Lebanon: Is there a Way out of the Economic Doldrums?

Lebanon is facing a serious economic and financial crisis. Successive large budget deficits pushed the stock of public debt to a very high level, and since 2011, the overall balance of payments turned into deficits. Financing the twin deficits was complicated by dwindling capital inflows, and the high interest rates needed to maintain the exchange rate peg brought economic activity to a halt. Putting Lebanon on a recovery path will require immediate actions including reducing interest rates on both creditors and debtors to ease the debt service burden and stimulate private sector activity. This needs to be accompanied by uniform (transitory) capital controls if the peg is to be maintained for now. These urgent measures should be followed immediately by a comprehensive and bold medium-term adjustment program that could be backed by the international community through an IMF-supported program.

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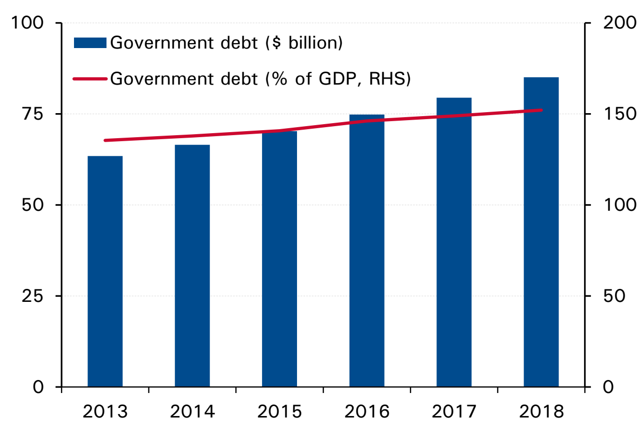
Background

Lebanon is now in the throes of a major economic crisis that has been brewing for a long time. While it is now well known how Lebanon got to this point, a brief reminder should be useful. The large public sector debt of about $83 billion (155% of GDP) has been the result of running large budget deficits over the years. These deficits resulted mainly from a sharp rise in spending that was not allocated to productive uses or invested in worthwhile public projects that would have generated good economic or social rates of return. Rather, spending increases were mainly on wages, electricity subsidies and debt servicing; large but difficult to quantify expenditures were also likely wasted and/or channeled through patronage networks. (Chart 1)

Chart 1: Government Debt

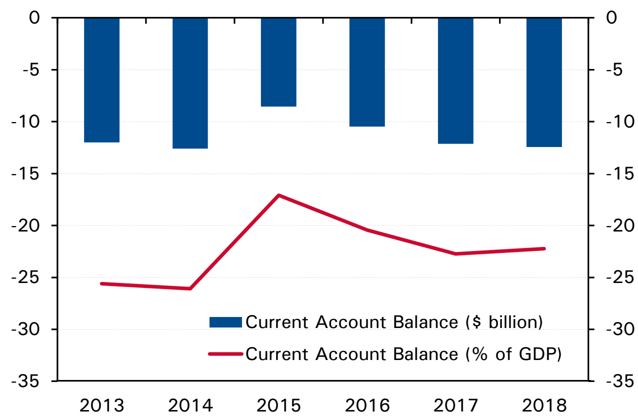


Source: National Authority / IIF

The decline in the rate of capital inflows, mainly remittances from the overseas Lebanese diaspora, has complicated budget financing. For years, the government went on a borrowing binge to finance an ever-increasing succession of budget deficits. Up until 2015, deficits were financed mainly by the banking sector, which relied on remittances from the Lebanese diaspora. Lebanese working abroad would send money to Lebanese banks, which in turn would use part of this money to finance outsized budget deficits. But beginning in 2011, capital inflows started to dwindle, forcing BDL to step up purchases of government debt instruments.

The overall balance of payments (BoP) has been in deficit since 2011, putting pressure on official foreign reserves. Lebanon has always run huge current account deficits that used to be financed by larger capital inflows leading to an overall balance of payments surplus. (Chart 2).With capital inflows decelerating since 2011, the overall balance of payments turned into deficits and the pressure on official reserves intensified. To maintain an adequate level of reserves, Lebanon central bank, the Banque Du Liban (BDL) resorted in 2016 to unorthodox financial operations, dubbed "financial engineering". These operations saw astronomically eye-catching interest rates offered to banks, which in turn offered high rates to wealthy individuals and various entities in a bid to bring in fresh dollars.

