



Lebanon: From Dollars to Lollars

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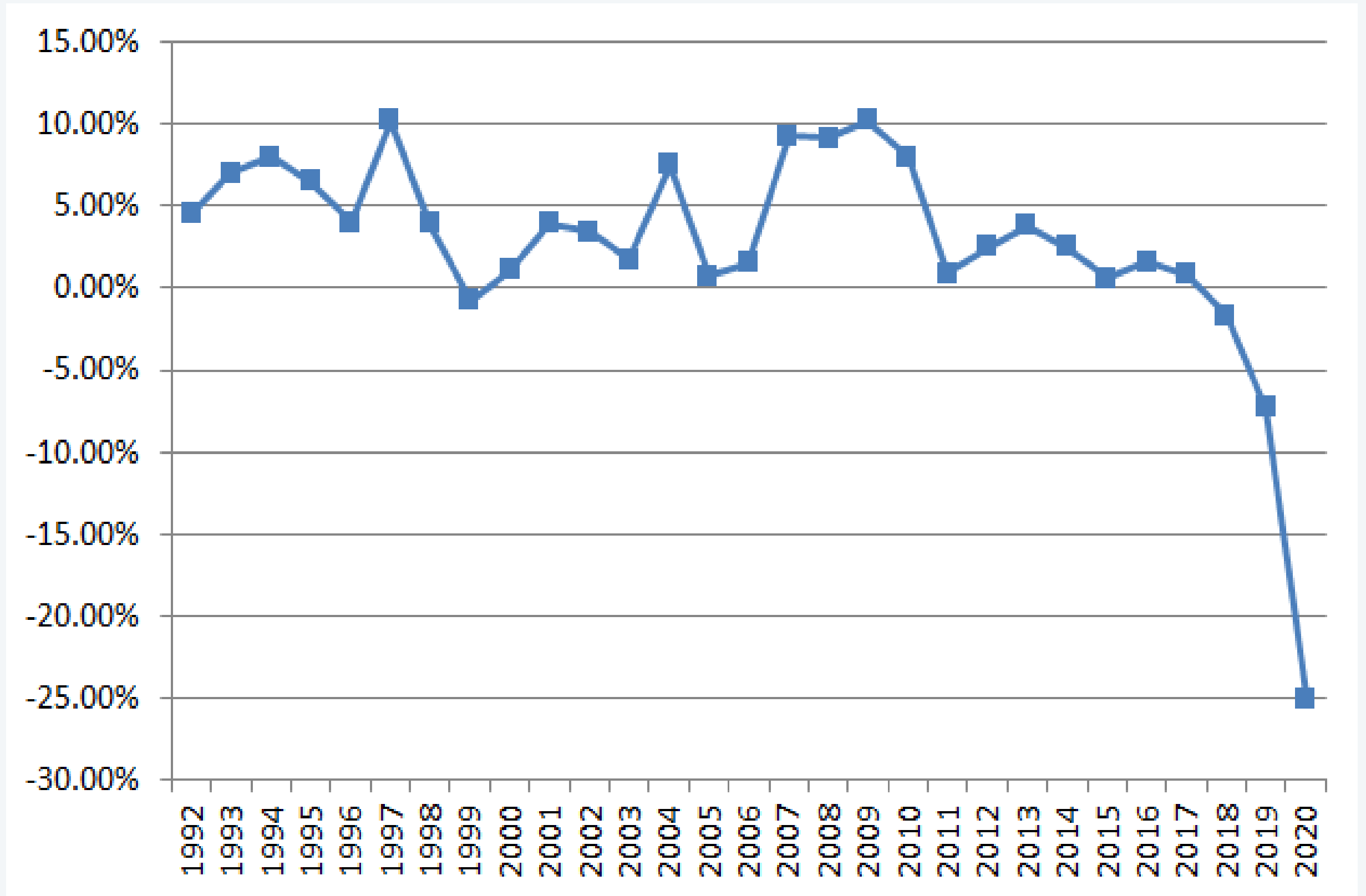
