

Lebanon's Economy: Staring into the Abyss

*Presentation to the Harvard University Alumni Association of Lebanon
(HUAAL) and the Harvard Business Club in Lebanon*

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24 April 2020

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Agenda

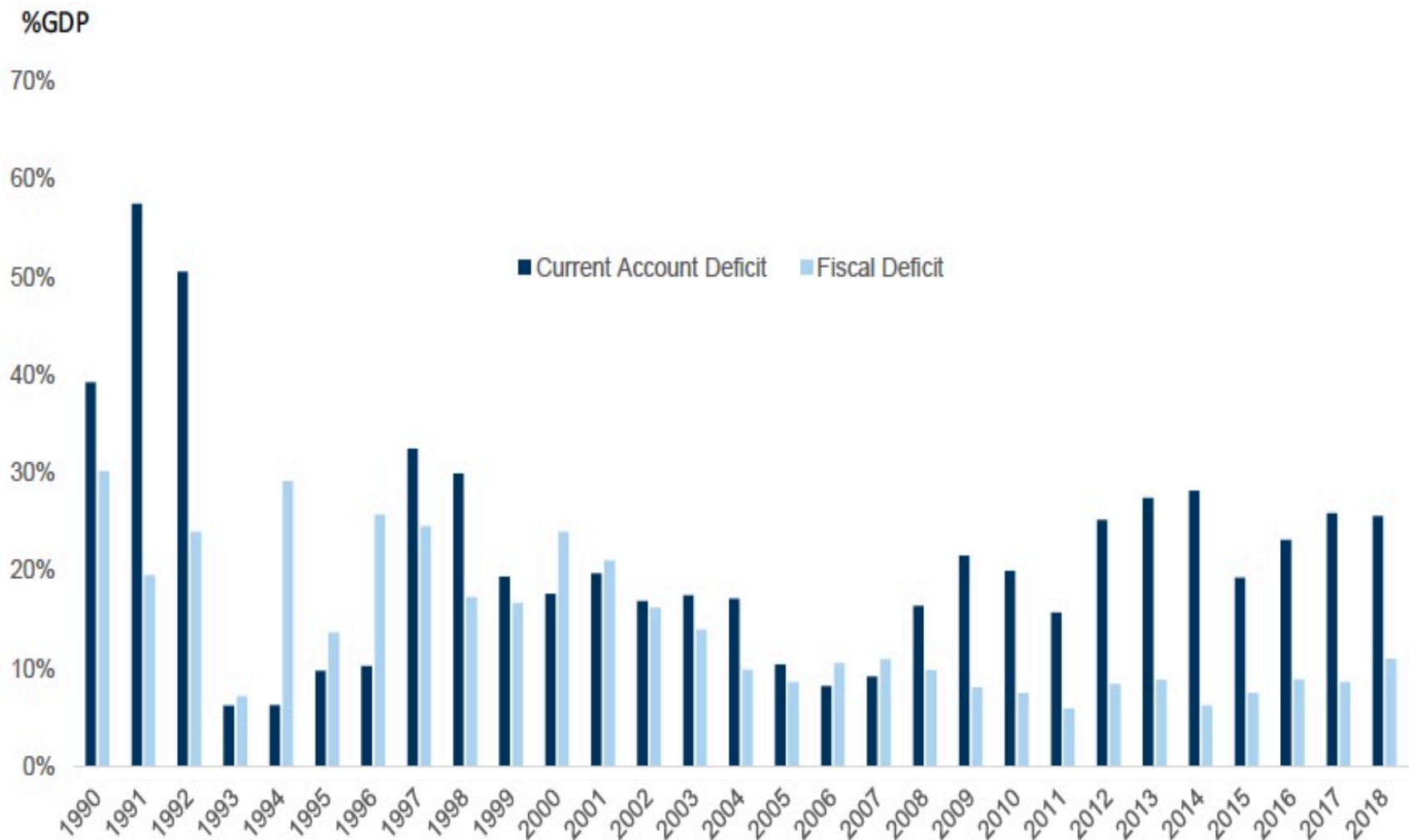
- ✓ **Macroeconomic developments 2011-2019**
- ✓ **Real, monetary, financial, fiscal reasons for the crisis**
- ✓ **Moving out of the abyss: Government Proposal; Potential Solutions**

Macroeconomic Overview

- Lebanon has entered its third consecutive year of negative growth
- Economy is collapsing: businesses are closing + unemployment is rising + lira's black market value against the dollar has plummeted
- Banking system as a whole has lent 75% of its assets to State/BDL

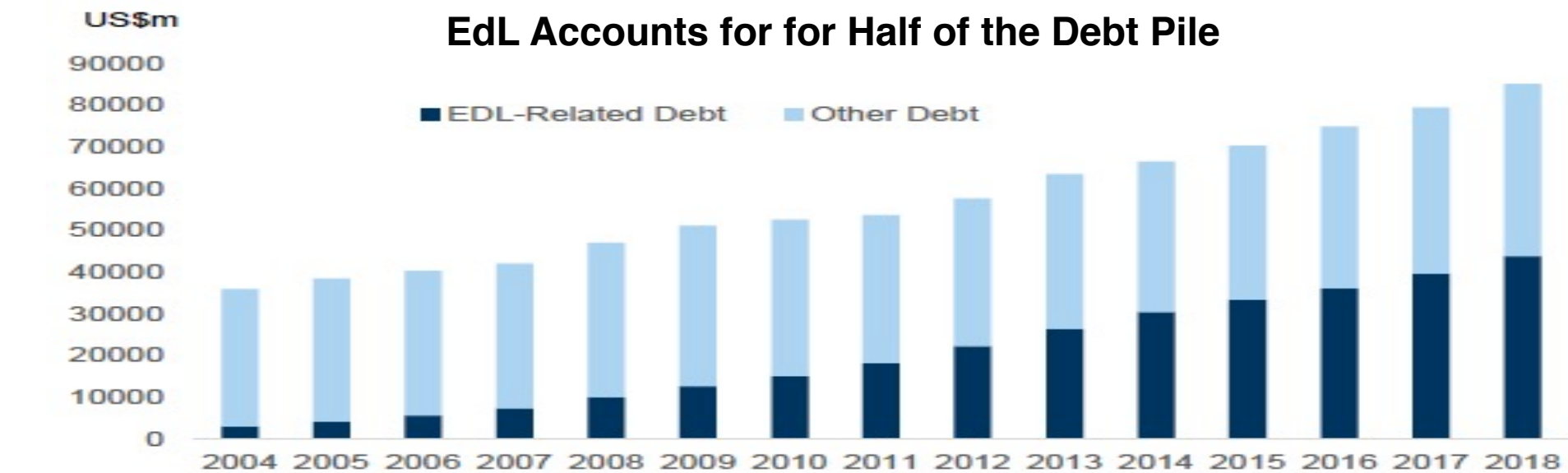
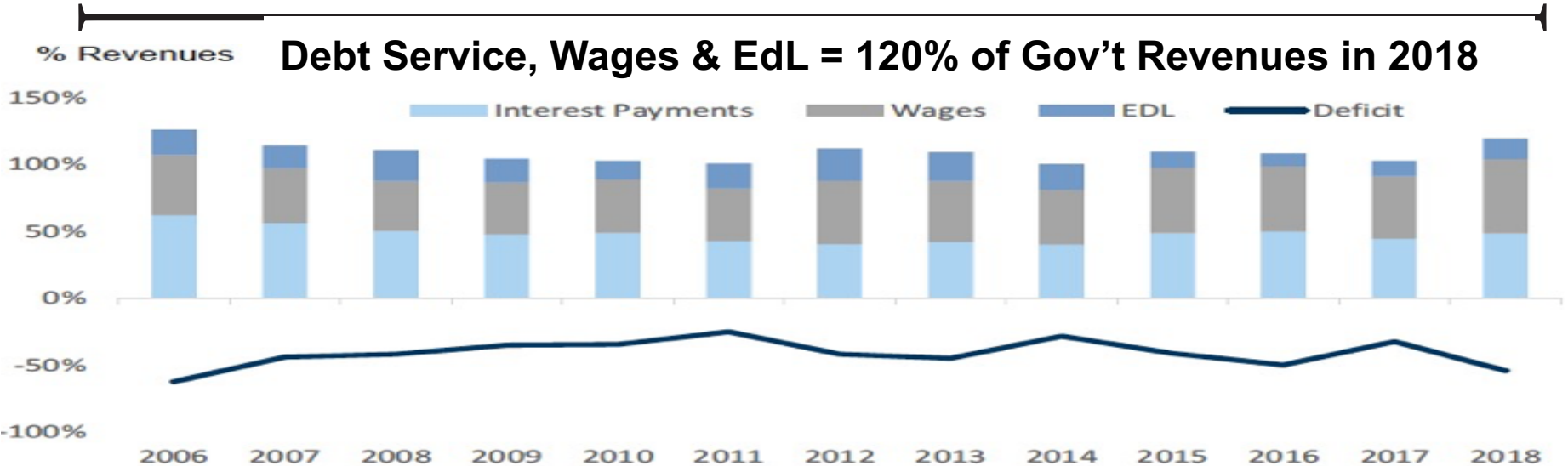
	2018	2019	2020
Real GDP growth (%)	-1.9	-6.5	-12.0
Inflation (%)	4.6	2.9	17.0
Fiscal balance, % of GDP	-11.3	-10.7	-15.3
Govt gross debt, % of GDP	154.9	172.2	183.6
Gross external debt, % of GDP	192.8	196.3	186.6
Current account, \$ bn	-14.7	-10.9	-6.8
Reserves, \$bn	36.5	31.8	24.4
GDP, USD bn	55	52.7	53.9