Chart 2: Current Account Deficit



Source: National Authority / IIF

The authorities realized that something needed to be done to stop the deterioration in the fiscal accounts. They started looking, in the context of the 2019 and 2020 budgets, for quick fixes to generate additional revenues and cut spending. These actions were not part of a medium term strategy or a vision that aims to address the difficult financial situation. A simple announcement of a possible tax on WhatsApp calls sparked demonstrations on the streets of Beirut that morphed into a full-fledged revolt across the country, a revolt that it is now in its sixth week and that shows no sign of abating.

Cash money withdrawal and transfers outside the country that had begun a few months ago intensified as of late. When banks re-opened to the public after almost two weeks of closure following the revolt of October 17, the rush to take cash out of banks and stack it at home or transfer money abroad (for those who have foreign accounts or who can open such accounts) intensified. Facing such a run on dollar accounts, banks haphazardly introduced capital controls that vary from one bank to another. Shortly after, the Lebanese Banking Association issued guidelines to limit foreign exchange withdrawals to a maximum of $1,000 a week and forbade any transfers overseas except for small amounts that could be justified by urgent needs. These are typical features of a capital control regime although this has not been declared so by BDL or the government.

Lebanon is already in the eye of the storm, witnessing one of the most serious economic crises to have befallen the country in the past three decades. Recent de facto capital controls, which are a first for the country, are a clear manifestation of the severity of the situation. Lebanon has always taken pride in its liberal capital account system, where money can flow in and out freely with no questions asked, but this is no longer the case.

There is an urgent need to form a capable and credible government that has the authority and the tools to face head-on the present economic challenges. The new cabinet should be entrusted with extraordinary powers to allow for the urgent implementation of the required reforms. Going through the normal process of seeking parliamentary approval for much needed important measures would entail delays that the country can ill-afford at this time. These extraordinary and transitory powers are critical given the seriousness of the situation. The new 'salvation cabinet' should be ready to enact tough measures that may not be to everyone's liking.

The ongoing revolt requires transparency and forthrightness from the new government. This is indeed a daunting task as Lebanon is facing a revolution of rising expectations. Given people's heightened expectations, as reflected in their diverse and wide-ranging socio-economic demands, it is clear that this is not something that can be resolved in the short term by any government. The government needs to communicate clearly that there is no magic bullet going forward. Lebanon will have to go through a very difficult and painful adjustment phase to compensate for the gross economic mismanagement of the past. Expectations must be managed and the reform program adequately signposted, with periodic reporting to the wider public so they can feel part of the adjustment process.

Immediate economic measures are urgently needed

Addressing the current economic crisis should be based on a credible, front-loaded, bold and ambitious reform program that instills confidence and puts the country on a long-term sustainable path. Such a plan will need to be properly elaborated and realistic in order to get the necessary buy-in from the different stakeholders. Given the seriousness of the present situation, some emergency measures are required to arrest the deterioration in the fiscal accounts and reduce the need for new borrowing, which will come, if at all, at a very high cost.

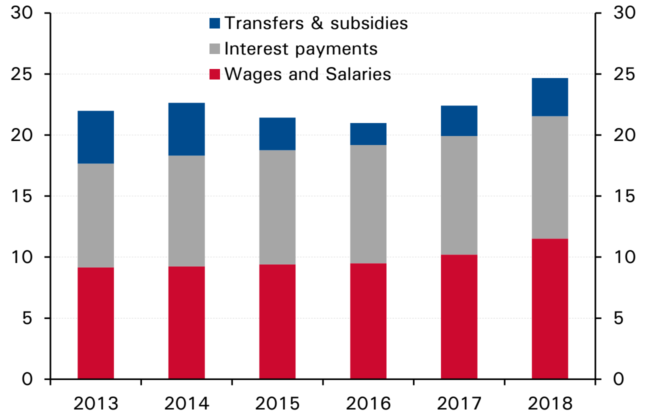
One immediate step is to reduce the debt service burden, which is one of the largest drags on the budget. Interest payments on public debt amount to about $5.8 billion in 2019 on a stock of public debt of some $83 billion. This translates into an average interest rate of 7%, and this rate is susceptible to increases as the cost of new borrowing becomes more exorbitant by the deteriorating financial conditions. (Chart 3)

