

Lebanon: 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

Monetary Policy Strategy & Tactics

Indicators of goals
Indicators of Policy
Intermediate Targets

Monetary Strategy

Final Goals: Inflation,
Growth, Unemployment

Instruments
-Discount rate
-Market Operations
Reserve Requirements

Monetary Policy
Implementation

Operating Objectives/
Targets
Exchange Rate
-Short term rates
-Monetary Base

Choices for Exchange Rate Regimes

- Choice depends on predominance of shocks, nominal v/s real and degree of capital mobility
- Mundellian criteria imply that if an economy experiences mainly:
 - Nominal Shocks \Rightarrow Fixed rates
 - Real Shocks \Rightarrow Flexible Rates

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: 1992-2002

- Uneven Economic Growth
- Exchange Rate Stability
- Reduced Inflation
- Large Capital Inflows & Remittances
- Reconstruction
- Large budget deficits & Public debt accumulation

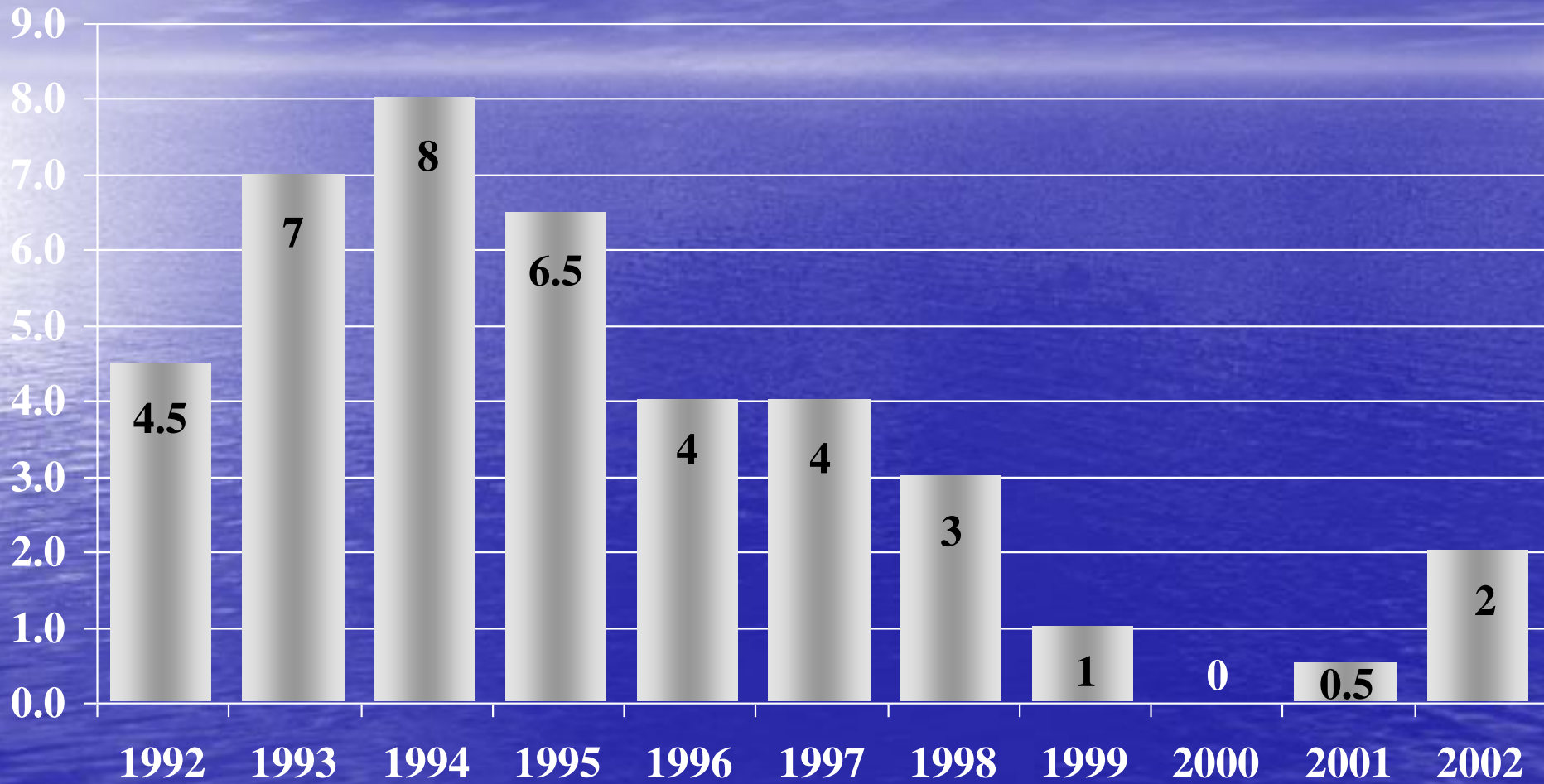
Main Features I

- 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

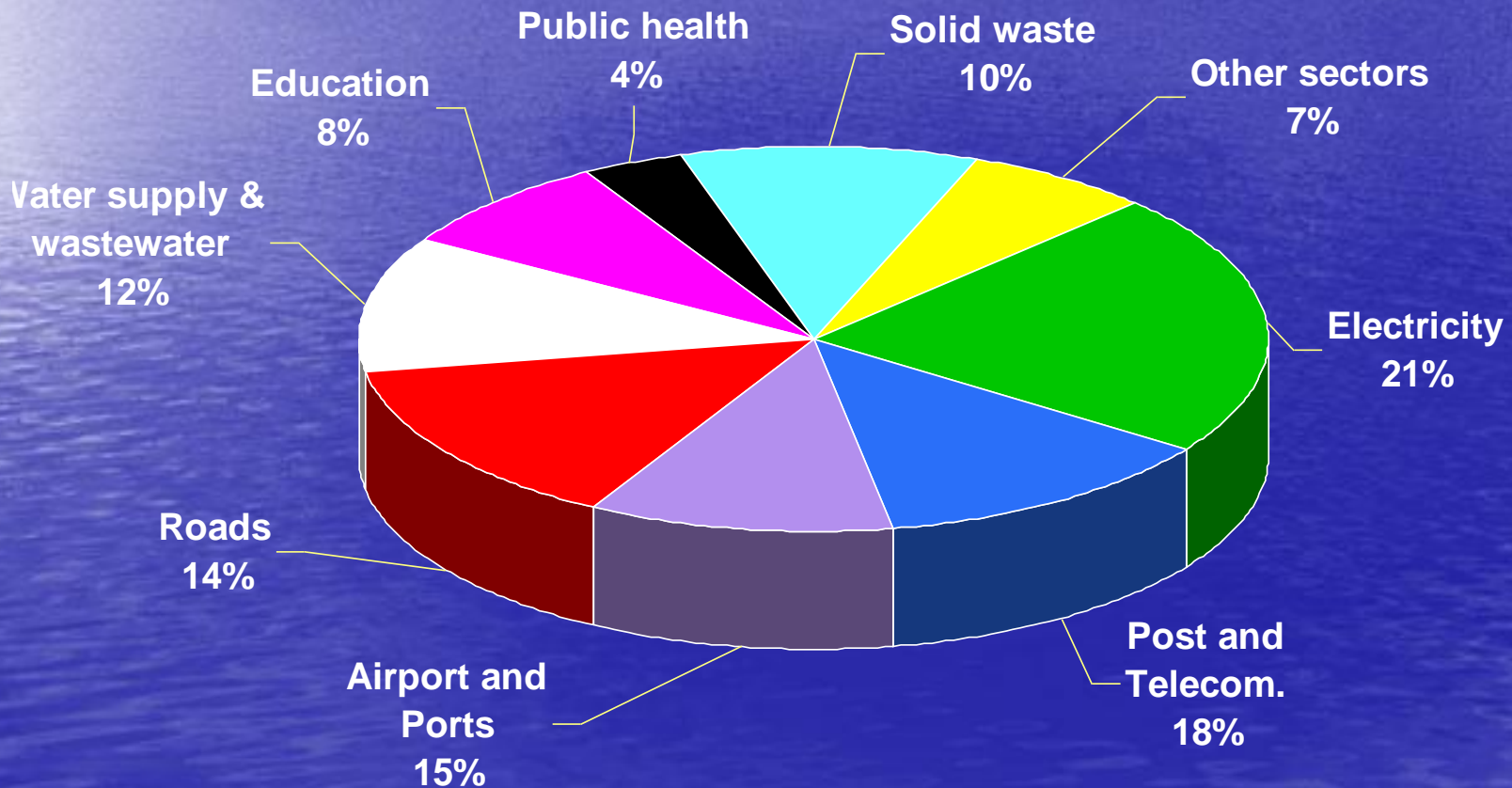
- Introduction of New Laws and Modernization of Existing legislation to deal with structural and institutional issues and change
- Introduction of money market and financial market instruments: CD's, Repos', Swaps
- Flexibility: BDL and BCC issue regulations to manage, organize, supervise
- Comprehensive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

REAL GDP GROWTH RATE



RECONSTRUCTION PROGRAMME, 1992-2001

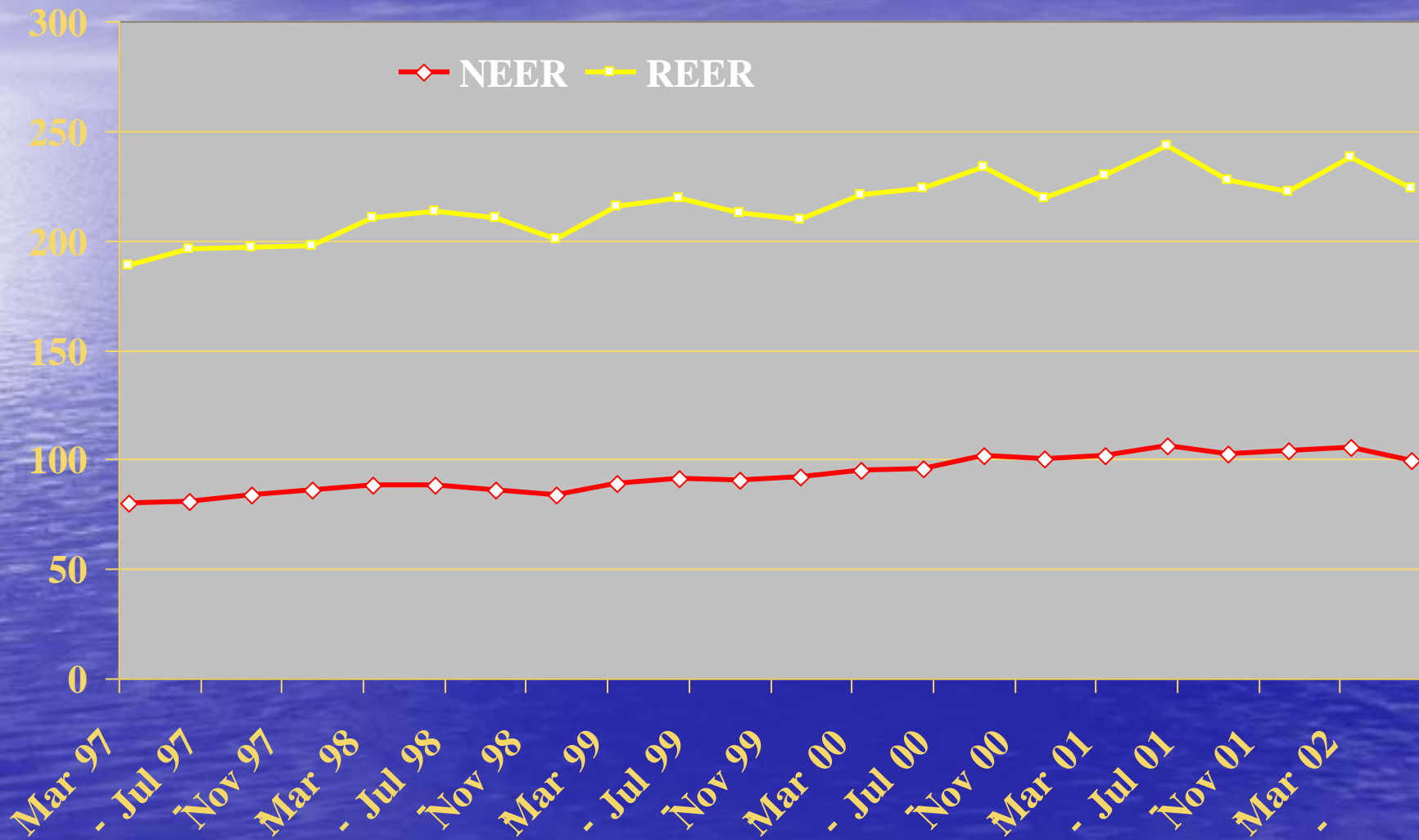
TOTAL: \$ 6,209 Million, o/w \$ 3,079 million executed and \$ 3,130 million to be executed



Stabilization Policy: Exchange Rate Policy

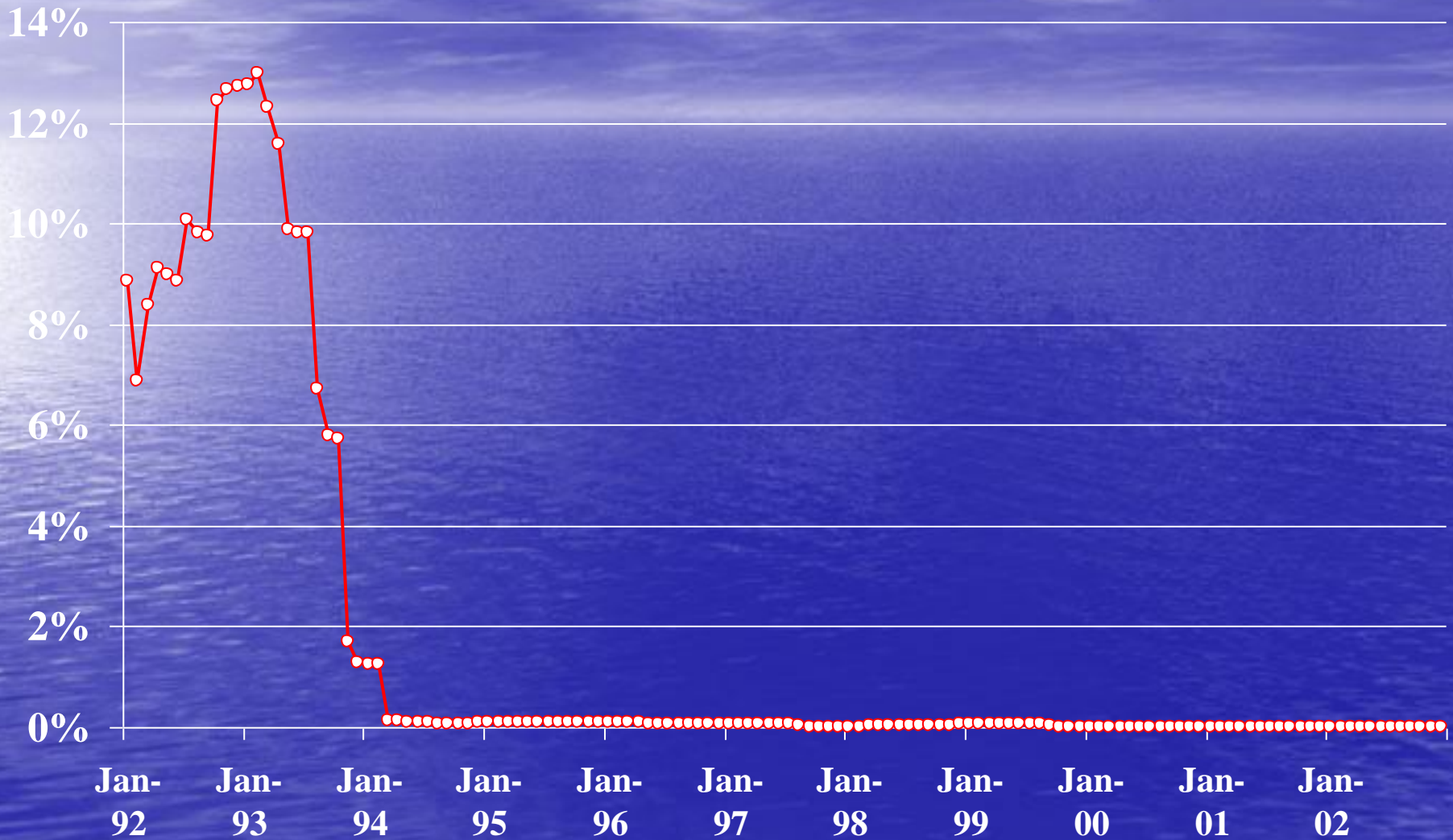
- US\$ Nominal Anchor
- Tight Link Between Inflation and Exchange Rate Movements
- Achieve Stable Real Exchange Rate
- Sterilization operations to offset capital flows

NOMINAL AND REAL EFFECTIVE EXCHANGE RATE (Jan1991 = 100)

