate Arrangements & Policy
- Public Debt Management

# Role of Central Banks: II

- Payment & Settlement Systems
- Banking Control & Supervision
- Financial Market Supervision

# Role of Central Banks: III

- Wider Role & Responsibility:
  - Inform the general public
  - Advise Government
  - Inform International Organizations
  - Inform Markets: domestic, international
- International Economic & Financial Integration

# ER Fixed vs. Flexible, Optimal Currency Area

- Lower transactions costs vs. loss of exchange rate as a policy instrument; but depends on degree of labor and capital mobility and correlation of shocks between countries.
- How important are OCA issues?
  - Motivations are more likely to be political or credibility issues (e.g. German re-unification, Euro).
  - Free trade areas (NAFTA, ECM) delivered substantial trade gains without common currency.
- Applicability to Lebanon & Syria ?

# Fixed vs. Flexible: Credibility

- Inflation convergence: significant gains while the hard peg lasts. Lebanon's example.
- Fiscal discipline:
  - currency unions can lead to smaller government size and narrower fiscal deficits
  - Unilateral dollarisation not likely to have similar effects

# Choices for Exchange Rate Regimes

- Impossible Trinity: Pegged rates-Open Capital Markets- Monetary Independence not compatible or sustainable⇒collapse Gold Standard and Bretton Woods
- Under capital mobility, monetary policies cannot be aimed both at maintaining stable exchange rates and smoothing cyclical output fluctuations
- Monetary Constitution criterion:
  - nominal anchor; peg to low inflation country
  - Pre-commitment mechanism to anchor expectations

# Financial Dollarisation

- Financial dollarization: Assets & Liabilities are dollarized
- Limits scope of ER fluctuations that monetary authorities can tolerate
- Foreign currency denominated external debt  $\Rightarrow$   $\uparrow\uparrow$  currency mismatch



# Dollarisation and implications for Exchange Rate Regime Choice

- Monetary Aggregate: expand to include foreign currency deposits and currency in circulation
- Choice of regime: financial stability considerations imply that fixed rate is preferable

# Emerging Markets

- Hard Pegs/Currency Boards: did not rule out banking/financial crises
- Problem of 'Original Sin': limited access to international capital markets + high costs of access
- High pass-through from exchange rates to prices
- Central issue: how to achieve **financial development and maturity**

# Exchange Rate Anchors & Currency Unions: Benefits & Costs

- Secure inflation rate of anchor  $\Rightarrow$  credible price stability policy, greater financial stability
- Lower transactions costs: goods, services
- Loss of independent monetary policy/lender of last resort; depends on correlation of shocks with anchor
- Loss of seigniorage/sovereignty; but depends on seigniorage compensation arrangements

# Currency Co-Circulation/ “Dollarization”: Pros

- Control and lower inflation
- Greater credibility of monetary policy and fiscal discipline due to constraints on government financing
- Lower & less volatile interest rates
- Lower transactions costs in international trade and investment

## Dollarisation: Con

- Loss of independent monetary policy: can no longer use interest rate policy for counter-cyclical policy or exchange rate for commercial policy
- Lack of lender of last resort (LOLR)
- Loss of seigniorage
- More costly adjustment to real shocks and asymmetric shocks
- Loss of ability to use inflation tax:
  - Save banking system by eroding real liabilities
  - Depreciate real value of nominal debt and fiscal commitments
  - Adjust misaligned wages

# Dollarisation: new arguments

- Avoid financial fragility caused by 'original sin': countries that have sinned in the past do not have access to international markets (using their own currency) and cannot borrow long-term even in local market
- Dollarisation avoids the likely consequences of exchange rate floating with 'original sin': (a) depreciation, mismatching and balance-sheet effects; (b) monetary tightening, roll-over risk

# Floating with 'original sin'

- High & volatile domestic interest rates
- Lower demand for domestic assets and more dollarisation of savings
- Riskier banking systems
- Difficulty in developing financial long-term markets & less financial development
- Lower foreign currency borrowing
- Lower international market access & investment leading to lower growth

# LEBANON MACROECONOMIC DEVELOPMENTS: 1992-2003

- Uneven Economic Growth
- Exchange Rate Stability
- Reduced Inflation
- Large Capital Inflows & Remittances
- Reconstruction
- Large budget deficits & Public debt accumulation
- Public Finance Reform & Public Debt Restructuring; the Paris II process



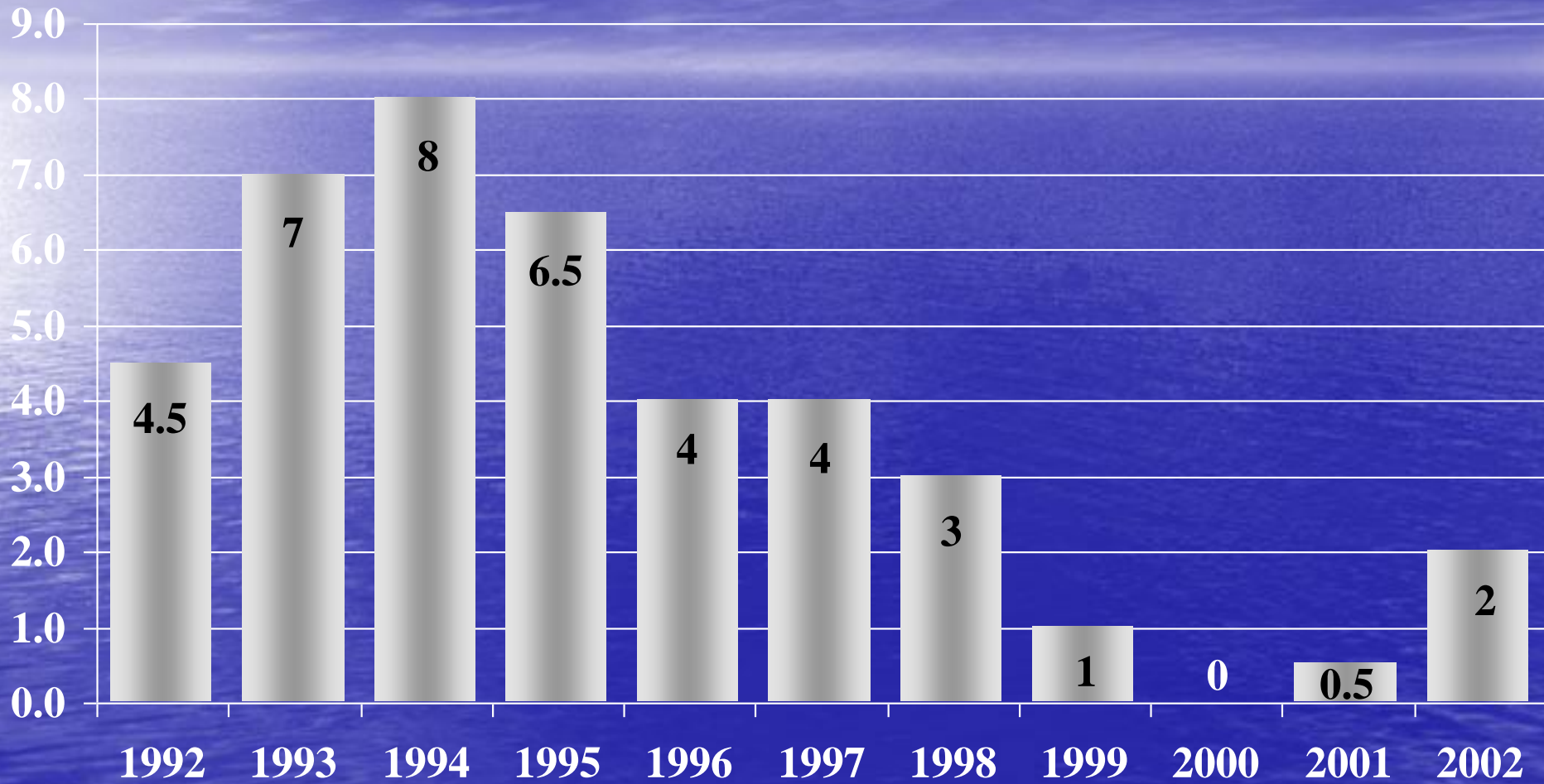
# Main Features I

- Economy Private sector based
- Finance of Reconstruction
- Large Budget Deficits
- Dollarized Economy: payments, assets and liabilities of banking system; corporate sector
- Open Economy: freedom of payments and capital flows; limited protection
- Multi-currency payment system
- Independent Central Bank
- Independent Banking Control and Supervision

# Main Features II

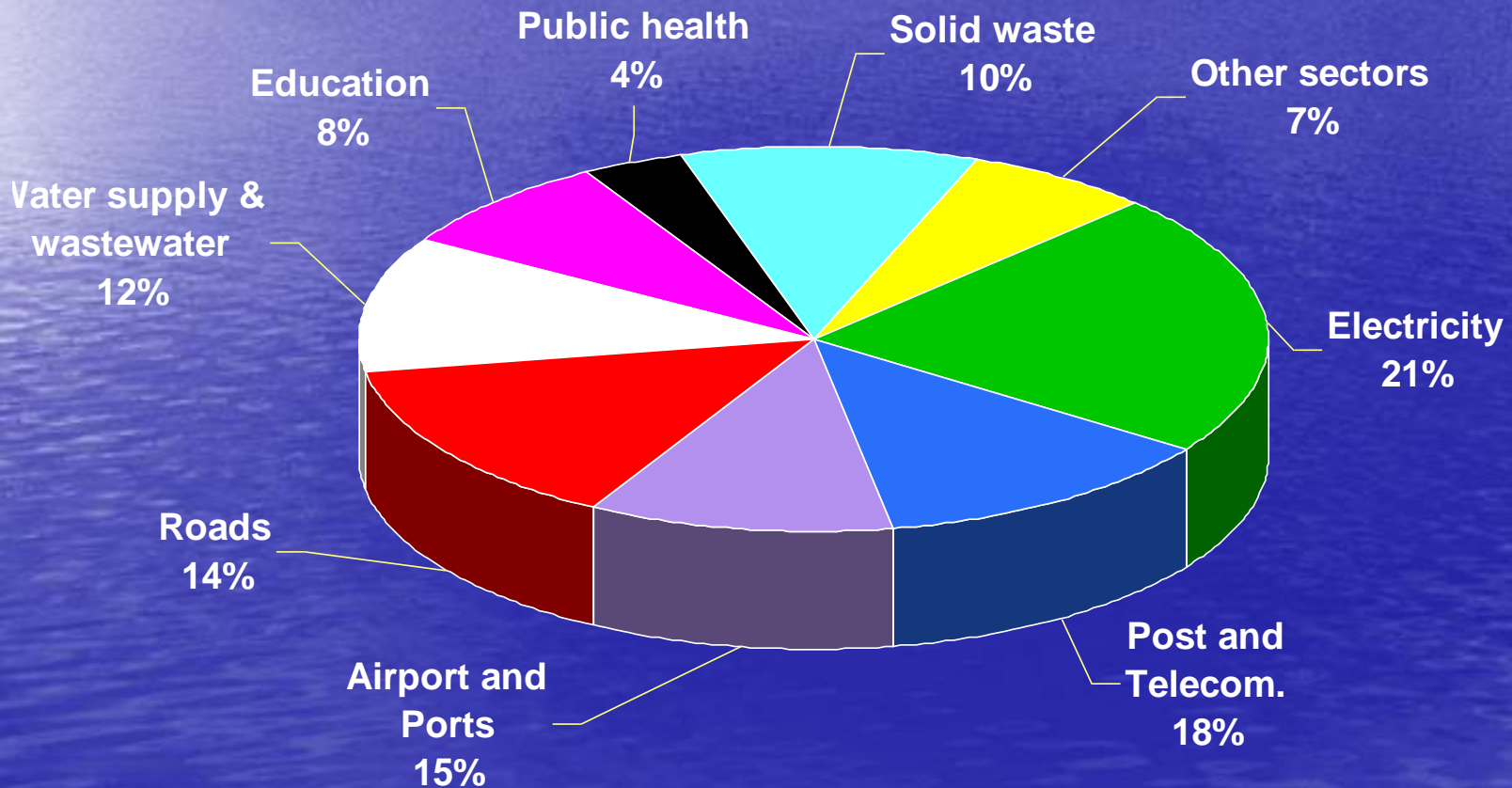
- Introduction of New Laws and Modernization of Existing legislation to deal with structural and institutional issues and change
- Introduction of money market and financial market instruments: CD's, Repos', Swaps
- Flexibility: BDL and BCC issue regulations to manage, organize, supervise
- Comprehensive view: fiscal policy, monetary policy, exchange rate policy, payment system, banking and financial sector

# REAL GDP GROWTH RATE



# RECONSTRUCTION PROGRAMME, 1992-2001

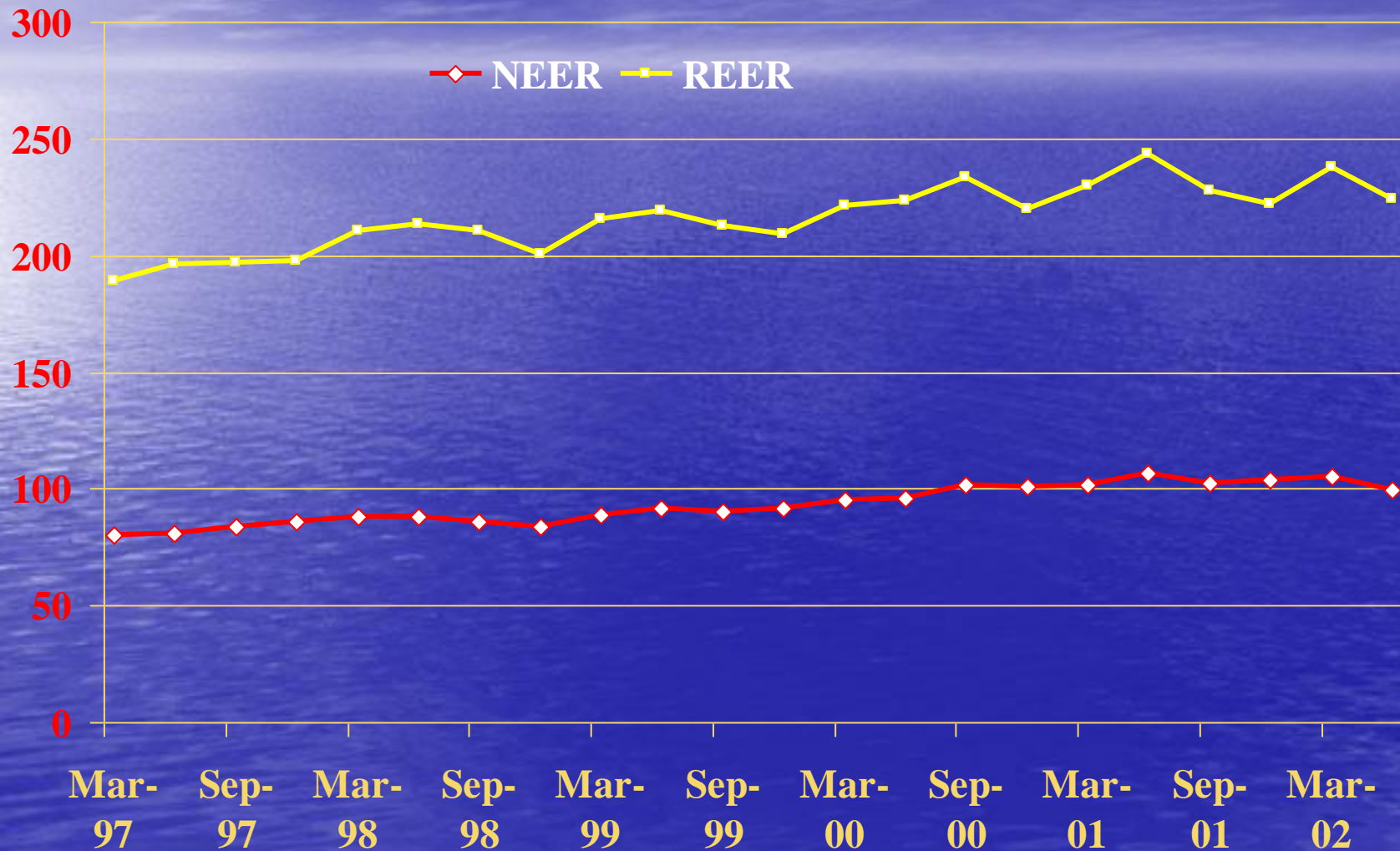
**TOTAL: \$ 6,209 Million, o/w \$ 3,079 million executed and \$ 3,130 million to be executed**



# Stabilization Policy: Exchange Rate Policy

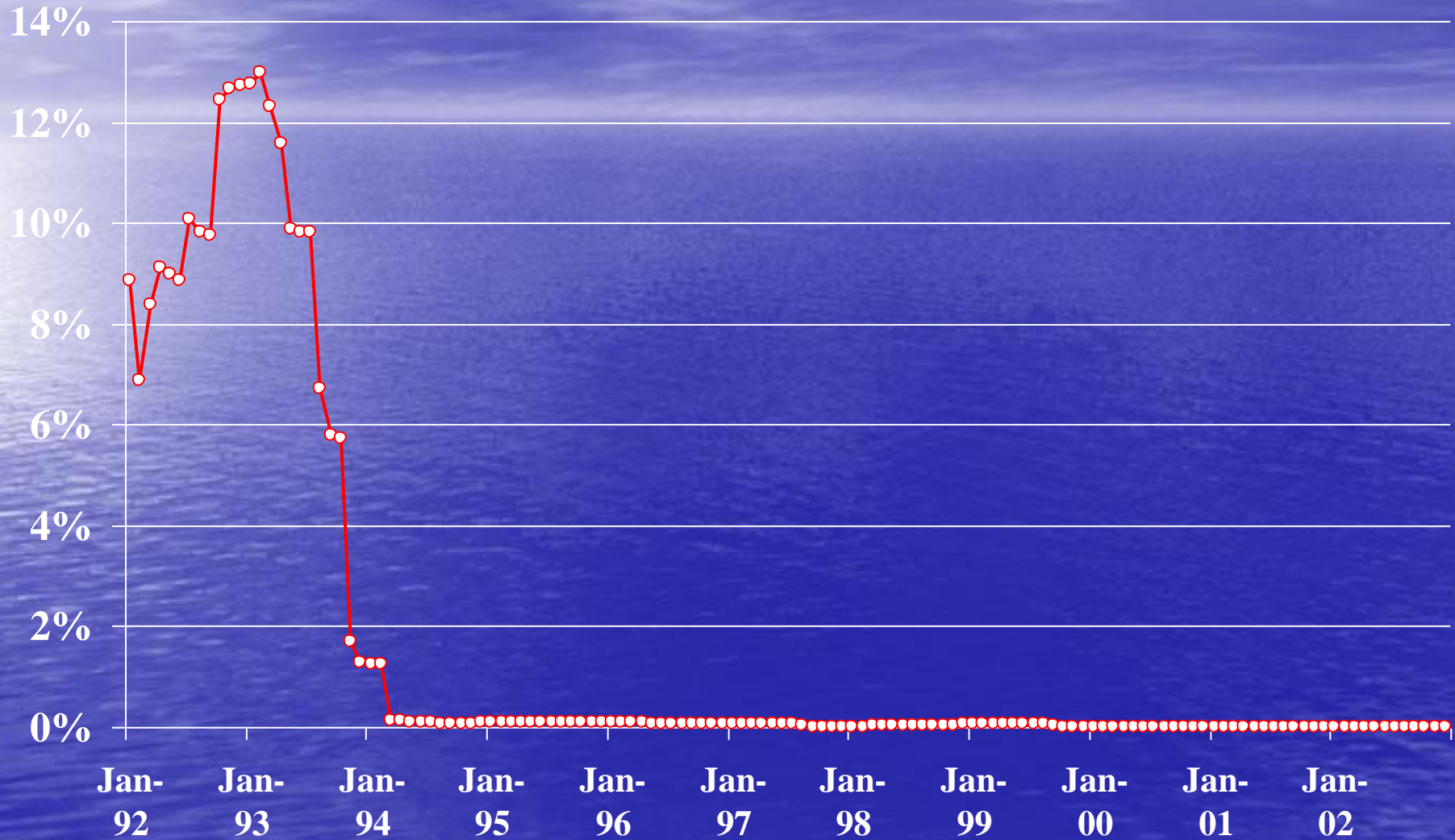
- US\$ Nominal Anchor
- Tight Link Between Inflation and Exchange Rate Movements
- Achieve Stable Real Exchange Rate
- Sterilization operations to offset capital flows