Most of the public debt is held domestically by both commercial banks and the central bank. The composition of public debt is distributed as follows: about 60% is in LBP (equivalent to $50 billion at the official exchange rate) and $33 billion in Eurobonds. Banks hold around $15 billion in government debt in LBP while BDL holds $35 billion in LBP. As for the debt in US dollars, $4 billion is with BDL, while $15 billion is held by commercial banks. The remaining amount of some $14 billion is owed to other financial institutions (including a large portion held by insurance companies), individual investors, and foreign creditors (a relatively low $10 billion). (Chart 4)

Public debt service could be substantially reduced as part of a package that will lower the whole interest rate structure. This means cutting interest rates on: (i) public debt held by commercial banks and BDL; (ii) private sector deposits in the banking sector; (iii) banks' deposits held

Chart 3: Main Current expenditures

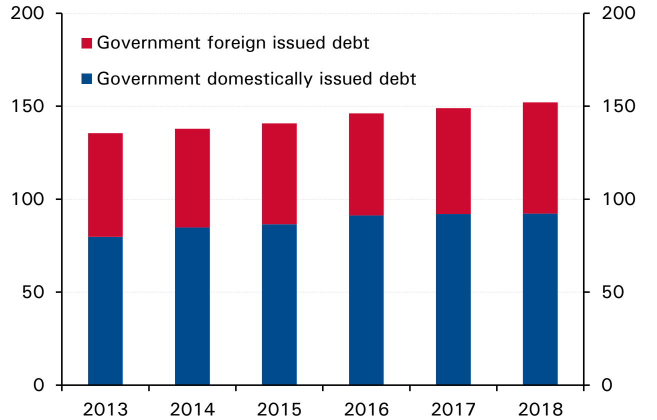
(% of GDP)



Source: National Authority / IIF

Chart 4: Government Debt issuance

(% of GDP)



Source: National Authority / IIF

at BDL; and (iv) interest rates on private sector bank loans. Making the banking sector alone pay for a large reduction in interest payments on government debt would affect their balance sheets and undermine the functioning of the banking sector, which will lead to major repercussions on economic activity.

Reducing interest rates on deposits should be tailored in a way to minimize the adverse impact on small and mid-size depositors. Ideally, the interest rate cuts should be applied on large depositors exceeding a certain threshold while maintaining the rates on small and medium-sized deposits. This could be difficult to implement in practice given that a person could have different accounts below the threshold in different banks. In any case, and in the absence of timely data, and given that low and middle-income groups tend to save more in LBP—as they derive income, at least partly, off the interest on these deposits, which pay a higher rate—cutting the rate on LBP should be less than that on dollar accounts to minimize the impact on those savers. This would also have the added advantage of encouraging people to move to LBP accounts, reducing in the process the pressure on the exchange rate.

A well-designed cut in deposit rates will generate substantial savings that should be passed on to government debt and to private sector bank loans. Deposits in the banking system stand at about $175 billion (more than 72% of which are in US dollars). Considering that the average interest rate on LBP and dollar deposits is 9% and 6.5%, respectively, cutting the rate by 3 percentage points on LBP deposits and 4 percentage points on dollar deposits would bring the average interest on LBP to 6% and to 2.5%, respectively. These rates are still higher than what would be paid in matured markets. Such cuts imply a significant reduction in interest payments on deposits, by about $6.5 billion ($5 billion on dollar deposits of $125 billion and $1.5 billion on $50 billion in LBP deposits).

The banking sector will have to pass on most of these savings to the budget by reducing the rate on government debt. Commercial banks should be able to top up the reduction in interest rate on public debt and reduce it by, say 5%, given that their holding of government and private sector debt combined is much smaller than the size of deposits. This would translate into a budget saving of some $1.5 billion on total holding of government debt of some $30 billion. In addition, BDL will pay banks at least 5% less on their deposits, which are estimated at some $70 billon, reducing the burden on BDL's already stressed balance sheet. BDL in turn will charge a lower interest on its holding of government debt in both currencies (some $40 billion). A cut of 5% in the rate would generate $2 billion. Applying the same rate on the remaining amount of $15 billion, would generate savings close to $750 million. Overall, the budget saving will be about $4.2 billion in annual interest.

As a result of these operations, the budget deficit will be substantially reduced. If the interest rate reduction is accompanied by some non-essential spending cuts and additional revenues stemming from better tax collections (rather than a tax increase), this could add about $1 billion in savings and bring the budget closer to balance during this transitory period.