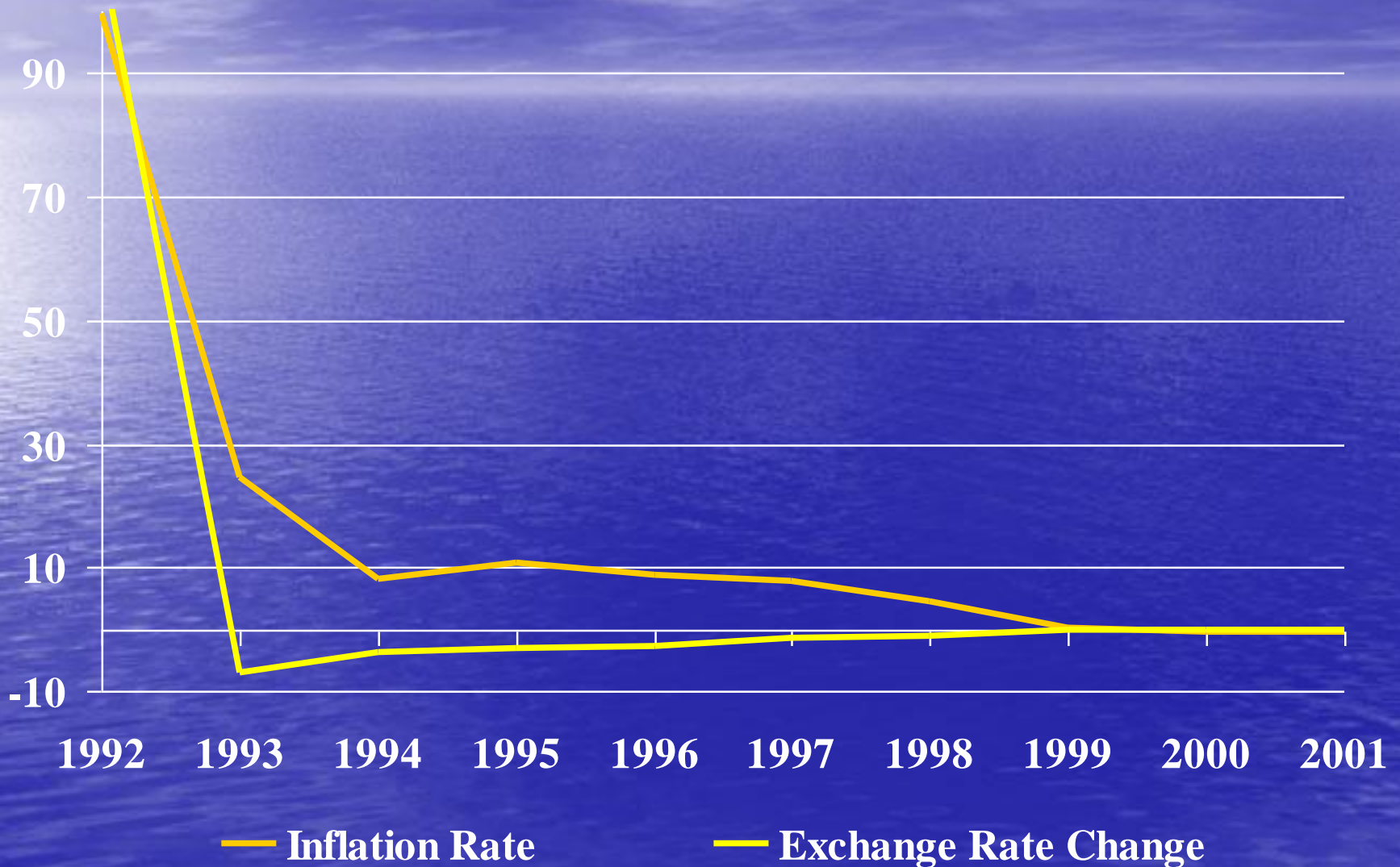


EXCHANGE RATE VOLATILITY

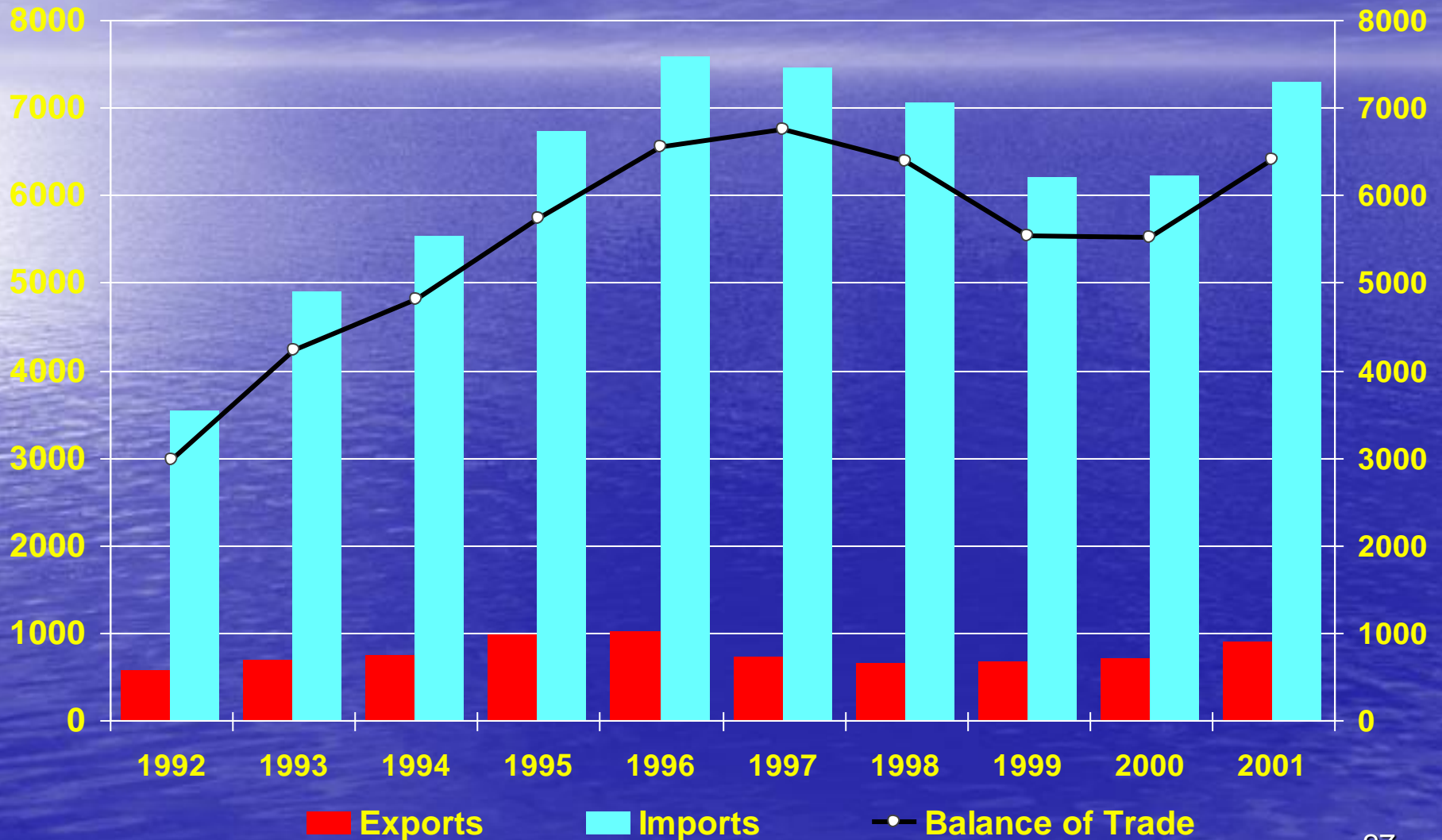
(Standard deviation of monthly % change)



INFLATION AND EXCHANGE RATE

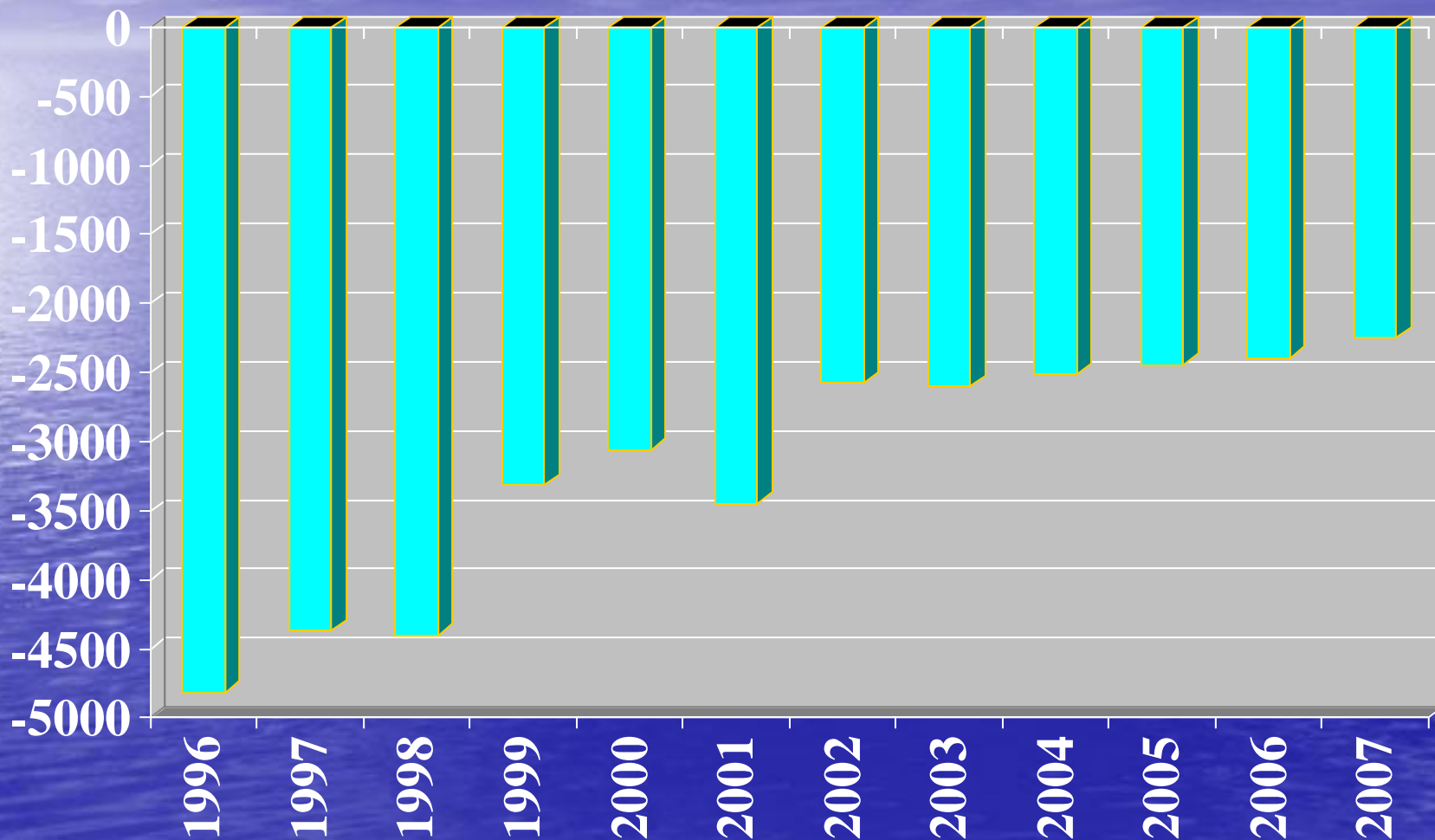


TRADE BALANCE (Mn \$)

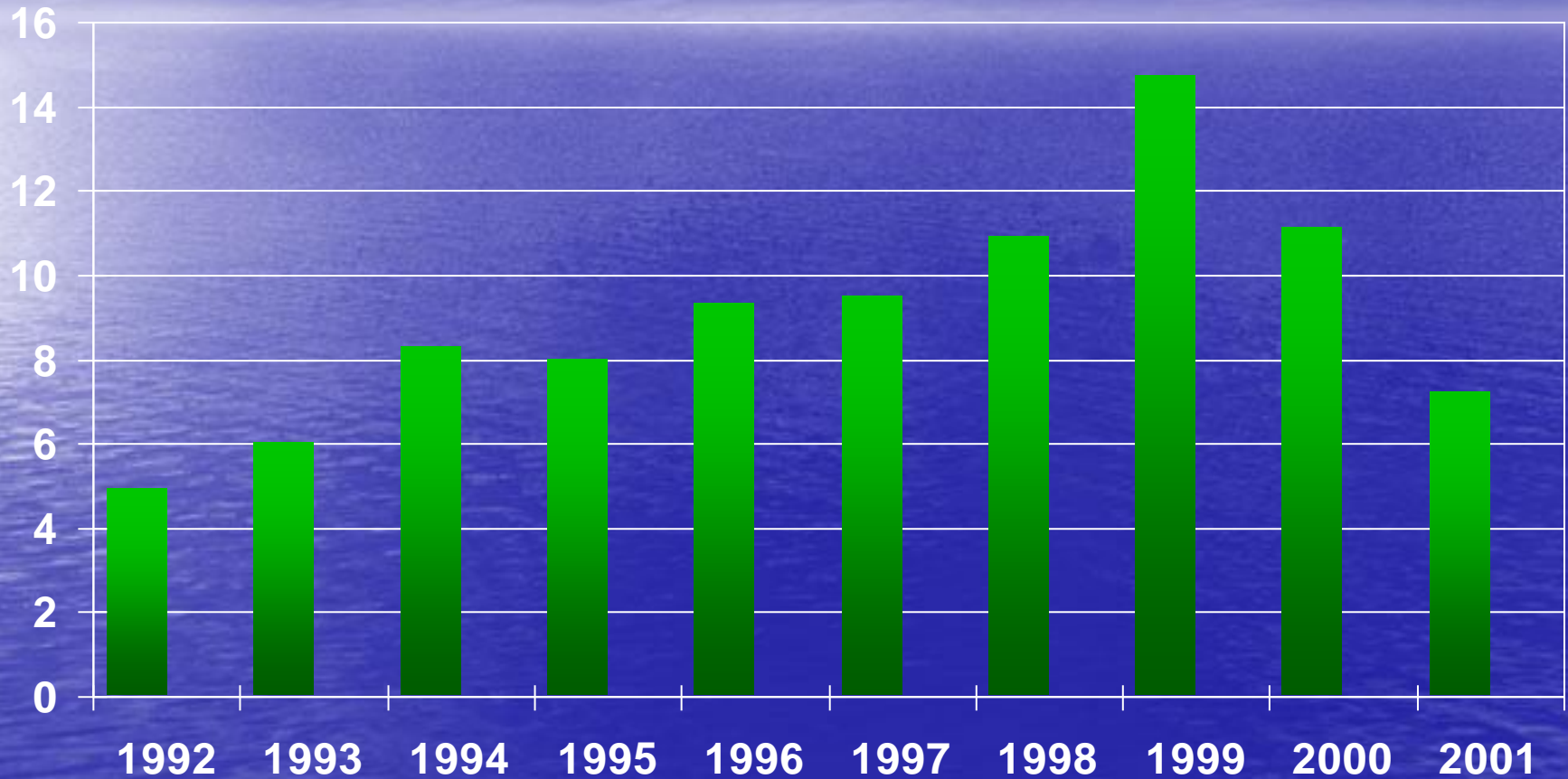


Current Account (Mn. \$)