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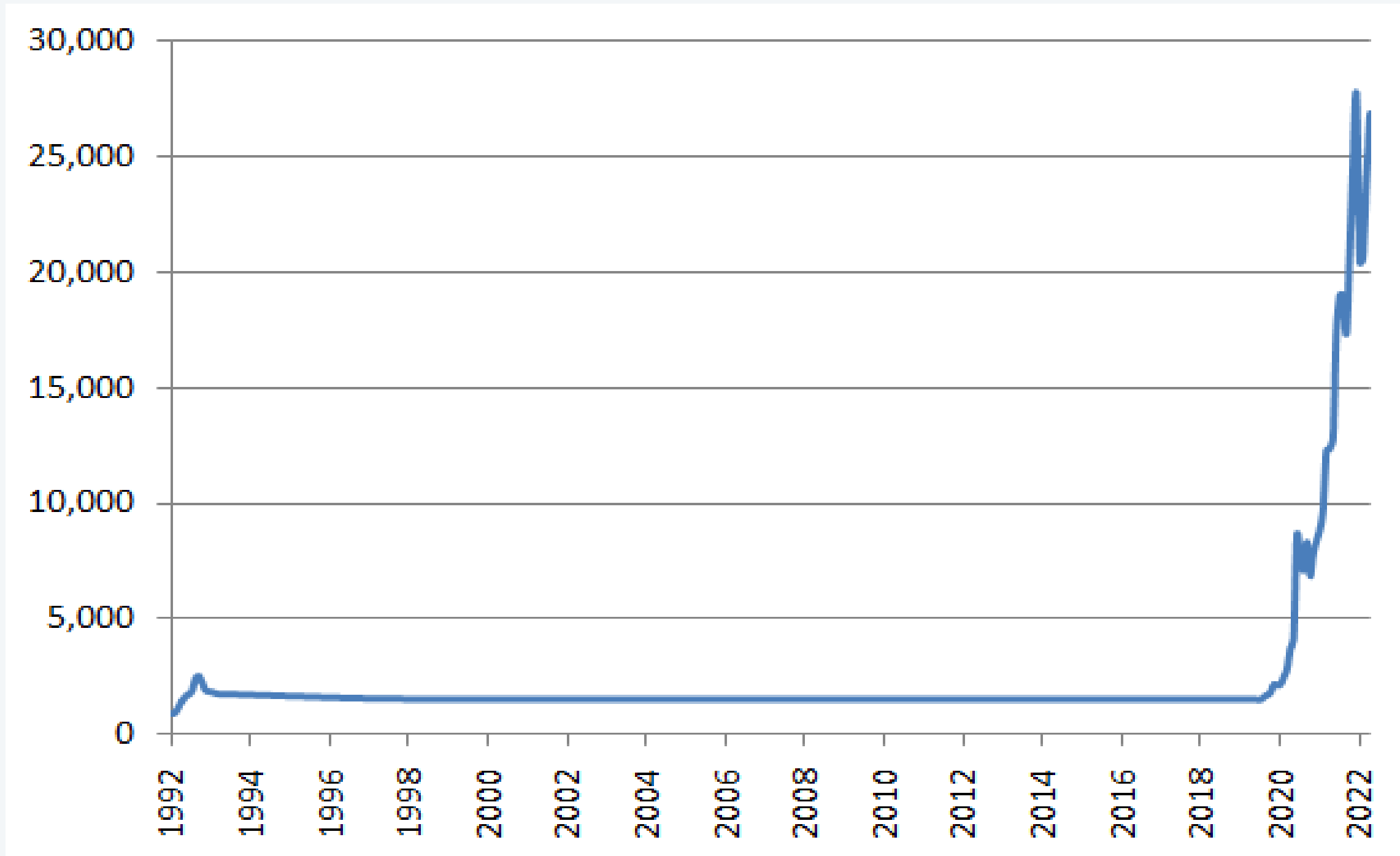
The Lebanese Economic Crisis