# NOMINAL AND REAL EFFECTIVE EXCHANGE RATE (Jan1991 = 100)

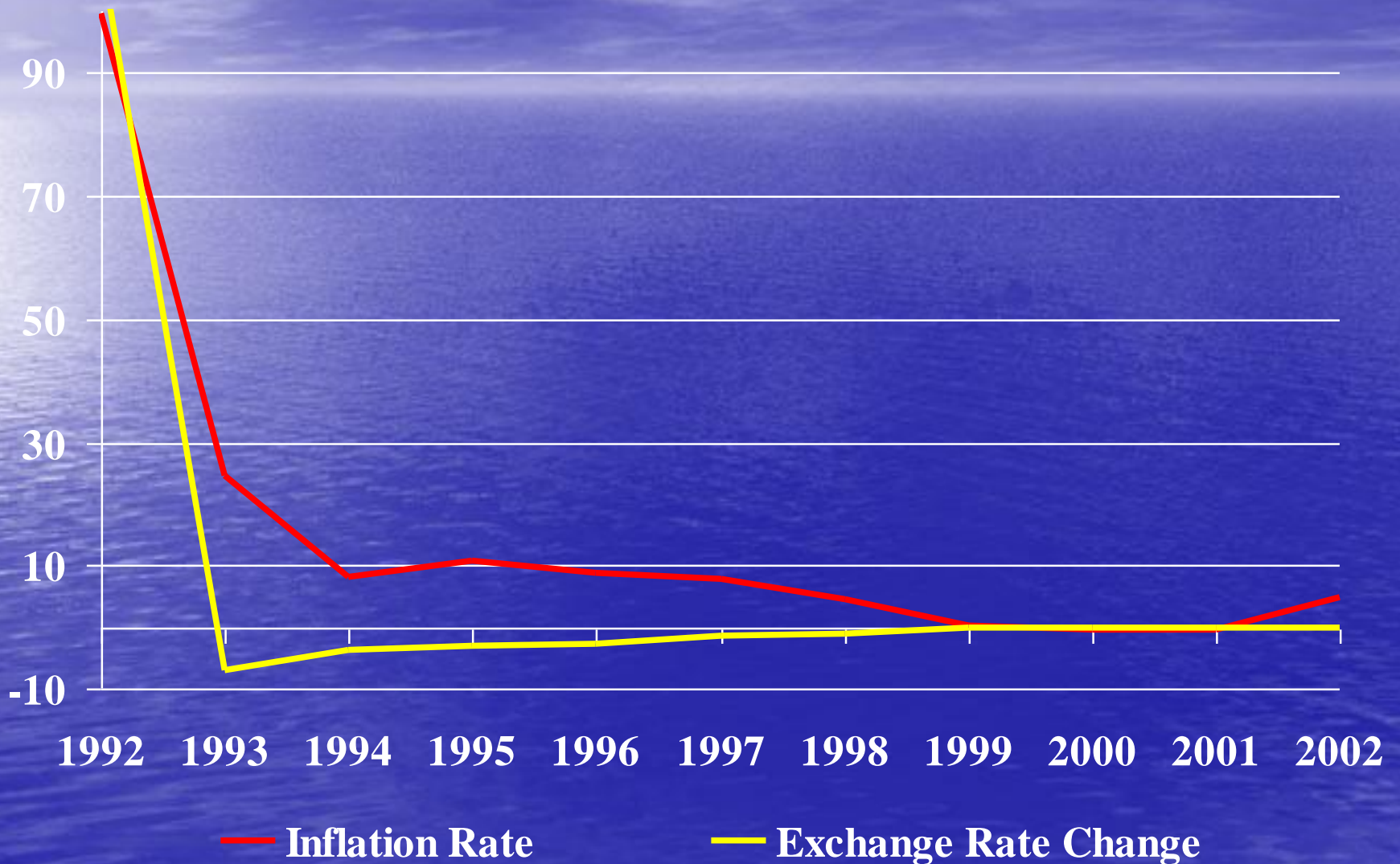


# EXCHANGE RATE VOLATILITY

(Standard deviation of monthly % change)

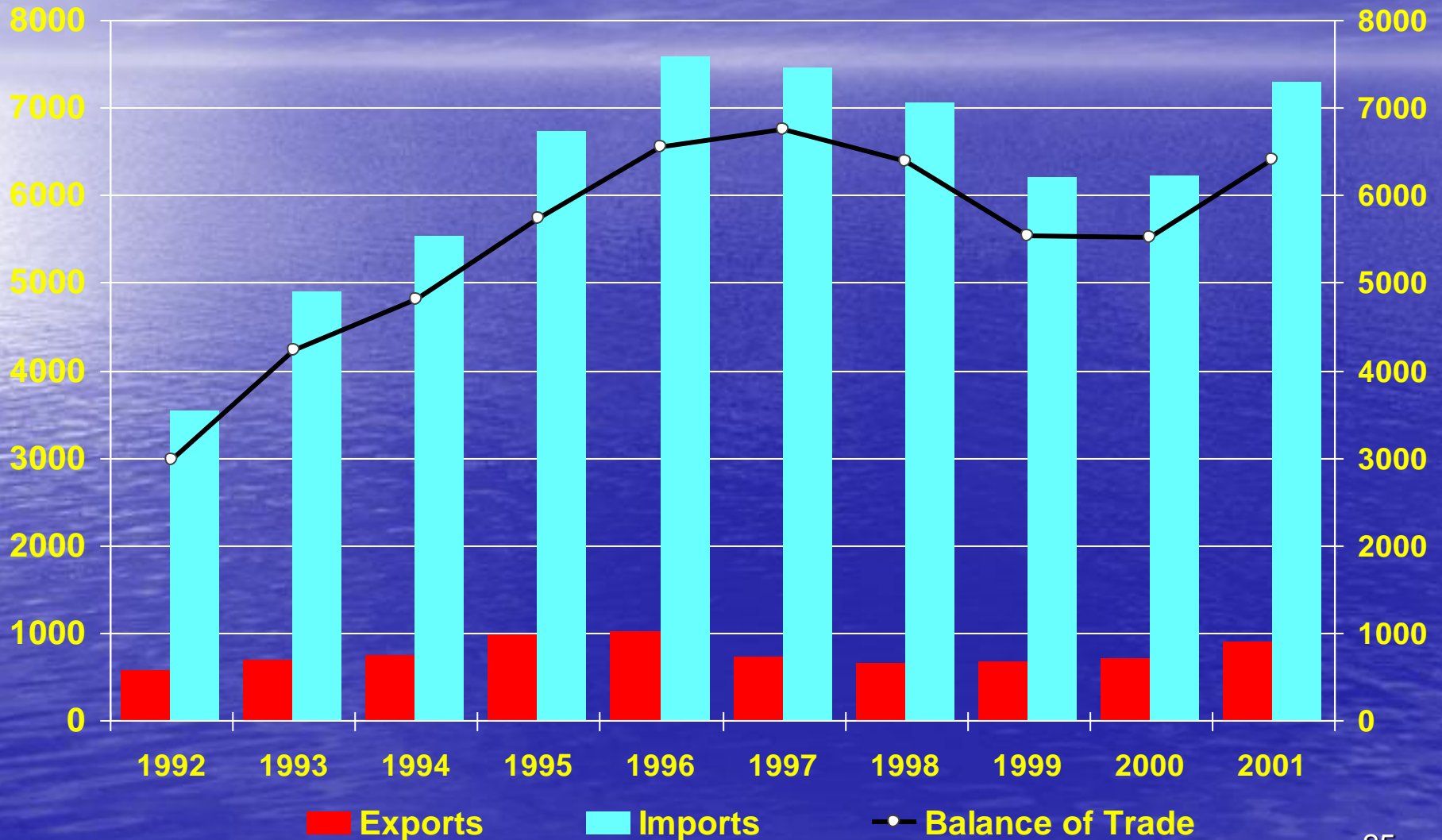


# INFLATION AND EXCHANGE RATE



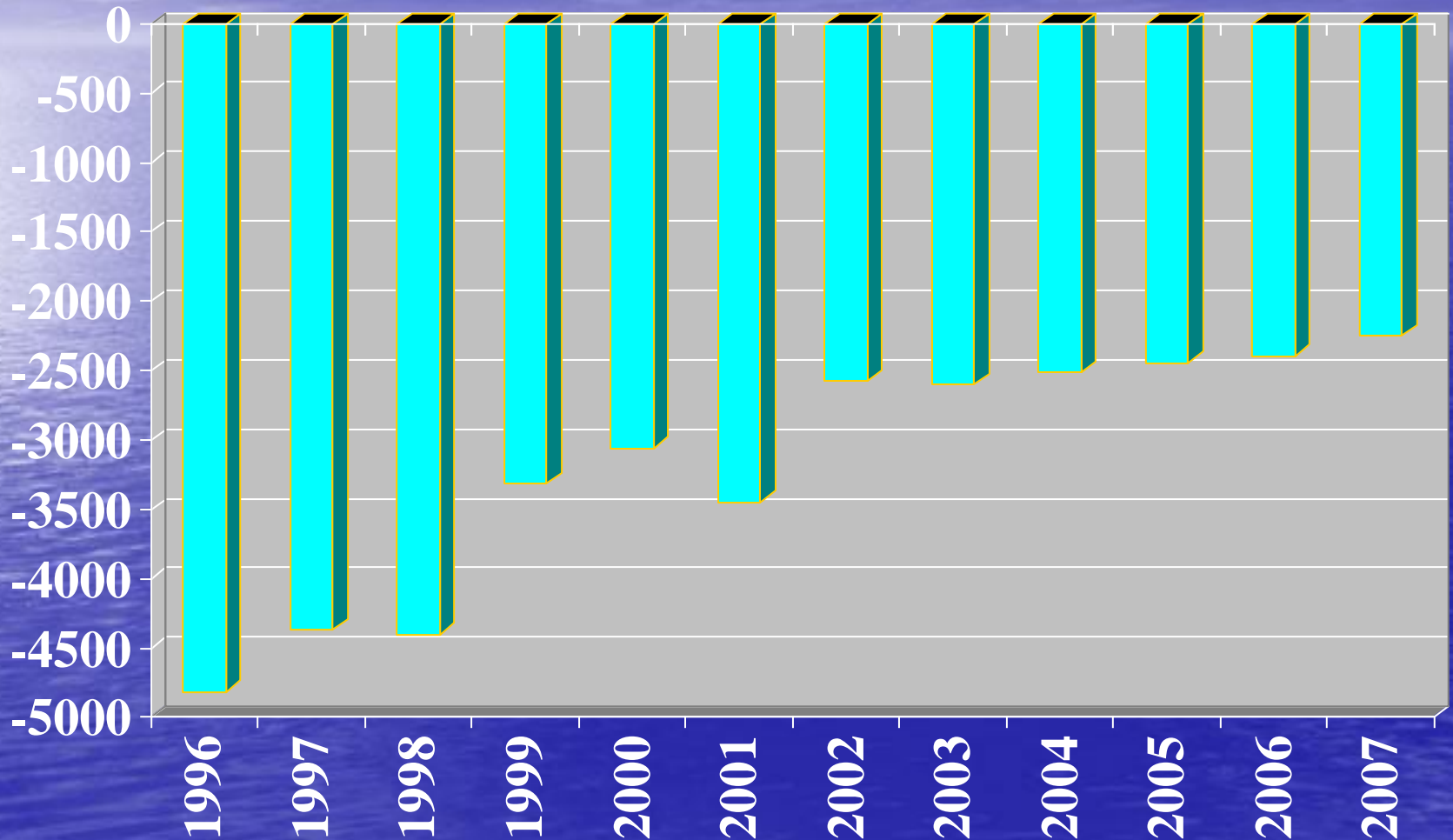


# TRADE BALANCE (Mn \$)

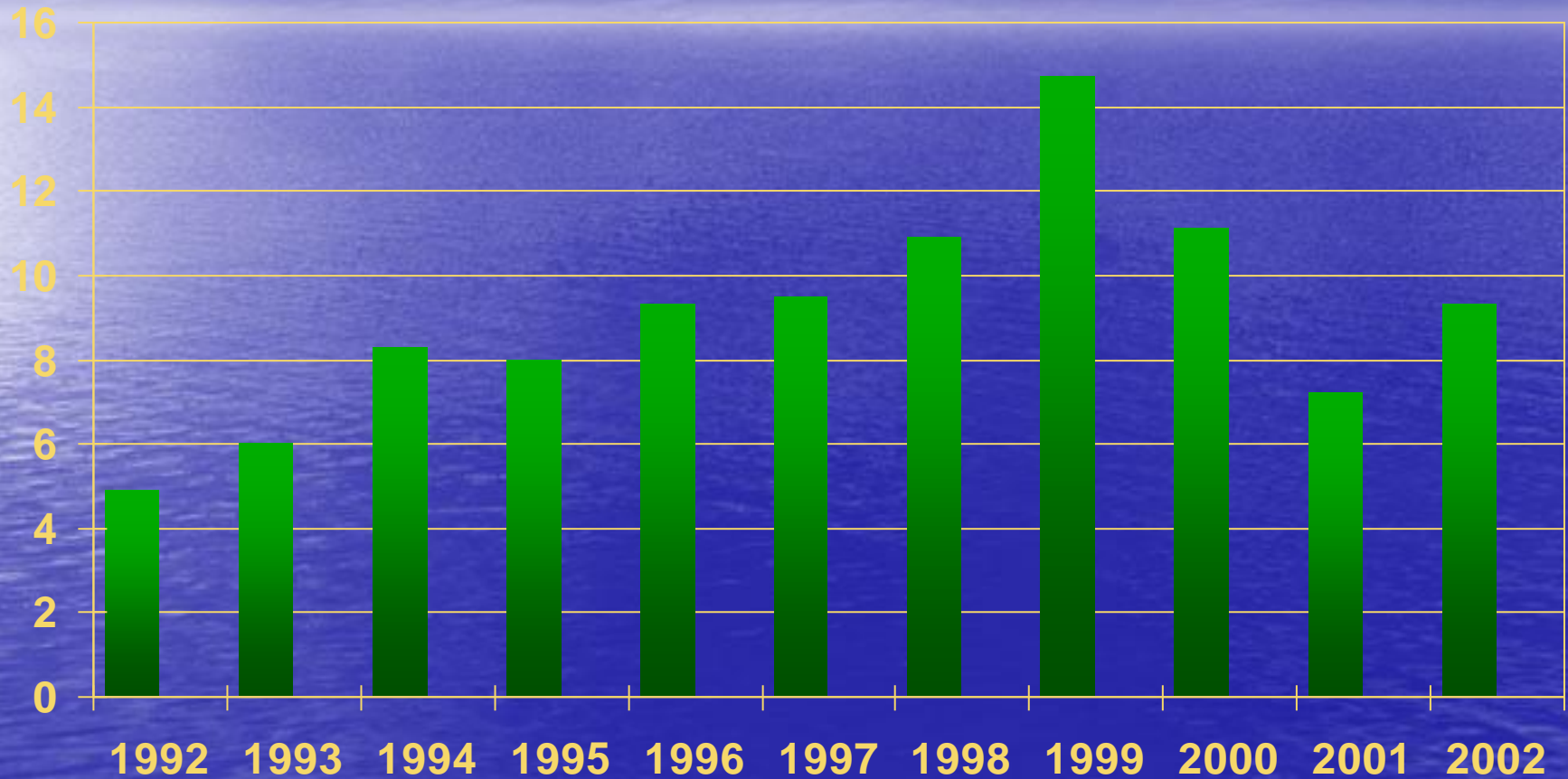


# Current Account (Mn. \$)

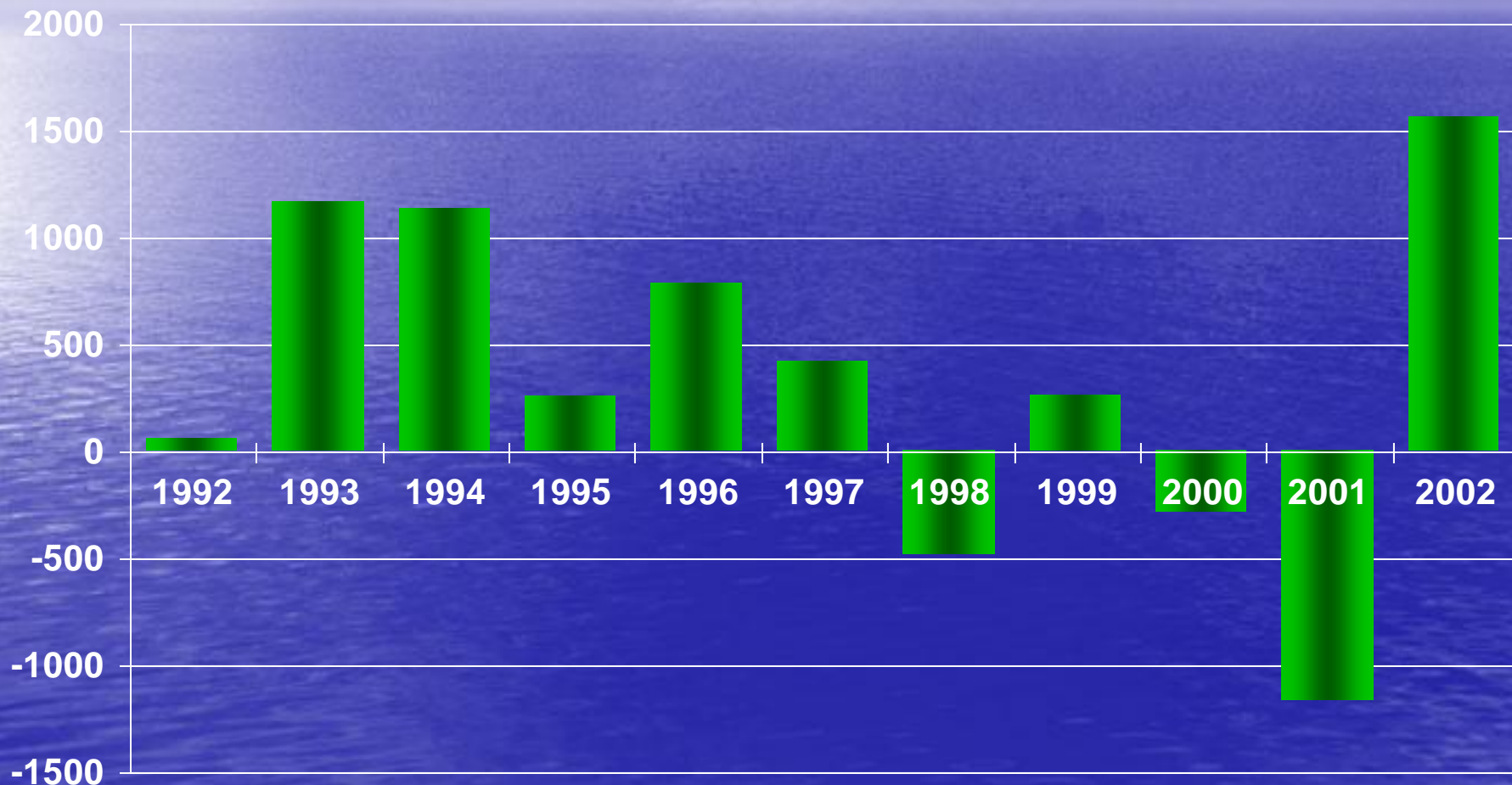
Forecast for 2002-2007



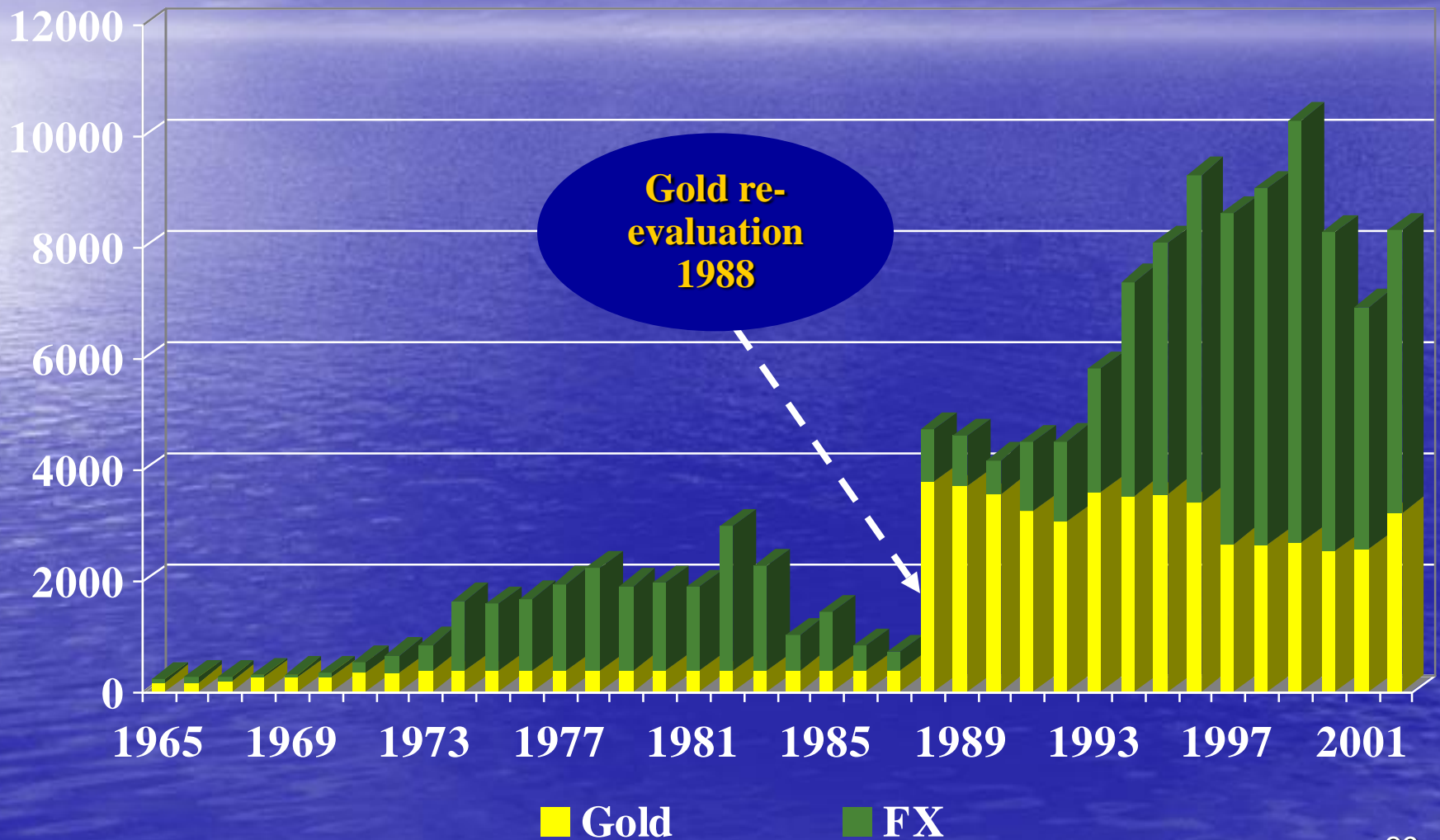
# IMPORT COVERAGE (# of months)



