Part II of Crisis in Lebanon: Buildup of Interrelated Challenges

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Original post [here](#).

What led Lebanon into this financial crisis, the biggest challenge the nation has faced since its 1975-1990 civil war? The underlying economic problems are complex and interrelated. In this blogpost of the [Lebanon series](#), we provide an overview of the causes, focusing on five areas: 1) the large current account deficit, 2) the unsustainable fiscal deficit, 3) the fragile financial sector, 4) the Bank of Lebanon’s “financial engineering,” and 5) slow growth, political deadlock, and the impact of the Syrian crisis.

#1: The large current account deficit

For years, Lebanon has run a large current account deficit, equivalent to roughly 25 percent of annual gross domestic product (GDP). The vast majority of imports are composed of fuel and food; Lebanon depends on imports to meet 80 percent of its daily needs of these items (Figure 1).

Figure 1
As introduced in Part I, Lebanon has committed itself to a fixed exchange rate, pegging the Lebanese Pound (LBP) at 1,507.5 to the US dollar since 1997. The fixed exchange rate, which stabilized Lebanon’s inflation over a decade, eventually led to the overvaluation of the Lebanese pound (LBP); IMF (2019) suggests that the LBP is overvalued by more than 50 percent. As a result, under the fixed exchange rate regime, Lebanon enjoyed access to imports but its export sector suffered from the lack of competitiveness. Corruption and insufficient business foundation also hinder the development of the export sector (IMF, 2019).

Lebanon depends on imports for petroleum products and fuel; unlike the neighboring Gulf States, Lebanon does not enjoy oil money and its recent attempt to exploit offshore hydrocarbon reserves exploration has been failing. Most of the energy used in Lebanon is derived from oil.

The majority of exports is led by services, namely the tourism industry. The total contribution of the sector was estimated to be $10.4 billion or 19.1 percent of GDP in 2018. However, the outbreak of protests, travel restrictions imposed by COVID-19, and the recent explosion in Beirut cast a dark shadow on the outlook for the leading industry. Compared to the previous year, the total visitor arrivals to Lebanon plunged by 98 percent in May 2020 (Figure 2).

Figure 2
#3: The fragile financial sector

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Historically, many people migrated to other countries from Lebanon. Most recently, there were three waves of migration: (i) from the mid-19th century to World War I, (ii) during the civil war (1975–90), and (iii) after the end of the civil war. Consequently, more people of Lebanese origin live outside Lebanon than inside. Some estimate that there are 8 to 20 million Lebanese people outside Lebanon in contrast to its 6.8 million population. This diaspora is global but concentrated in Arab countries.

The remittance from these diaspora people has supported the Lebanese economy for years. Over the past decade, the annual remittance has been over $7 billion, more than 10 percent of GDP. Remittance has become an indispensable part of the country’s safety net, representing over 40 percent of household income.

The remittance and credit kept flowing into Lebanon even when many other emerging economies suffered from the pullback of credit after the Global Financial Crisis (GFC). In contrast to most countries, private-sector credit growth surged from 2008 to 2010. An IMF report concluded that the improved political environment had contributed to the surge in demand for credit; low domestic interest rates had led to the surge in supply. Salim Chahine, professor at the American University of Beirut, argued that Lebanon benefitted from the GFC as Lebanese people withdrew money from low-rate US banks and parked the money at Lebanese financial institutions with higher rates. The influx of cash caused by the asymmetry in the interest rate further contributed to the growth of the banking sector (Figure 7); retail banks started to campaign for personal loans. This fueled leverage by households and firms and eventually changed lending habits. From 2006 to 2017, the country’s lending via personal loans and credit cards rose from $3.7 billion to $20.5 billion.

**Figure 7**
Meanwhile, foreign direct investment, which is typically more steady and stable over the long run, have declined by approximately 40 percent after 2010, given the unfavorable investment environment.

Capital inflows from remittances and increasing domestic borrowing supported the growth of the banking sector. By the middle of 2019, banking sector assets had increased 83 per cent in eight years to $253bn, equal to roughly five times the country’s economic output. According to IMF (2017), as of December 2015, 66 banks account for 97 percent of financial system assets, while nonbanks play a minor role. As Figure 7 shows, the development of the banking sector eventually turned the small country into the second-largest in the world in terms of banking assets relative to GDP (Lebanon Finance Minister, March 2020).