Persistent Twin Deficits over past 30 years: Fiscal & Current Account



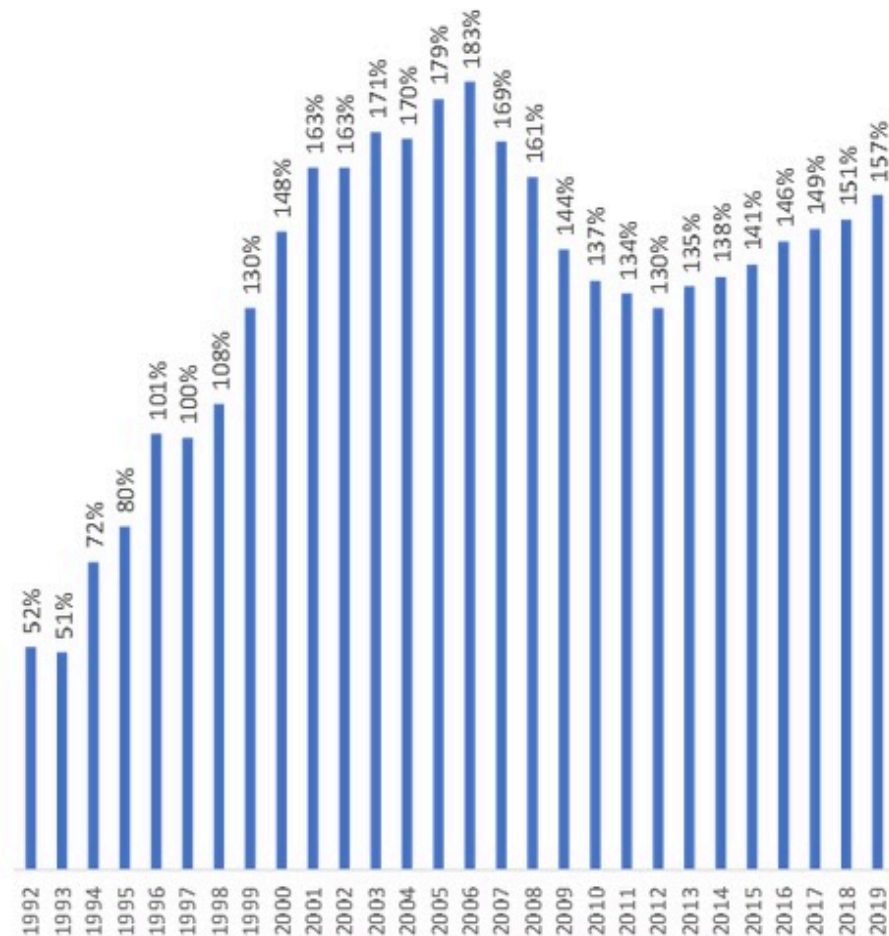
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Loose fiscal discipline, corruption, increased budget rigidity & an eroding revenue base exacerbated fiscal imbalances