# BALANCE OF PAYMENTS (Mn \$)



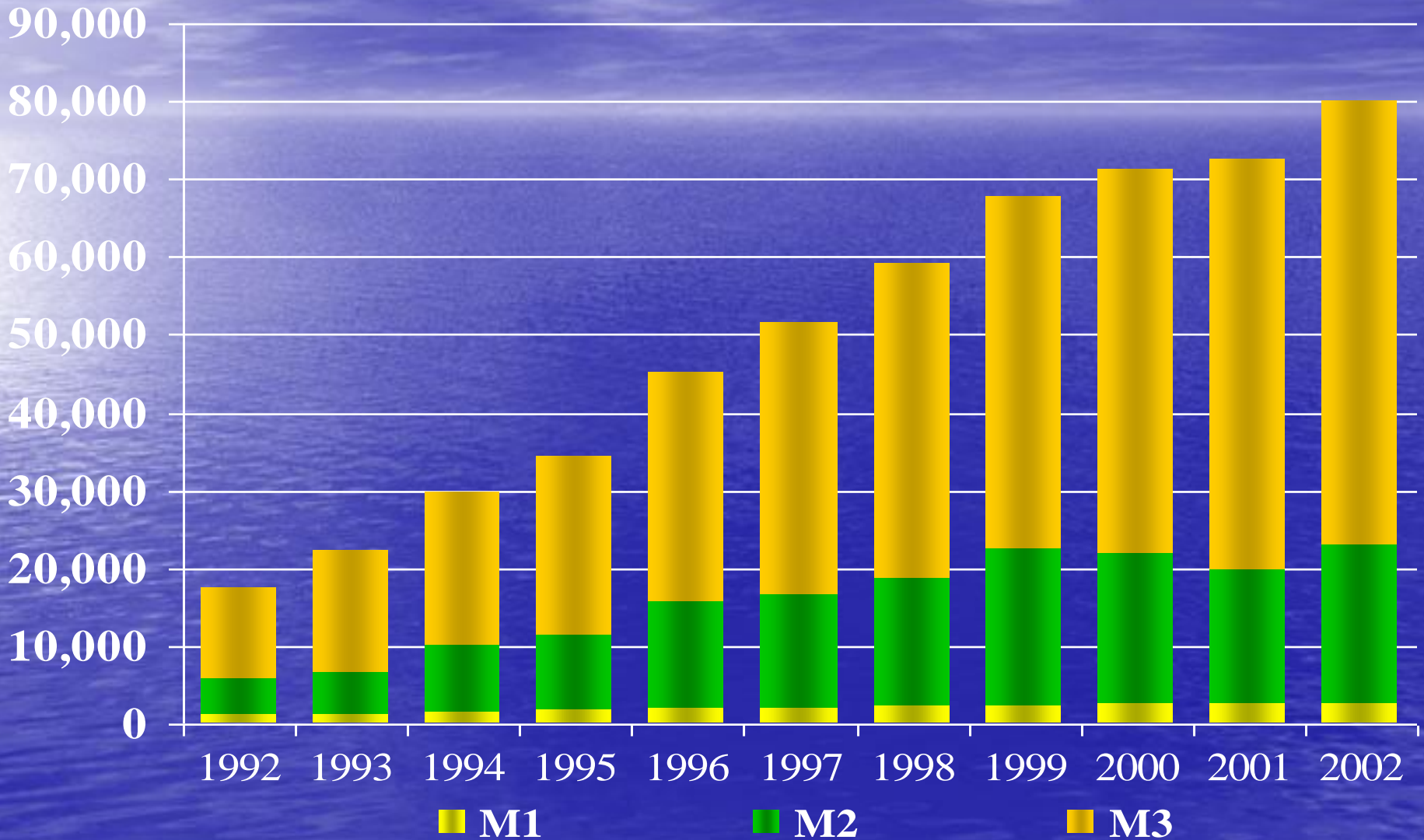
# BDL INTERNATIONAL RESERVES, 1965-2002 (Millions US\$)



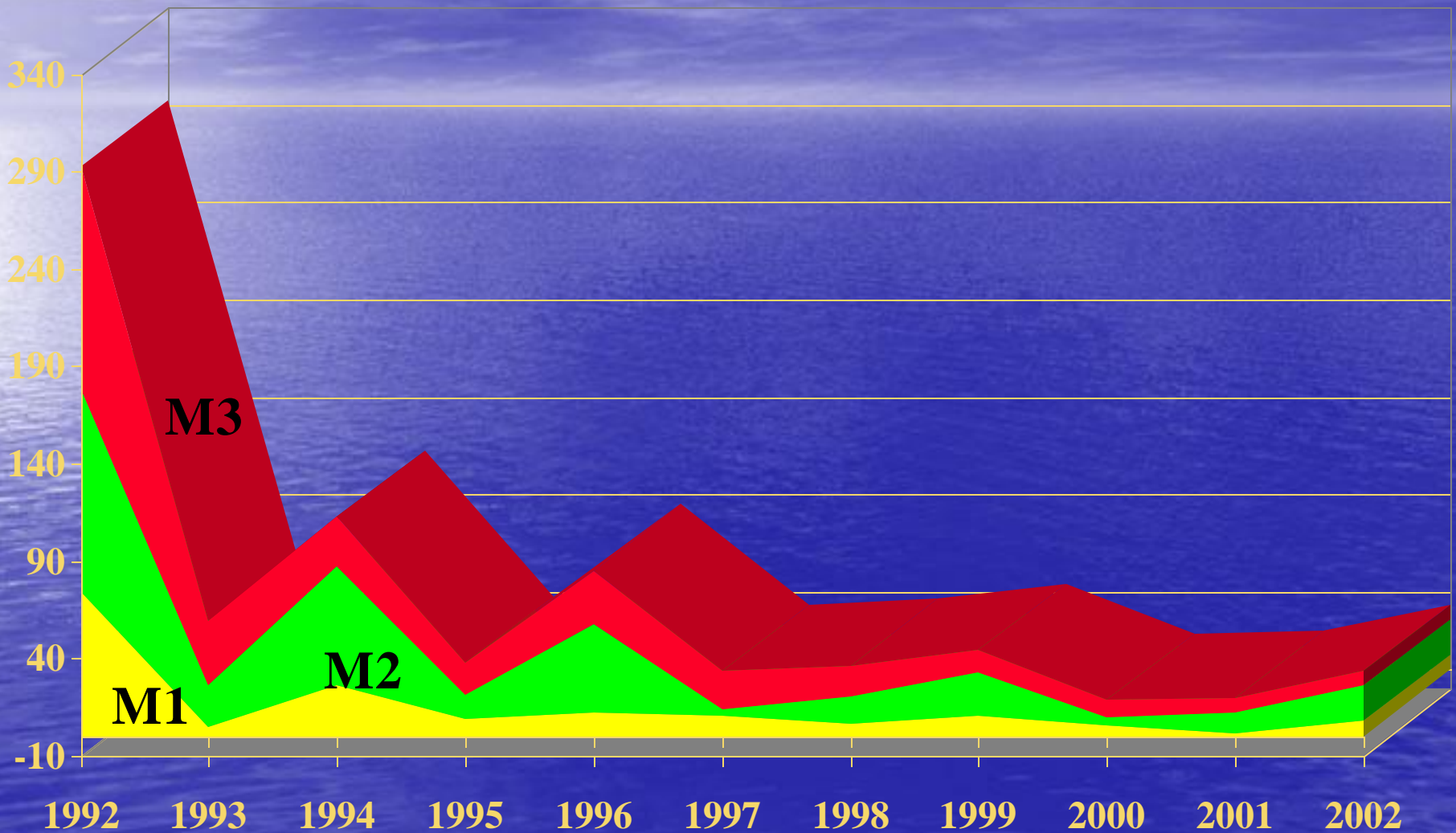
# Economic Stabilization: Monetary Policy Aims

- Monetary Policy Geared to Achieve Lower Inflation in Line with Trading Partners.
- Achieve Gradual De-Dollarization.
- Temporary Sterilization of Capital Inflows.
- Tight Money Leading to High Nominal & Real Interest Rates.