Lebanese banks are primarily deposit-funded, and the secondary debt market is undeveloped (IMF, 2017). Deposit concentration, rooted in the significant inequality in the country, has been another concern in the banking sector. The IMF’s Financial Sector Assessment Program (FSAP) report in 2016 warned that the largest one percent of deposit accounts held 50 percent of total deposits, while the largest 0.1 percent of accounts held 20 percent of total deposits. Furthermore, those deposits have short maturity. About 60 percent of total deposits by value are either demand deposits or mature in less than 30 days.

Bank assets are somewhat concentrated as well. Banks have large exposures to the public sector. As of September 2019, more than 70 percent of banking sector assets are composed of government securities and deposits at the BdL, the central bank. Under the current treatment in the Basel regulatory framework, in calculating risk-weighted assets under the standardized approach, banks can apply low risk weights to their sovereign exposure or BdL deposits if those
are issued or funded in domestic currency. According to the IMF’s 2016 FSAP report on Lebanon, such sovereign exposure accounted for more than six times Tier 1 capital owned by assessed banks on a non-risk-weighted basis.

The BdL has been allowing banks to assign a 50 percent risk weight for foreign currency-denominated BdL debt, and 100 percent for foreign currency-denominated Lebanese government debt. That is much more generous than Basel II recommends for internationally active banks. The Basel II standardized approach would require risk weightings of 100 or 150 percent based on Lebanon’s sovereign credit ratings, which range from B- to CC (see IMF, 2017). Given the large sovereign exposure, a sovereign debt write-off or a haircut by the Lebanese government could make some banks insolvent. Even after the IMF’s 2016 warning, banks’ exposures to the BdL and government debt further increased after the implementation of “financial engineering” by the central bank, as described below under #4.

Banks only lend 25 percent of their balance sheets to the private sector. In recent years, the overall lending to the private sector has fallen significantly (Figure 8). The real estate sector, whose performance had been stagnant in recent years, accounts for the majority of private-sector loans; however, more recently, some report that the real estate market is rapidly reviving while other assets rapidly lose value. As the economy slowed down, non-performing loans have surged; they now account for more than 10 percent of total loans.

Figure 8

Banks are also vulnerable in terms of liquidity risks, given the currency and maturity mismatches on their balance sheets. Attracted by higher interest rates, banks in recent years increased their
exposure to longer-term government debt, sometimes up to 30 years. This has elevated interest-rate risks and maturity-transformation risks, as bank deposits have short maturities.

In order to ensure that banks would have sufficient liquidity, Basel III, the post-crisis regulatory reforms, introduced two liquidity ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR, designed to ensure that banks survive a period of significant liquidity stress lasting 30 calendar days, requires banks to hold high-quality liquid assets (HQLA). HQLA are cash or assets that can be converted into cash quickly through sales (or by being pledged as collateral) with no significant loss of value.

IMF (2017) questions whether much of the government and BdL debt held by banks could really be convertible in private markets under stress. According to the IMF’s 2016 FSAP report, the BdL considers term deposits and certificates of deposit to be safe in a crisis (see #5 for the role of certificate of deposits in Lebanese financial system and the BdL). While Lebanese banks met both LCR and NSFR requirements in the 2016 FSAP, the IMF warned that most banks would fall short of the LCR threshold of 100 percent, if long-term term deposits parked at the BdL were excluded from the HQLA; this indicates that widespread foreign currency liquidity pressures could threaten the financial system.

The constant inflow of remittance from the diaspora kept the fragile financial sector together for many years. However, the remittance has started to ebb in recent years, partially due to the oil price plunge from mid-2014 (Figure 9). Conventionally, an oil-importing country is expected to benefit from a cheaper price of oil. However, in the case of Lebanon, the decline in the oil price could slow the economy by reducing capital inflows and external demand in its service industry, including tourism. Both remittance and tourism dollars rely on Lebanese expatriates who live in oil-producing countries that are affected by falling oil prices. The IMF estimates that the oil price drop led to a decline in capital inflows by at least 19 percent, approximately 3 percent of GDP.

Figure 9
Commercial banks used various approaches to sustain deposits, particularly in foreign currency. According to IMF (2017), banks tried to attract USD by offering very attractive rates on sizable deposits, selling Eurobonds earned by the financial engineering (see #4) to foreign investors, and by repatriating funds from correspondent banks. Recently, despite these attempts, the deposits in commercial banks plummeted and capital inflows dried up significantly after the outbreak of protests in October 2019 (Figure 10; see Part III for the cause of the protest). While the government has not implemented capital controls, banks are implementing de facto capital controls by limiting the withdrawal of cash by depositors. While some in the international community have suggested a haircut on depositors, Lebanese authorities have strongly rejected levying any haircuts on bank creditors.