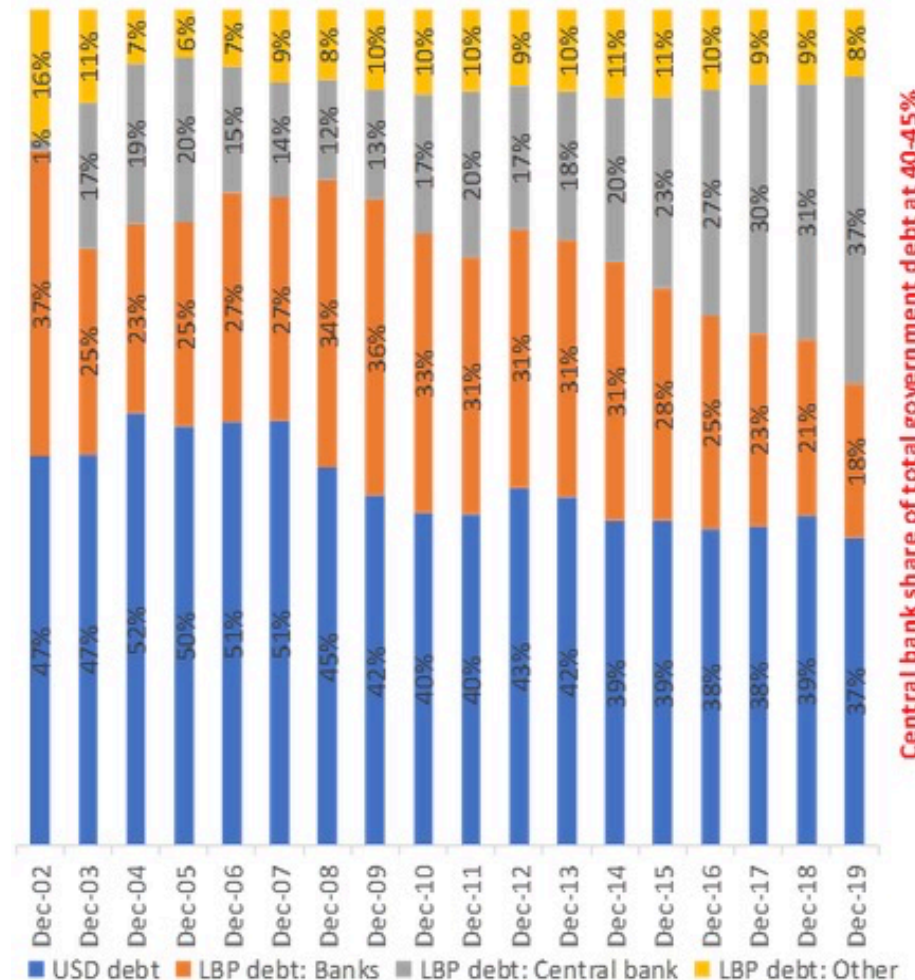


Unsustainable twin deficits led to a rapid build-up of public and external debt

Public debt since 1992 (% GDP) is among the highest in the world



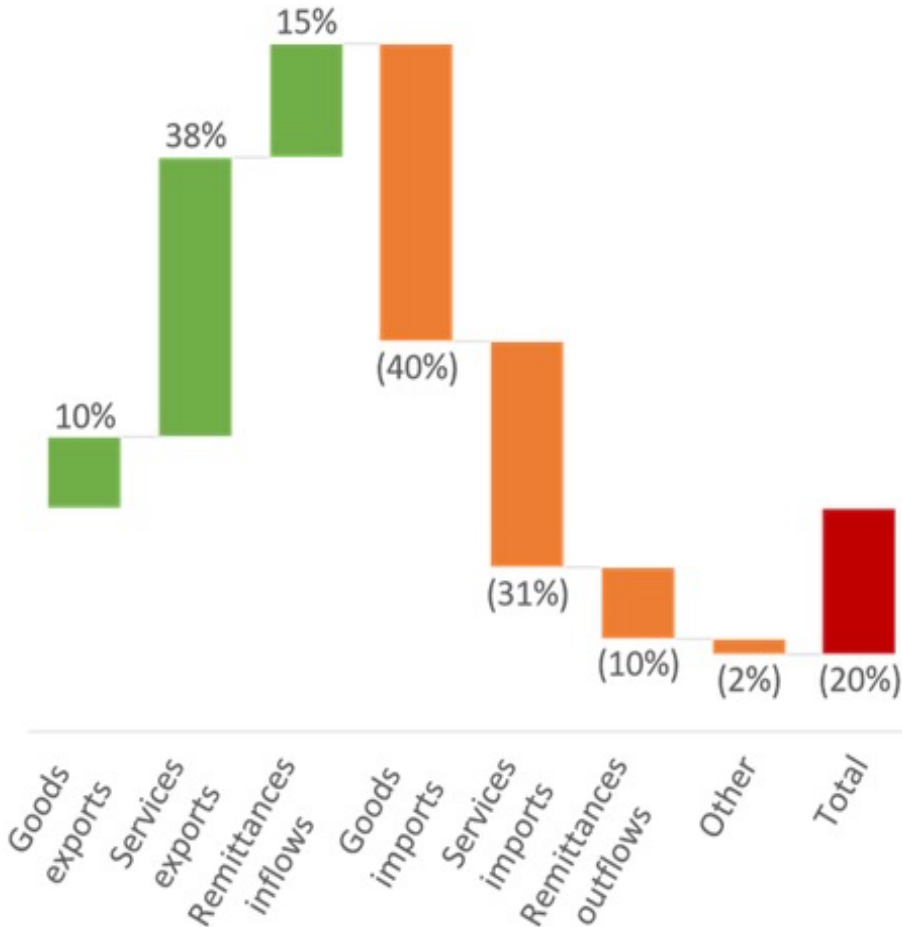
Composition of public debt (% of total)



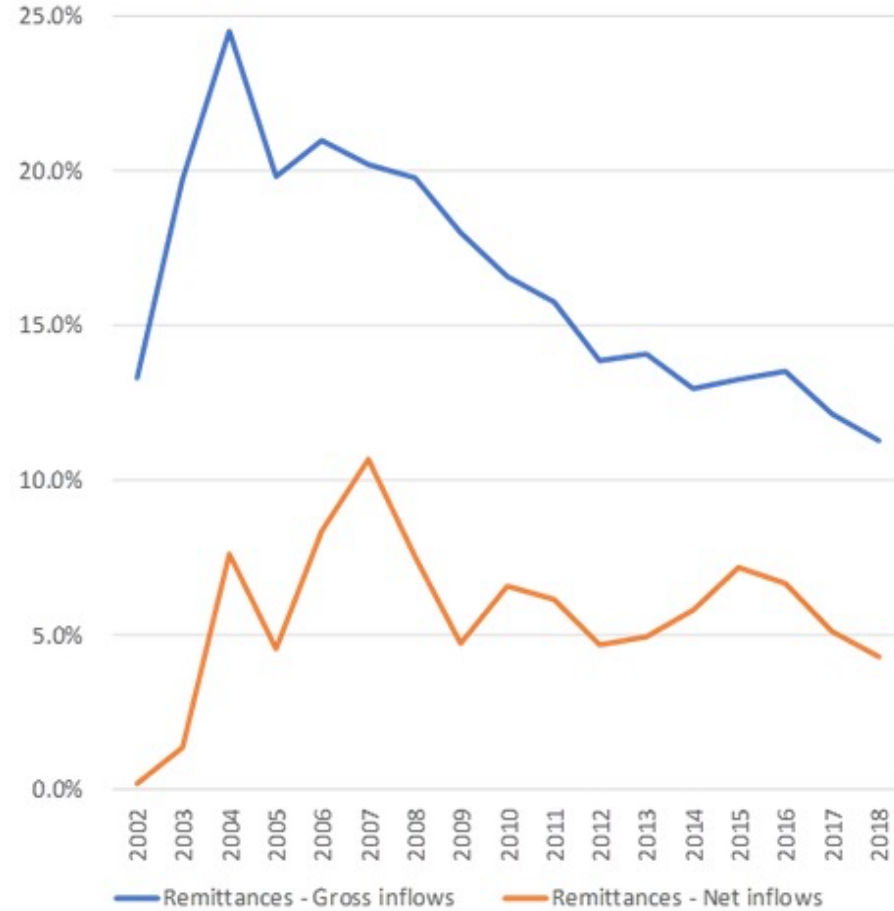
Central bank share of total government debt at 40-45% (55-60% of LBP debt and 20% of USD debt) vs. 20% 5 years ago

Lebanon has been living above its means for decades, paid for by remittances & debt

CA deficit breakdown (% GDP)-cumulative 2002-18

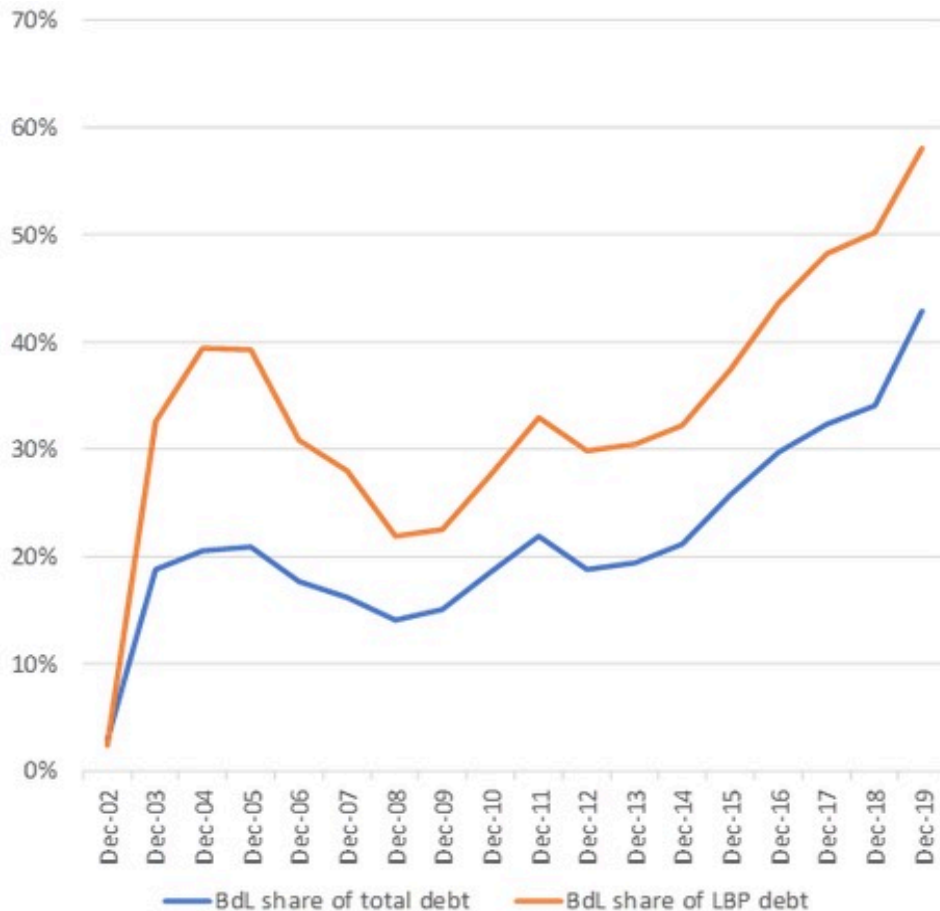


Remittances (net and gross as % GDP)