# Monetary Aggregates (LBP Bn.)

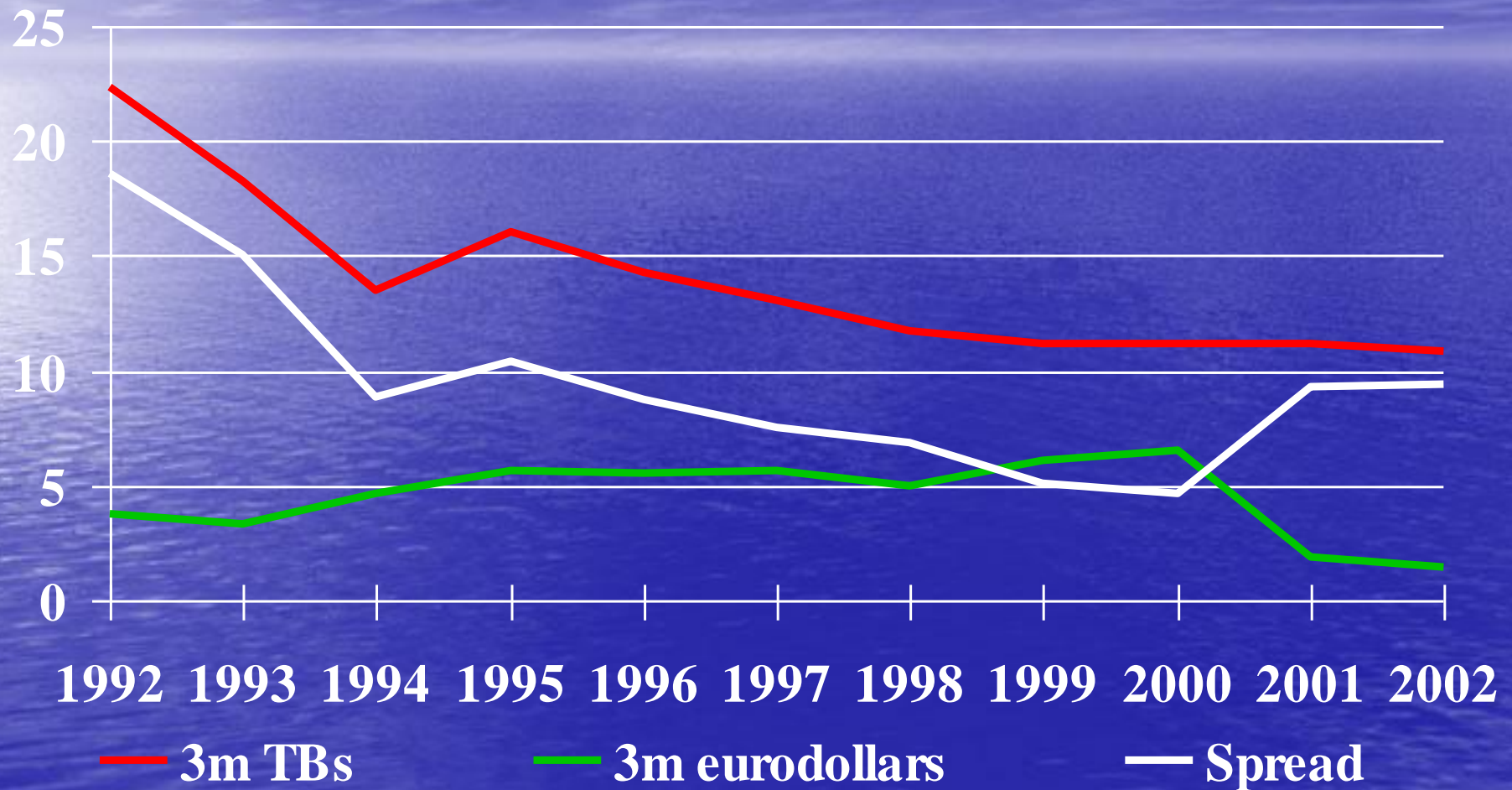


# MONEY GROWTH RATES %

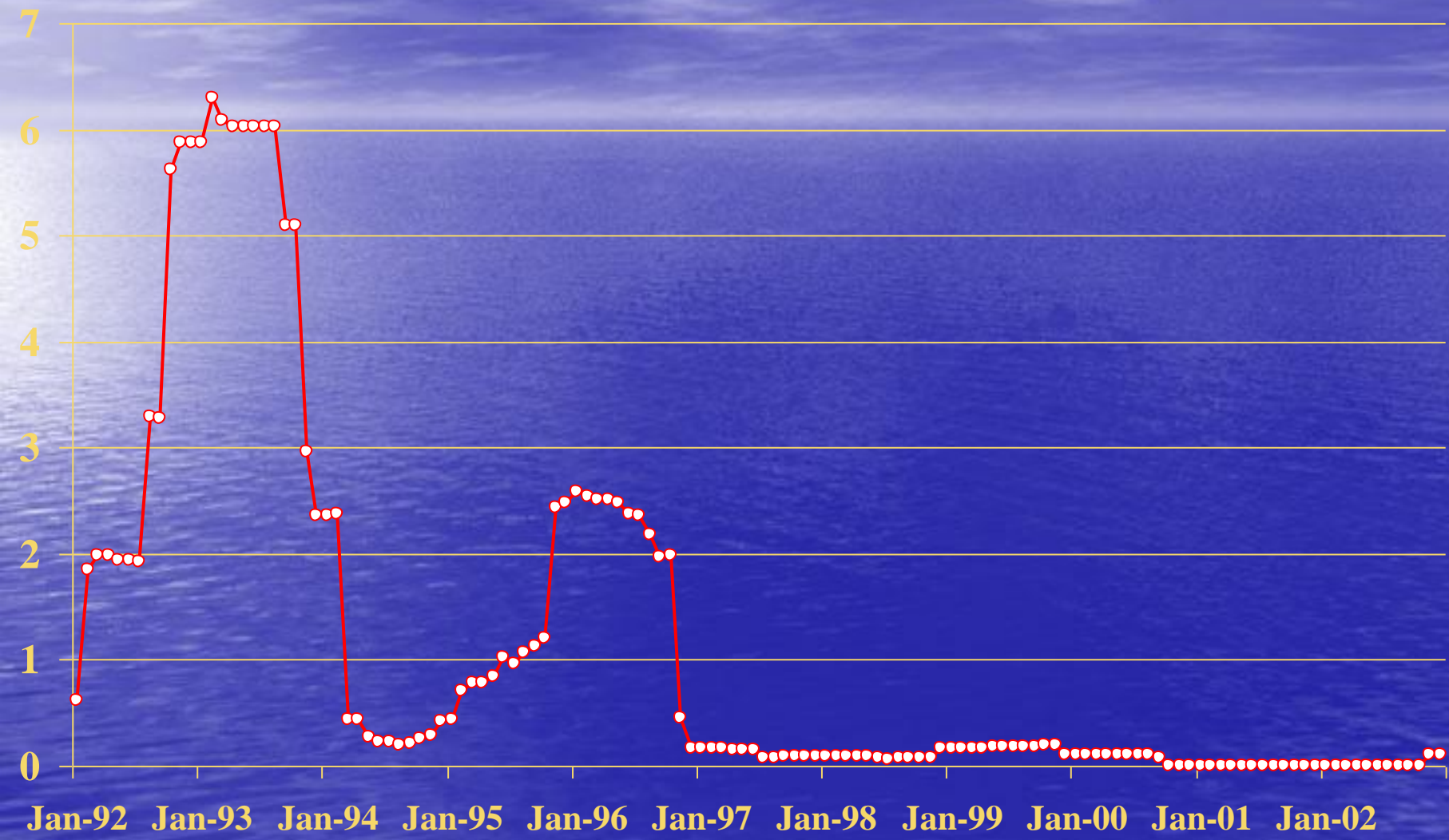




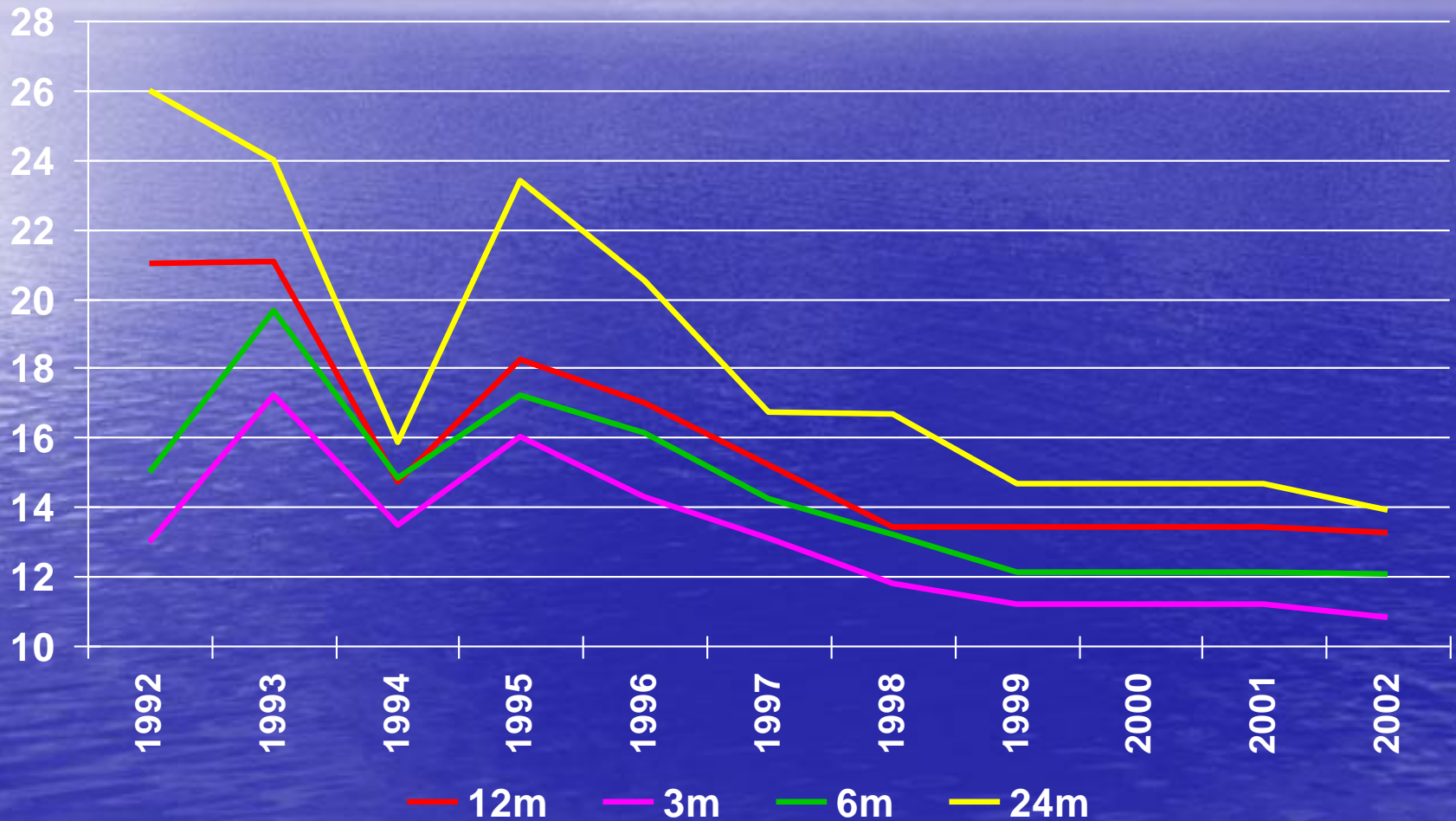
# INTEREST RATE DIFFERENTIAL



# VOLATILITY 3-MONTH TB RATE



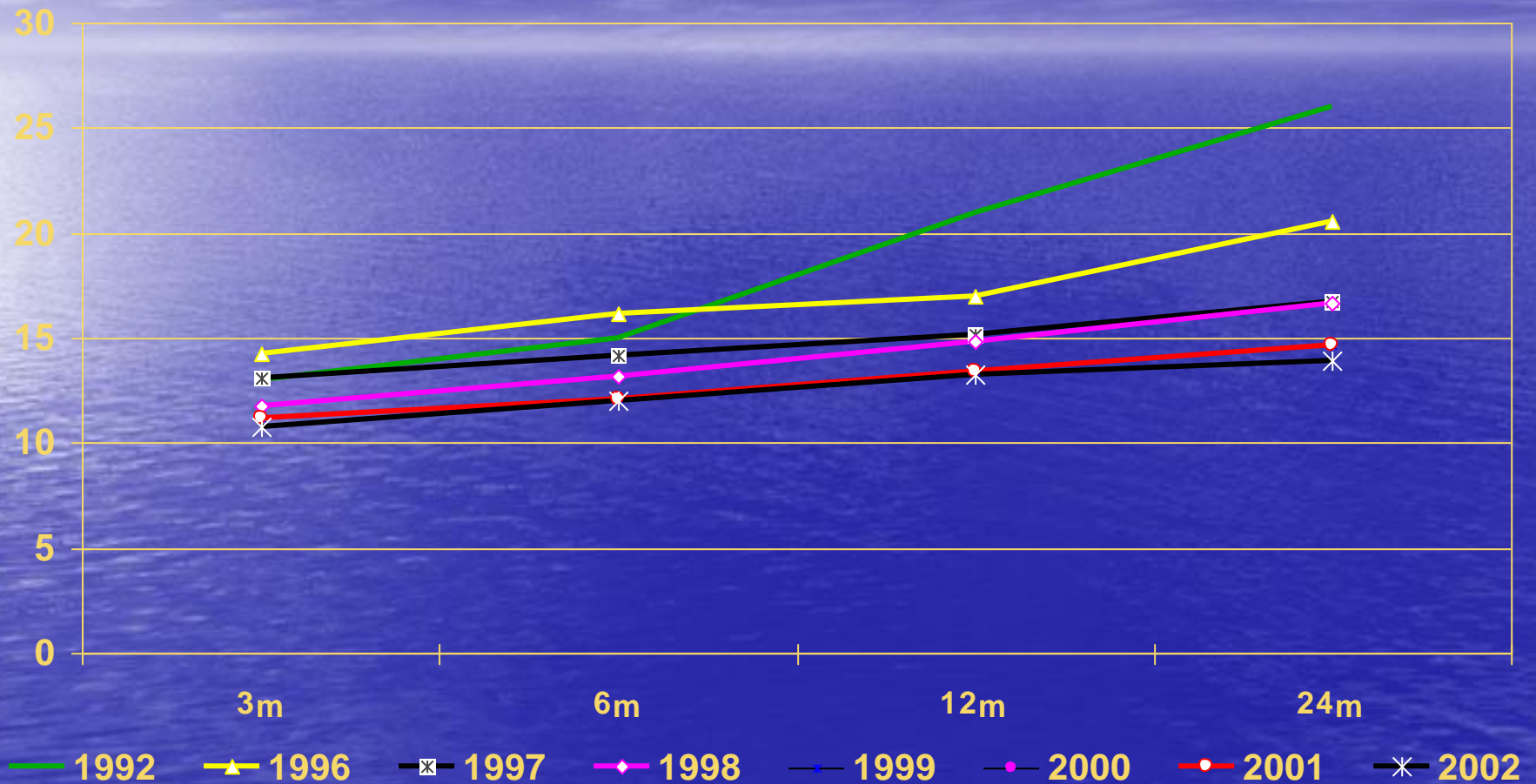
# TB RATES, 1992-2002



# TB RATES, 1997-2002

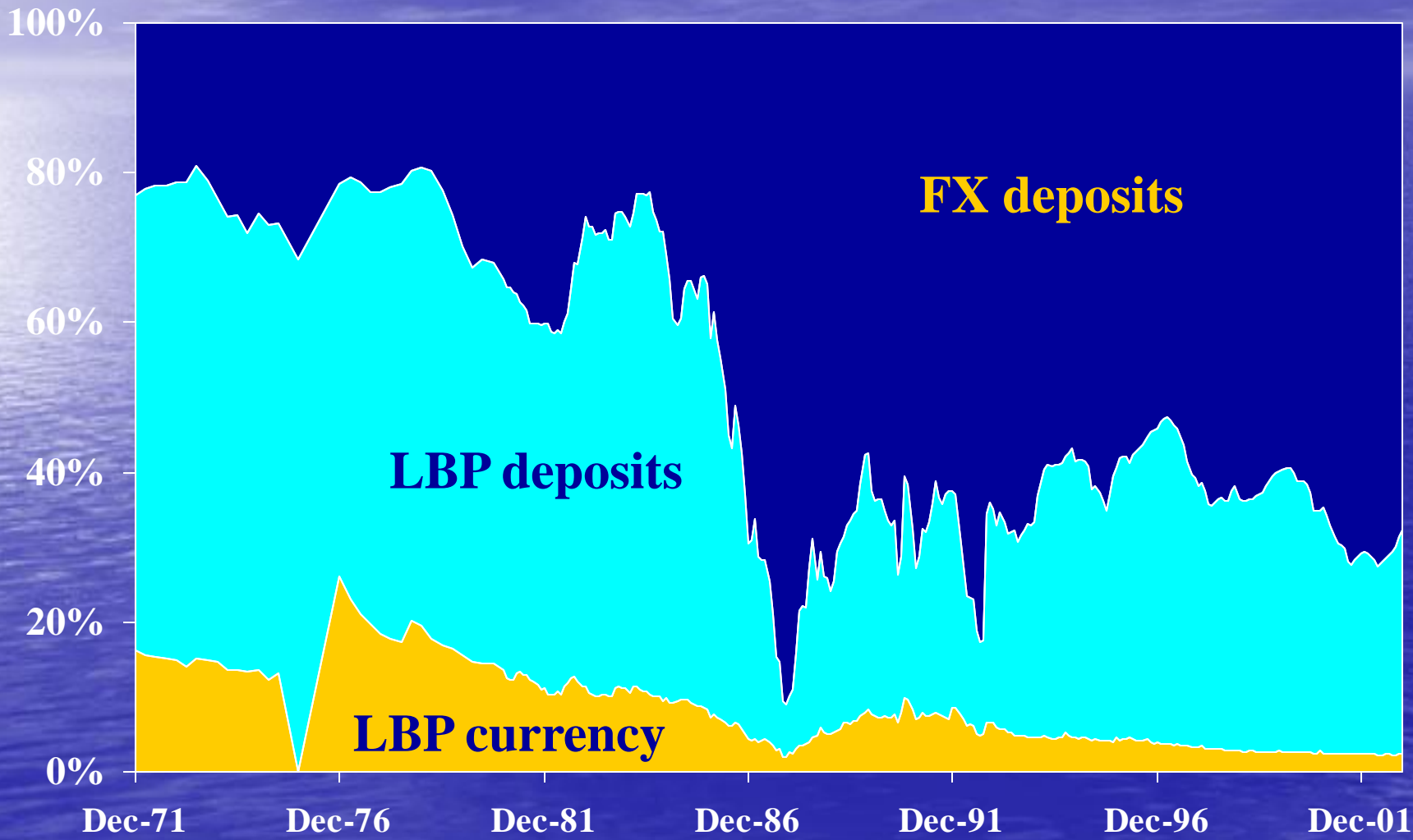
	<b>3m</b>	<b>6m</b>	<b>12m</b>	<b>24m</b>
<b>1997</b>	<b>13.09</b>	<b>13.97</b>	<b>15.20</b>	<b>16.73</b>
<b>1998</b>	<b>11.77</b>	<b>13.21</b>	<b>14.84</b>	<b>16.66</b>
<b>1999</b>	<b>11.18</b>	<b>12.12</b>	<b>13.43</b>	<b>14.64</b>
<b>October 2002</b>	<b>11.18</b>	<b>12.12</b>	<b>13.43</b>	<b>14.64</b>
<b>November 2002</b>	<b>10.80</b>	<b>12.05</b>	<b>13.28</b>	<b>13.93</b>
<b>December 2002</b>	<b>7.77</b>	<b>9.15</b>	<b>9.13</b>	<b>9.20</b>

# YIELD CURVE

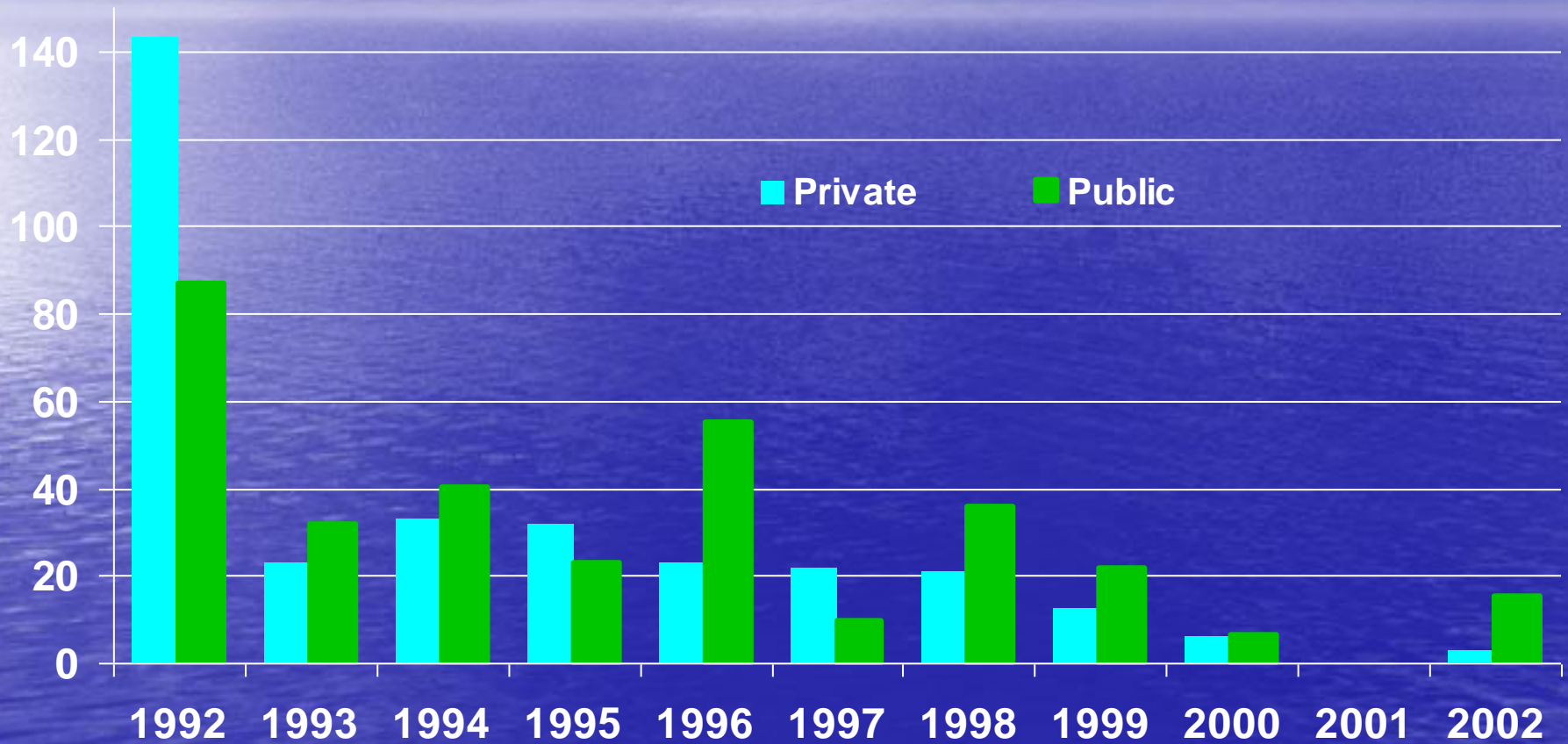


# COMPOSITION OF TOTAL LIQUIDITY %

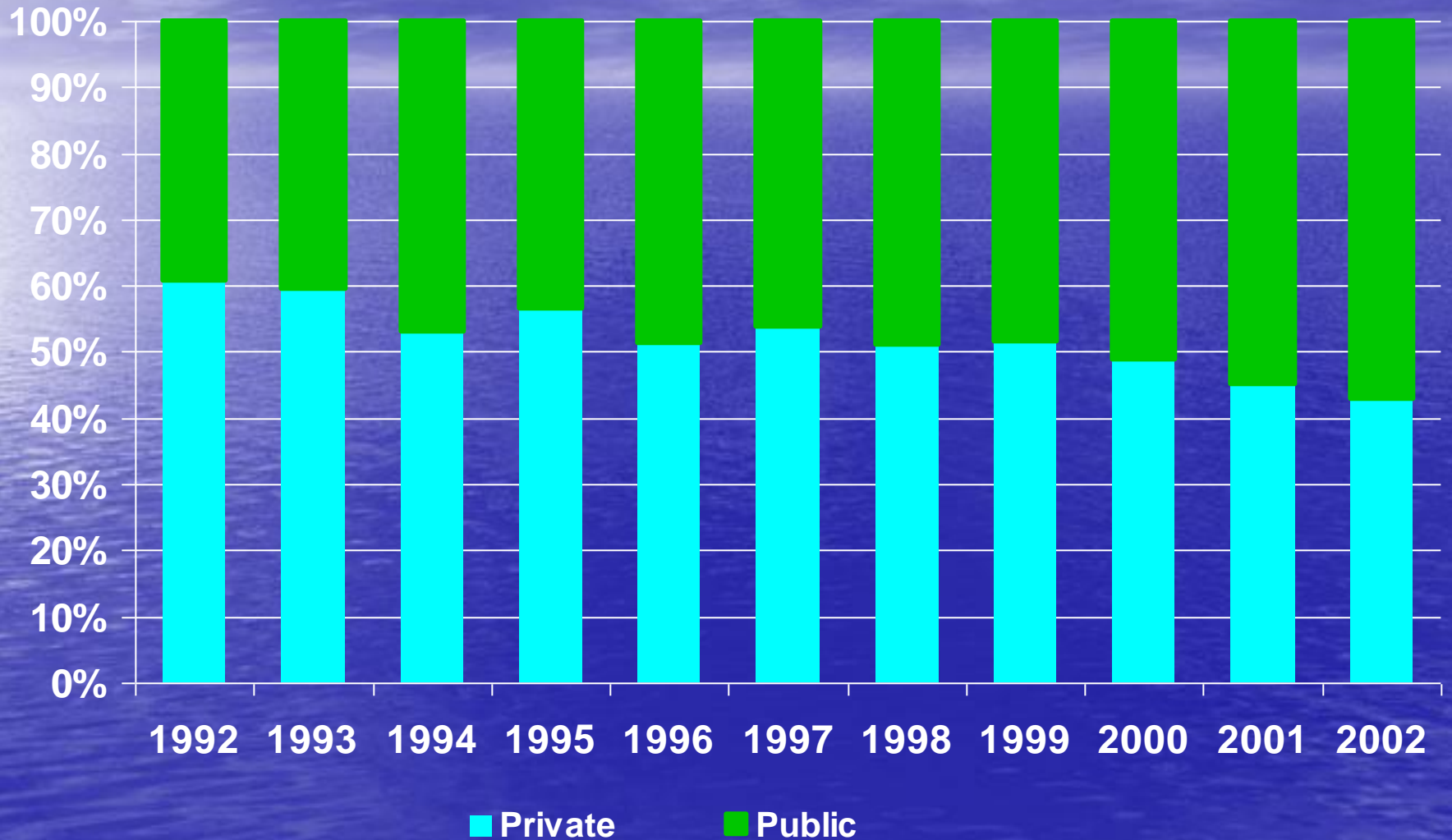
(December 1971 - December 2002)