- Worst economic crisis in peace-time history when measured relative to GDP (World Bank)
- Came at the back of a stable 1,507.5 LBP/USD exchange rate since 1997
- Ongoing crisis without resolution in sight since 2019

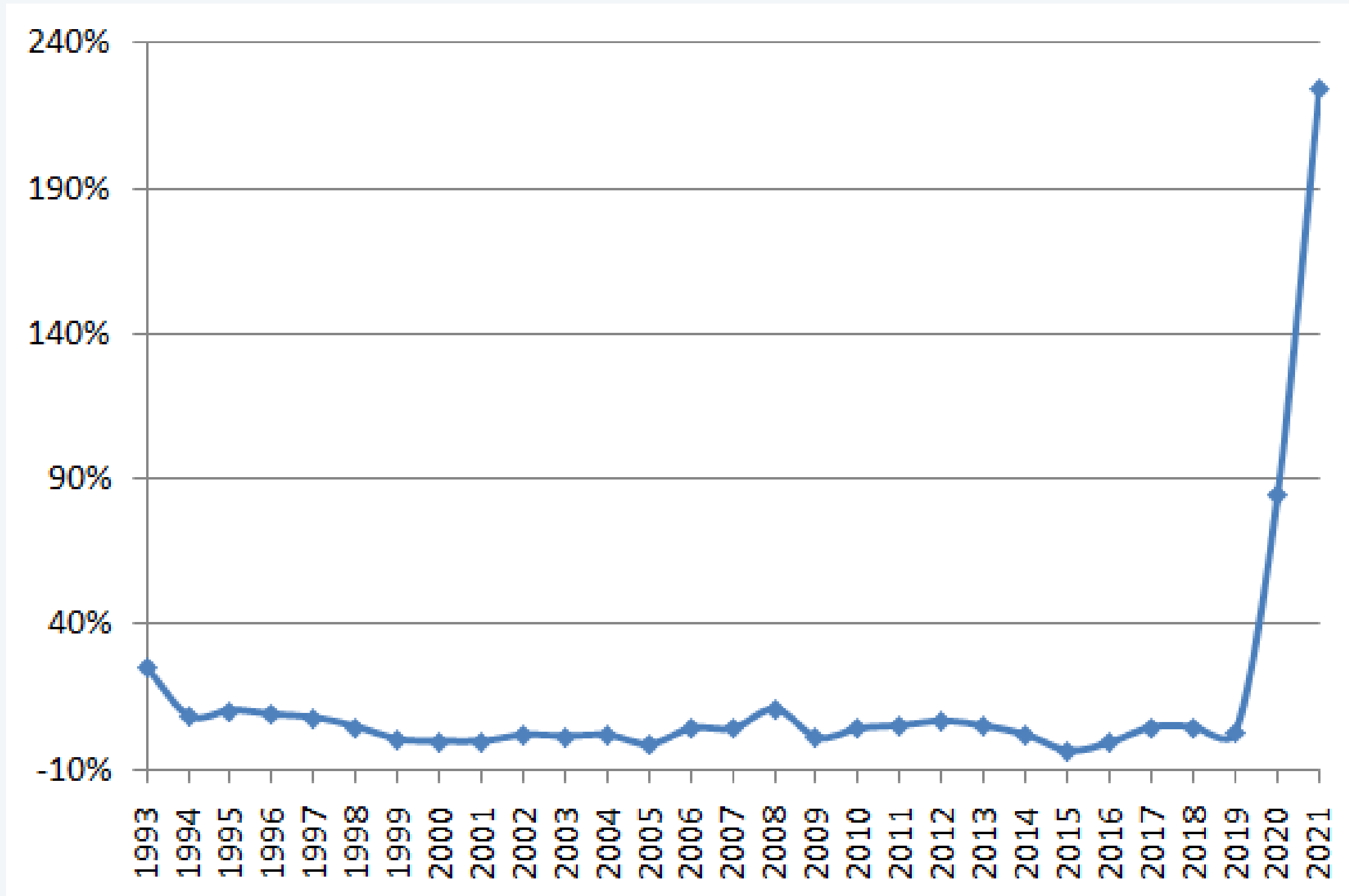