With repricing of banks' liabilities and their public debt assets, commercial banks should then commensurately reduce the rate on private sector loans. This will boost private sector activity, enhance growth, and eventually create jobs that Lebanon desperately needs. Savers earning lower interest rates on their bank deposits will be more incentivized to invest their savings in productive sectors that could generate a higher rate of return. This may not take place immediately but it could once a comprehensive reform program is implemented. Reducing the interest burden on businesses will also help prevent a further increase in non-performing loans (NPLs), which are estimated now at about 15%. Private sector outstanding loans stand at about $50 billion, and an average interest rate cut of 4% will cost the banks $2 billion. In sum, banks' savings in interest payments on deposits will be distributed in the form of savings on interest payments by the government and the private sector.

With lower interest rates across the board, strict temporary capital controls should be enforced uniformly to avoid capital flight and to maintain the exchange rate peg. Of course, a smaller interest margin over interest rates abroad will not be sufficient to compensate for the country's risk and will encourage people to take their money out of the country. Hence, official, uniform and clear capital controls should be adopted to reduce pressure on the exchange rate and on official international reserves. The flip side is that capital inflows will dry out, except perhaps for some small amounts that the Lebanese overseas diaspora will keep sending to their families for day-to-day expenses. However, to offset partially some of the negative effects of capital controls, the central bank could create incentives to keep some money flowing in—as long as this money is provided with a guarantee to get out freely. (As part of capital controls imposed after the revolution, Egypt put in place an automatic repatriation mechanism whereby the central bank guaranteed that fresh money could be repatriated without any restrictions—this mechanism was only recently discontinued after macroeconomic stability had been achieved.)

Medium-term economic and social reform plan

Capital controls should be implemented only for a transitory period and should be followed shortly by a medium to long-term credible reform program. Permanent capital controls will be damaging to Lebanon and to the free market economic model that has characterized it since independence. But more important, in view of Lebanon's continued reliance on capital inflows and remittances, capital account restrictions should be lifted as soon as the macroeconomic situation stabilizes. Capital inflows are needed to finance the external current account deficit and preserve (and hopefully rebuild) official reserves.

A comprehensive reform program should be adopted as soon as possible to put the country on a recovery path. Since budget deficits are at the heart of the problem, the program should aim first at adopting front-loaded fiscal measures that would reduce the budget deficit over time to more sustainable levels following the lifting of restrictions on interest rates, which should eventually be market-determined. Also, as long as capital controls are in place, monetary policy has more room for flexibility in setting interest rates, which should remain low for some time, even at the cost of higher inflation. Other structural measures that deal with corruption and the recuperation of stolen money should also be priorities going forward. This will send a strong signal that the government is committed to reform and provide some reassurance for protesters that the government is addressing their concerns and moving in the right direction.

In addition to debt servicing, electricity subsidies should be addressed in the short term, while reducing the size of the wage bill should be looked at in a longer-term perspective. The size of the wage and pension bill is very high by any metric. However, reducing it in the short term is practically impossible and socially undesirable. Reducing the size of the civil service is a long-term objective. It should preferably proceed in parallel with the pick-up in economic activity and the creation of new private sector jobs. Over the medium and longer term, imposing a freeze on wage increases and hiring, and letting the size of the civil service shrink by attrition will eventually reduce the wage/GDP ratio. The electricity subsidy is another drain on the budget and should be reduced as soon as possible with a view to eliminate it fully within 2-3 years (which is in line with the plan recently adopted by the government).

The fiscal component of the reform package should aim at reaching a primary budget surplus in the range of 3-4% for a number of years. This requires, in addition to reducing the electricity subsidy, cutting all the fat in current spending (and still there is a room for a cut), and increasing budgetary revenues. The latter does not necessarily mean an increase in regressive taxes, i.e. taxes that hurt the most vulnerable segments of the population. Even with the existing tax and custom rates, there is room for a significant increase in tax revenues, including by better collection and by combatting fraud and smuggling across all points of entry.

Addressing years of fiscal profligacy and economic mismanagement will undoubtedly require tough and painful measures. The design of an adjustment program should aim at distributing the burden fairly across different income groups to ensure that the impact will not fall disproportionally on the less fortunate. This will be a tall order since ensuring complete fairness in undertaking reforms in a dire economic situation may not be easy to achieve. The issue of recovering the money stolen in the past is a noble objective that should be pursued vigorously. But this will most likely take time for the judicial system to go through given how difficult it is to estimate and prove that the money has been appropriated unlawfully by those who have been in power or those who have been part of their inner circles.