**Figure 10**
Lebanon started to face dwindling inflows from diaspora families in mid-2015. To preserve the large stock of foreign reserves that are the foundation of currency stability, Riad Salamé, the BdL Governor, implemented so-called “financial engineering” in 2016.

The financial engineering scheme involved three steps among the BdL (central bank), Ministry of Finance (Government), and private Lebanese banks. The financial transactions across these actors were designed to resolve the pressing concerns each of them had been facing: the foreign exchange scarcity for the BdL, the high debt service for the Ministry of Finance, and the insufficient capital and liquidity for private banks (Figure 11).

In short, BdL paid banks an extraordinary return on dollar deposits, effectively around 15 percent, in order to maintain its dollar reserves and to provide a windfall boost to bank earnings and capital. However, it created such an incentive to park funds with the government that banks sharply slowed lending to the real economy. Moreover, the BdL’s generosity was ultimately financed with Eurobond sales by the Ministry of Finance. While BdL’s gross reserves grew, its net reserves (after accounting for liabilities) fell. Its reserve adequacy metric, a measure the IMF uses to evaluate countries’ forex risk, fell below 100% at the end of 2018 and the situation seems to be worsening as time passes. The government’s growing dollar liabilities also made it vulnerable to a potential devaluation in the event it fails to hold the dollar peg.

The scheme included the following steps:

Figure 11
STEP 1: BdL swaps Lebanese Pound (LBP) denominated treasury bills (TBs) held in its portfolio with equivalent Eurobonds issued by the Ministry of Finance.

- The government liabilities increase in USD but decrease in LBP. This reduces the cost of debt service, as long as the exchange rate is stable. Furthermore, this lengthens the public debt maturity structure. However, it also increased the government’s exposure to the USD.
- The BdL has converted part of its assets from LBP to USD.

STEP 2: BdL sells the recently acquired Eurobonds and issues USD-denominated long-term Certificates of Deposits (CDs) to commercial banks against USD inflows provided by banks.

- The BdL’s foreign exchange reserves increase, supporting the currency peg.
- Commercial banks earn higher margins for holding Eurobonds and USD-denominated central bank CDs instead of cash.
- Banks can also reduce their risk-weighted assets (RWAs), increasing their capital ratios, because BdL allows banks to weight the USD-denominated central bank CDs at 50 percent, compared with 100 percent for the Treasury-issued Eurobonds. (As noted in #3, according to IMF (2017), risk weights are currently set at zero for government and BdL debt in LBP, and at 100 percent and 50 percent, respectively, for foreign currency denominated government and BdL debts).
STEP 3: BdL pays banks an effective interest rate of about 15 percent to finance LBP-denominated debt (TBs) and LBP-denominated BdL CDs that banks hold on their balance sheets. The amounts of these loans are set at an amount equivalent to the previous transactions (Eurobonds and USD CDs). Banks paid no interest on these transactions, which gave banks an incentive to participate. In exchange, the BdL also benefits from 50 percent haircut on interest rates, which is voluntarily offered by participating commercial banks.

- The LBP liquidity in the market increases by converting long-term assets of banks into liquid cash.
- IMF (2017) notes that the discount at zero percent is “akin to a money-financed capital injection (without any equity stake in return […]), which helped strengthen banks’ capital buffers.”

IMF (2019) and others have analyzed the impact of financial engineering. First, they found that, under the quasi-fiscal scheme, the BdL ultimately became the primary actor to finance the government debt. As of 2018, the banking system as a whole provided almost 12 percent of GDP of new financing to the government (more than the overall deficit since foreign investors reduced their Eurobond holdings), with about three-quarters of the financing coming directly from the BdL (Figure 11).

Second, the Eurobond yields seemed to settle down, but only for a while. In contrast to the expectation, the yield has surged rapidly, particularly after the Prime Minister Hariri’s temporary resignation in November 2017 (Figure 12). The sudden disappearance of the Prime Minister was resolved only after a political intervention by French President Emmanuel Macron. This political fiasco seems to have had unsettling impacts on foreign investors and depositors.