# DOMESTIC CREDIT GROWTH % (by sector)

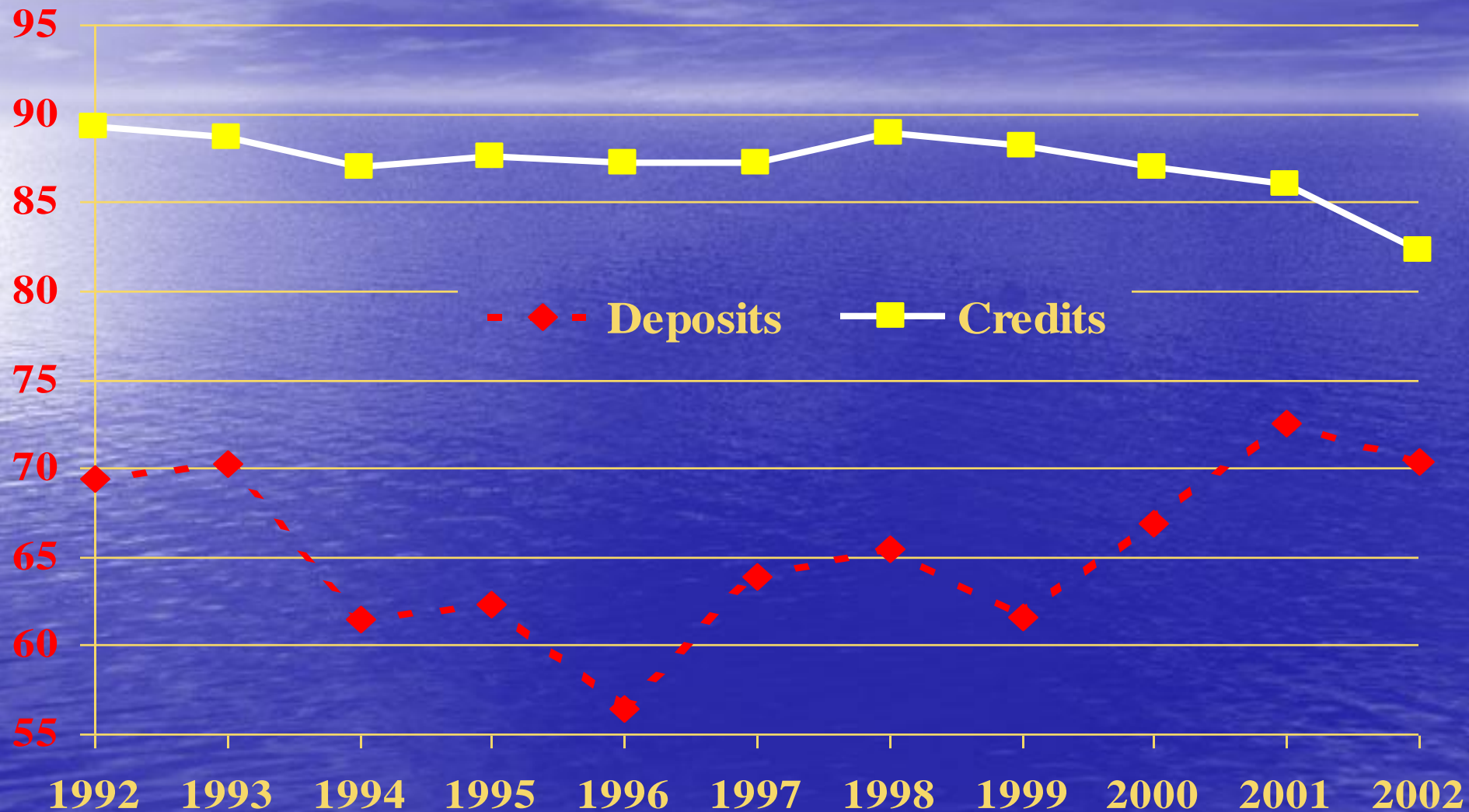


# DISTRIBUTION DOMESTIC CREDIT





# DOLLARISATION RATES

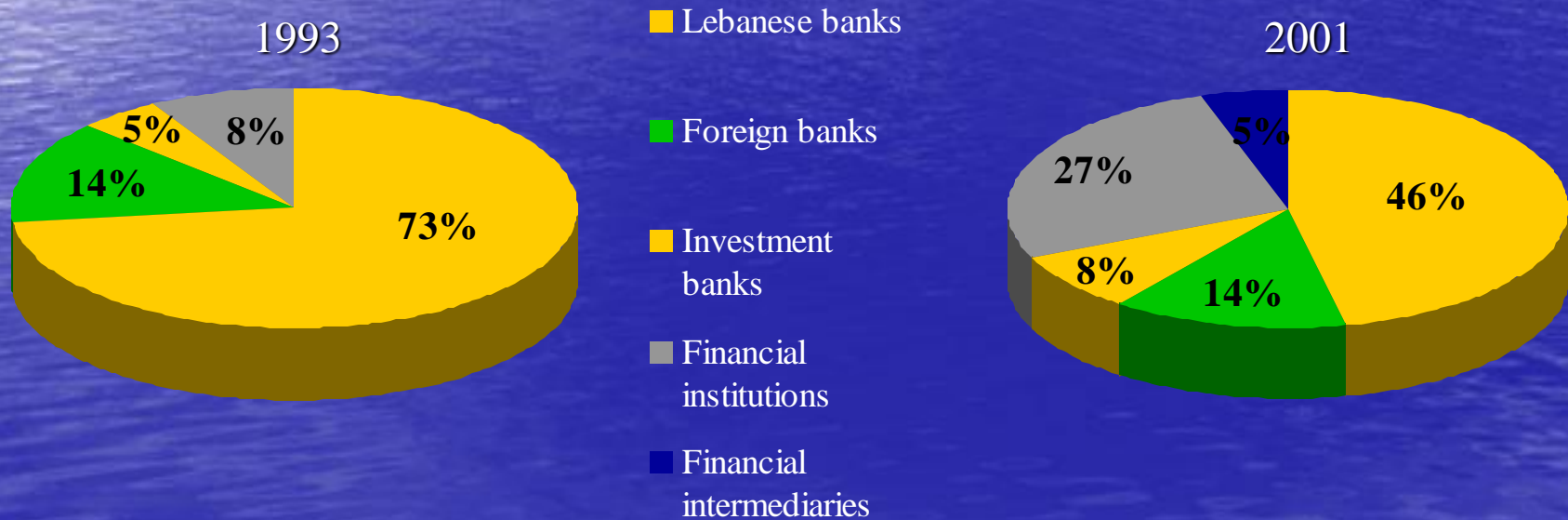


# BANKING AND FINANCIAL SECTOR

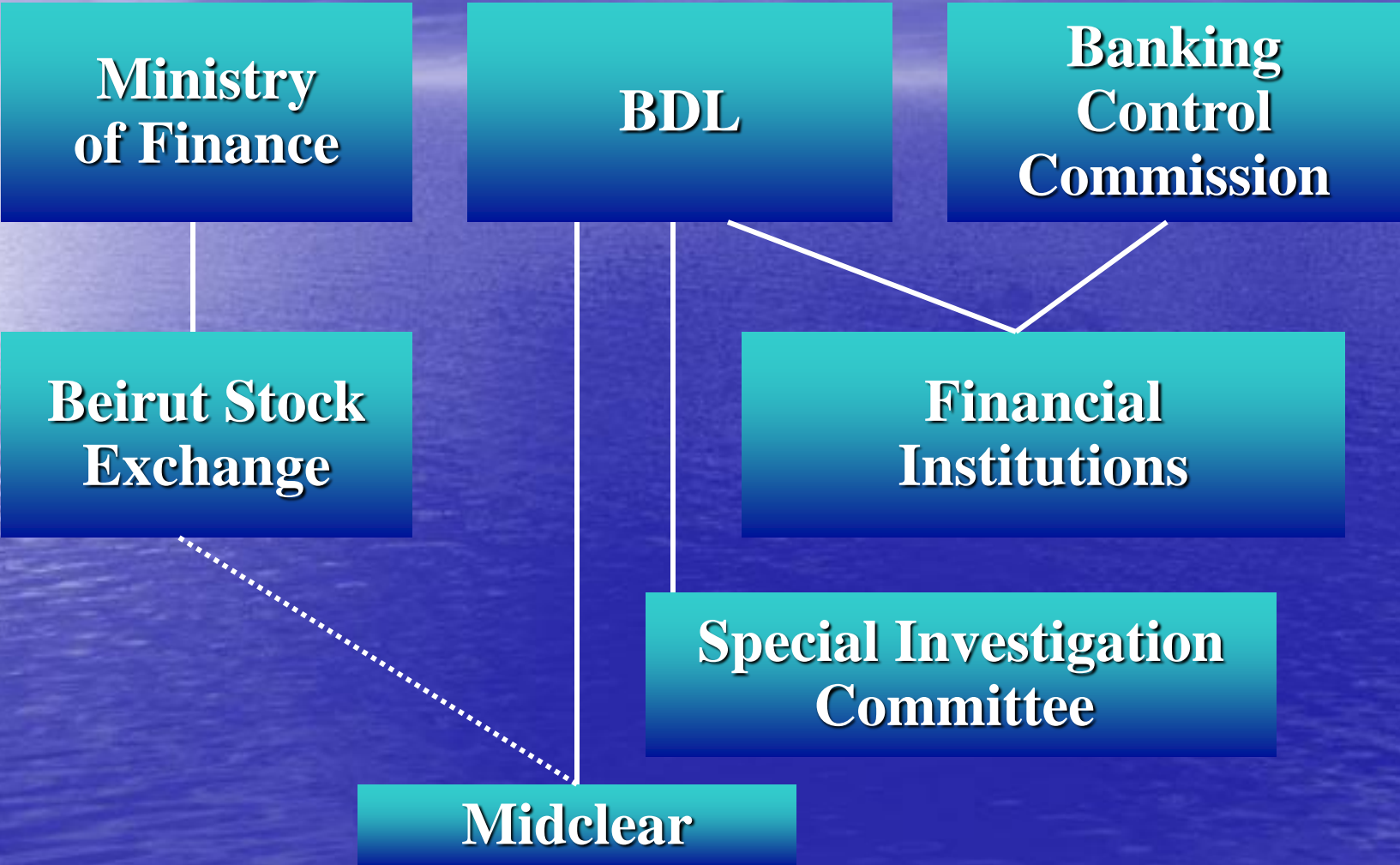
- Structure
- Financial performance
- Regulatory performance

# STRUCTURE OF THE FINANCIAL SECTOR I

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Commercial banks	74	74	74	75	71	70	67	62	61
o/w lebanese banks	62	62	61	61	56	54	51	48	47
o/w foreign banks	12	12	13	14	15	16	16	14	14
Investment banks	4	5	5	8	8	8	7	7	8
Financial institutions	7	11	14	18	20	23	23	26	27
Financial intermediaries	-	-	-	-	3	3	5	5	5



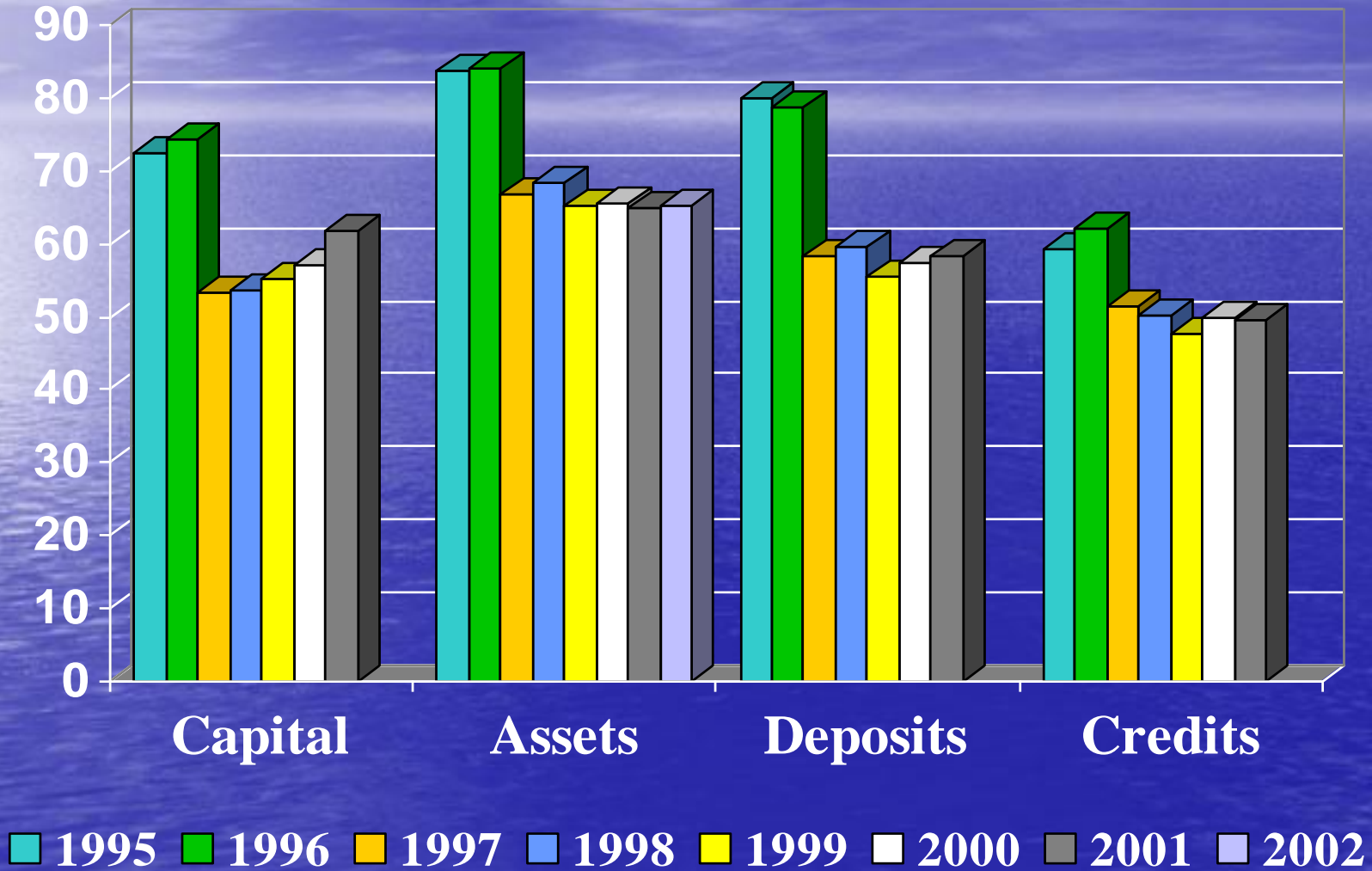
# STRUCTURE OF THE FINANCIAL SECTOR II



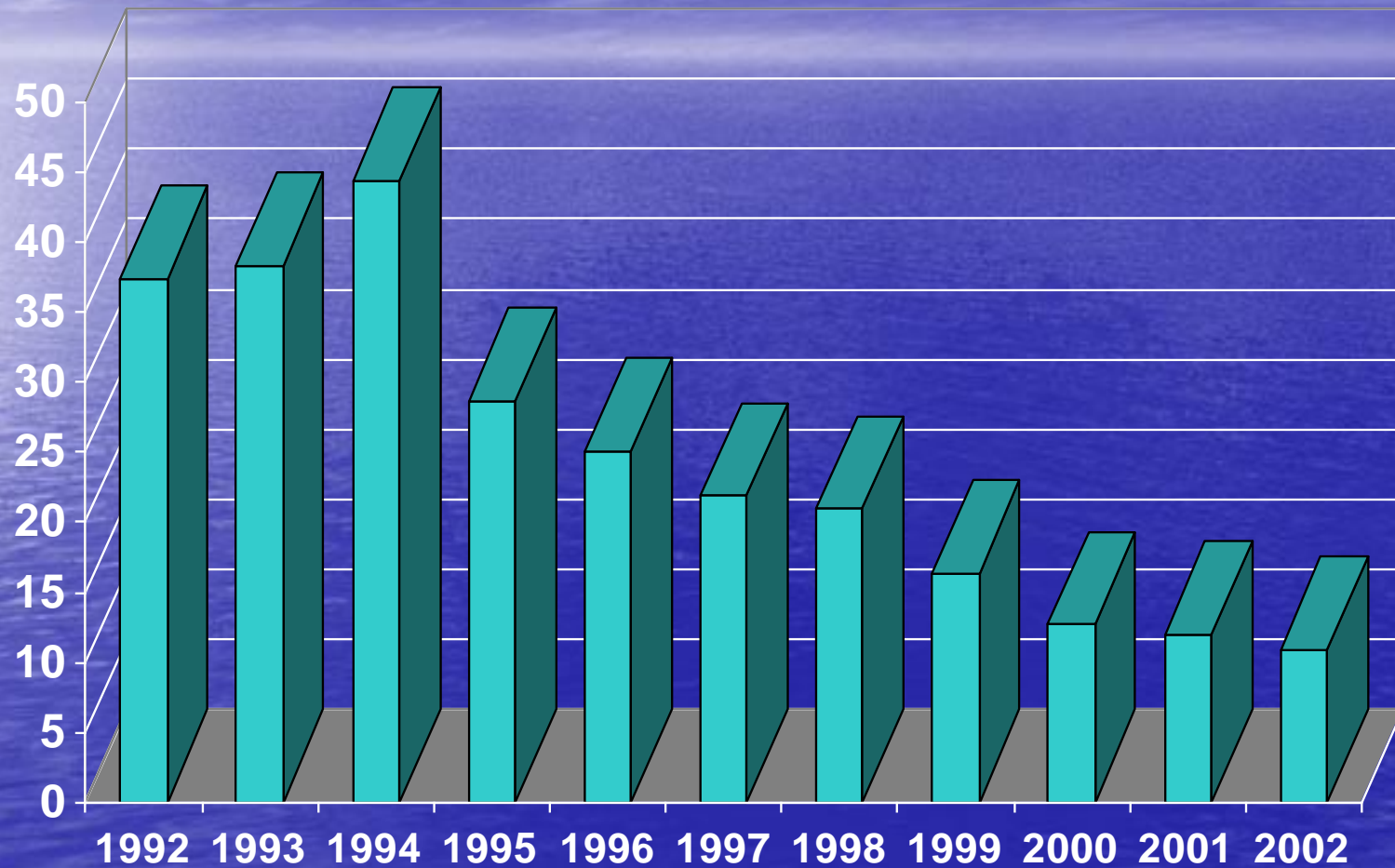
# Banking Control & Supervision

- Independent, Professional Banking Control Commission
- Apply international norms and standards; Basel Core Principles (augmented)
- Independent External Auditors
- Internal Audit and Controls
- Internal Committees to control and manage risks
- Separation of ownership from management
- Supplement by Market Supervision and Control whenever possible

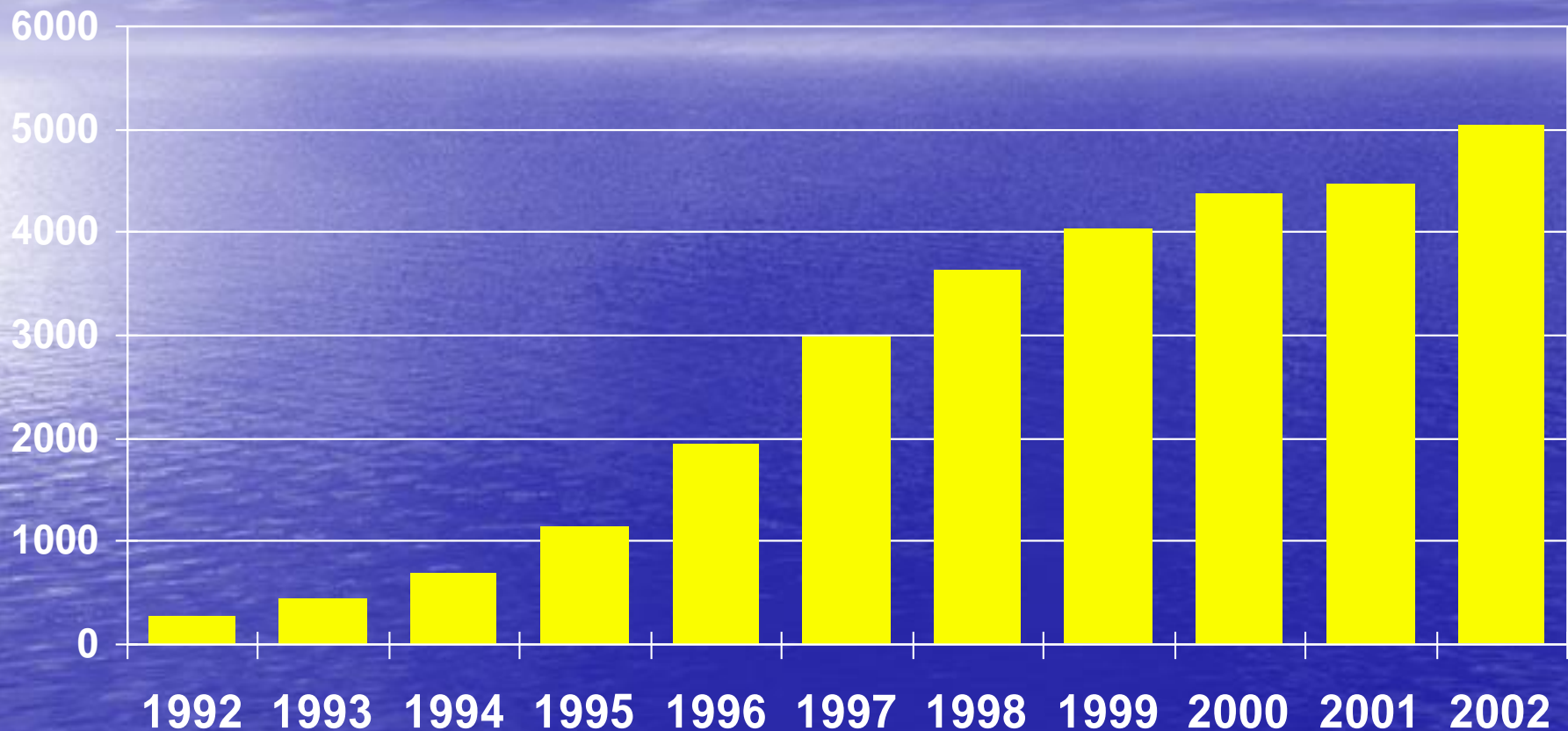
# BANKING CONCENTRATION (Largest 10 banks shares in percent)



