Comments on Lebanon's fiscal standing in the Executive magazine, Jun 2018

Dr. Saidi’s comments on Lebanon’s fiscal standing are highlighted in the article below, titled “The noose around Lebanon”, published in the Executive magaine in June 2018. Click here to access the original article.

The noose around Lebanon

Lebanon’s economy at risk from external pressures

Over 300 days have passed since Saad Hariri, Lebanon’s prime minister, stood on the White House lawn next to Donald Trump as the US President promised an answer to the “menace” of Hezbollah within 24 hours. That answer did not materialize in the form of a comprehensive foreign policy or as diplomatic niceties, at least where the public is concerned, but now in mid-2018 we indeed have the answer—namely that actions speak louder than words. With that principle in mind, Trump’s politics vis-à-vis Hezbollah and the region has been made clear.

American focus appears to follow that of Israel. In other words, their focus is on Iran. This leaves Syria, as of right now, as a tertiary concern to the Americans. Meanwhile the month of May saw escalations from the Israeli side over what it perceives as Iranian encroachment, escalations that risk further inflaming the Syrian war. These included Israeli airstrikes on Iranian military facilities in Syria, the American withdrawal from the Iran Deal (formally known as the Joint Comprehensive Plan of Action), moving the American embassy in Israel to Jerusalem, and American sanctions that targeted Iranian central bank officials, leaders of Hezbollah, and Hezbollah's alleged illicit global financial network. All of these could increase the risk of a new war in the region. But what could happen to Lebanon and its economy, including the financial sector?

Wider consequences

On May 8 Donald Trump abandoned the Iran Deal, fulfilling a promise made on the campaign trail. The US president offered no strategy or alternatives, with a list of demands only later fleshed out by US Secretary of State Mike Pompeo. The Iranians have a list of their own that they have sent to the European parties to the deal who wish to keep the agreement in place. These include European protection of Iranian oil sales and a continuation of purchases. The Americans have threatened sanctions on European companies if they do business with Iran, and so far Total, an international oil company, announced it would freeze its $1 billion investment in an Iranian gas field if the Americans reaply sanctions on Iran later this year. Other global companies have also said they would wind down business in Iran. In the 1990s the United States threatened sanctions against European companies for trading with Cuba, but the European Union was able to neutralize the threat by suggesting retaliatory sanctions. Right now it is anyone's guess how this chapter of the saga might play out, and at this point it is unclear how wider American actions will affect the regional economy. We also do not yet know what sanctions targeting senior officials connected to Hezbollah will do to Lebanon, its banking sector, or the local economy.

Economic woes

What we do know is that the risk of a regional war that could engulf Lebanon has already had implications for the country's economy.

Moody’s, a credit agency, reported in mid-May that global financing conditions will tighten gradually but also said that Lebanon, as one of several sovereigns, could be vulnerable to an interest rate shock. In the event of such an episode, the Moody’s report concludes that “the most exposed emerging market and frontier market sovereigns would see fiscal strength weaken. Absent a policy response that effectively mitigated the erosion of fiscal strength, these shifts would strain ratings, even for sovereigns we already assess with the lowest fiscal strength.” Their announcement does not directly address war risk, but Lebanon’s vulnerability to an interest rate shock could be due, as they put it, to “high debt burdens, eroded revenue bases after the commodity price shocks, and an untested capacity to refinance sizable maturities in an environment of tighter financing conditions.” The indirect effect of oil prices, which now hover around $80, will heavily impact the Lebanese economy, putting pressure on exchange rates and the international interest rate environment. There is also speculation that Brent Crude trading could reach $100 per barrel next year, in part due to US sanctions on Iranian oil.

Lebanon has one of the world’s highest debt-to-GDP ratio, estimated above 150 percent in 2017 by the International Monetary Fund (IMF), and the government recently swapped Eurobonds with Banque du Liban (BDL), Lebanon’s central bank, worth $5.5 billion in Lebanese treasury bonds, according to a Ministry of Finance statement. The swap is meant to finance the government through the end of the year and to reduce debt-servicing costs.

Challenges ahead

The Eurobond fell to 94.67 points as of May 14 according to the BLOM Bond Index, a measurement of the performance of the Lebanese government in the Eurobond market, a decline of 8.5 percent from its peak of 103.42 points on January 17. *Dollar-denominated bonds have also tumbled, according to the May 14*

Weekly Economic Commentary published by Nasser Saidi, a former Lebanon economy minister: "Lebanon's dollar-denominated bonds fell to multi-month lows after Trump pulled out of the Iran deal: the $1 billion bond maturing in 2022 tumbled to 90.66 cents (the steepest loss) – its lowest level since Nov 2017." In a message to Executive, Saidi explained the drop as investor uncertainty by stating that "investors consider Lebanon at risk of war as a result of potential Iran confrontation."

Lebanon's fiscal standing is, in polite terms, very challenging. Saidi, responding to an Executive email, summarized the choppy strait that Lebanon must navigate, while also considering the external pressure points: "Given the high and growing risk premium, the spread on sovereign debt and interest rates are likely to remain high and rise further in Lebanon. This will be further exacerbated by the rise in US interest rates as part of monetary policy normalization and higher inflation. Given the peg of the LBP to the USD, there will be upward pressure on Lebanese interest rates. The impact of rising rates is substantial. It is estimated that a 1 percentage point (100 basis points) increase in interest rates would raise the cost of debt service by 7 percent of government revenues, from an already unsustainable 49 percent. However, BDL indicated in March this year that there would be no further rate hikes in spite of the [US Federal Reserve's] anticipated hikes later this year, indicating monetary accommodation of budget deficits by the central bank. Trying to lower spreads will hamper the nation's ability to attract inflows, thereby raising risk premiums further."

Internal dynamics, coupled with some external factors, hold the possibility to trip up Lebanon's economy, rather than indirect pressure of sanctions which at this point really do not look like an economic instrument but more like a political one that makes noise and headlines but does not change the economic equation fundamentally. Yes, there are sanctions on

Lebanese individuals and companies and that does pile on political pressure on the country, but the standard answer from Lebanon's central bank is that it complies with international standards and foreign and local legislation, while the banking community is in compliance with global anti-money laundering and counterterrorism financing requirements.

Riad Salameh, governor of BDL, does not seem so fazed by the myriad challenges piling on the country. He has, afterall, guided Lebanon through similar rocky periods over his 25 year tenure. "The challenges are true challenges and we will be facing them, whether the increase in interest rate because of the world increase in rates, or whether the higher oil prices. [It is also true that] the geopolitical risks will be influencing the economy," Salameh said in a recent interview with Executive.

Past experience has demonstrated the vulnerability of Lebanon's economy to external shocks and maybe it is so far positive that there has been only limited military action in the immediate period following America's JCPOA withdrawal, embassy move, and targeted sanctions. How Lebanon plays into these geopolitical issues we still do not know, but the sound of the Trump administration's war drums grow ever larger and the latitude afforded to Israel to do as they may in the region widens.