Figure 12
Third, the scheme successfully boosted the BdL’s foreign currency holdings in the short term (Figure 13). However, the downside was the high rate that BdL offered commercial banks to attract deposits. According to the IMF report, for each new deposit at the BdL in USD, banks would earn a 6.5 percent interest in USD; this interest rate offered by the BdL is very generous, especially given the persistently low interest rates in international markets (Gaspard, 2017). In addition, the BdL would give the bank an opportunity to borrow a slightly larger amount in LBP at 2 percent and re-deposit it at the BdL at 10.5 percent for 10 years. As a result, the commercial bank effectively earned approximately 15 percent on its foreign currency holdings, a much higher return than any commercial loans banks would underwrite. Consequently, the high rates banks could earn on USD deposits through the financial engineering scheme affected the USD lending rates. They rose from roughly 7 percent in early 2018 to 9.7 percent in June 2019. This had a negative impact on private-sector credit, as banks preferred to park their money at the BdL rather than take risks by lending.

Fourth, the sovereign-risk exposure of banks significantly increased since the launch of the scheme. As of June 2020, banks’ exposures to the BdL and government increased to 70 percent of their total assets, more than eight times their Tier 1 capital (Figure 13).

Figure 13
While the BdL claimed that the financial engineering was “based on a win-win situation” and “didn’t burden the Central Bank neither the Lebanese Government with any costs,” many questioned its long-term viability term. Indeed, in an interview with the Financial Times in 2017, Mr. Salamé, the Governor of the BdL since 1993, admitted that his financial engineering has amounted to short-term fixes to keep the economy afloat until a more sustainable solution is found. “If the Syrian war ends, then we have major sectors that can drive the economy forward.” Unfortunately, the long-term fix was never implemented.

On the other hand, many criticized the potential risks embedded in the framework. Nasser Saidi, a former central bank vice governor, has explained the scheme as a “Ponzi scheme” as it relies on fresh borrowing to pay back existing debt.

The recovery plan prepared by the government for the ongoing IMF negotiations said that the financial engineering transactions had “proved unsustainable and very risky (… They) couldn’t address the core imbalances that generated the regular fall in FX reserves (a very large current account deficit) and they transferred to BdL a large exposure to FX risk.”

The financial burden on BdL increased. Although BdL has not reported its losses from the scheme, many suspect that these losses are included under the surging “other assets” item on its reported balance sheets (Figure 14).

Figure 14
Compared to its peers, the Lebanese economy is known for slow growth. The overvalued currency has diminished the competitiveness of its export sector. High production costs, which could be partially explained by the dependence on imports, also hinder growth. Also contributing to the high costs are the antiquated administrative system, the poor electricity supply, and other infrastructure and poorly defined or protected property rights. Furthermore, Lebanon is known for rampant corruptions; the country has ranked 137 out of 180 countries on Transparency International’s 2019 Corruption Perception Index. Many of the distortions that constrain growth could be attributed to governance and political uncertainties.

Lebanon’s politics is known to be inefficient. The Economist in 2018 explained that “it took two and a half years for the country to elect its current president, nine years to hold parliamentary elections and 12 years to pass a budget.” This is due to the historical divide in the domestic and international politics.

Excluding refugees, Lebanon has a population of 5.4 million, which is constituted by mixed religions: Christian 33.7 percent (Maronite Catholics are the largest Christian group), 30.6 percent Sunni, 30.5 percent Shia, and others. Following the power-sharing agreements established during the French colonial era, parliamentary seats are allotted proportionally to 18 religious groups, as are government posts and public-sector jobs. This leads to deadlocks in policy planning and implementation.

Political interference by Hezbollah, a Shia Islamist political party and military group, has increased tension with international communities as it has been designated as a terrorist group by the US and several other countries. Hezbollah holds parliamentary seats and has strong social
and political influence, including the nomination of the Minister of Public Health and other ministries. A number of municipalities are also run by Hezbollah politicians.

The fragmented political environment also hinders formation of effective cabinets. Not only domestic but also geopolitical risks are material: enmity between Hezbollah and Israel, US policy against Iran (where Shia Islam is dominant), and the rivalry between Saudi Arabia (where Sunni Islam is dominant) and Iran. The sanctions by the US on Hezbollah also disrupt the economy of those areas governed by Hezbollah.

The conflict in neighboring Syria since 2011 has had significant impacts on the country’s economy. Although data are unreliable, the influx of Syrian refugees is estimated to account for more than 10 percent of its population (Figure 15). An IMF Report illustrates that the scale of the impact for Lebanon is akin to “the United States experiencing a refugee influx the size of the Canadian population, or Germany absorbing the combined Austrian and Swiss populations.” According to the same report, the conflict in Syria not only increased geopolitical tensions but also heightened uncertainty, contributing to the decline in consumption, business investment, and tourism. The fiscal burden for the government has increased, especially in health and education.

**Figure 15**

![Graph: #5 Slow Growth, Political Deadlock, and the Impact of the Syrian Crisis](image)