# BANKS' RETURN ON EQUITY

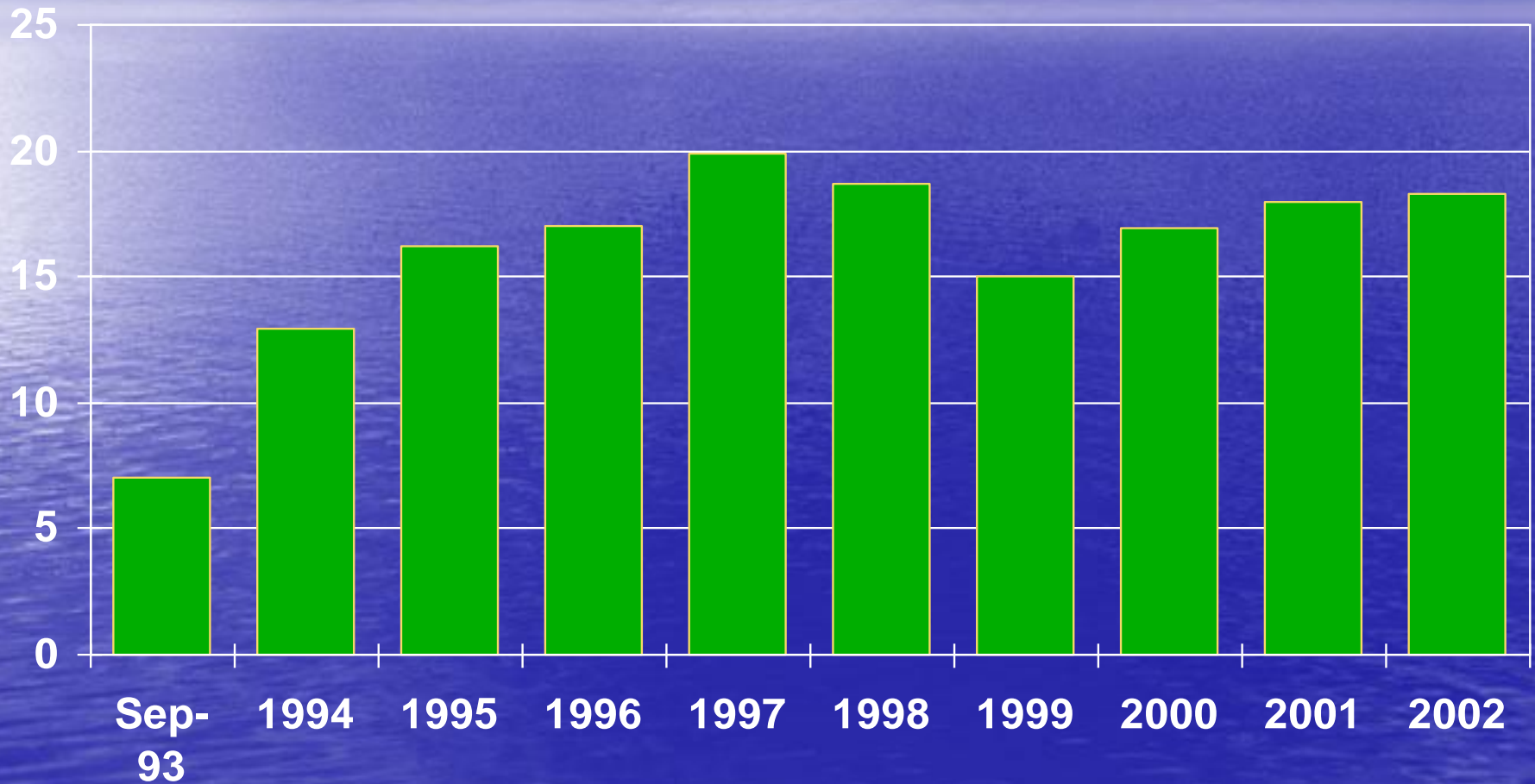


# BANKS' CAPITAL, LBP Bn.

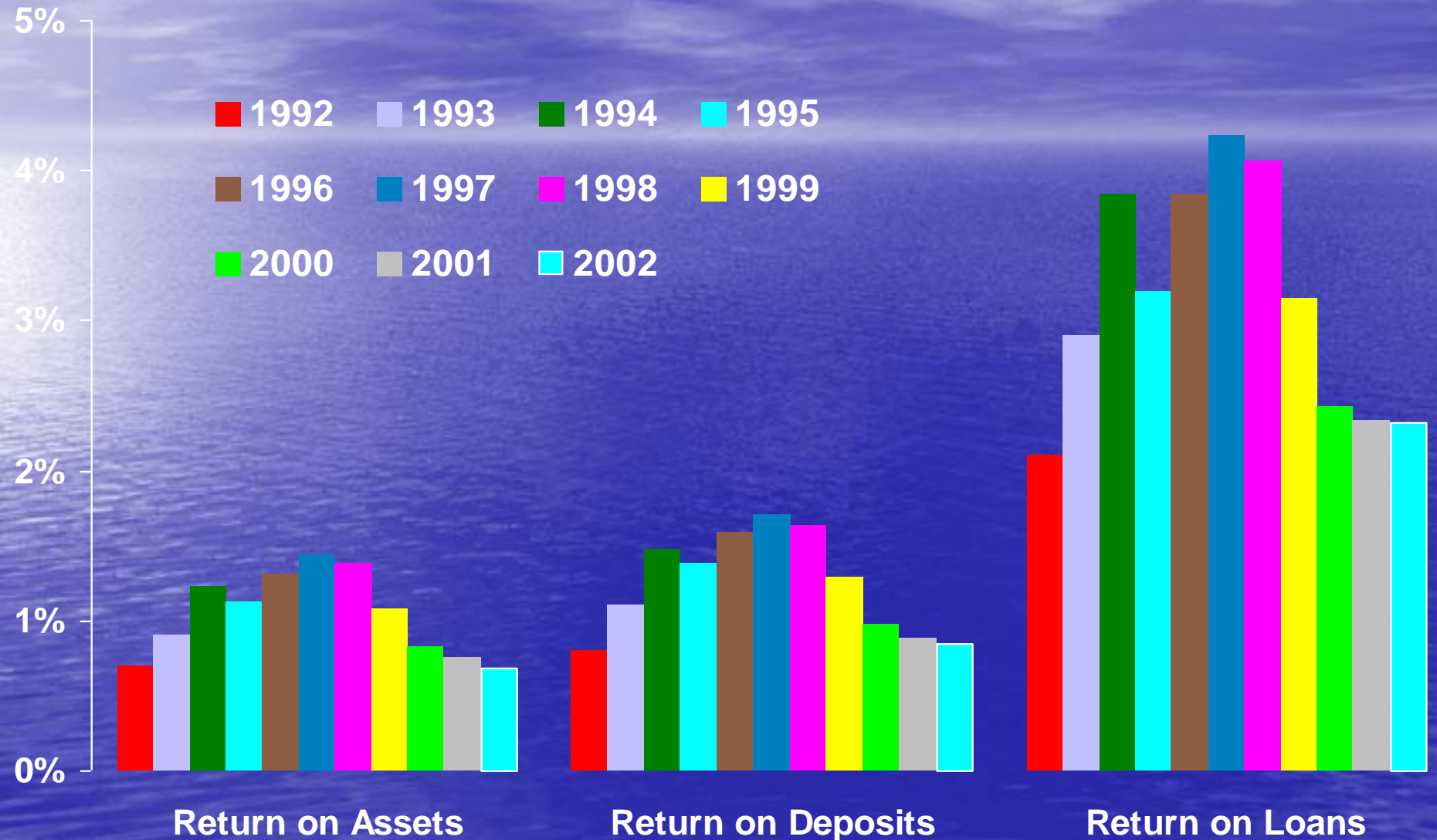




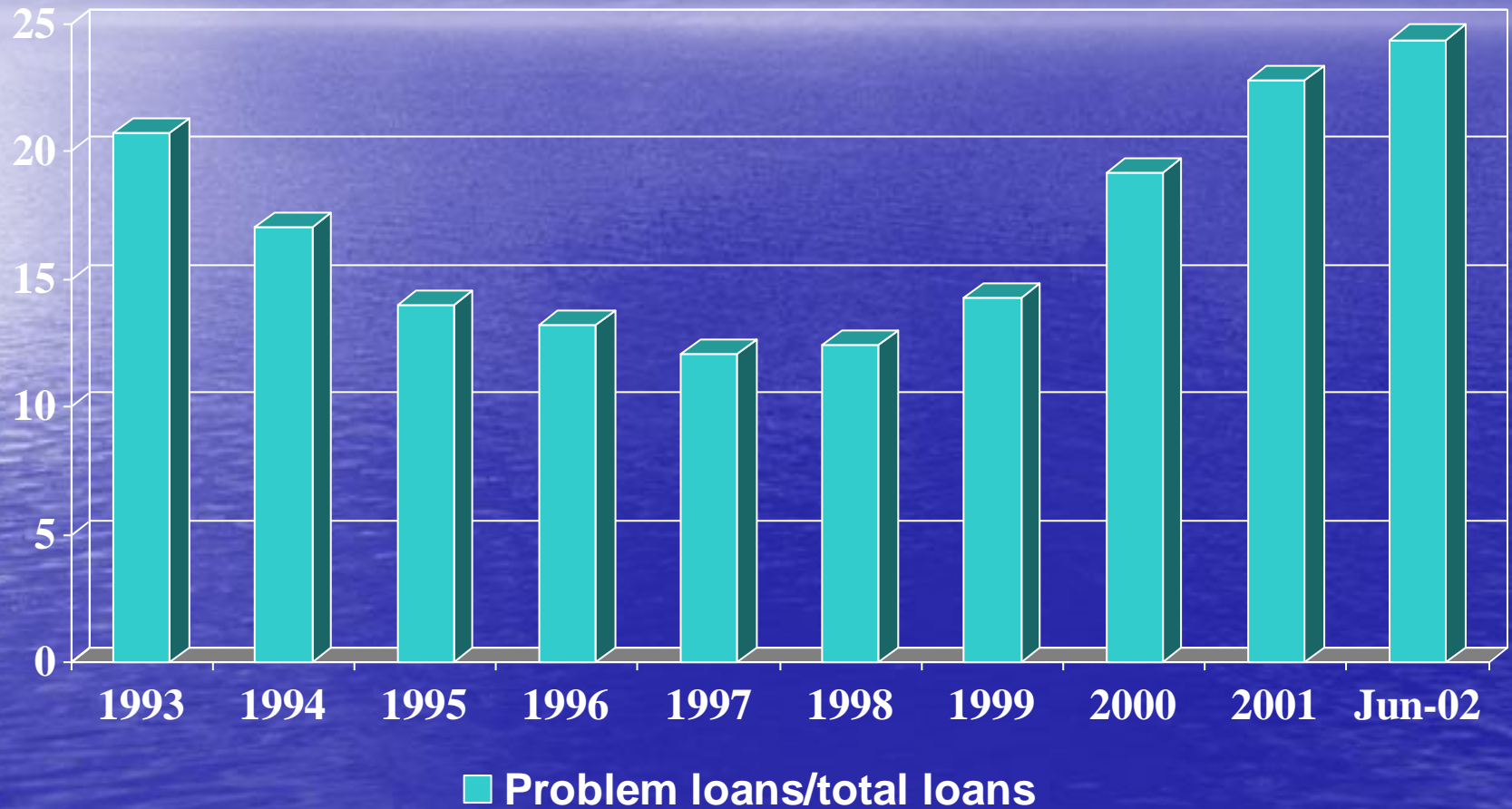
# CAPITAL ADEQUACY RATIO



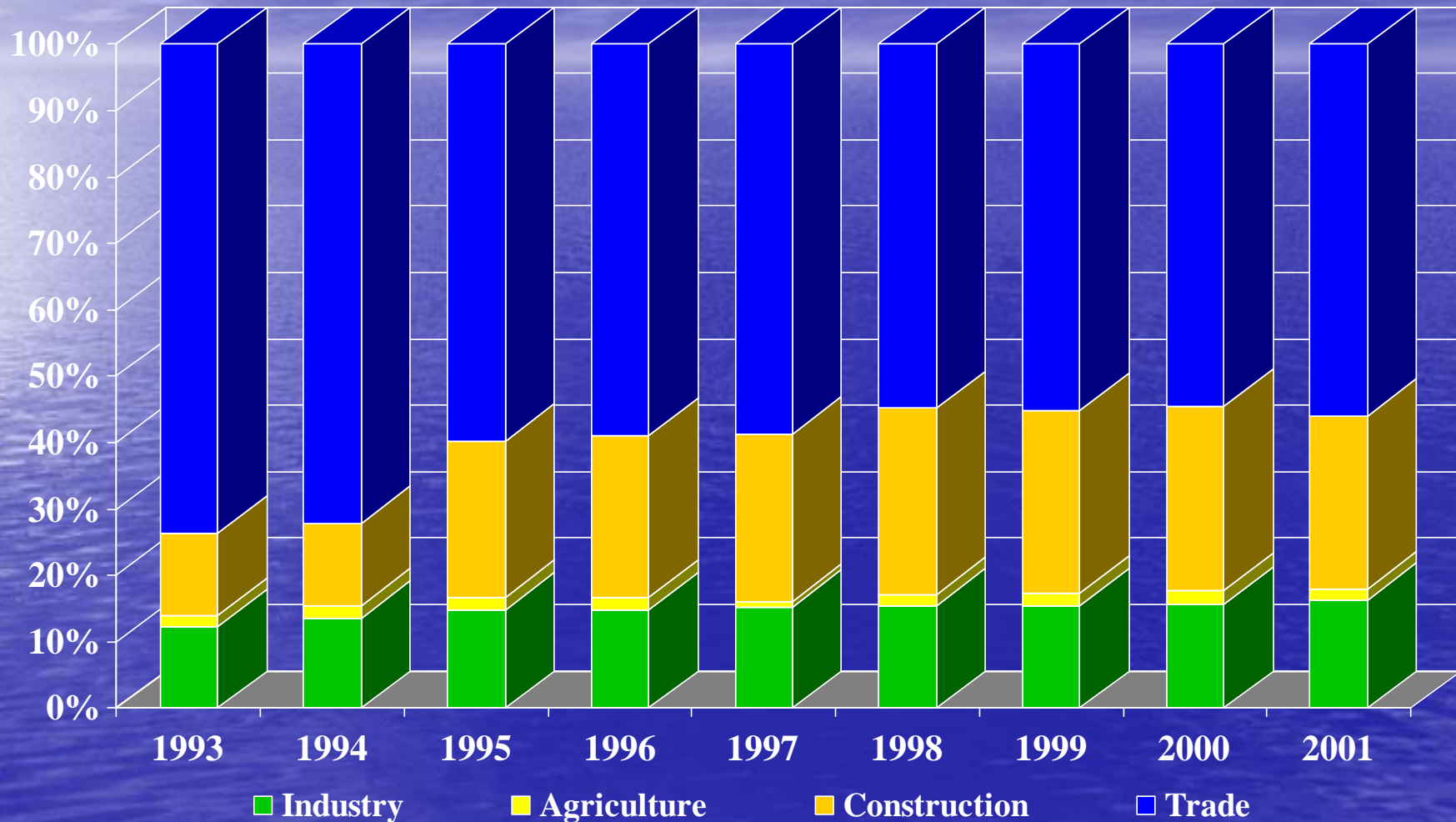
# BANKING SECTOR PERFORMANCE



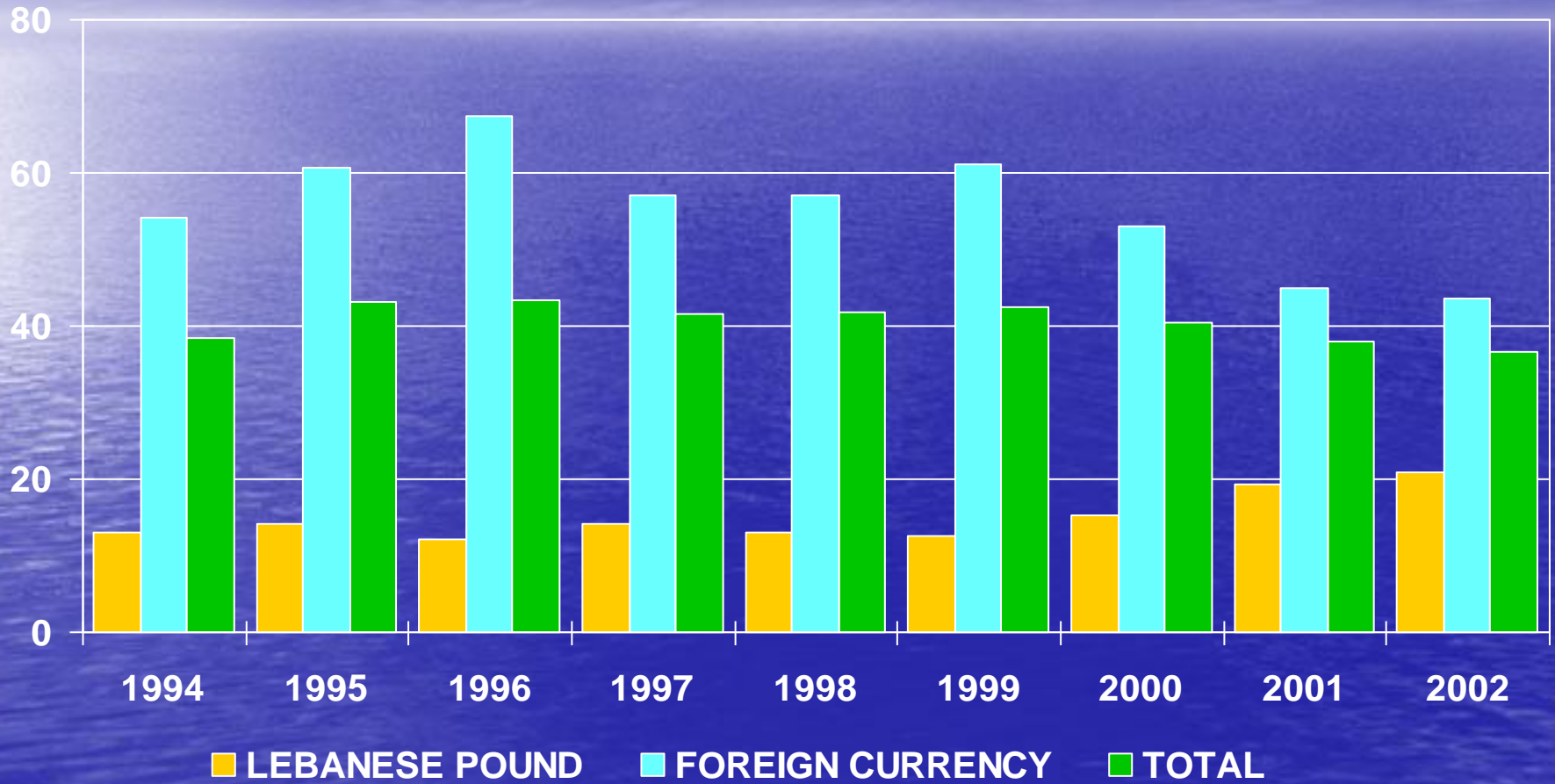
# INDICATORS OF BANKING SYSTEM'S FINANCIAL STRENGTH (1)



# SECTORAL DISTRIBUTION OF BANKING CREDIT



# LIQUIDITY OF THE LEBANESE BANKS (Ratio Credits to Deposits)



# PROFITS GROWTH

USD Mn

%



# Stabilization Policy: Tax Reform

- Improvement in Tax Collection Efforts
- Personal Income Tax Rates Reduced
- Corporate Tax Rate Reduced
- Introduction of the VAT (Feb. 2002)

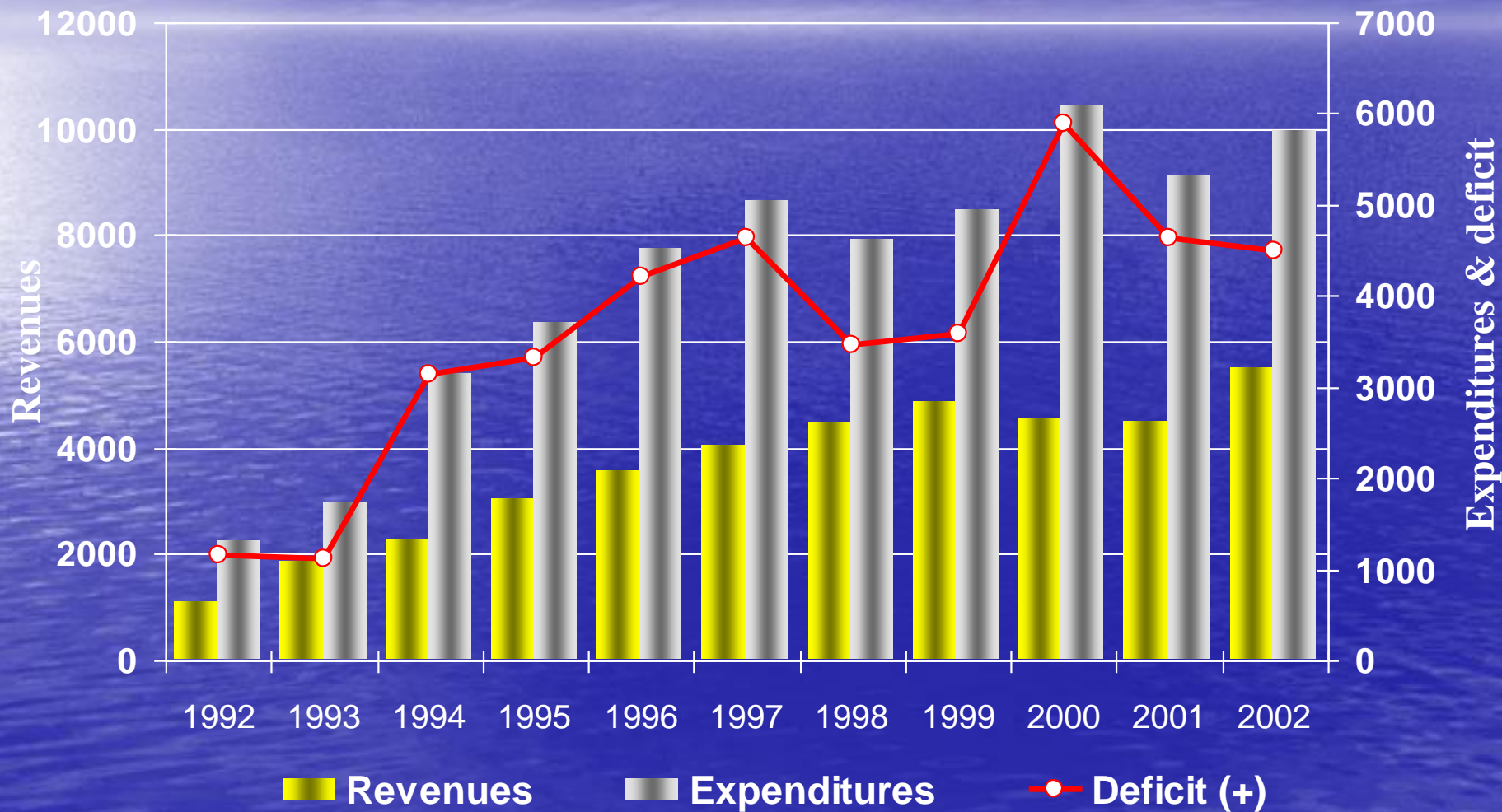
# Stabilization Policy: Fiscal Policy

- Increased Revenue Collection
- Control of Budgetary Deficits
- Increase in Public Utilities Prices
- Reliance on Domestic Debt