Real GDP Growth



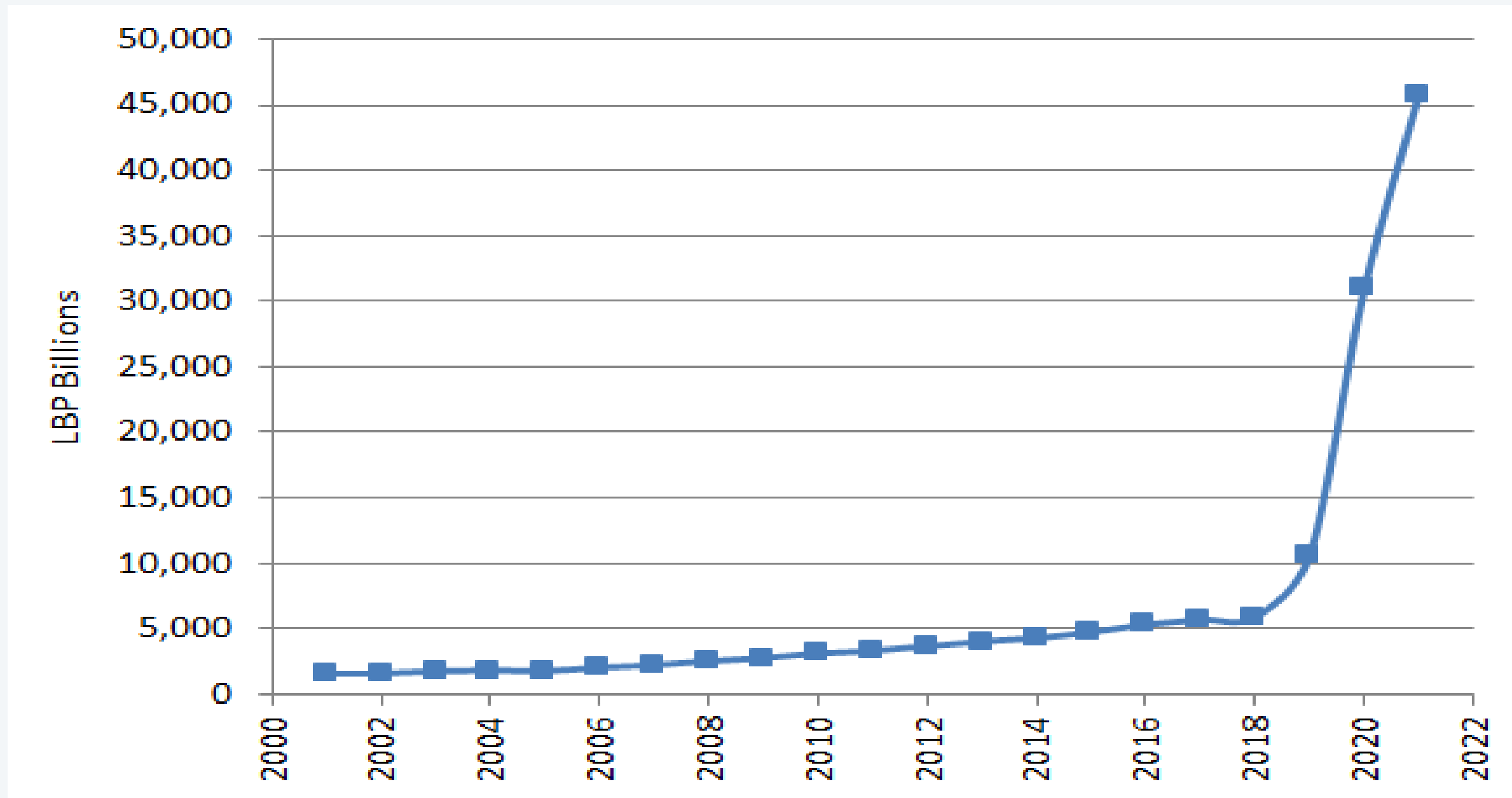
LBP to USD



Inflation



Currency in circulation



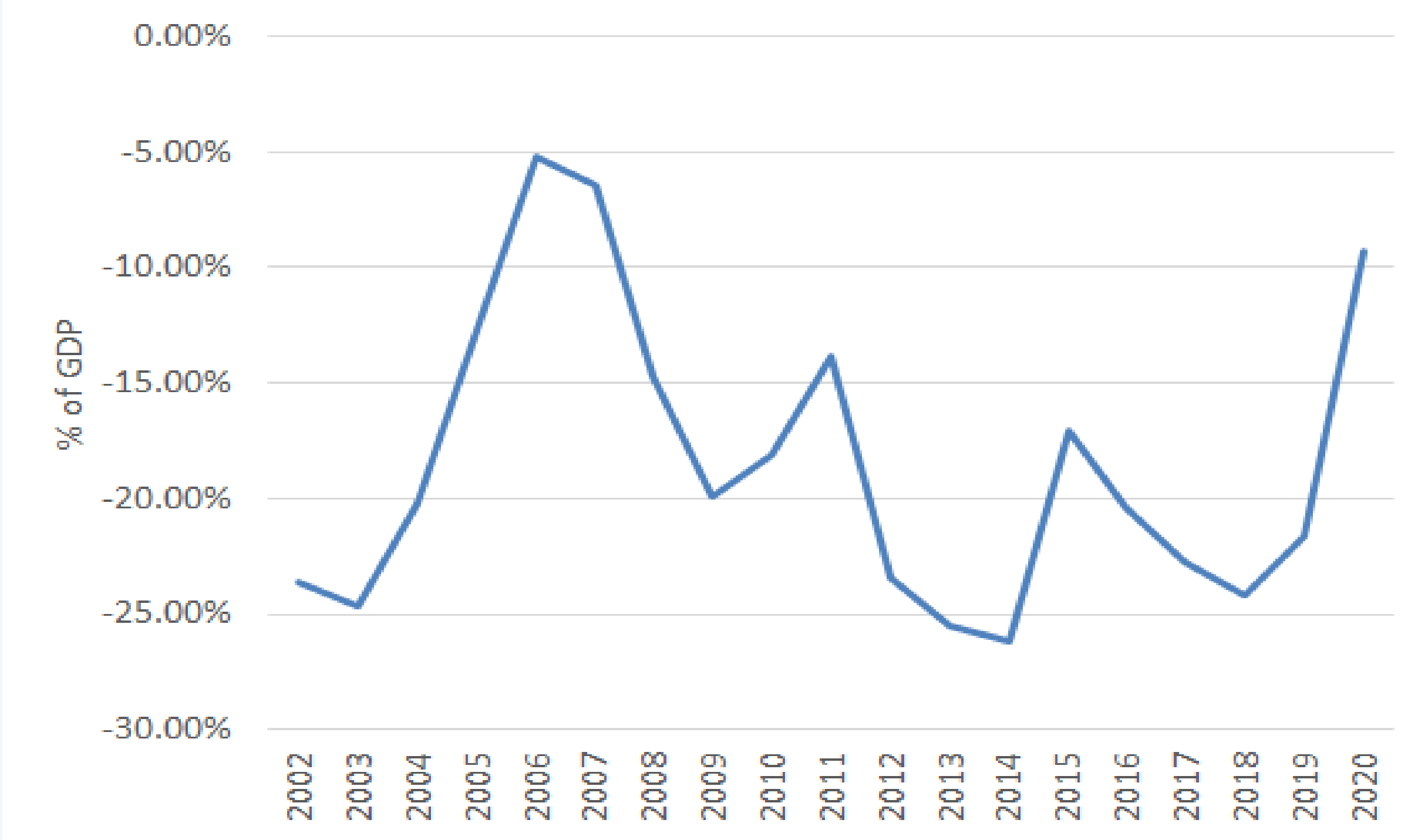
Historical Background

- Lebanon was created in 1920
- Lebanon obtained independence from France in 1943
- The 1975-1990 civil war was fueled by the fractionalization of the Lebanese population
- The post-war era
 - Reconstruction and development
 - Aim to create financial stability and economic growth (peg since 1997)
 - Dollarization of the economy (USD is legal tender)