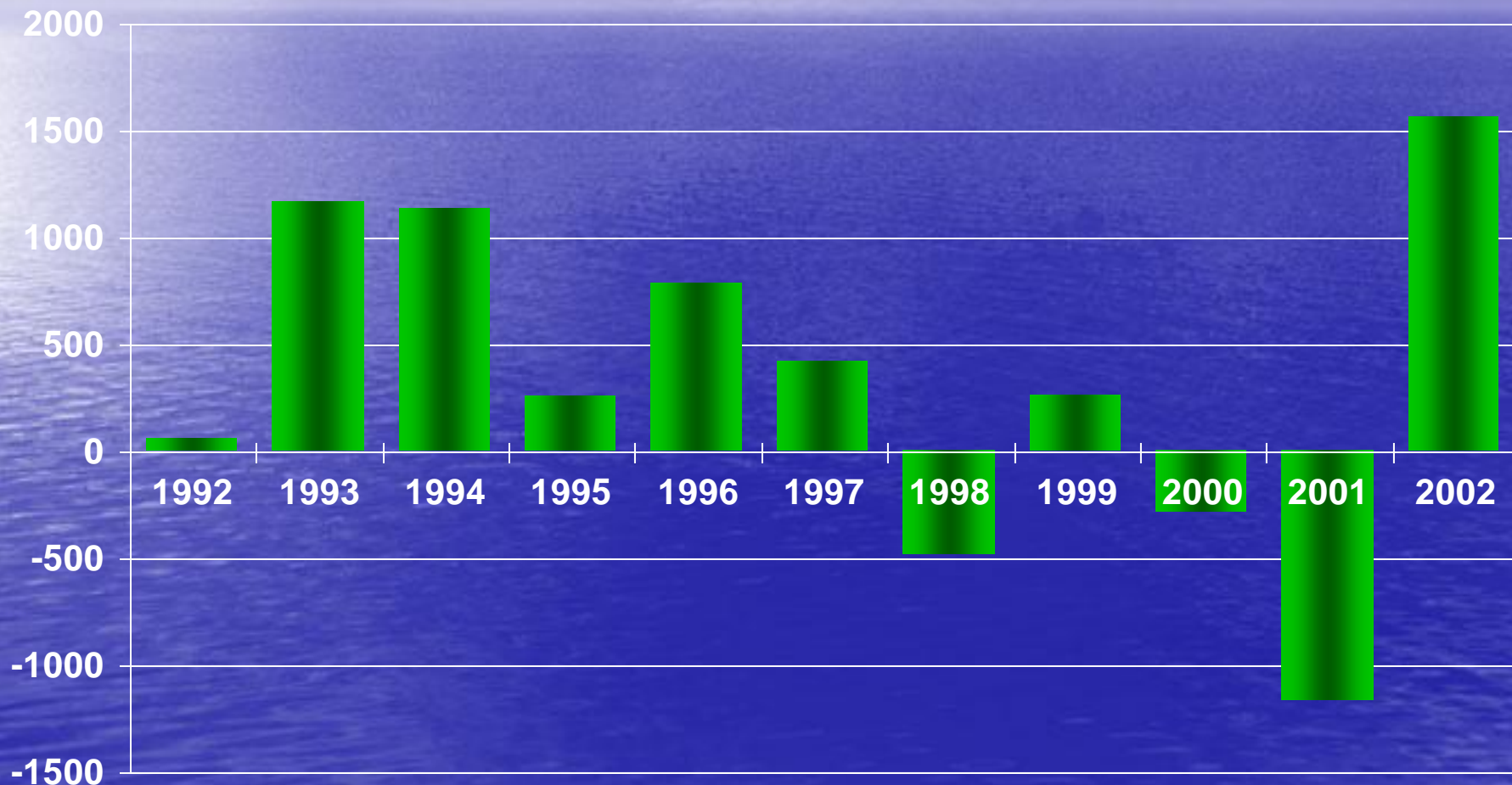
Forecast for 2002-2007



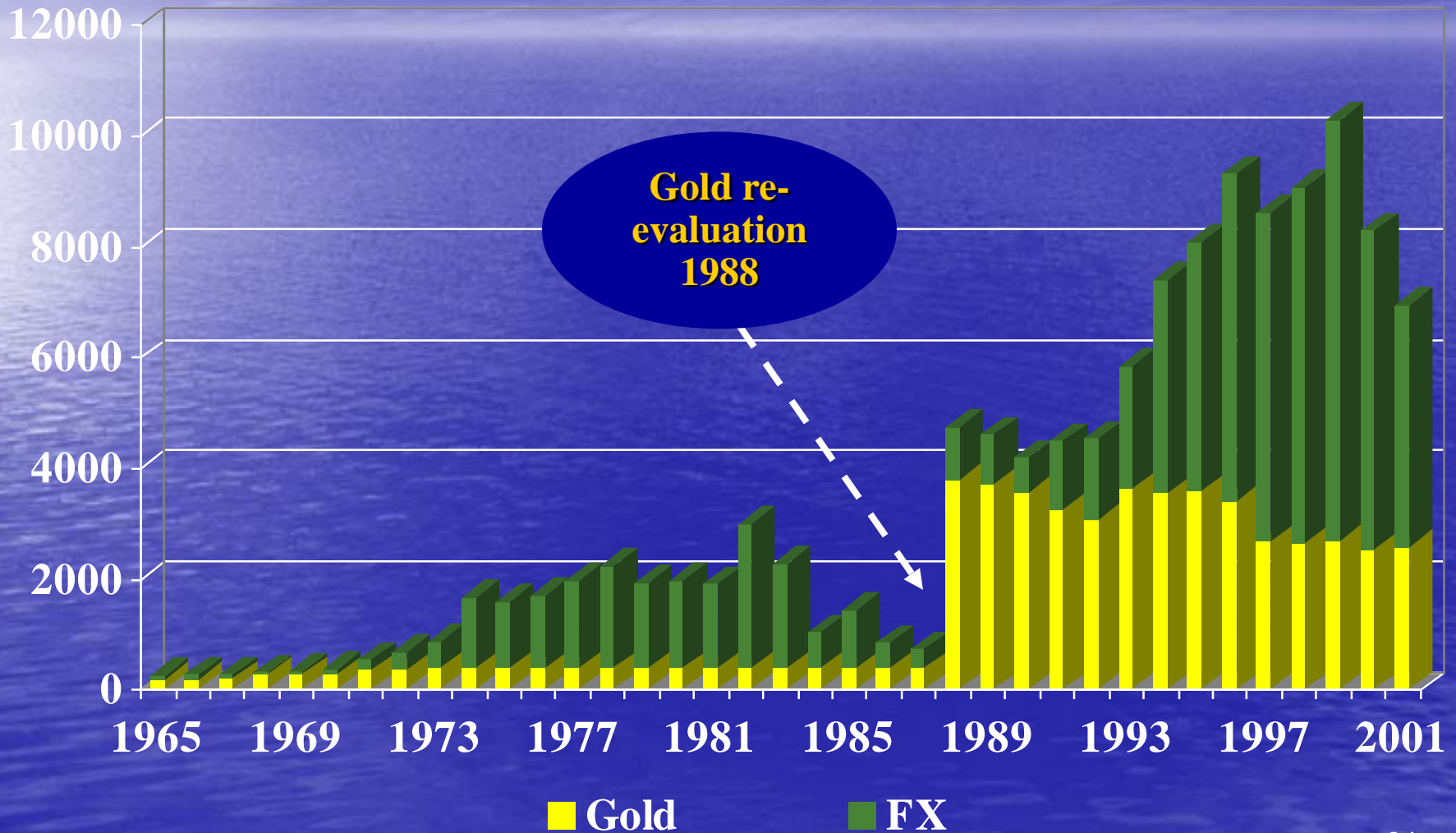
IMPORT COVERAGE (# of months)



BALANCE OF PAYMENTS (Mn \$)



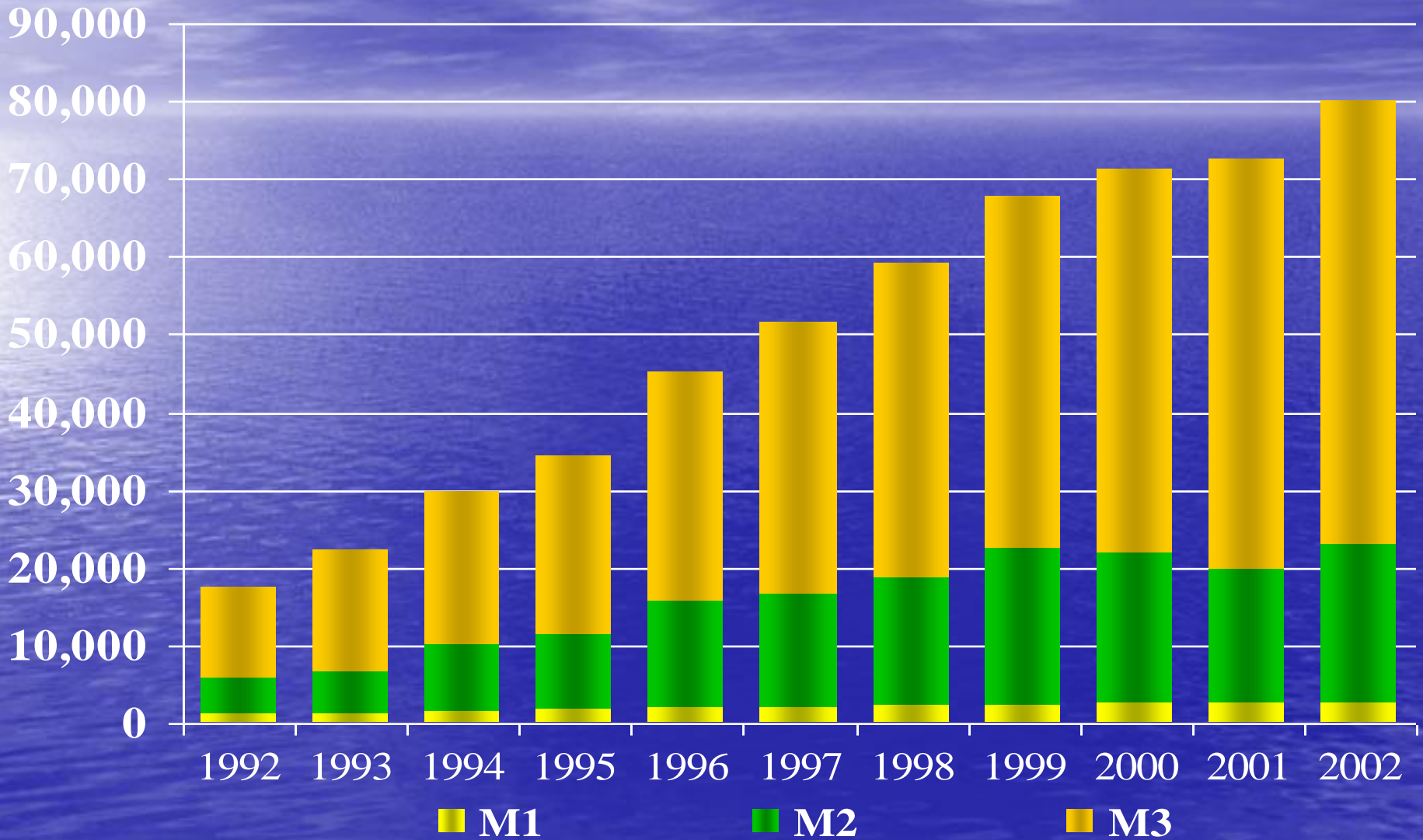
BDL INTERNATIONAL RESERVES (Millions US\$)



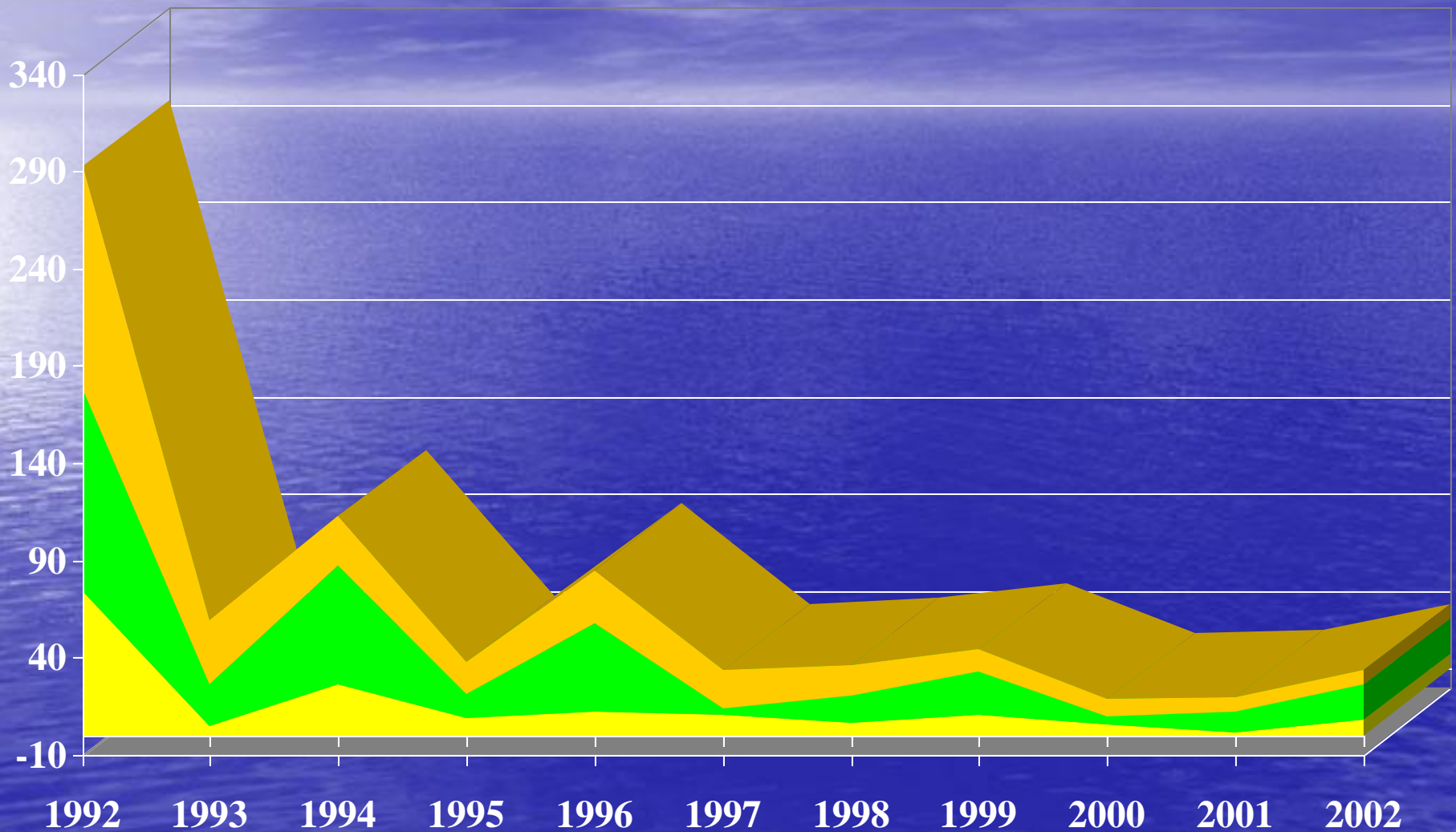
Economic Stabilization: Monetary Policy Aims

- 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.

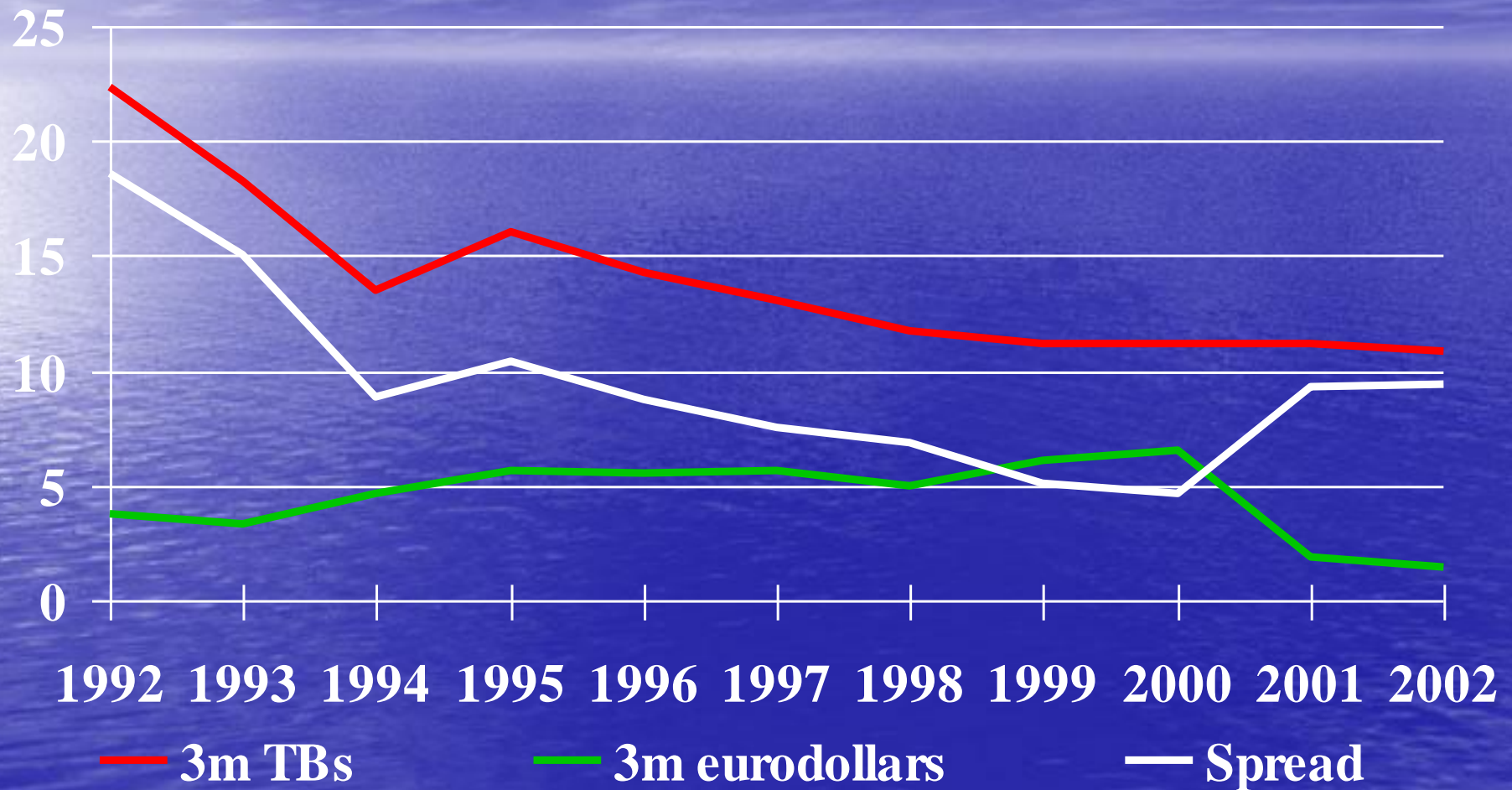
Monetary Aggregates (LBP Bn.)