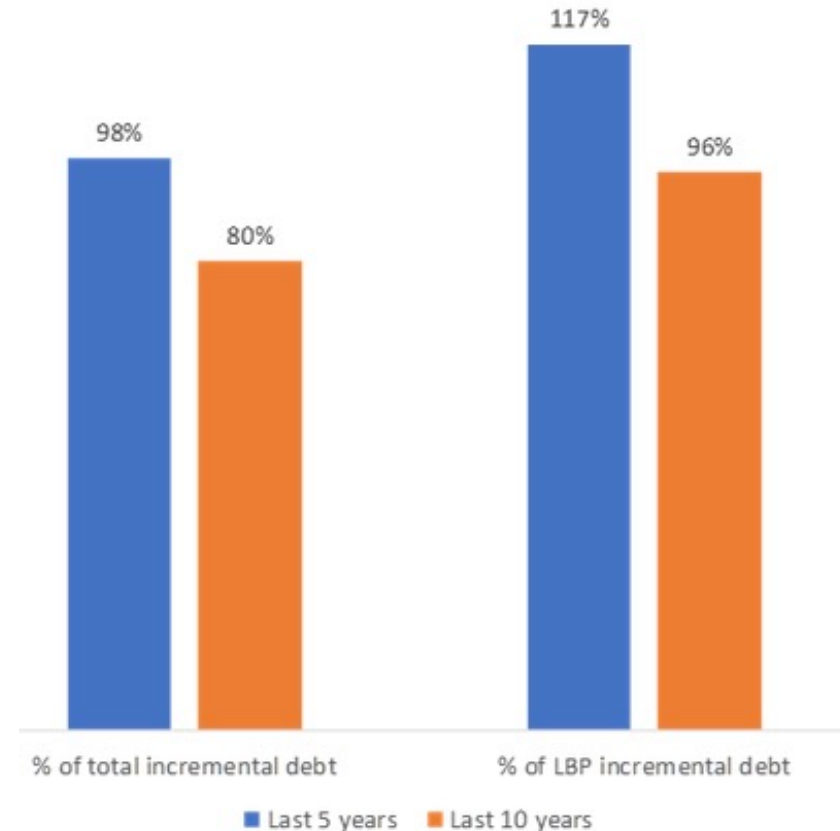


As creditworthiness deteriorated, local banks reduced their exposure to the sovereign, while BDL monetized large and persistent fiscal deficits and debt

BDL share of government debt over time (in %)



BDL share of incremental govt debt (in %)



Unsound macro policies exacerbated the overvaluation of LBP & led to black market

The appreciation of the REER has accelerated since 2015/16 and severely undermined (with other factors) the external competitiveness of the economy.

Real & Nominal effective exchange rate (2000-2019)



LBP to USD Parallel Exchange Rate



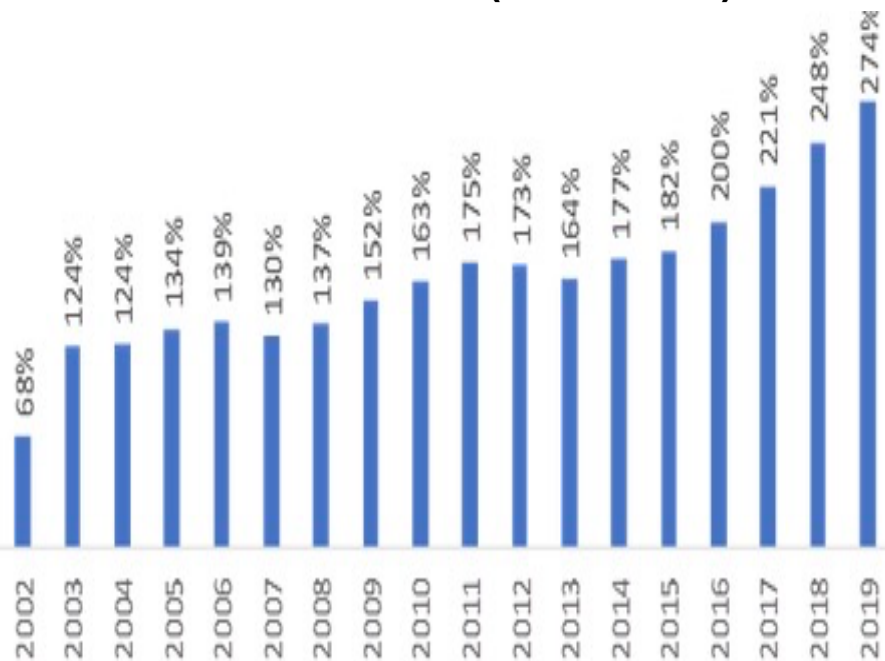
Source: Bruegel

Source: <https://lirate.com/>

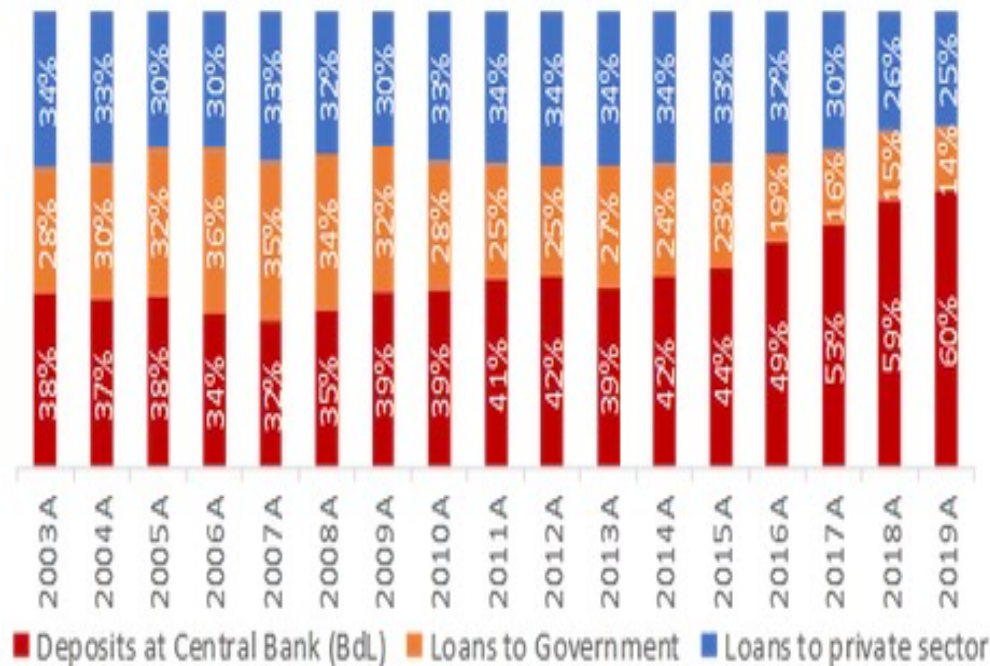
Banks' increased exposure to BDL => inflated BdL balance sheet significantly since 2016