Any reform package should be accompanied by social safety net (SSN) measures to protect the most vulnerable groups. The poverty rate is already high, estimated at about 30% of the population and is susceptible to an increase as the country adopts austerity measures to come out of the crisis. Financing an SSN program could be taken up by donors including the World Bank in the context of a full-fledged adjustment program. The Bank and other donors have already provided support to build a poverty targeting system in Lebanon that could be immediately deployed to fund the SSN program.

A tight fiscal policy will not only improve the budgetary situation but should also improve the external current account. Restoring domestic demand through cutting government spending will have an impact on private consumption and investment and thus will reduce demand for imports. As such, this should work its way through a reduction in domestic demand and bring down partially the external current account deficit, and hence the overall balance of payments, which has been a drag on foreign reserves.

Even under a strict implementation of a strong reform program, and in view of the severity of the financial situation, there may still be a need for external financial support. The likelihood of such support coming from the region is remote under the present circumstances. The best possible means of encouraging external support and capital inflows is through an IMF-supported program. The IMF will help the new government design an adjustment package—not because there is not enough expertise within Lebanon to do that, but mainly because the IMF has considerable international experience working on similar cases in other countries in addition to its financial support.

An IMF-supported program will not only bring financial support to the balance of payments, but will also be a catalyst for other international support. The size of the IMF financial support package depends on the country's quota and the strength of reform measures. It could be up to 5-10 multiples of the quota (Lebanon's quota is about $880 million) and could reach $5-$8 billion if the program is well grounded and supported wholeheartedly by the Lebanese authorities. (Egypt got more than 4 times its quota in financial support from the IMF while Argentina received support of more than 11 times its quota.) More important, the IMF's presence will be a conduit to other donors' support, multilateral and bilateral, as well as private investors, relieving pressures on the overall balance of payments. It will also unclock the money pledged to Lebanon in the context of the CEDRE conference.

In case a strong reform package cannot lead to sustainable debt, then other measures could be considered including debt rescheduling. This could be structured in a way to avoid a major negative impact on the banking sector and the economy, and which could still open the door for foreign investors to buy new debt in case there is a need. It could take the form of changing the maturity structure (in addition to the interest rate) of existing debt. The presence of an IMF program will improve the credit rating and thus provides assurances to foreign creditors and investors who can then provide additional lending at a lower interest rate.

Once the financial situation improves and macroeconomic stability is entrenched, a relaxation of the exchange

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rate peg as well as other transitory arrangements could be considered. Changing the peg during a distressed period could see the value of the LBP tumble and overshoot its true market value, with severe social consequences for most Lebanese, especially wage earners and pensioners. A move towards a more flexible exchange rate—at a time where the official rate is now hanging by a thread as a parallel market has developed—under calmer conditions and from a position of strength would minimize the impact of speculative factors. A more flexible exchange rate could be considered to help the country absorb shocks and reduce the real value of the debt (the majority of which is in local currency). More important, a more competitive real effective exchange should encourage the development of some promising sectors, such as IT, manufacturing and others, adding to the contribution of Lebanon's traditional sectors such as finance, tourism, and construction.

Conclusion

The objective of this note is to prescribe some urgent macroeconomic measures that should immediately be put in place before the country slips into an economic collapse. These emergency measures include the adoption of official, strict and uniform capital controls. These controls are a prerequisite for a reduction in the interest rate structure with a view to: (i) reduce substantially the budget deficit in the very short term; (ii) preserve the solvency of the banking sector, which is essential for boosting economic activity; and (iii) more importantly, to avoid any haircut especially on deposits.

These emergency measures, some of which are transitory in nature, should be followed immediately by a comprehensive, bold, and credible medium-to-long-term economic reform program that could be supported by the international community. Such a program should also look to implement critical structural measures to complement and support the actions taken on the macroeconomic front. These include: (i) adopting legislations aimed at fighting corruption and recovering the money that was misappropriated over the years; (ii) having a competent and independent judicial system; (iii) creating a conducive and business-friendly environment; (iv) encouraging foreign direct investment through different incentive schemes; (v) initiating a transparent and well deigned privatization program; and (vi) developing economic sectors that rely on human capital that Lebanon is not short of.

In conclusion, we should not be under any illusions though that achieving these targets will be either easy or completely fair. For a country that has been bankrupted by gross economic mismanagement and deep-rooted corruption, there is no easy and simple way out. We have to go through a long and painful adjustment process. The alternative will be an economic collapse with severe social consequences. There is a still a small window of opportunity, but it is closing very fast and we need to act now.

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