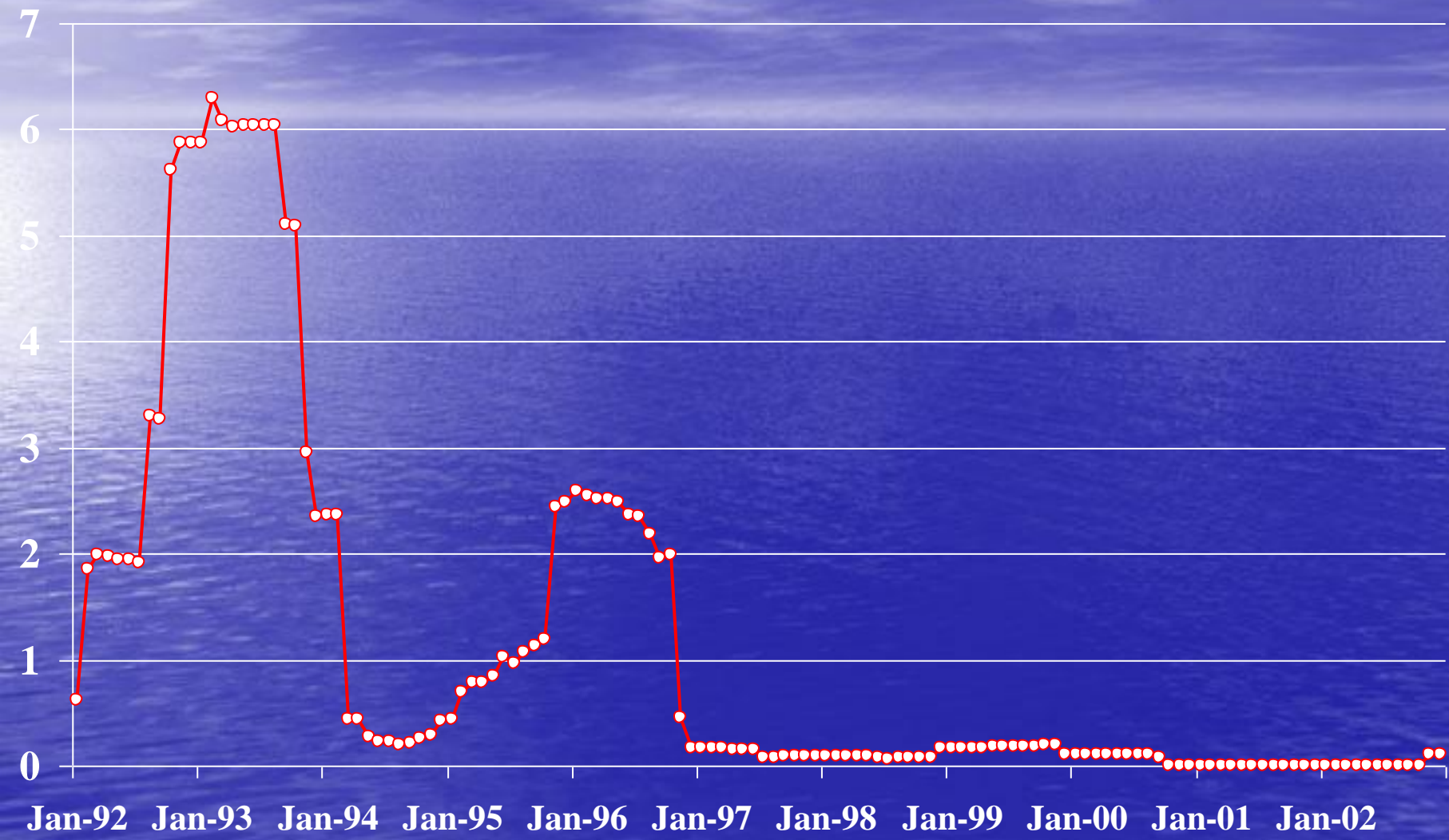
MONEY GROWTH RATES %



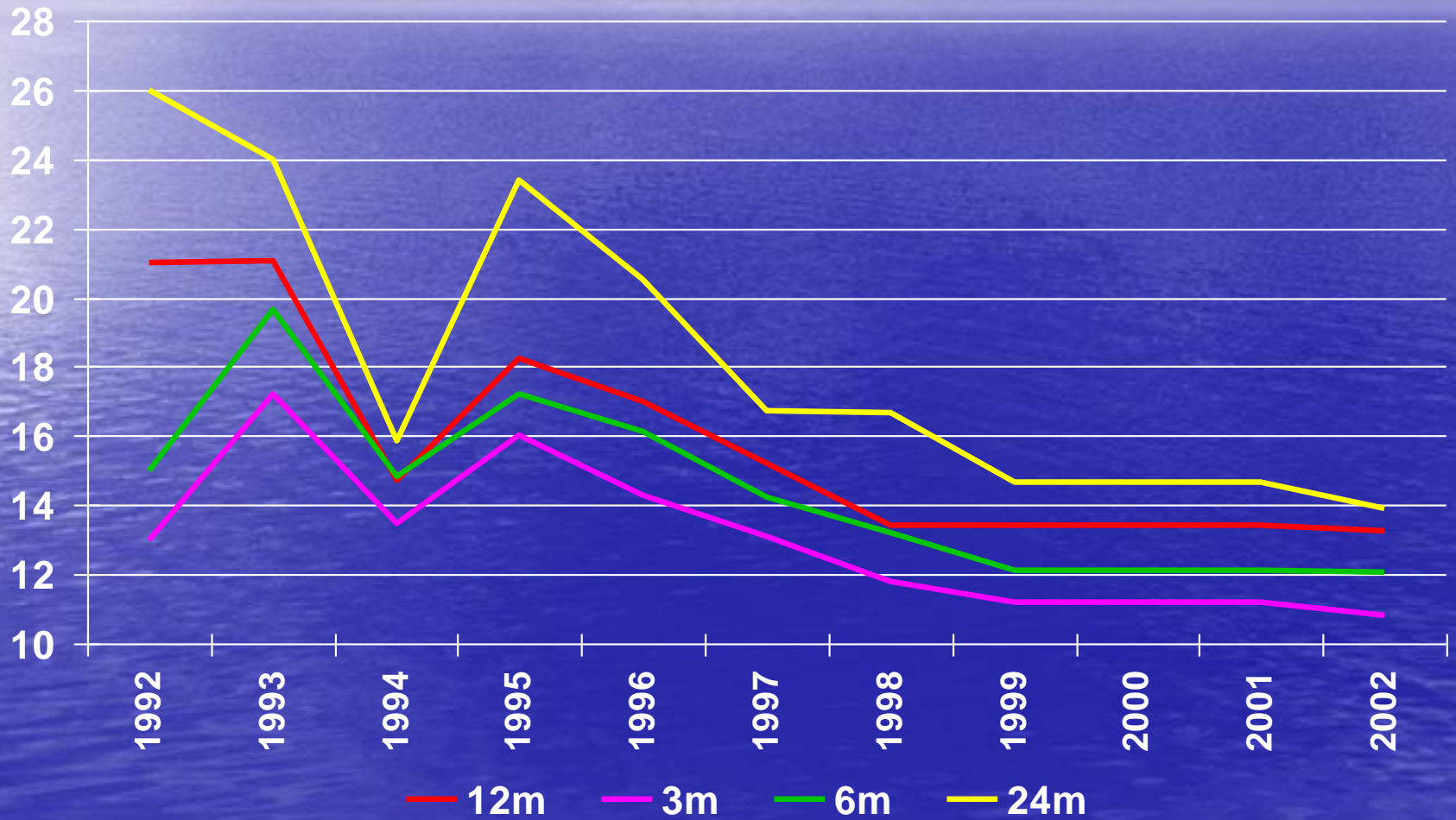
INTEREST RATE DIFFERENTIAL



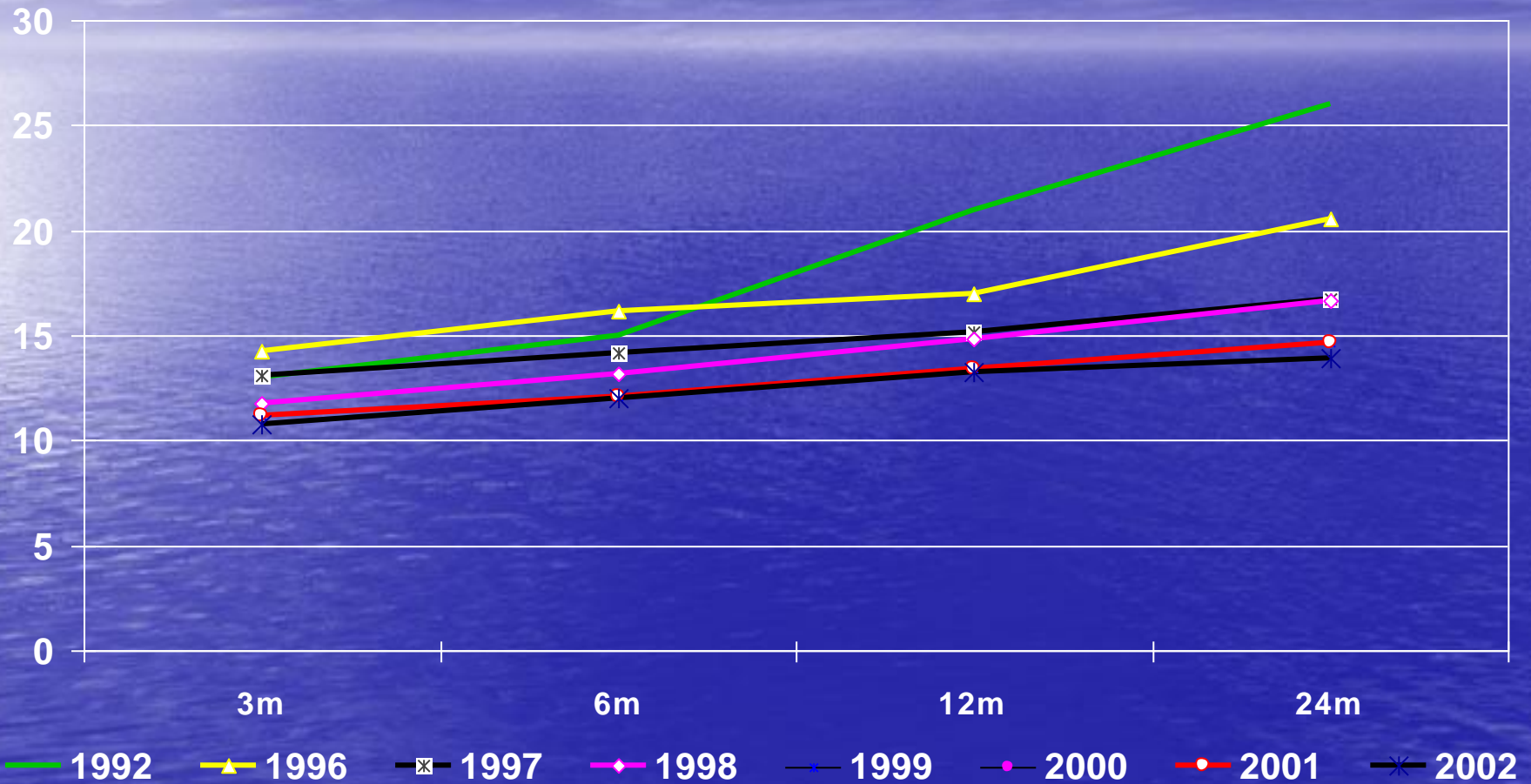
VOLATILITY 3-MONTH TB RATE



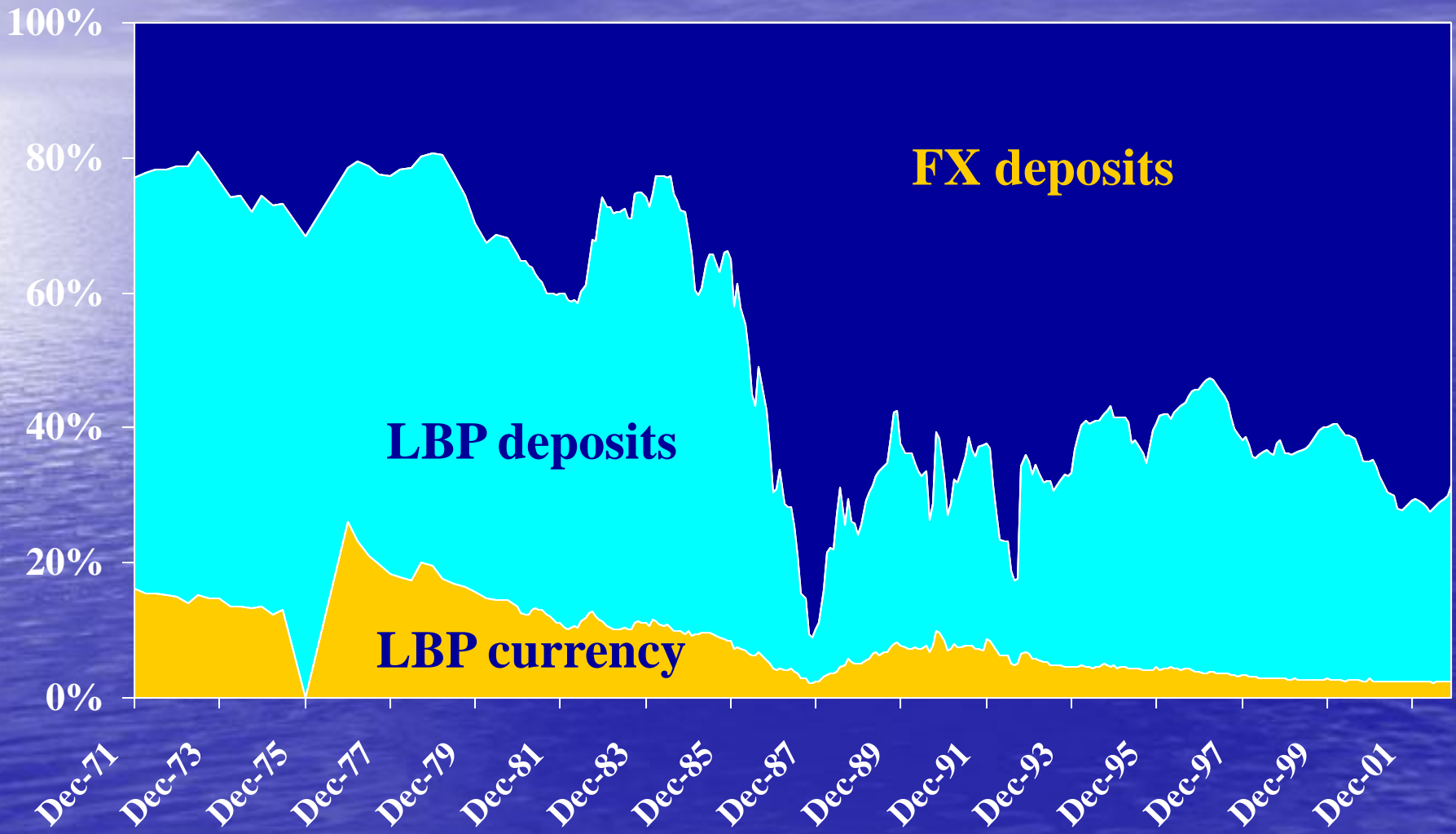
TB RATES, 1992-2002



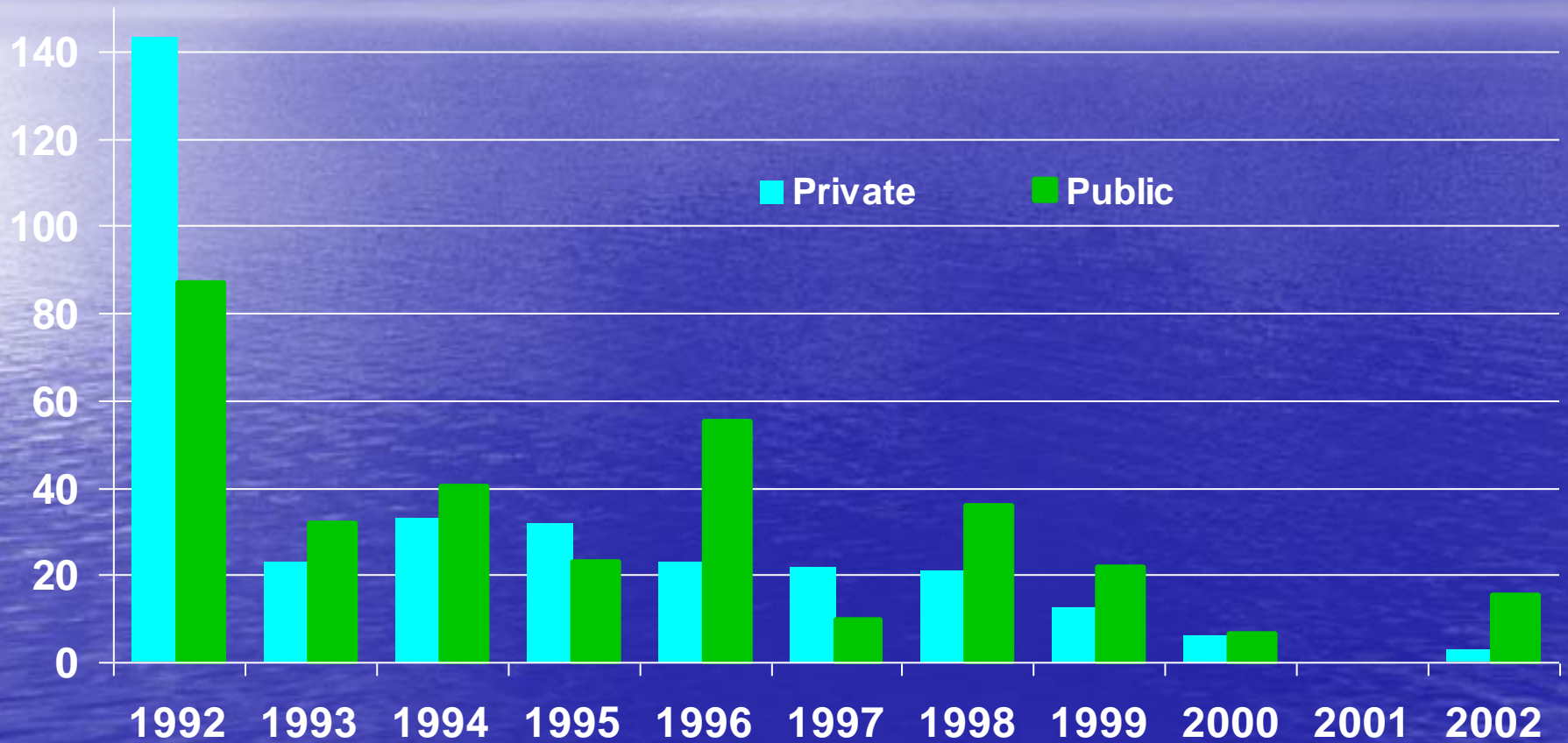
YIELD CURVE



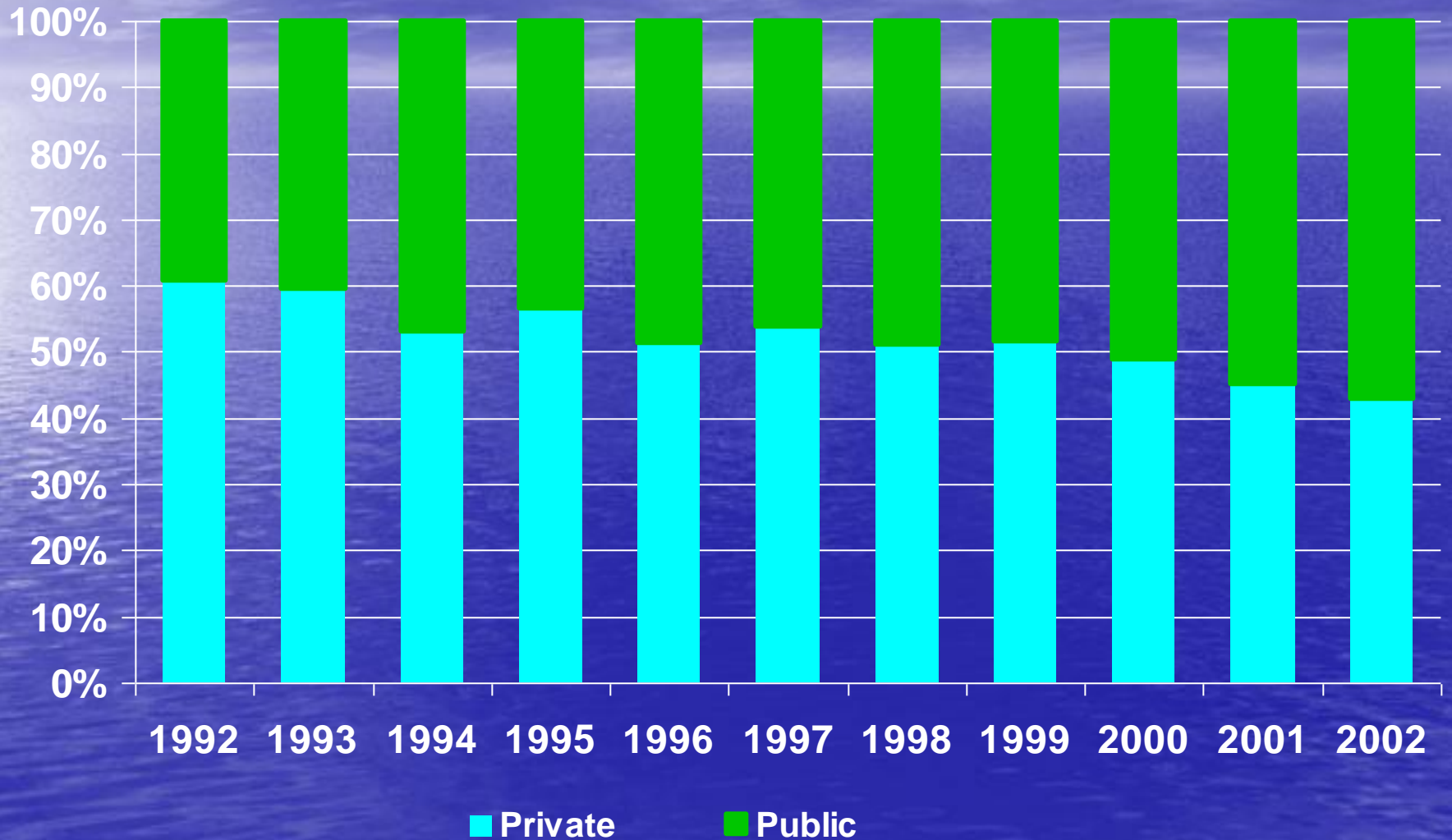