At end-Dec 2019, ~60% of banks' risk assets were placed at BDL vs 38% in 2003 and 44% at end 2015. The financial engineering operations provided high marginal returns in LBP and in USD on new bank USD deposits at BDL; interest earned from banks' deposits at BDL is estimated to have reached \$8-10bn in 2018, and inflated paper profits of banks => combined bank exposure to BDL and government thus reached 75% of total assets

BDL total assets (% of GDP)



The evolution of banks' risk exposure (%)



BDL Policies led to a Crowding-out of both the Private & Public Sectors

- BDL's high interest rate policy to protect an over-valued LBP led to higher borrowing costs for government exacerbating loose fiscal policy and deficits
- BDL policies led to a growing credit and liquidity squeeze on private sector and a **crowding out of the private sector** as well as the **public sector** due to high rates paid by BDL.
- These policies **also led to disintermediation** => the government could no longer tap markets so BDL acted as financial intermediary i.e. paying high rates to the banking system while allowing the government to borrow at lower rates

=> BDL losses estimated at more than \$46 bn and ongoing (April)

Real Economy Impacted by Unfavorable Geopolitical Factors since 2011

- **Impact of Arab Firestorm:** deteriorating growth in the region with spillover effects for Lebanon;
- **Impact of war in Syria:** refugees and displaced but also cutting off road access to GCC countries (decline of exports) + lower tourism levels;
- **Impact of oil and commodity prices on remittances:** expats are located in countries in Africa and the Arab world (mainly GCC) that are highly vulnerable to volatility of commodity prices
- **Geopolitics:** Lebanon caught in the maelstrom of US-Saudi-Iran confrontation affecting trade and FDI and tourism from GCC. Also has implications for potential future aid.

Lower growth because of flawed macro and internal policies + high cost of doing business



Starting a Business (rank)	151
Score of starting a business (0-100)	78.2
Procedures (number)	8
Time (days)	15
Cost (number)	42.3
Paid-in min. capital (% of income per capita)	41.5

Dealing with Construction Permits (rank)	164
Score of dealing with construction permits (0-100)	53.7
Procedures (number)	22
Time (days)	276
Cost (% of warehouse value)	7.7
Building quality control index (0-15)	14.0

Getting Electricity (rank)	127
Score of getting electricity (0-100)	62.7
Procedures (number)	4
Time (days)	89
Cost (% of income per capita)	128.0
Reliability of supply and transparency of tariff index (0-8)	0

Registering Property (rank)	110
Score of registering property (0-100)	59.4
Procedures (number)	8
Time (days)	37
Cost (% of property value)	6.0
Quality of the land administration index (0-30)	16.0

Getting Credit (rank)	132
Score of getting credit (0-100)	40.0
Strength of legal rights index (0-12)	2
Depth of credit information index (0-8)	6
Credit registry coverage (% of adults)	21.3
Credit bureau coverage (% of adults)	0.0

Protecting Minority Investors (rank)	114
Score of protecting minority investors (0-100)	44.0
Extent of disclosure index (0-10)	9.0
Extent of director liability index (0-10)	1.0
Ease of shareholder suits index (0-10)	5.0
Extent of shareholder rights index (0-6)	3.0
Extent of ownership and control index (0-7)	1.0
Extent of corporate transparency index (0-7)	3.0

Paying Taxes (rank)	116
Score of paying taxes (0-100)	67.5
Payments (number per year)	20
Time (hours per year)	181
Total tax and contribution rate (% of profit)	32.2
Postfiling index (0-100)	27.5

Trading across Borders (rank)	153
Score of trading across borders (0-100)	57.9
<i>Time to export</i>	
Documentary compliance (hours)	48
Border compliance (hours)	96
<i>Cost to export</i>	
Documentary compliance (USD)	100
Border compliance (USD)	480

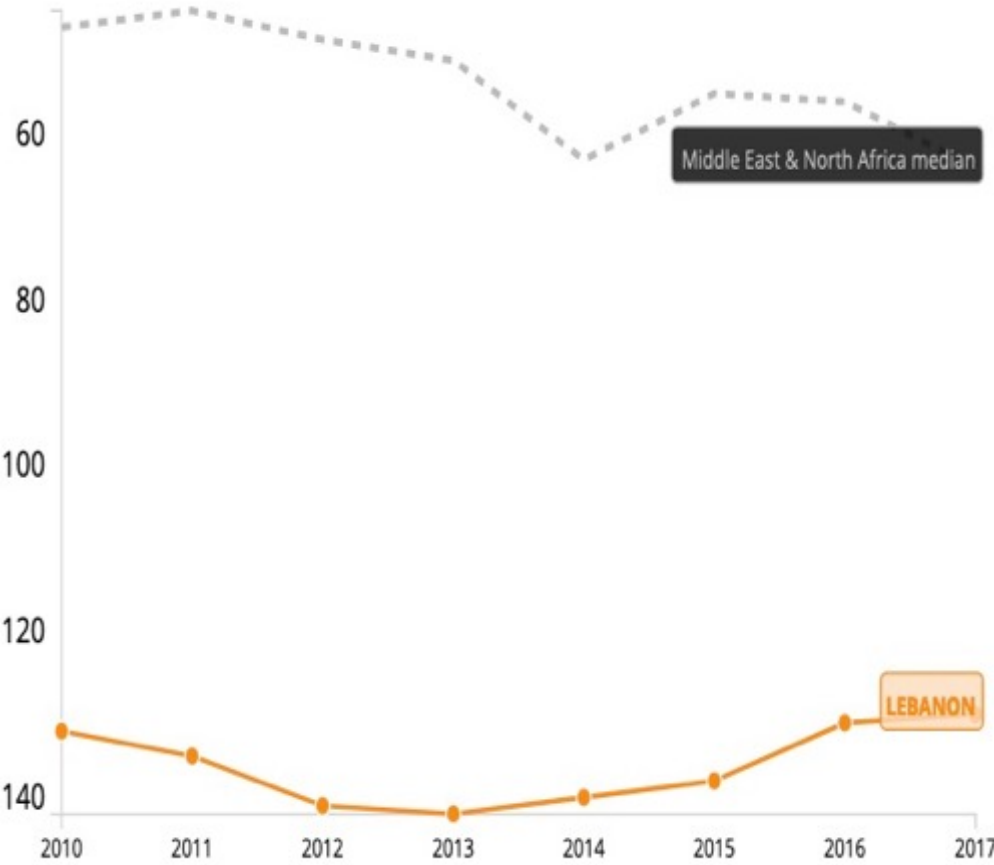
<i>Time to export</i>	
Documentary compliance (hours)	72
Border compliance (hours)	180
<i>Cost to export</i>	
Documentary compliance (USD)	135
Border compliance (USD)	790

Enforcing Contracts (rank)	131
Score of enforcing contracts (0-100)	50.8
Time (days)	721
Cost (% of claim value)	30.8
Quality of judicial processes index (0-18)	6.5

Resolving Insolvency (rank)	151
Score of resolving insolvency (0-100)	29.1
Recovery rate (cents on the dollar)	30.8
Time (years)	3.0
Cost (% of estate)	15.0
Outcome (0 as piecemeal sale and 1 as going concern)	0
Strength of insolvency framework index (0-16)	4.0