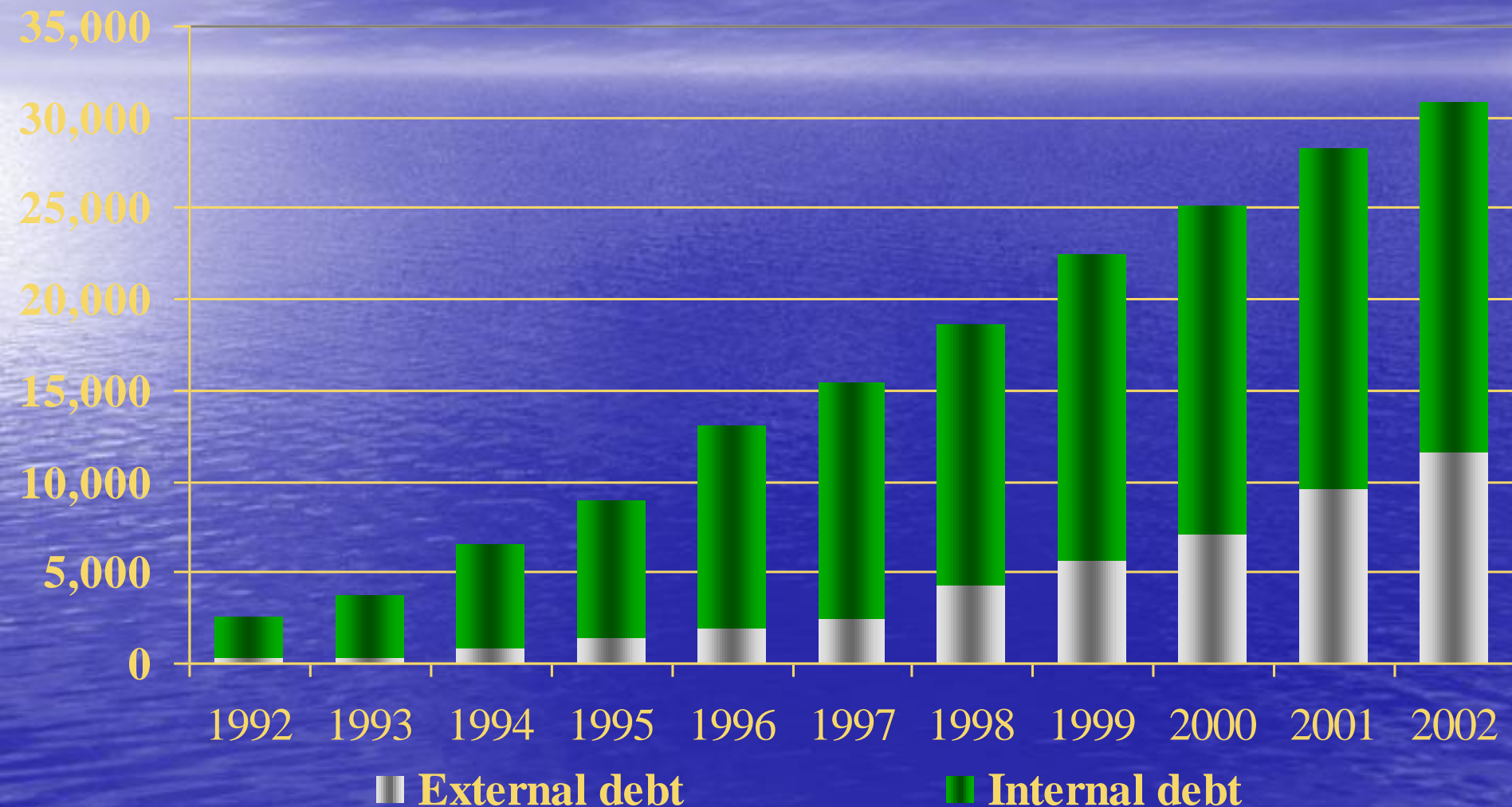


# PUBLIC SECTOR OPERATIONS

(Bn LL)

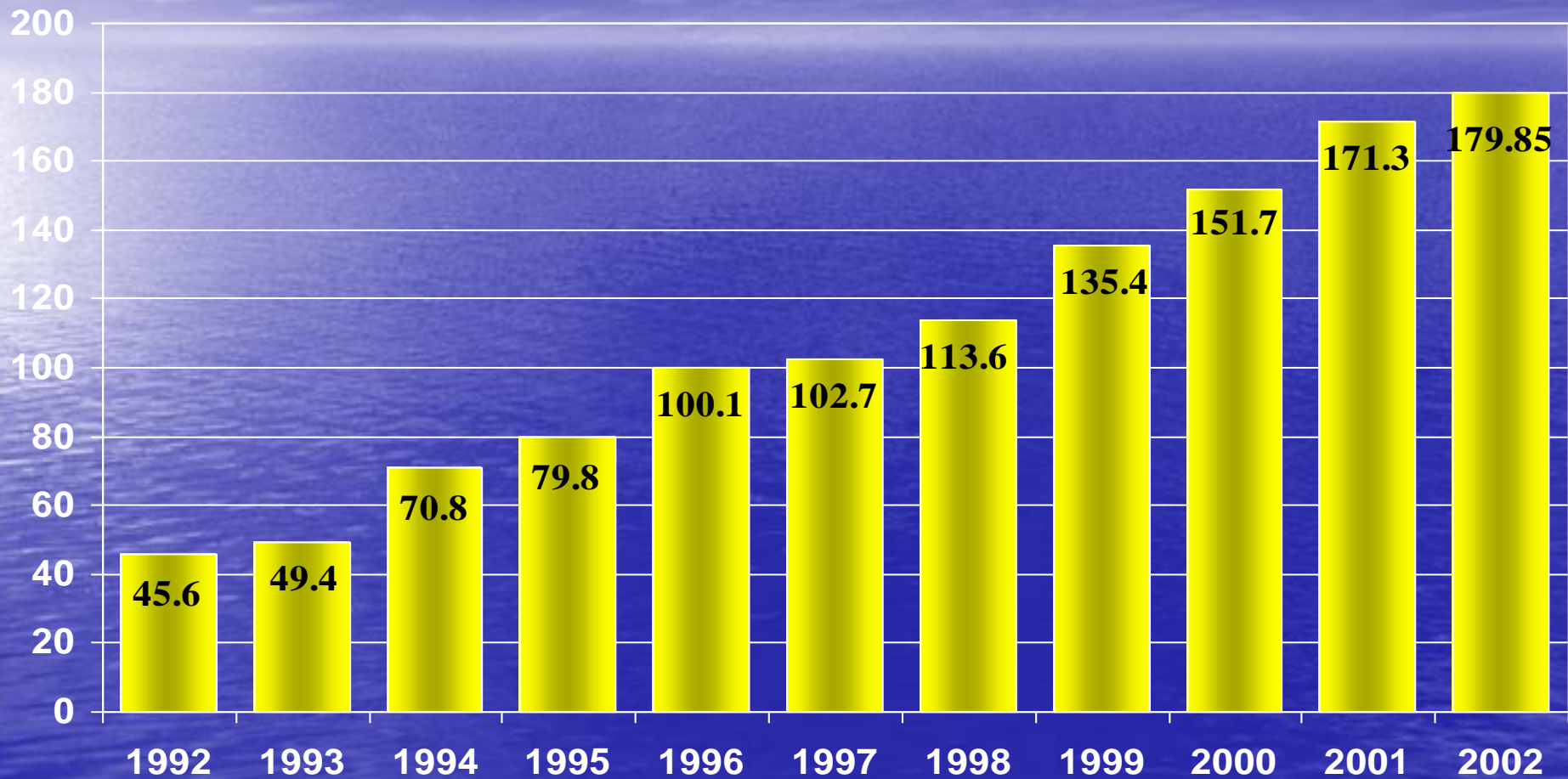


# GROSS PUBLIC SECTOR DEBT (Million of US\$)

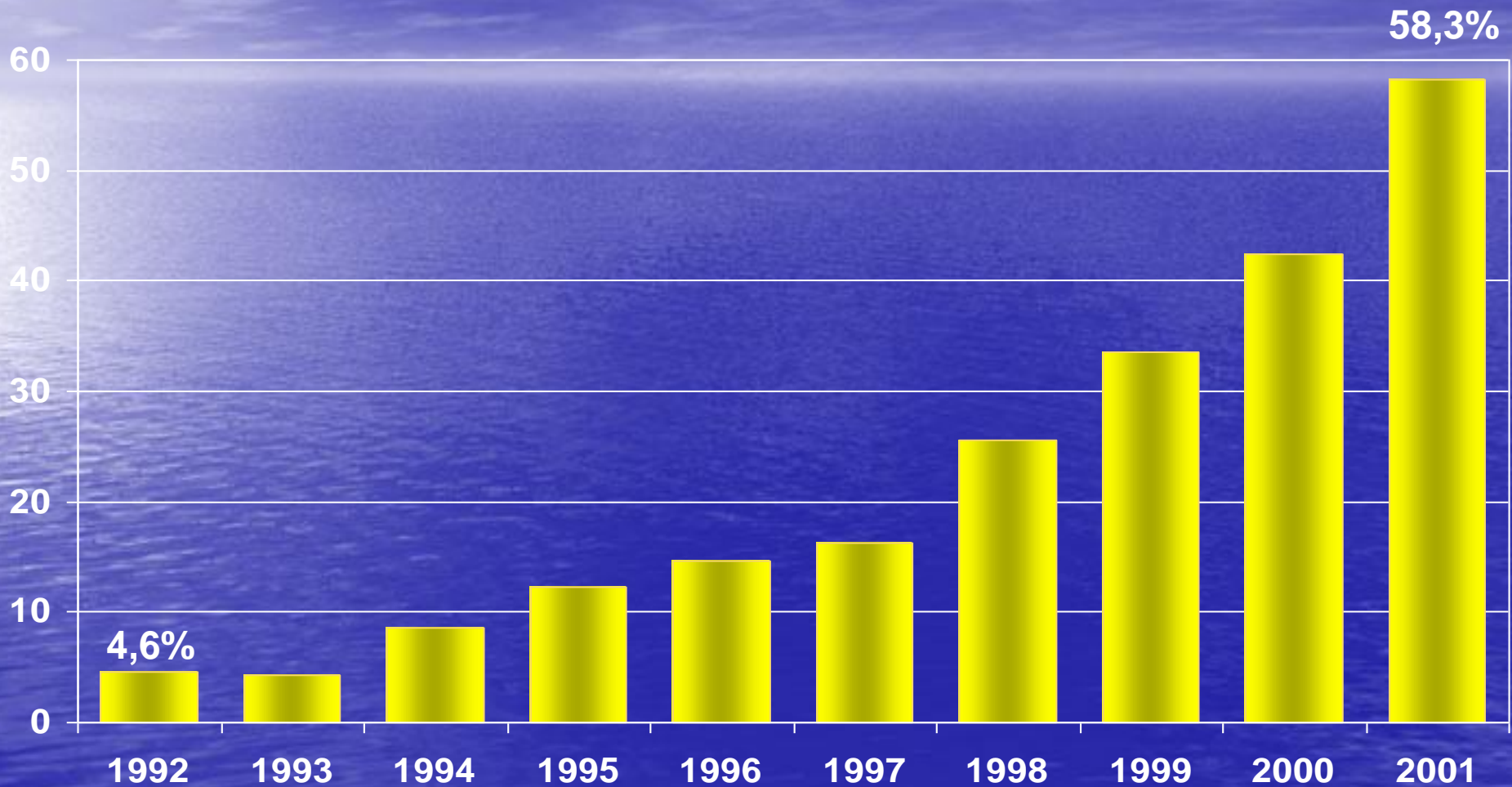


# GROSS DEBT/GDP

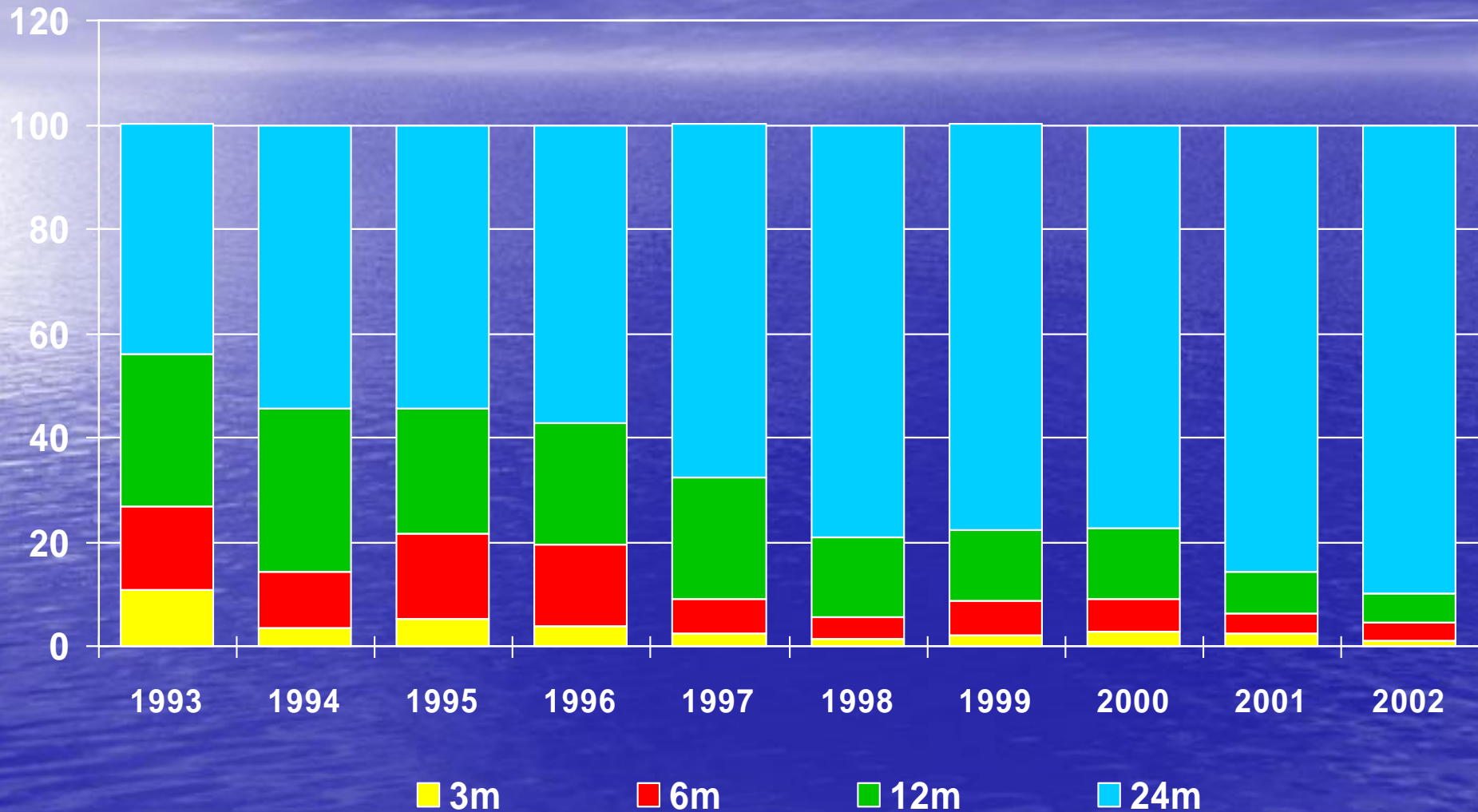
(in percent)



# EXTERNAL DEBT/GDP (%)



# DOMESTIC DEBT: MATURITY STRUCTURE



# LEBANON'S FINANCIAL MARKETS: OBJECTIVES

- Develop Major Sector of the Economy
- Finance Reconstruction
- Restructure Existing Finance: Mergers & Acquisitions, Securitisation
- Develop Lebanon's Role as a Regional International Financial Center

# FINANCIAL MARKETS: BUILDING BLOCKS

- Efficient Clearing & Payments System: Midclear, BDL, SWIFT
- International Accounting Standards
- Modernize Laws & Regulations
- Adopt Modern Regulatory & Supervisory Structure

# LAWS & REGULATIONS (2001)

## LAWS

- Anti-Money Laundering Law
- Law on bank share issuing and trading, bank bond issuing and bank ownership of real estate
- Law relating to leasing operations
- Law on the central securities depository
- Law on the Arab clearing corporation
- Law on electronic banking
- Law on Fiduciary accounts
- Law to facilitate bank mergers
- Law on the amendment and completion of the legislation related to banks and establishment of the National Guarantee Institution



# Anti Money Laundering Law No. 318

1. Defines money laundering as a criminal act.
2. Includes financing of terrorism as criminal offence.
3. Set-up of an independent Special Investigation Unit
4. SIU can lift Banking Secrecy

# Law 133 on modifying article 70 of the Code of Money and Credit

Expands the authority and competence of the Banque du Liban to:

- Organization of eBanking
- Payment Systems
- Securities Settlement System
- Electronic Money Transfers
- Electronic Clearing & Settlement relating to payment systems and financial Instruments

# LAW RELATING TO BANK EQUITY & BONDS

- Deregulation of issuing and trading
- Unify bank shares
- List up to 30% of Lebanese banks' shares on regulated financial markets
- Increase banking capitalization
- Allow banks and financial institutions to issue bonds

# Law relating to fiduciary accounts

- Allow banks and financial institutions to undertake fiduciary operations
- Develop off-balance sheet activities
- Develop Fund Management
- Introduce Islamic banking activities to the Lebanese market

# Law to facilitate bank mergers

- At its discretion, the BDL Central Council can grant the merging bank a soft loan, under conditions set by a contract between the BDL and the merging bank.
- Following agreement between BDL and the BCC, and following the year of the final decision of merger, the Central Council can provide tax incentives to a maximum LBP 2 billion.
- All the merger charges and procedures are exempted from fiscal stamps and transfers fees to the public authorities

# Laws & Regulations 2000-2002

## REGULATIONS

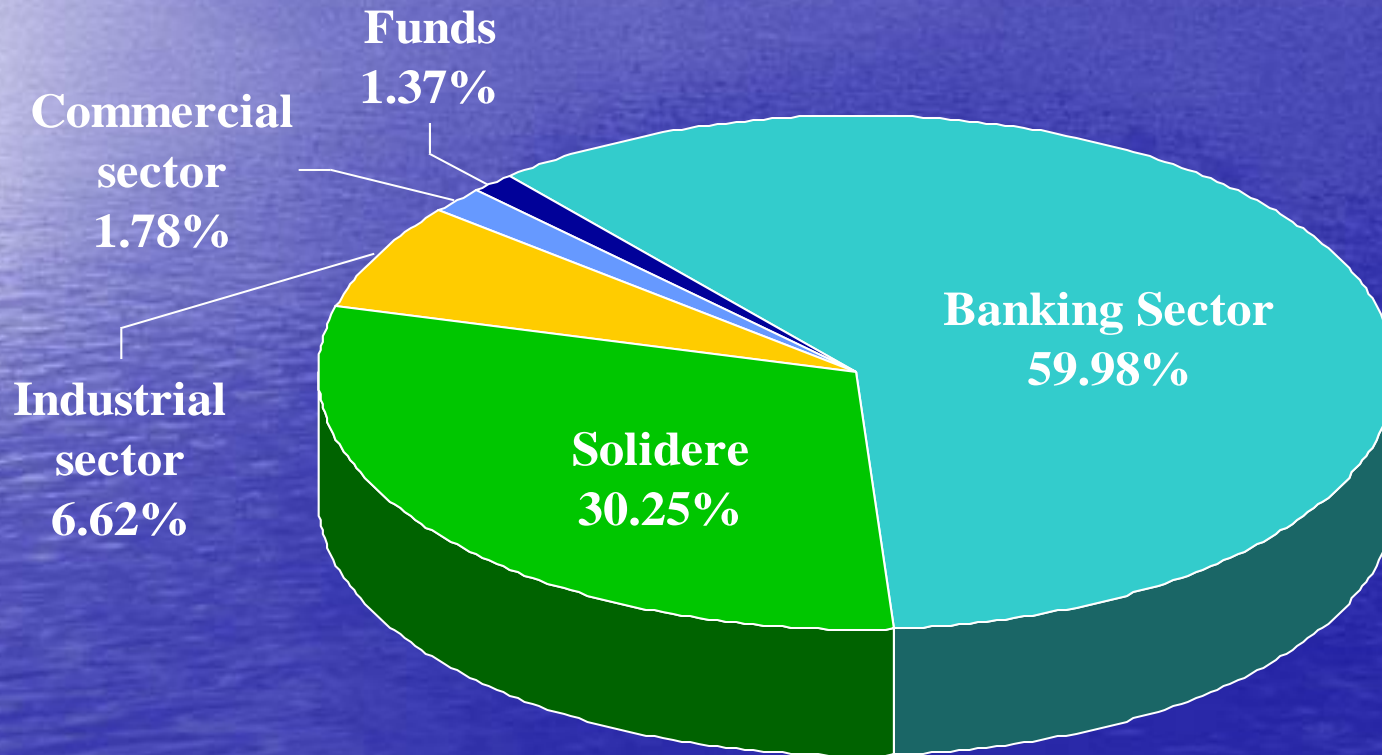
- Broker/Dealer & Intermediaries: licensing, regulation & supervision
- Medium & Long Term Lending
- Connected Lending
- Home Loans, saving/lending
- Bank Capital Requirements: 12% CAR
- Legal Reserve Requirements on LL
- Forex Deposit Requirement: 15%
- Credit card & ATM regulation
- Electronic clearing house for local credit card transactions (ATM)