COMPOSITION OF TOTAL LIQUIDITY %



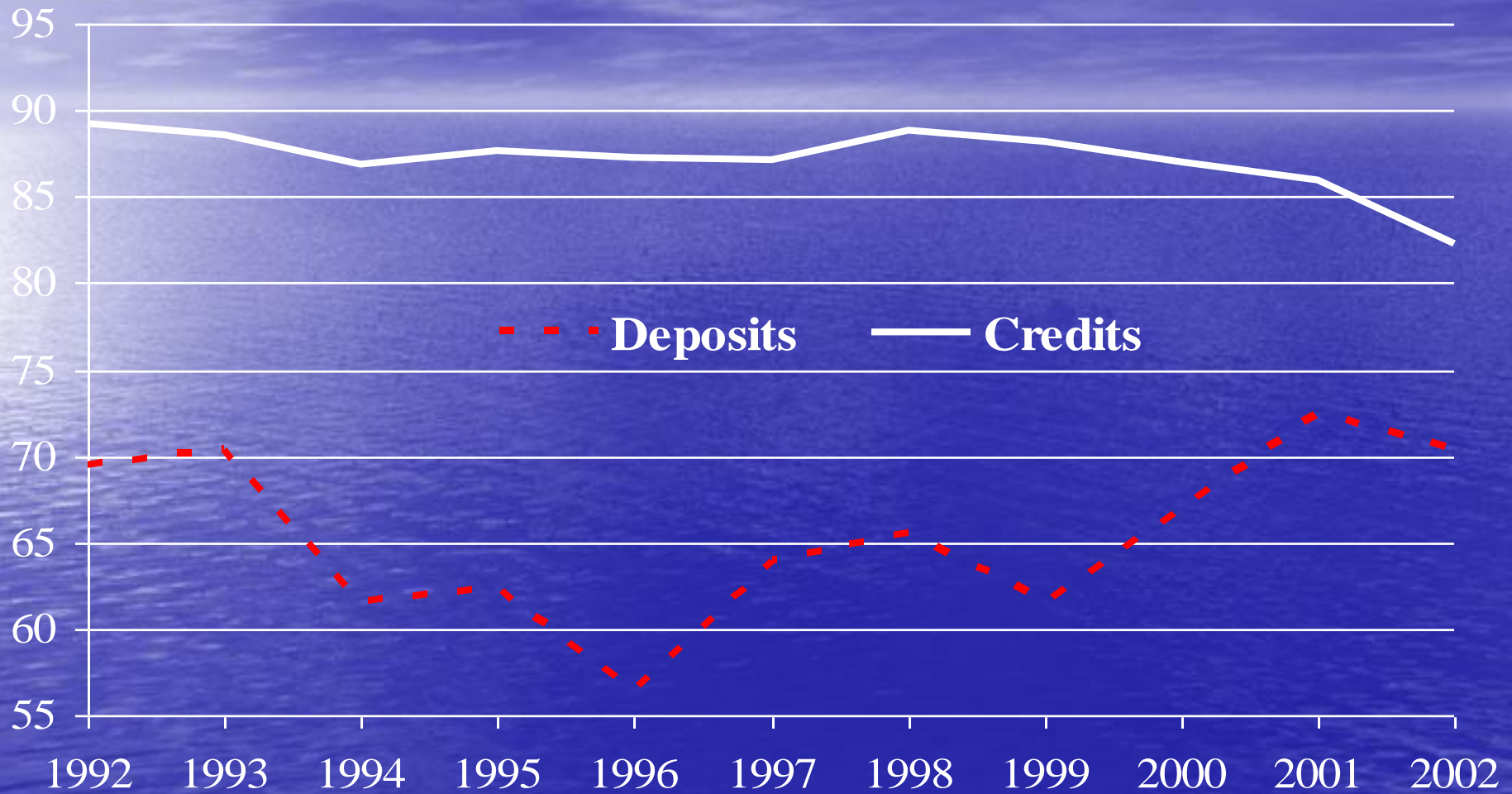
DOMESTIC CREDIT GROWTH % (by sector)



DISTRIBUTION DOMESTIC CREDIT



DOLLARISATION RATES

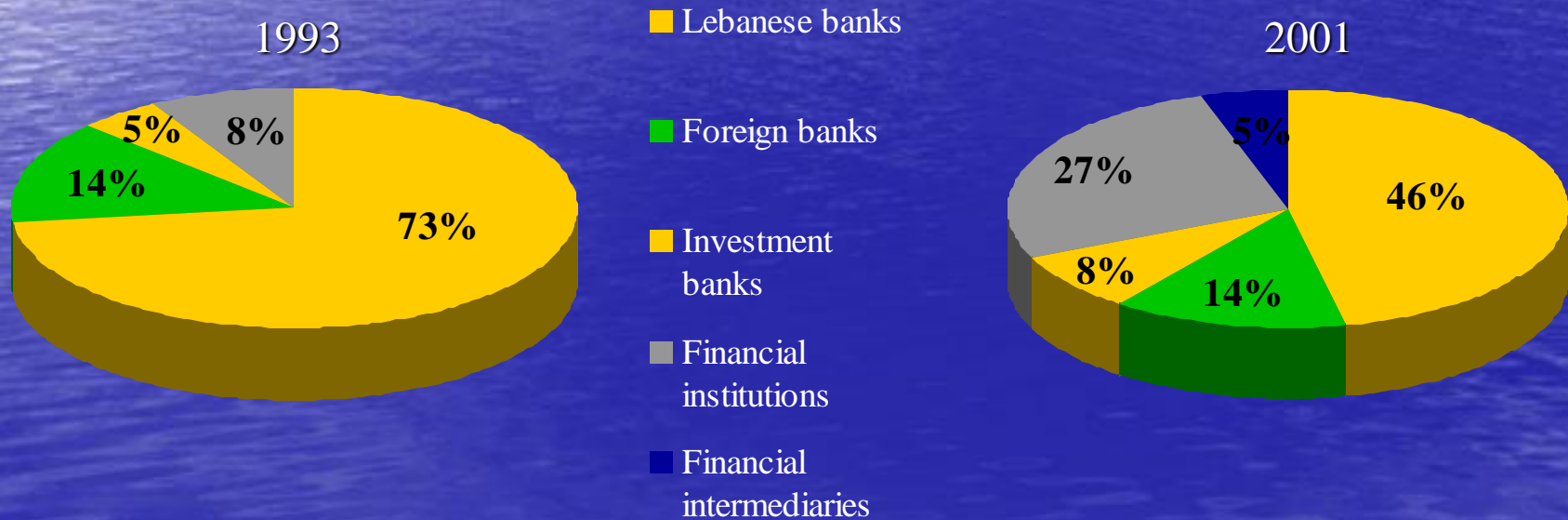


BANKING AND FINANCIAL SECTOR

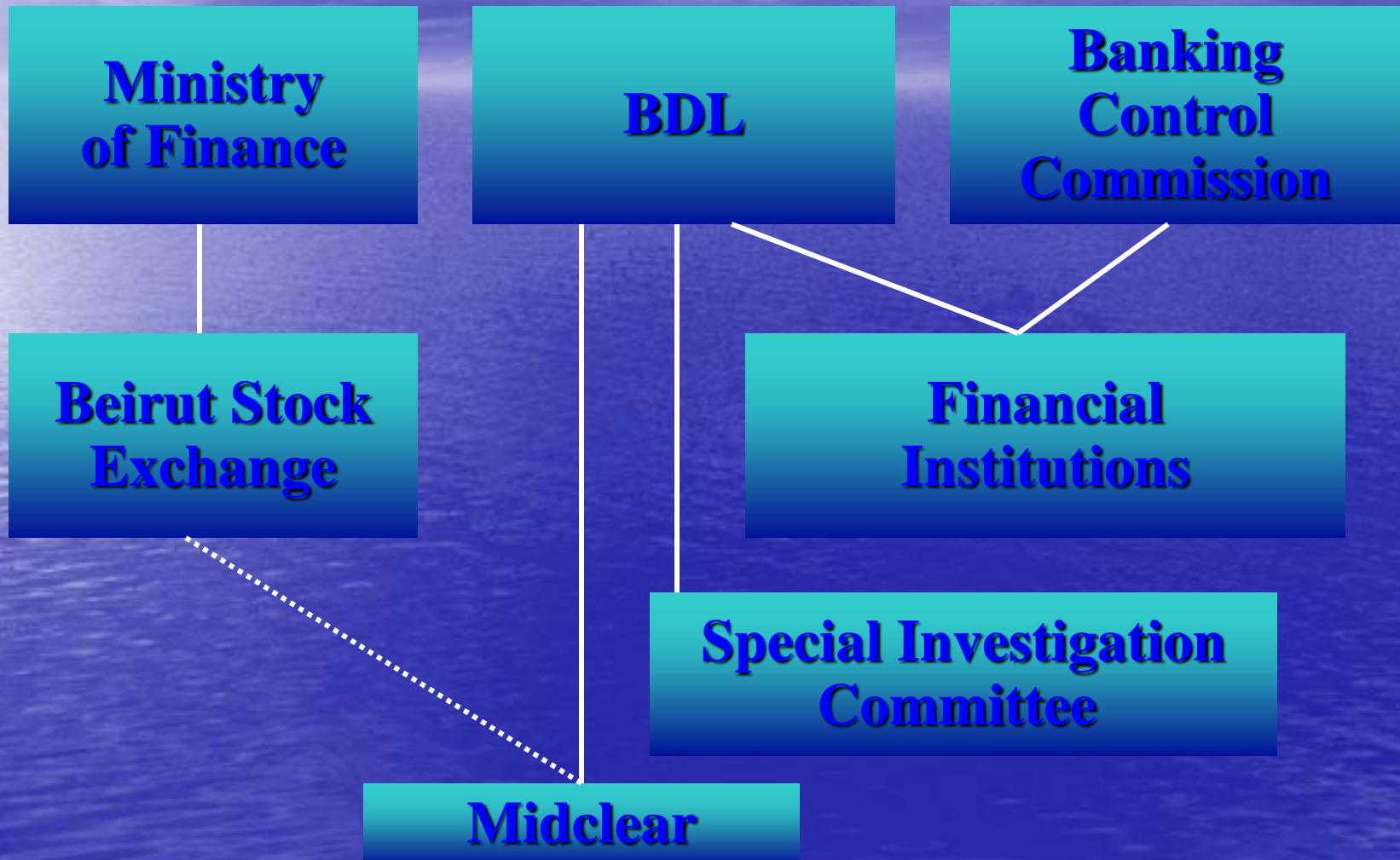
- Structure
- Financial performance
- Regulatory performance