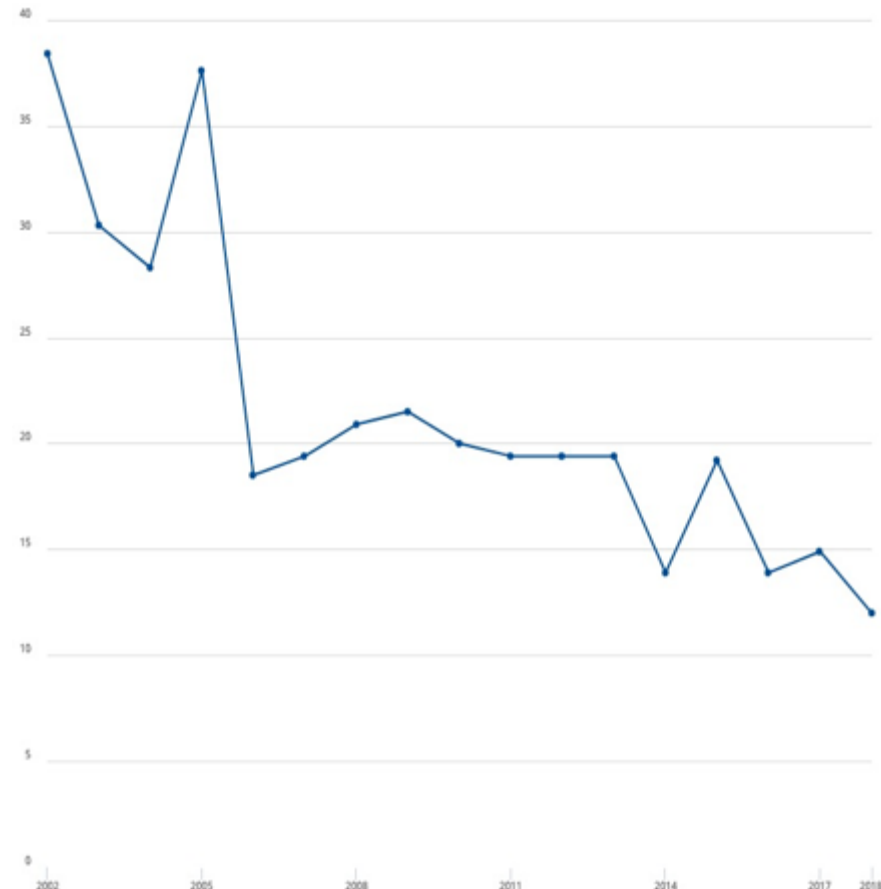
Deteriorating Infrastructure & Rising Corruption Levels...

Deteriorating infrastructure: quality has been falling; below the regional median



Source: WEF Global Competitiveness Index

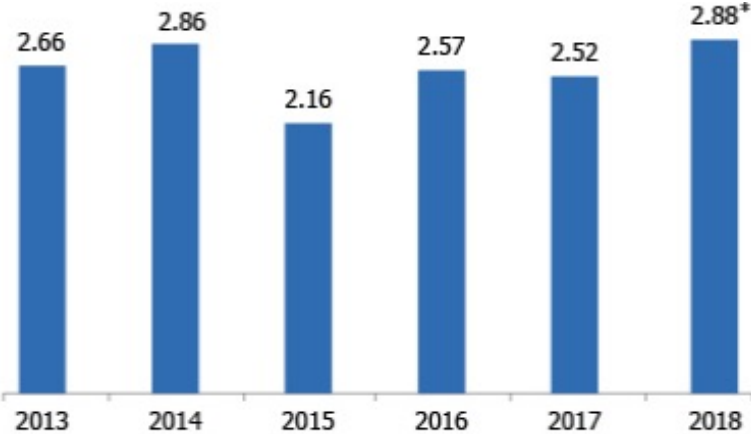
Increasing levels of corruption: percentile rank for LB keeps declining



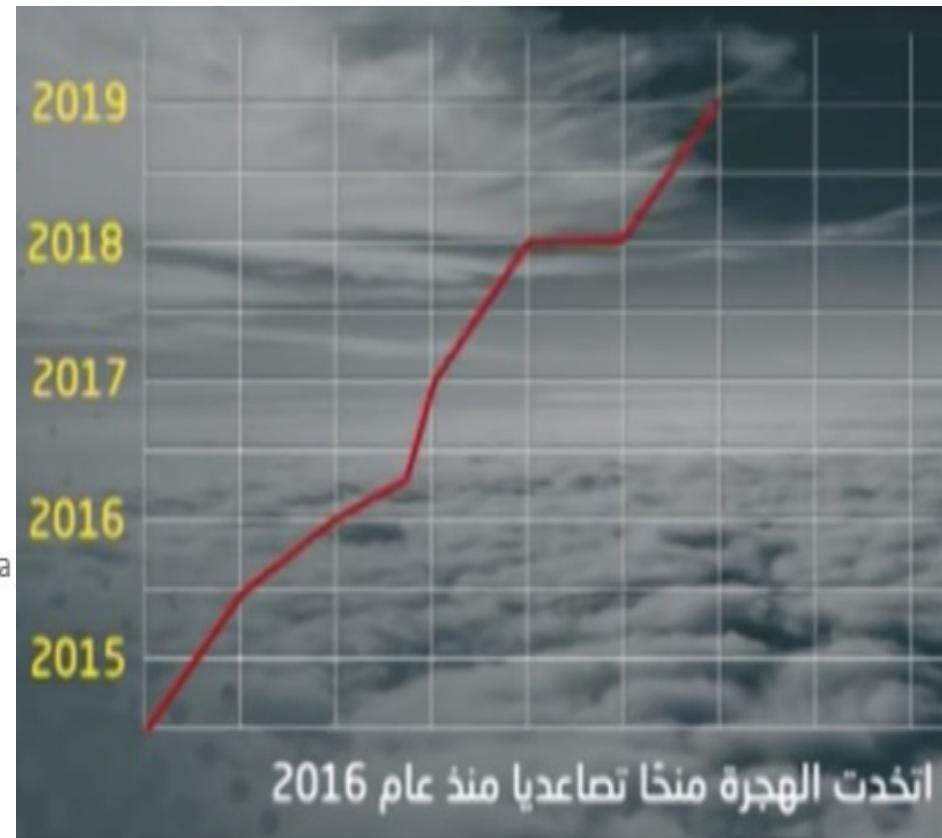
Source: World Governance Indicators 2019, World Bank

... Led to Low Levels of Investment & Growing Outmigration

FDI inflows into Lebanon (Source: UNCTAD)



Emigration steadily rising since 2016: 11k in 2016 to 66,806 in 2019



FDI by type of investments (% share, 2018)



Staring into the Abyss

- **Sharp fall in level of economic activity by 15% or more accompanied by large increase in layoffs, bankruptcies & insolvencies leading to a rapid increase in banks' non-performing loans & growing losses**
- **COVID-19 will deepen the sharp contraction**
- **Sharp reduction in government revenues and increase in budget deficit, inability to fund investment or social programs**
- **BDL monetization of deficits & debt => rapid acceleration of inflation and depreciation of the LBP**
- **Growing unemployment rates, poverty & famine => political & social conflagration**
- **Lost decade(s): permanent economic decline, out-migration and destruction of economic fundamentals**

Developments since Sep 2019: bank closure/ holiday in Oct => panic & run on the banking system + start of informal capital controls=> accelerated loss of inward capital flows & remittances

- Oct. 17: Govt announces a 20 cents-per-day fee for internet calls, including Facebook & WhatsApp. It also proposes to raise VAT to 15% by 2022 => Protests
- Oct. 18: Government abandons proposals. Protests continue
- Oct 21: Govt meets & agrees to a package of ambitious reforms + \$3.4bn reduction in state budget
- Oct. 29: Hariri government resigns
- Nov 1: Banks reopen; unofficial capital controls brought in
- Nov 16: Former finance minister backs down from becoming new PM
- Dec 19: Hassan Diab nominated to be next PM
- Jan 21: New PM forms govt
- Jan 26: 2020 budget passed by the Parliament
- Feb 6: Approves policy paper to tackle financial crisis
- Feb 11: Confidence vote
- Mar 7: announcement that LB would default on its Eurobond debt
- BDL (Apr 2020): all withdrawals from deposits in foreign currency accounts to be converted to lira at market rates; \$ Account withdrawals to have \$5k monthly Cap