# Laws & Regulations 2000-2002

- Electronic Banking Networks
- Trading of Bank Shares
- Internal Bank Supervision and Control
- Anti-Money Laundering
- Subsidized Credits
- Creation of a special account for the management of the proceeds resulting from the privatisation of public utilities

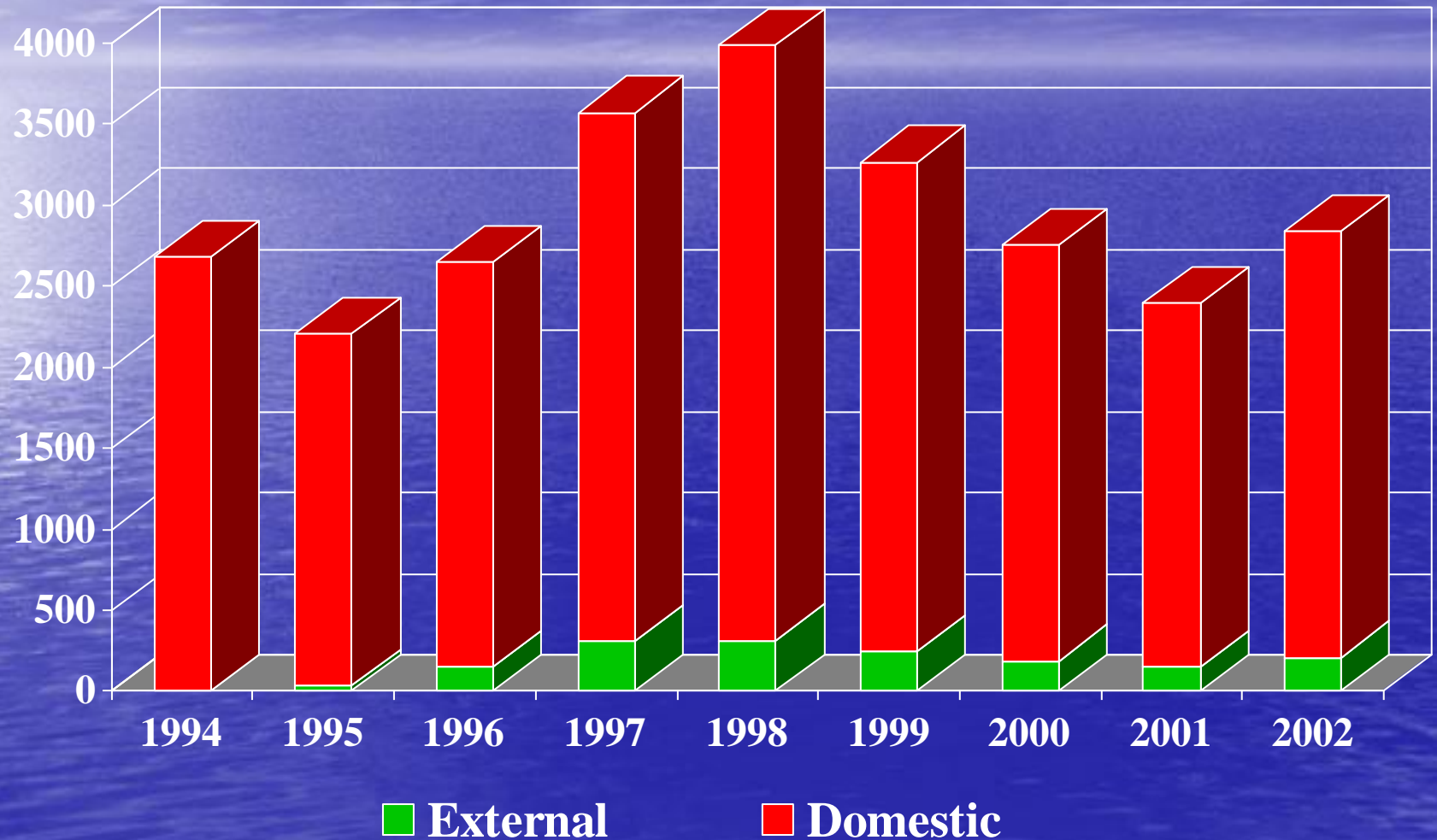
# BEIRUT STOCK MARKET CAPITALISATION December 2002

Market Size: US\$ 2,632.396 Mn

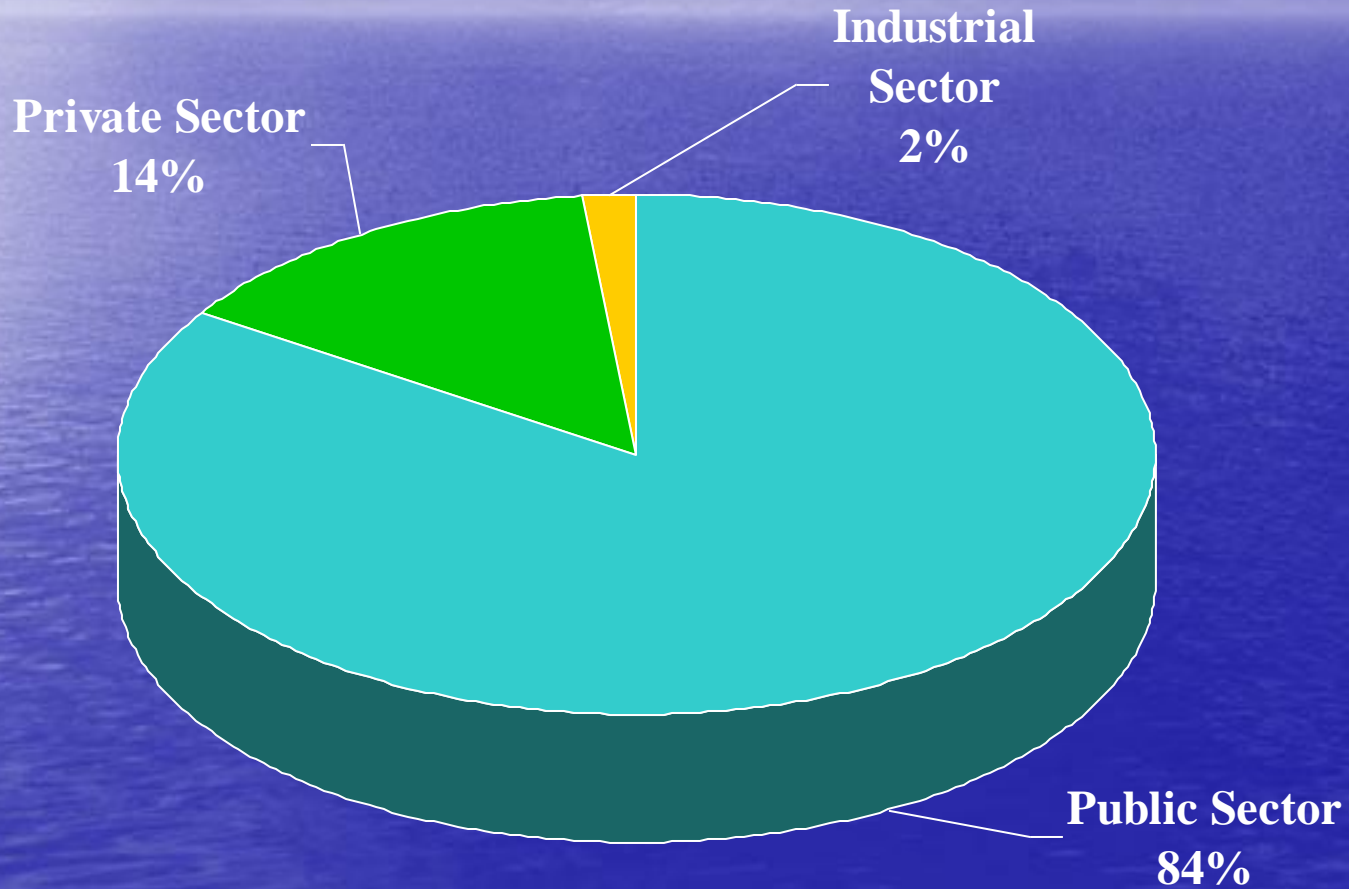




# EQUITY MARKET CAPITALISATION (Mn US\$)



# Lebanon's Bond Market (December 2002)



January 2002

# Macroeconomic Challenges

- Address twin problems: large and unsustainable budget deficits and public debt: flow & stock
  - Fiscal reforms aiming at reducing budget deficits on a sustainable basis
  - Public debt restructuring and reduction through privatization and securitisation of receivables
- Maintain real exchange rate stability
- Preserve financial & banking sector stability
- Adjustment program for entry into WTO, GAFTA and implementation of EU Association Agreement

# Paris II Meeting

- Place & date
  - Paris - November 2002, under the auspices of the French Government
- Participants
  - 22 major countries and international organizations
- Aim
  - To mobilize international financial assistance for Lebanon to restore public finance sustainability

# Commitments Received from Donor Countries

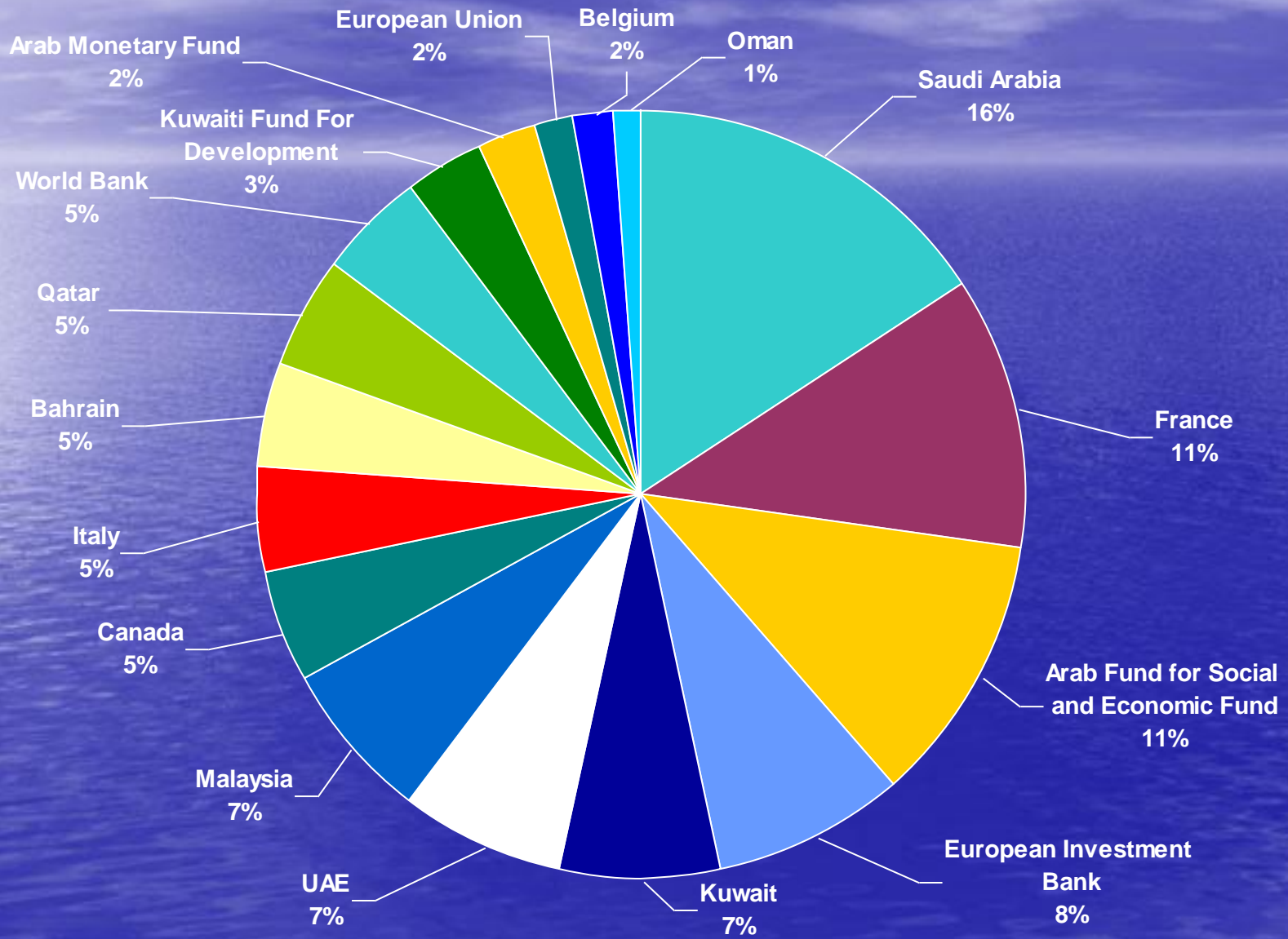
Total amount committed = US\$4.4 billion as follows:

- US\$ 3.1 billion budgetary support to assist in public debt restructuring
- US\$ 1.3 billion in long-term infrastructure project-related loans

# Commitments from Paris II by Country

Saudi Arabia	USD 700 million
France	USD 500 million
Arab Fund for Social and Economic Fund	USD 500 million
European Investment Bank	USD 350 million
Kuwait	USD 300 million
UAE	USD 300 million
Malaysia	USD 300 million
Canada	USD 200 million
Italy	USD 200 million
Bahrain	USD 200 million
Qatar	USD 200 million
World Bank	USD 200 million
Kuwaiti Fund For Development	USD 150 million
Arab Monetary Fund	USD 100 million
European Union	USD 80 million
Belgium	USD 70 million
Oman	USD 50 million

# Commitments From Paris II by Source



# Funds of US\$ 3.1 billion for budgetary support

- Total Disbursements to date: \$2,495 million
- Type of Financing:
  - US\$2,440 million in Eurobonds 15-year maturity with 5% coupon
  - USD 55 million soft loans with interest of 1.4 % & 4%
- Disbursements by month:
  - US\$ 405 million disbursed in Dec.2002
  - US\$ 600 million disbursed in Jan. 2003
  - US\$1,290 million disbursed in Mar.2003
  - US\$ 200 million disbursed in May 2003



# National Initiatives I

## 1. Agreement with commercial banks:

- subscription to zero-interest, two-year government securities
- amount equivalent to 10 percent of a banks deposit base as of October 31, 2002 (total of USD 4 billion )
- Subscription to be made in seven equal installments during January-August to control liquidity

# National Initiatives II

- Cancellation of US\$1.8 billion worth of the central bank's holdings TBs against a reduction in the revaluation account for gold and foreign exchange (December 2002)
- Swap of most of the central bank's remaining holdings of government debt (TBs and Eurobonds), amounting to an additional US\$1.8 billion, for a 15-year Eurobond carrying a 4 percent coupon (December 2002)

# Positive Results

- Paris II debt restructuring and project finance package, along with accompanying domestic initiatives affected expectations of current & future course of debt dynamics and market confidence
- Broad money (M3) increased by 3.2 percent in December, bringing its 12-month growth rate to 7.6 percent (compared with 3.6 percent in the year through July)

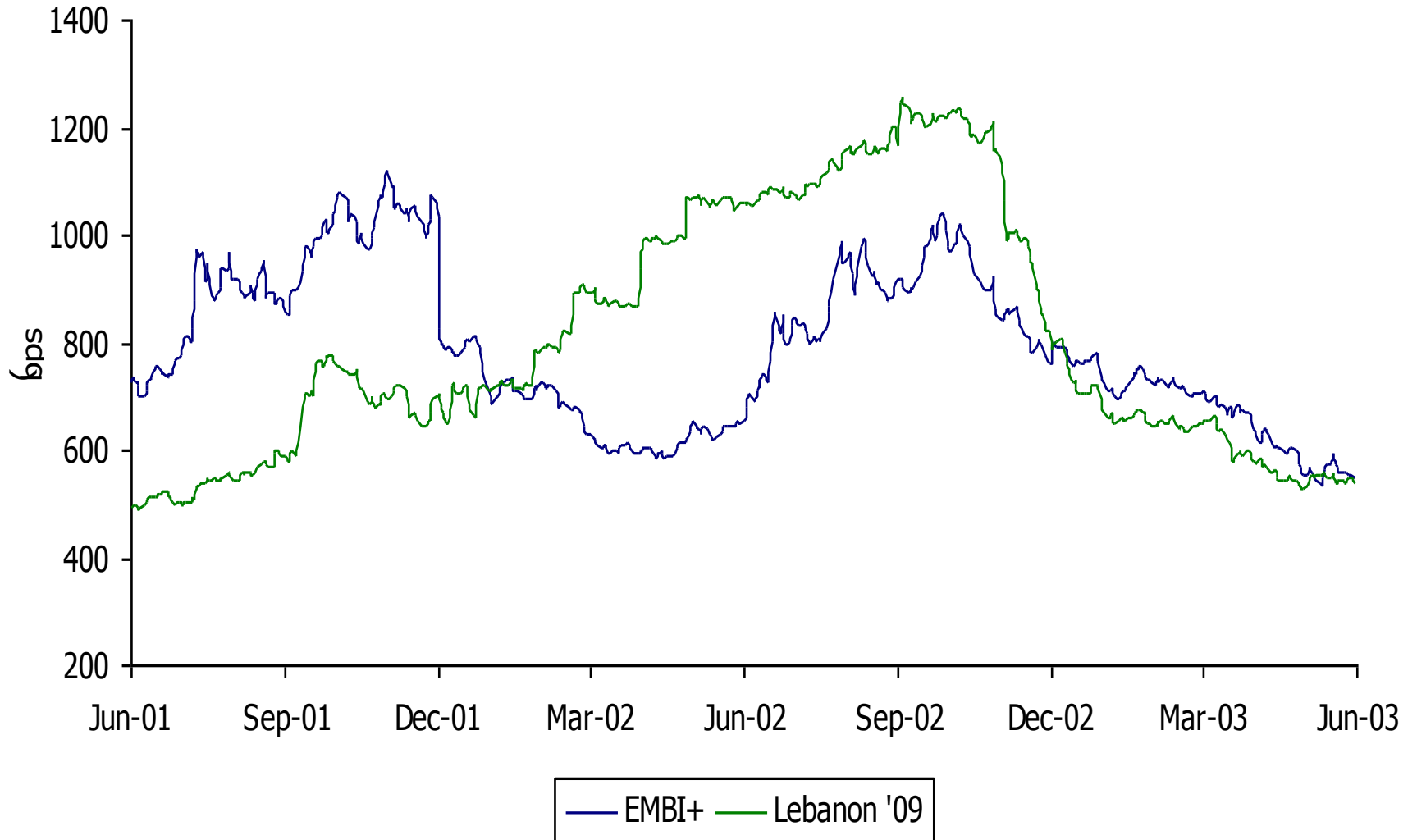
# Positive Results

- The share of dollar deposits in M3 declined to 64.2 percent in December, from a high of 69.8 percent in May 2002
- The interest rate on two-year TBs fell from an effective 16.1 percent (which included a 2 percent premium then offered by the central bank in its swap operations) to 9.2 percent by end December

# Positive Results

- The yield on the three-month TB declined from 11.2 percent to 6.9 percent in the last auction held on February 6. The government is not currently issuing Treasury bills, given its comfortable liquidity position
- Spreads on Lebanese Government Eurobonds narrowed from 987 basis points before Paris II to 611 basis points at end-January, compared with a compression of about 41 basis points in the EMBI Global spread during the same period
- Interest rates on Lebanese pound and dollar deposits have declined, by about 200 and 100 basis points, respectively

EMBI+ vs Lebanon '09 (2 Years Historical Spreads)



# Positive Results

- Lending rates on LBP dropped by about 180 basis points. Lending rate on USD dropped by 50 basis points
- The LBP/USD exchange rate improved from LBP 1,515 to LBP 1,500.

# Positive Results

- **Central Bank gross international reserves (excluding gold) increased to US\$5.1 billion by end-December (from US\$3.1 billion in June). Central bank accumulated another US\$ 5 billion in gross reserves during January - May, bringing gross reserves to more than USD 10 billion.**
- **Balance of payments recorded a surplus of 1,564 million at year end.**



*Thank you*

*Q & A*