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

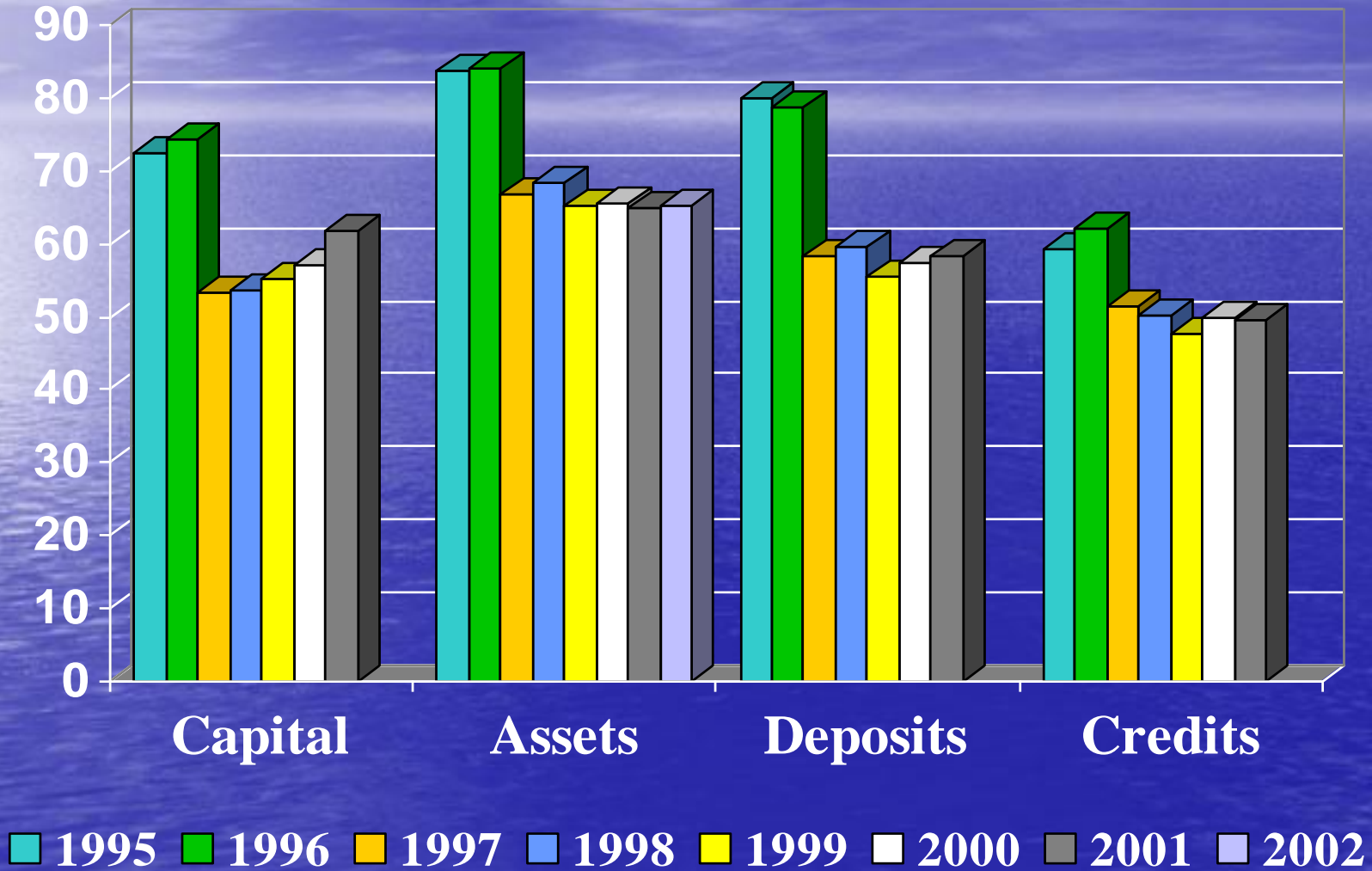


STRUCTURE OF THE FINANCIAL SECTOR II

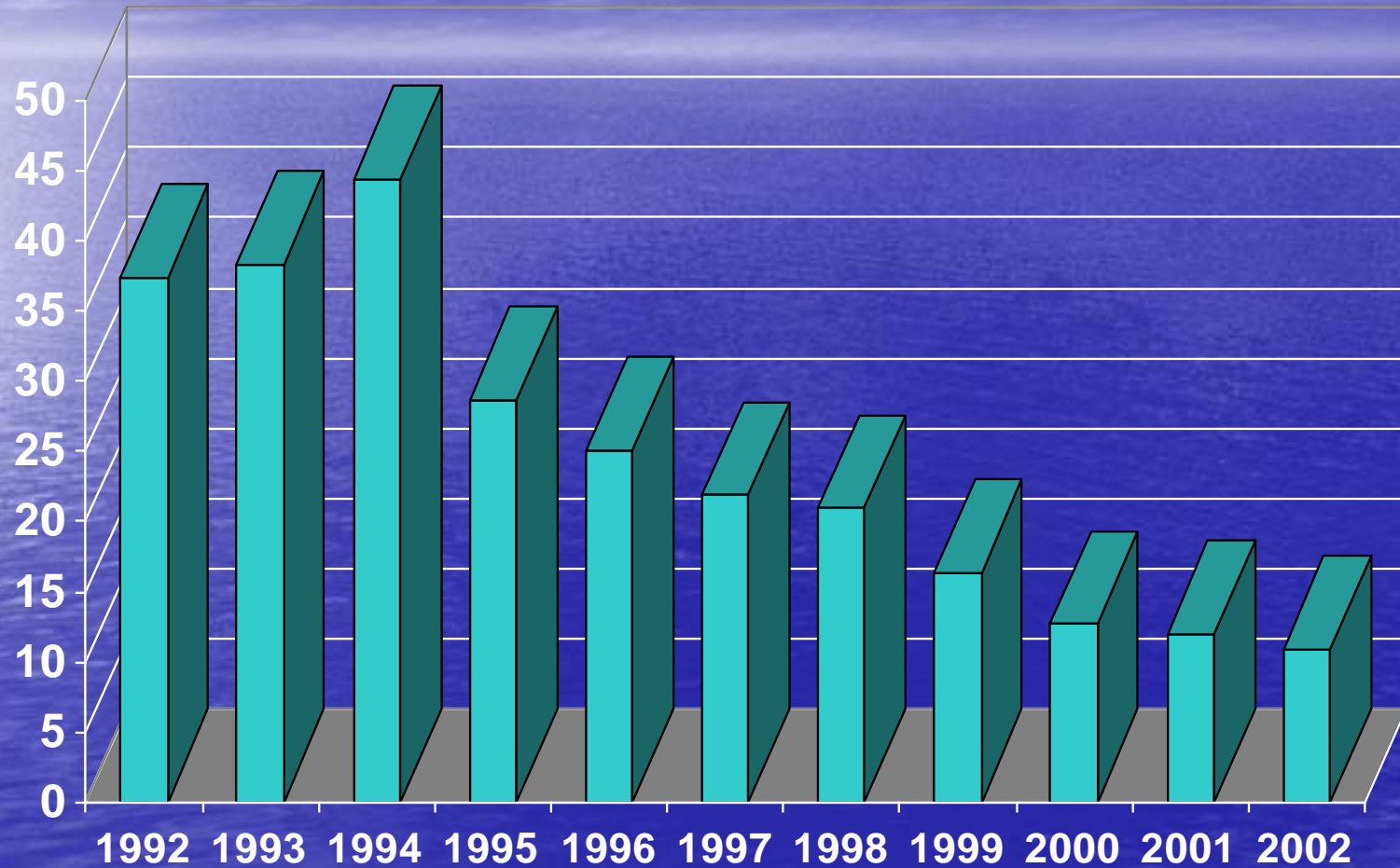


BANKING CONCENTRATION

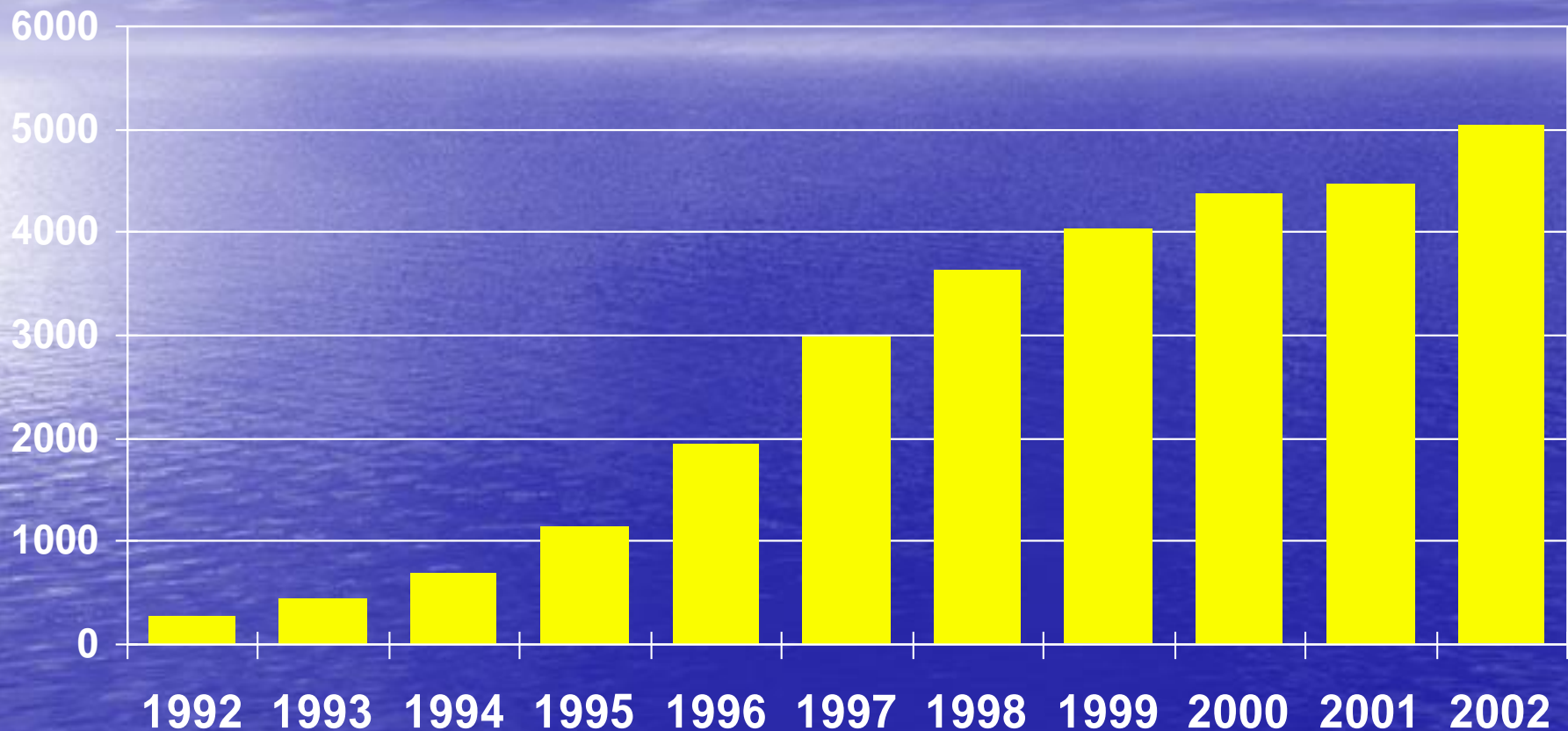
(Largest 10 banks shares in percent)



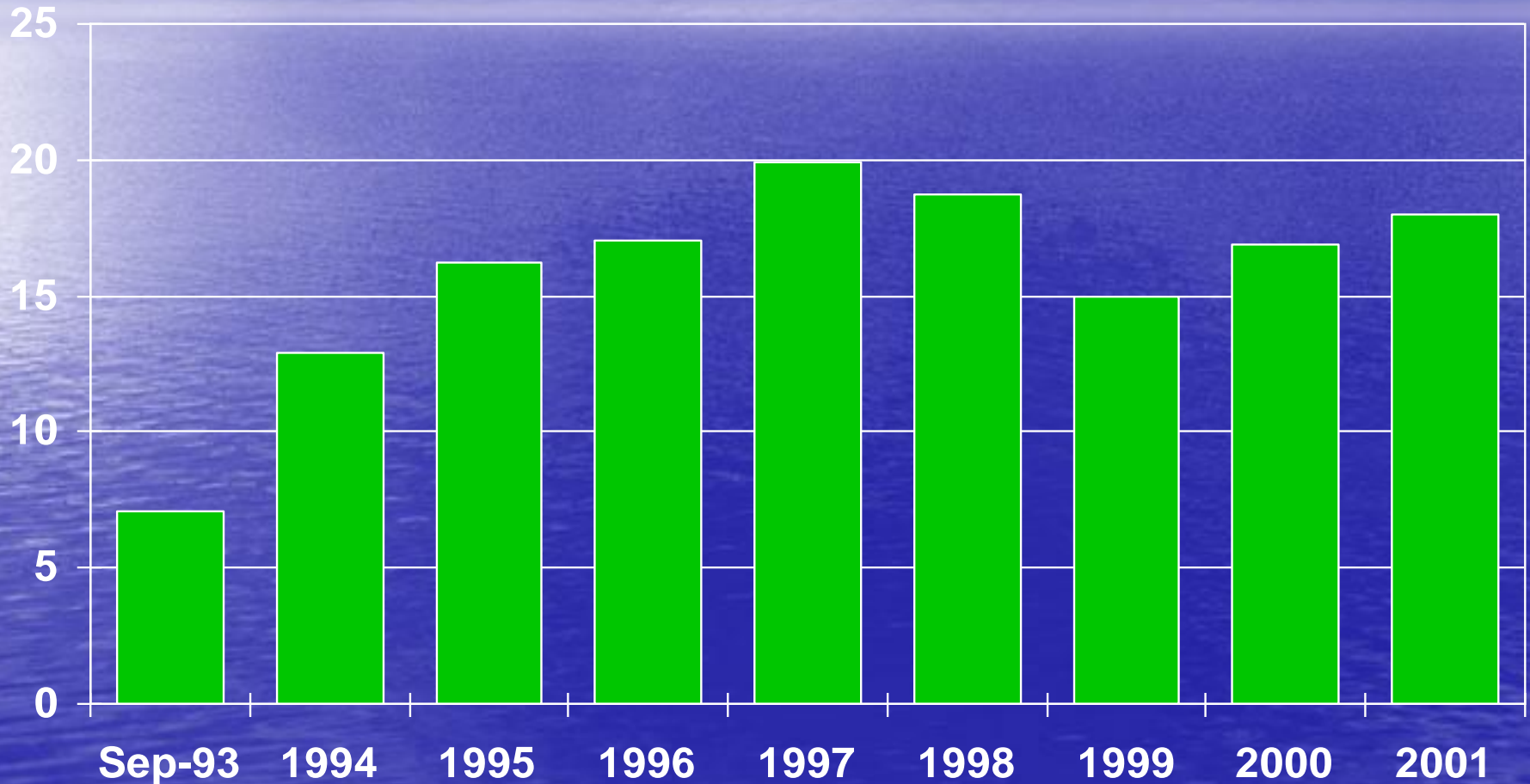
BANKS' RETURN ON EQUITY



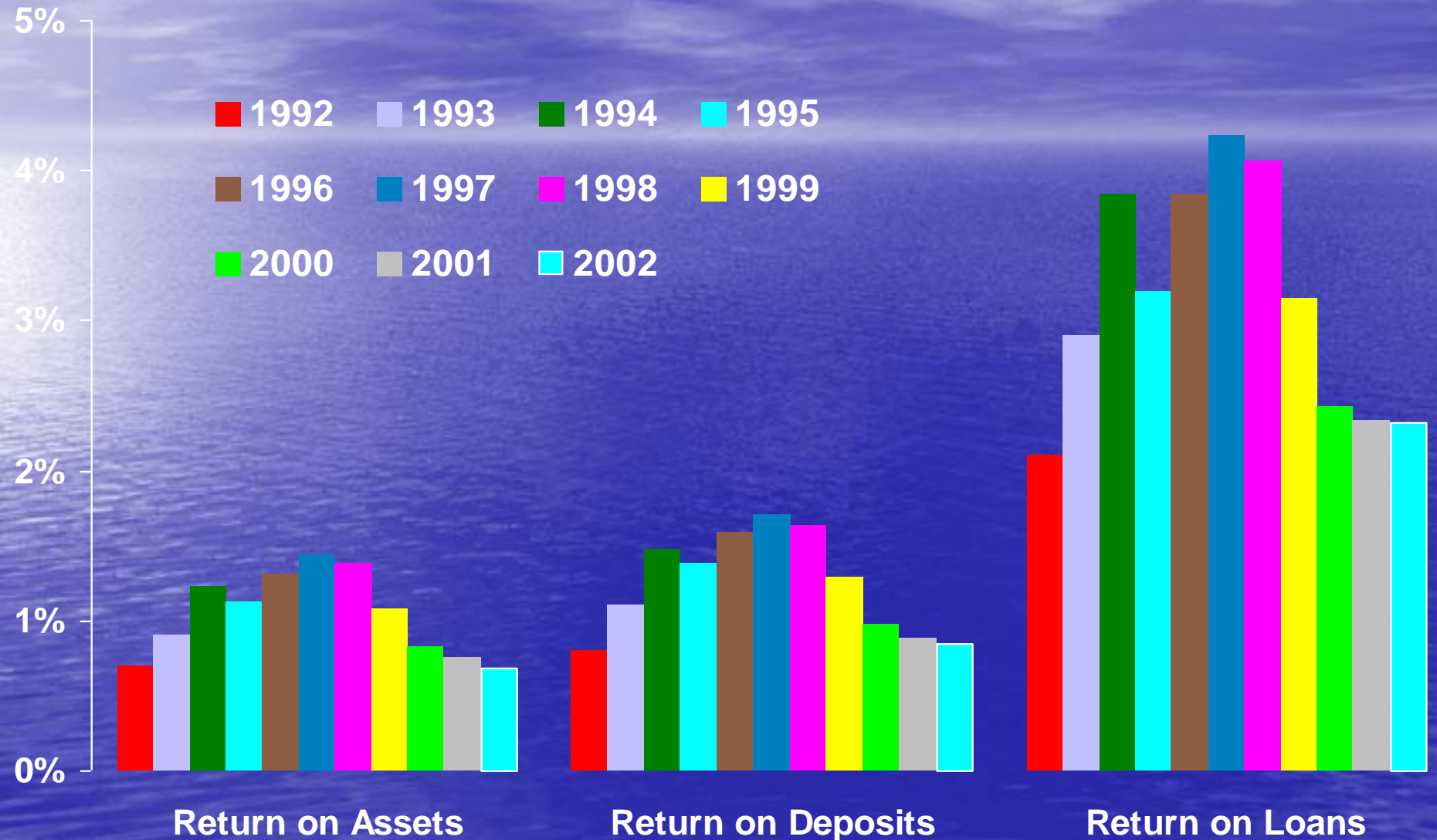
BANKS' CAPITAL, LBP Bn.