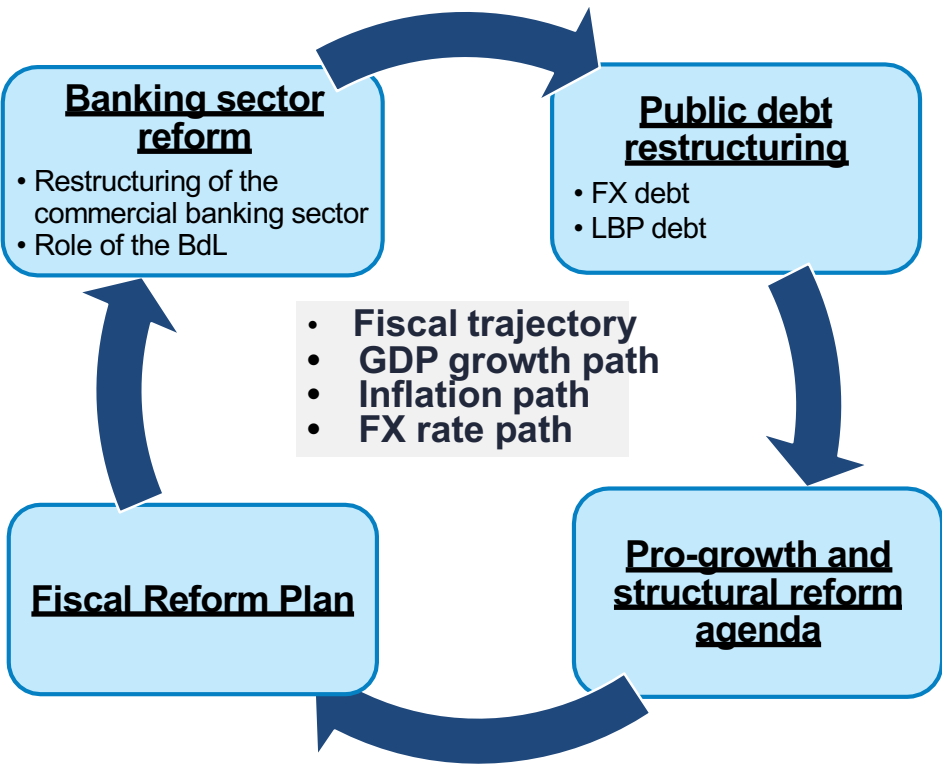
Government Reform Plan, April 2020

THE RECOVERY PLAN

Availability of external support

- Dependent on policy responses
- Will smoothen the impact of adjustments

Exchange rate framework



Overview of the Government's Recovery Plan

The reform of the banking sector

- *Restructuring of the commercial banking sector (size and organization), including disentangling the links between commercial banks and Banque du Liban*
- *Ensuring banking sector role to provide credit to the real economy*

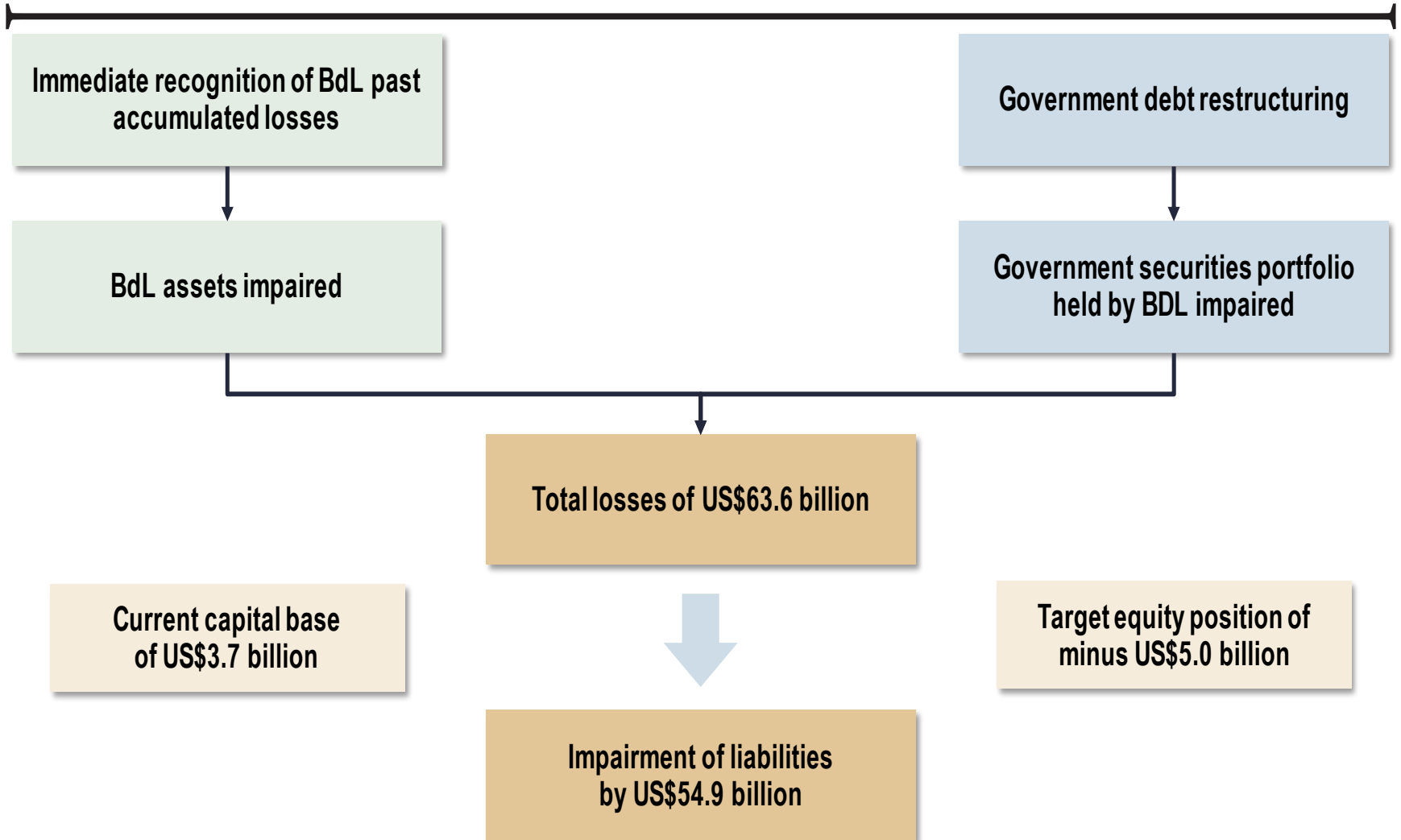
The Fiscal Reform Plan

- *Reforming the electricity sector (3% of GDP) and the pension system to reduce transfers*
- *Rationalizing current expenditures and streamlining the government's institutions and enterprises*
- *Improving tax collection, compliance rates and reorienting the tax system towards increasing the burden on rent income and privileges given on public properties and assets*

A growth-enhancing structural reforms agenda

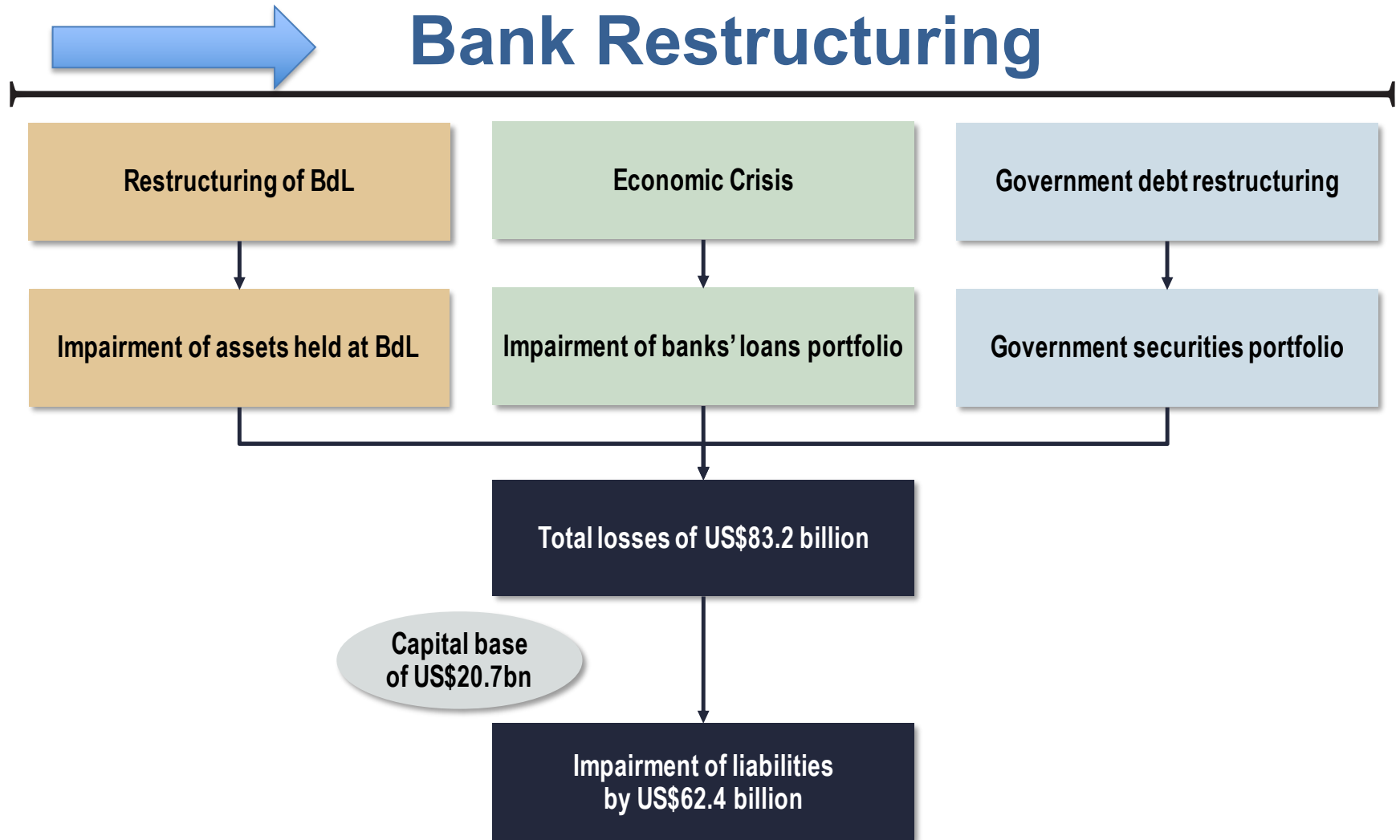
- *Strengthening of the judicial system (continue ongoing reforms on bankruptcy law, procurement law, competition law, etc)*
- *Sectorial strategies with a focus on land reform, energy, water, waste management, education and health*
- *Promotion of new dynamic industries and development of productive economy*
- *Gather external support to finance high value-added infrastructure projects and initiatives*

BDL Losses Require a Restructuring of its Balance Sheet



Note: Excludes losses from devaluation or required recapitalization of the banks

Public Debt + BDL Debt Restructuring Bank Restructuring



Note: Excludes losses from devaluation or required recapitalization of the banks

Elements of a Credible, Sustainable Reform Program I

- 1. Implement a comprehensive National Macro-Fiscal-Financial-Banking reform plan, a multilaterally funded Economic Stabilisation & Liquidity fund and program** under the aegis of the IMF to provide balance of payments support, CB swaps, debt guarantees, transitional fiscal support, SSN, private sector funding through PE and PPP and Infrastructure investment. **Size: \$25-30 bn**
- 2. Fiscal Reform, Public Sector Restructuring & Structural Reforms:** tax collection, EdL reform, targeting subsidies; reduce cost of doing business, government procurement, pension system reform, civil services pay and benefits, 'ghost workers' ...
- 3. Public debt (government & BDL) restructuring (haircut):** reduce principal, reduce interest rates, extend maturities, convert USD to LBP
- 4. Monetary & Exchange Rate Policy Reform. Move to flexible exchange rate; stop quasi-fiscal operations & government financing**

Elements of a Credible, Sustainable Reform Program II

5. Establish a **Sovereign Wealth Fund** to include all SOEs and GREs ...& future Oil & Gas Revenues : EdL, Telecom, Transport, Water, Ports, Airports, Casino, Tobacco etc. SWF to reform, improve governance, productivity & efficiency, generate revenue. Prepare for PPP and privatisation
6. **Economic & Financial Governance**: Establishing strong and independent banking, financial, telecoms, oil & gas, electricity and other regulators
7. **Bank Recapitalisation and Restructuring (bail-in)** will require ~\$25-\$30 bn, of which ~\$10bn would be foreign financing: shareholders cash injection; capitalisation of reserves; Sale of foreign subsidiaries, branches & investments; Sale of client real estate holdings; revaluation of own real estate assets against a cash injection & exemption from capital gains tax; Consolidation: M&A; new Insolvency Law & 'Bad Bank Act'
8. **Establish a Social Safety Net**: about \$800 Mn are required to alleviate growing poverty rates
9. **Anti-Corruption program and Stolen Asset Recovery Initiative (StAR)**: appoint and empower a special anti-corruption prosecutor and unit; Join StAR initiative; partnership between the WB and UN Office on Drugs and Crime (UNODC)

Moving Away from the Abyss I

- The current economic, monetary & financial meltdown has its roots in systemic, unsustainable fiscal and current account deficits over the past 30 years, leading to a Debt/GDP ratio in excess of 170%, financed by remittances & portfolio flows mainly from the Lebanese diaspora
- BDL high interest rates & other monetary policies to support an overvalued LBP compounded the growth of government & BDL debt
- The BDL effectively ran a Ponzi scheme in a failed attempt to defend the LBP and build forex reserves, leading to a large forex mismatch and credit risk concentration for the banking system.
- A series of policy mistakes starting with the closure of the banks in Oct 2019 & imposition of de facto, illegal, capital controls, led to a banking panic, deposit flight and Sudden Stop of capital inflows and remittances, and development of a black market and multiple exchange rates for the LBP.
- Economy is collapsing: businesses are closing + unemployment & poverty are rapidly rising + lira's black market value against the dollar has plummeted. These portend a humanitarian crisis, social and political upheaval. Lebanon is staring at the abyss and a lost decade

Moving Away from the Abyss II

To move away from the abyss Lebanon needs to immediately:

- Implement a comprehensive National Macro-Fiscal-Financial-Banking reform plan, a multilaterally funded Economic Stabilisation & Liquidity program under the aegis of the IMF
- Undertake a deep fiscal reform & Restructure its Public Sector
- Restructure its Government & BDL Debt
- Recapitalise & Restructure its banking system
- Establish a Social Safety Net
- Undertake Monetary Reform & move to a Flexible Exchange rate
- Establish a Sovereign Wealth Fund to manage its SOEs, GREs and future oil & gas revenues
- Launch an Anti-Corruption and Stolen Asset Recovery program
- Reform its Economic & Financial Governance by establishing strong and independent banking, financial, telecoms, oil & gas, electricity and other regulators

Lebanon's Economy: Staring into the Abyss

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