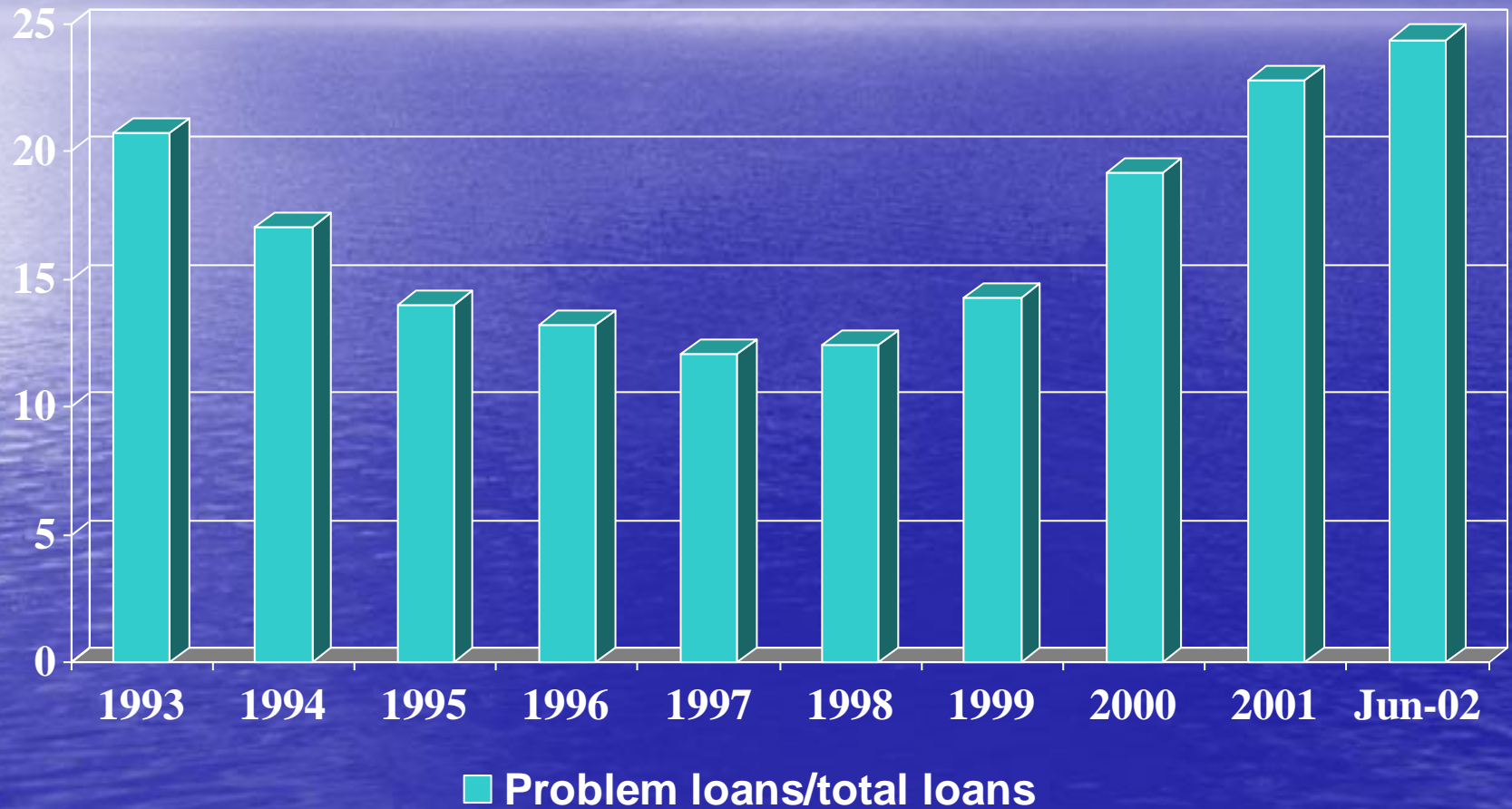
CAPITAL ADEQUACY RATIO



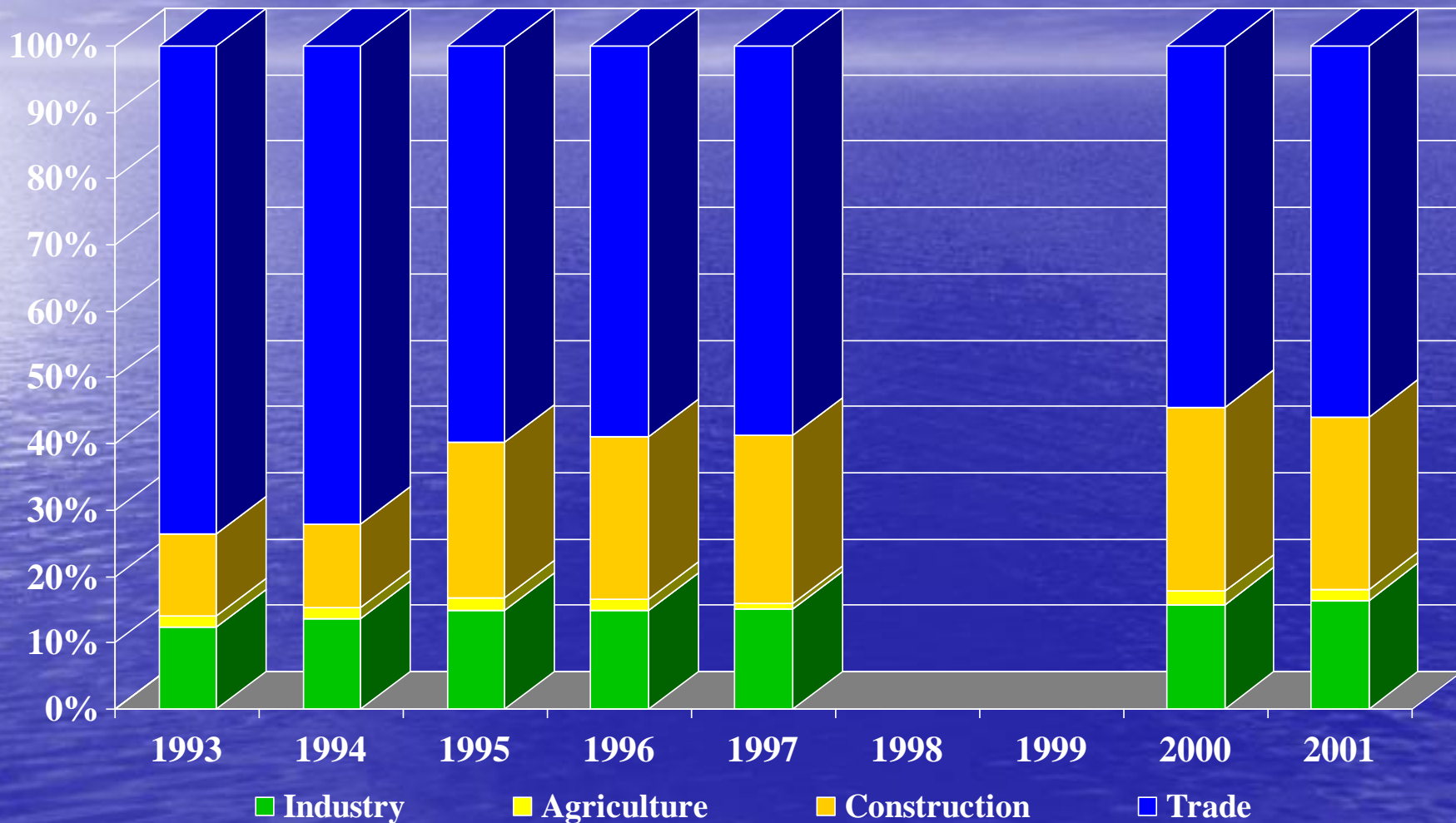
BANKING SECTOR PERFORMANCE



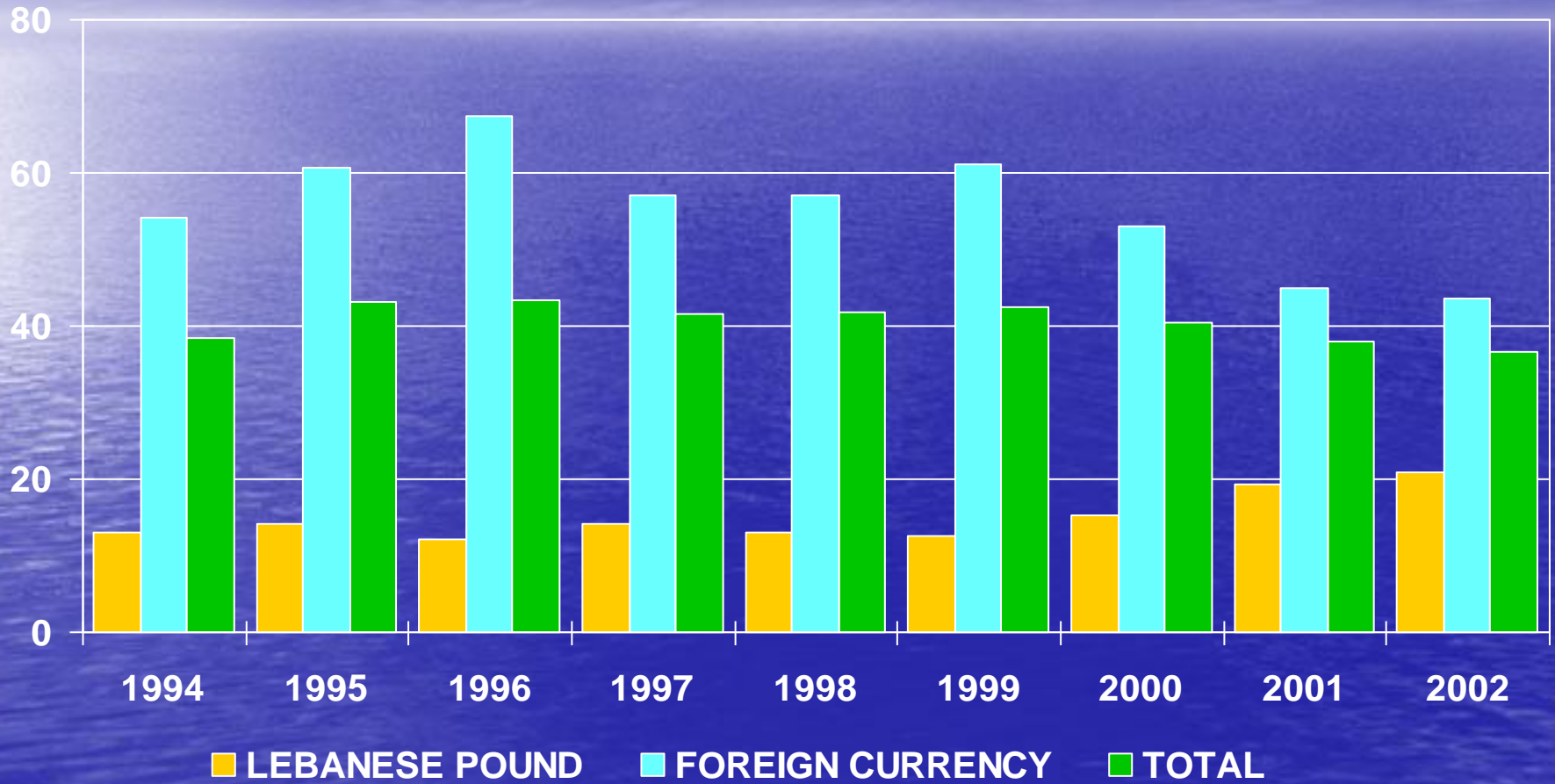
INDICATORS OF BANKING SYSTEM'S FINANCIAL STRENGTH (1)



SECTORAL DISTRIBUTION OF BANKING CREDIT



LIQUIDITY OF THE LEBANESE BANKS (Ratio Credits to Deposits)



PROFITS GROWTH

USD Mn

%



Stabilization Policy: Tax Reform

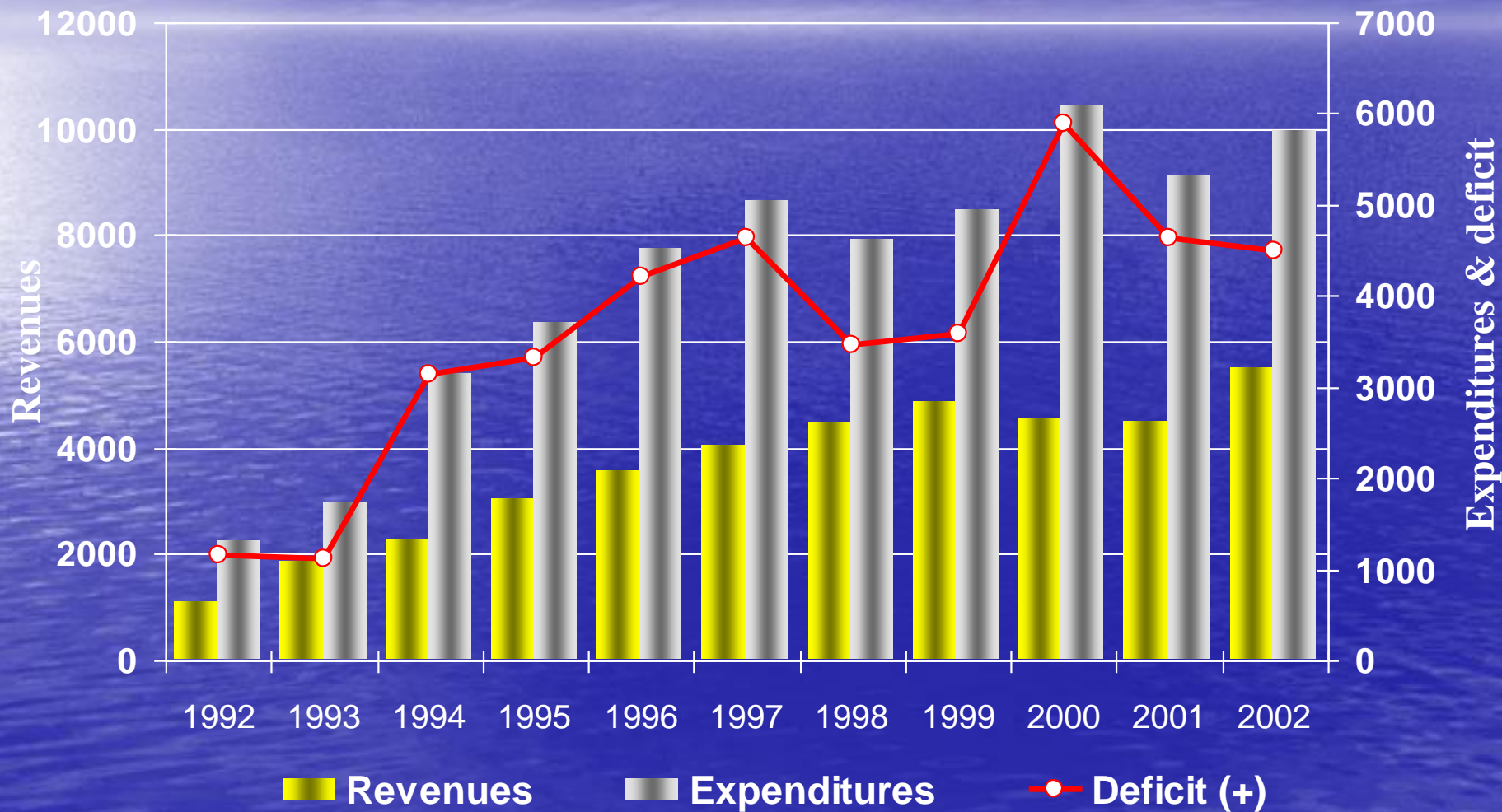
- Improvement in Tax Collection Efforts
- Personal Income Tax Rates Reduced
- Corporate Tax Rate Reduced
- Introduction of the VAT

Stabilization Policy: Fiscal Policy

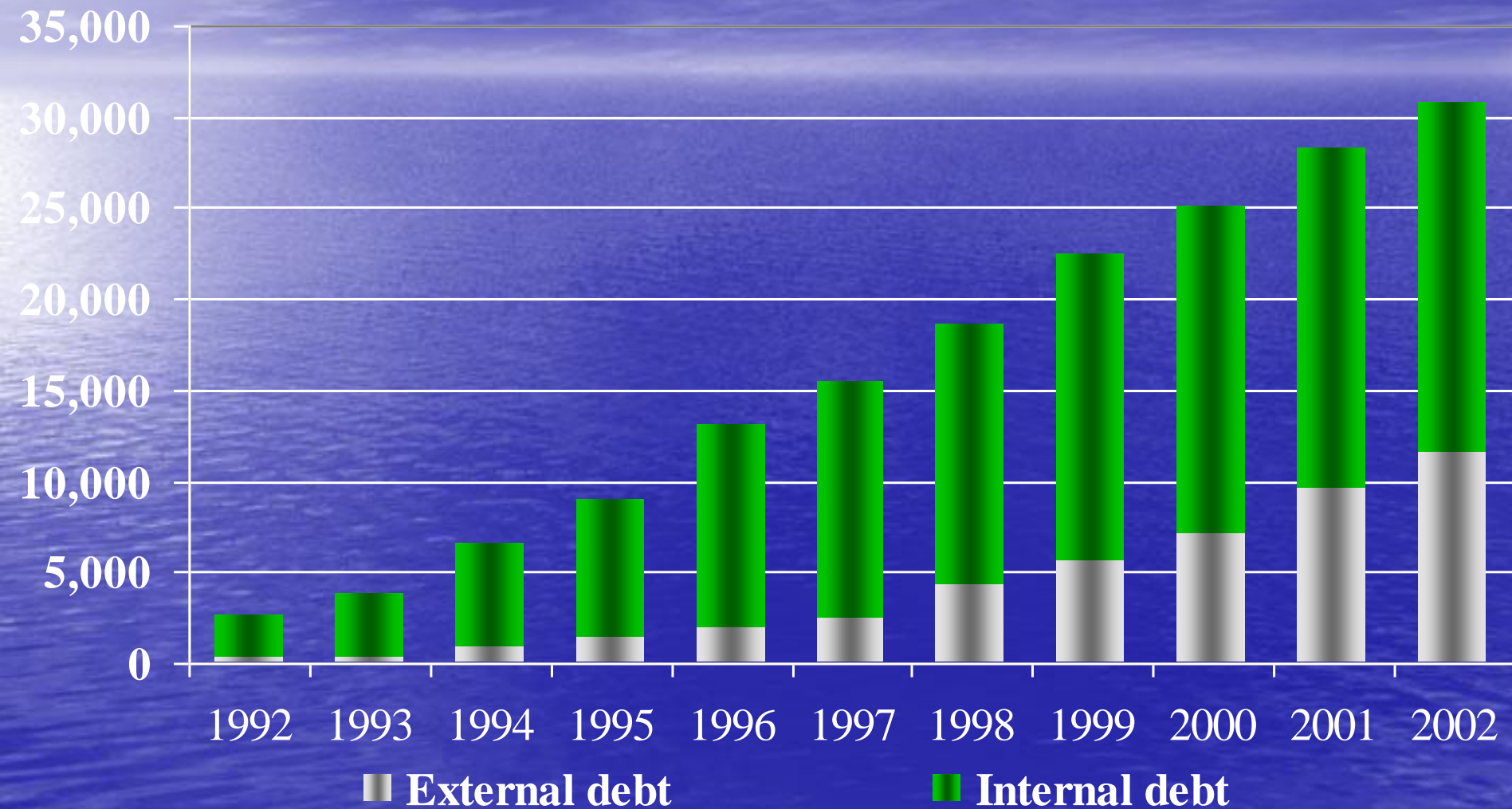
- Increased Revenue Collection
- Control of Budgetary Deficits
- Increase in Public Utilities Prices
- Reliance on Domestic Debt

PUBLIC SECTOR OPERATIONS

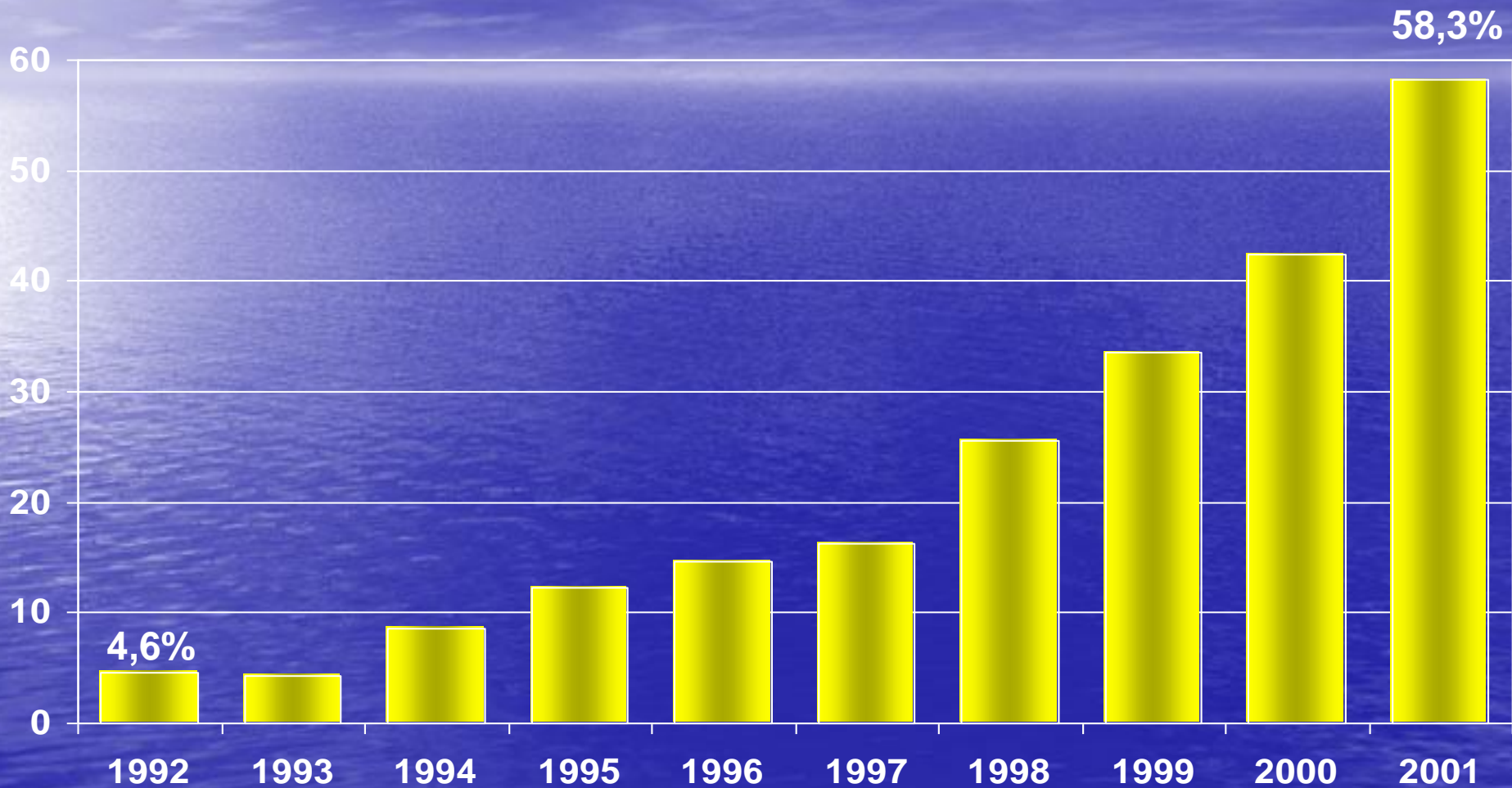
(Bn LL)



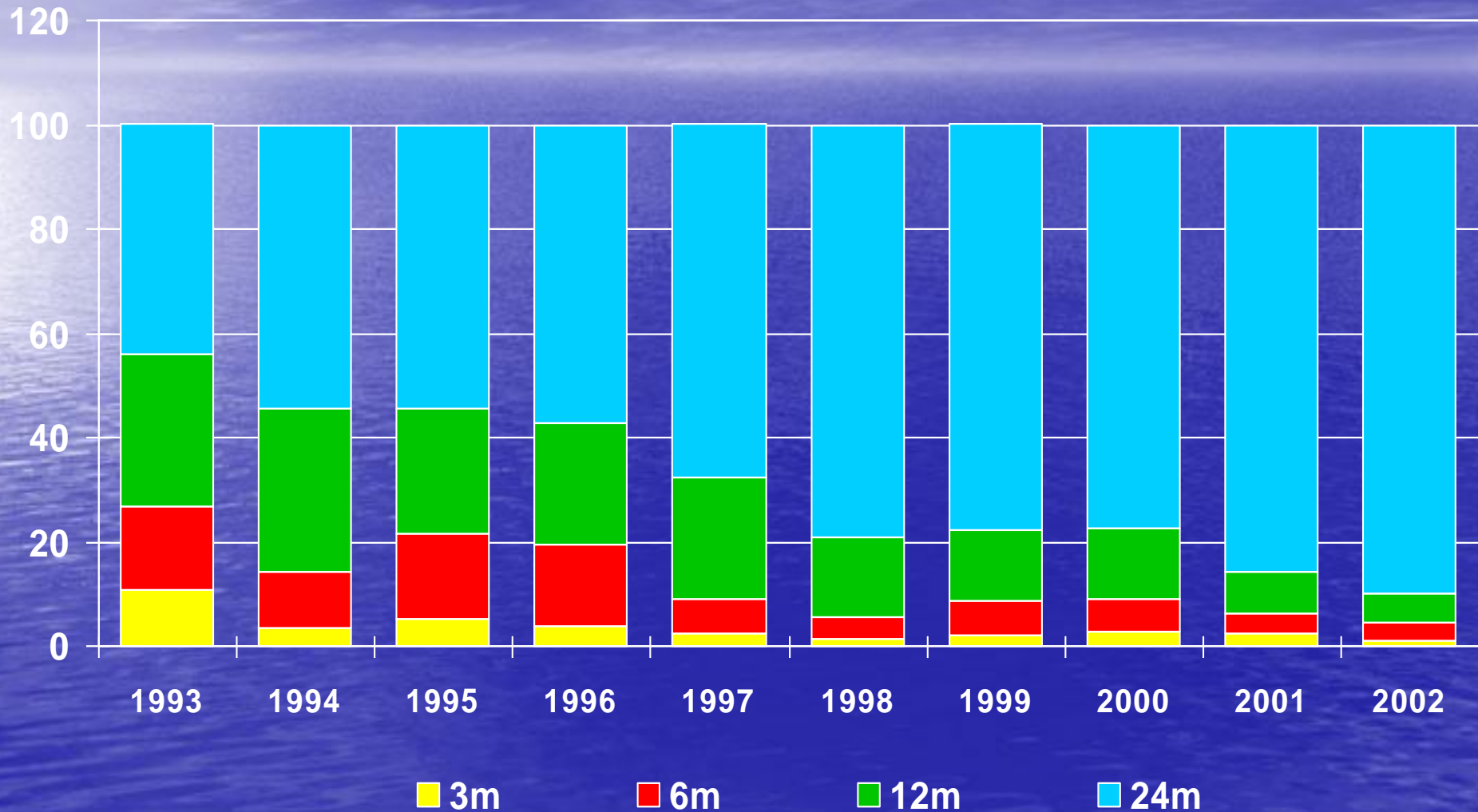
GROSS PUBLIC SECTOR DEBT (Million of US\$)



EXTERNAL DEBT/GDP (%)



DOMESTIC DEBT: MATURITY STRUCTURE



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

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 on modifying article 70 of the Code of Money and Credit

- 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 2000-2001

REGULATIONS

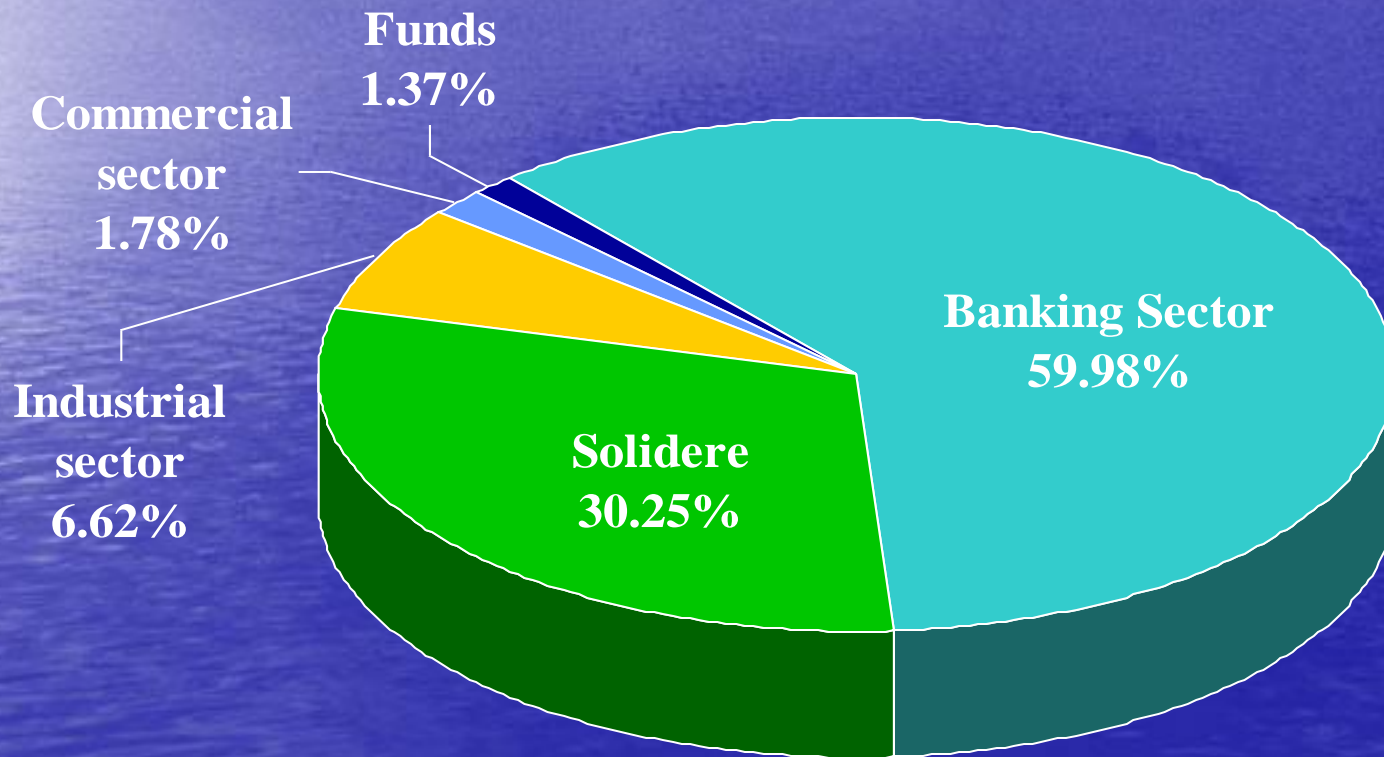
- Broker/Dealer & Intermediaries: licensing, regulation & supervision
- Medium & Long Term Lending
- Connected Lending
- Home Loans, saving/lending
- Bank Capital Requirements: 12% CAR
- Legal Reserve Requirements on LL
- Forex Deposit Requirement: 15%

Laws & Regulations 2000-2001

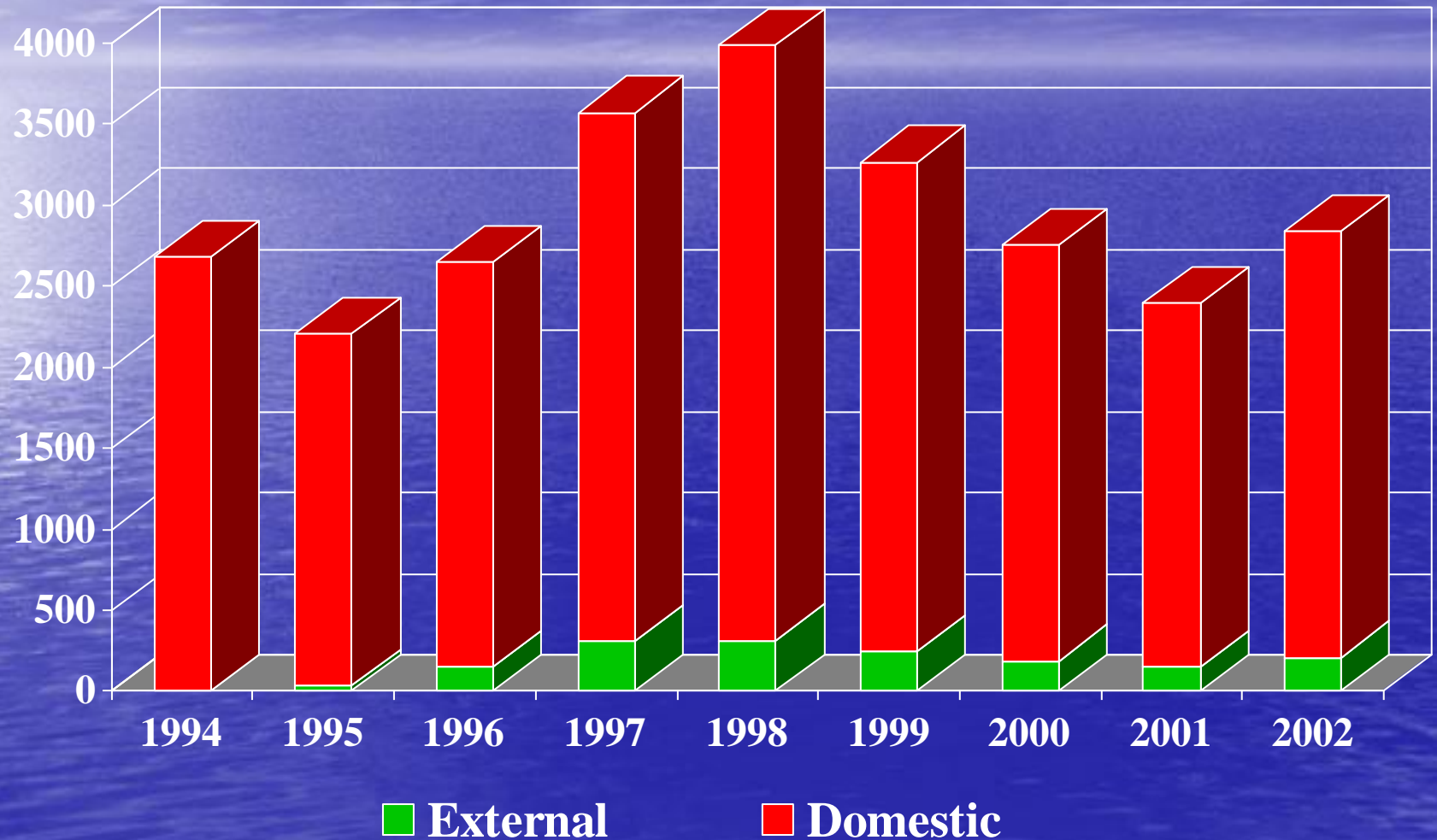
- Electronic Banking Networks
- Trading of Bank Shares
- Internal Bank Supervision and Control
- Anti-Money Laundering
- Subsidized Credits

BEIRUT STOCK MARKET CAPITALISATION December 2002

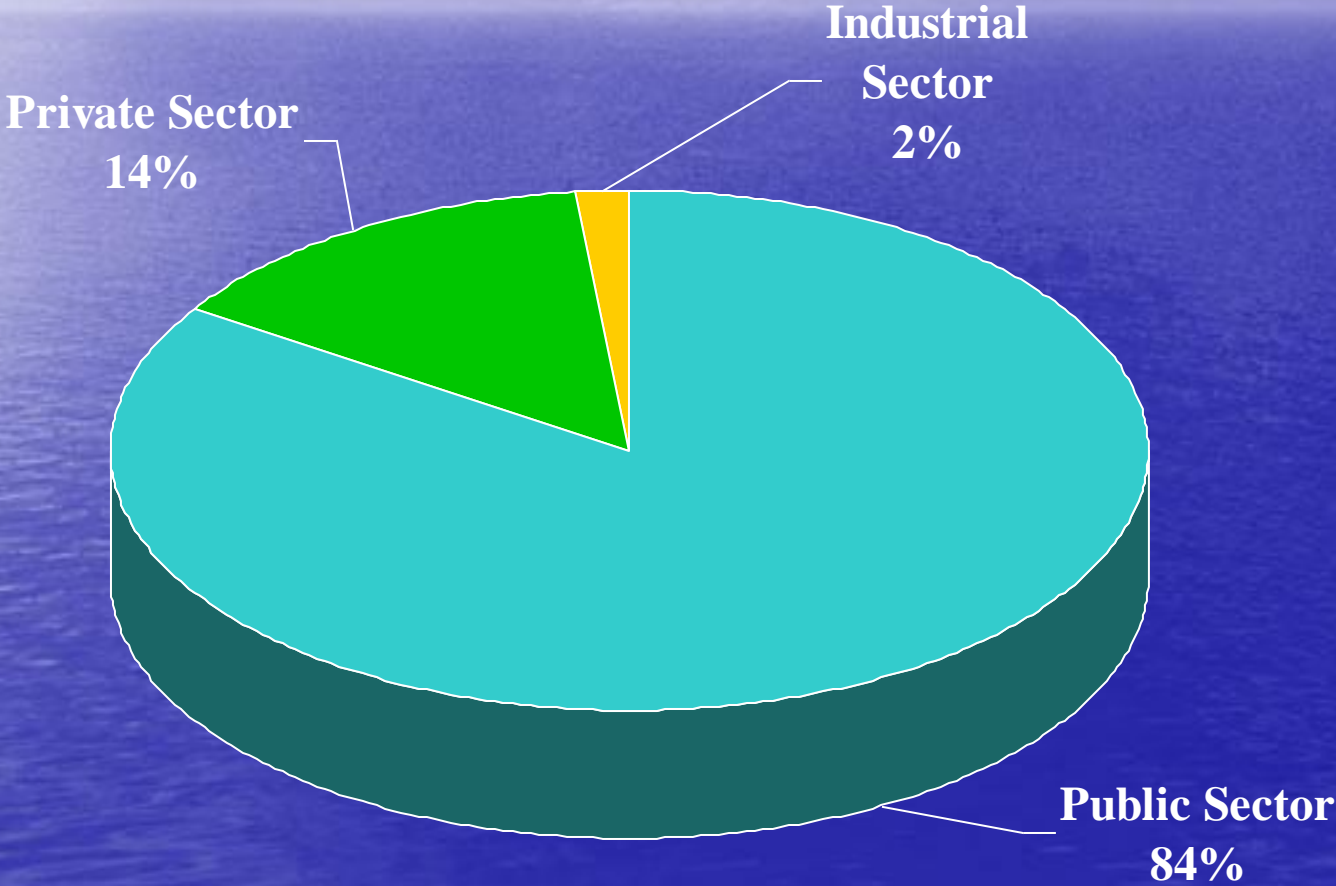
Market Size: US\$ 2,632.396 Mn



EQUITY MARKET CAPITALISATION (Mn US\$)



Lebanon's Bond Market



January 2002

Macroeconomic Challenges

- Fiscal reforms aiming at reducing budget deficits on a sustainable basis
- Public debt reduction
- Maintain real exchange rate stability
- Preserve financial & banking sector stability
- Adjust for entry into WTO, GAFTA and EU Association Agreement

Thank you

Q & A