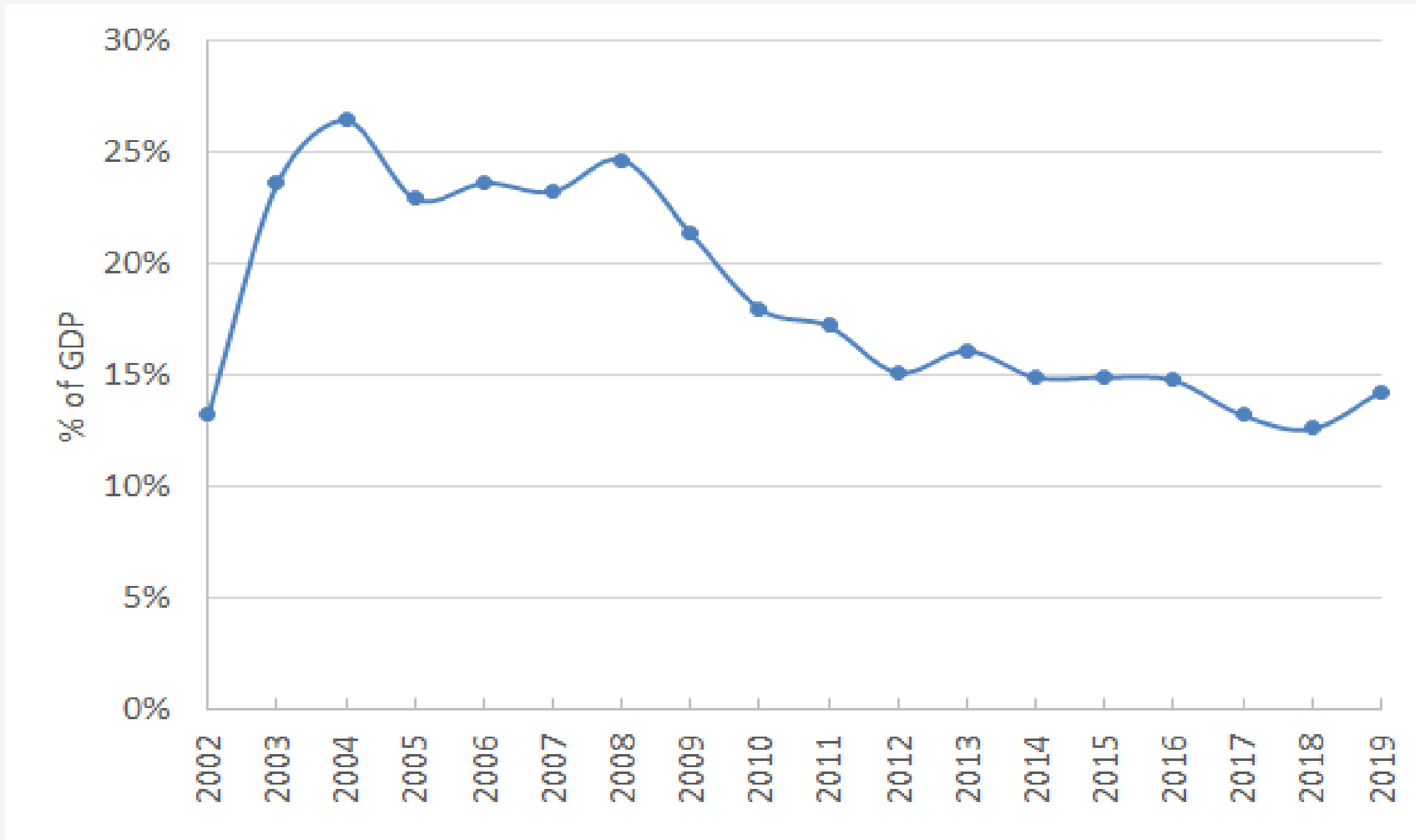
Macroeconomic Imbalances

- C/GDP ranges between 82 and 92 percent from 1997 to 2019
- Large Imports-exports difference to finance consumption
- Large trade deficit (30% of GDP)
- International remittances key and important source of funding for Lebanese banks

Current Account Deficit (% of GDP)



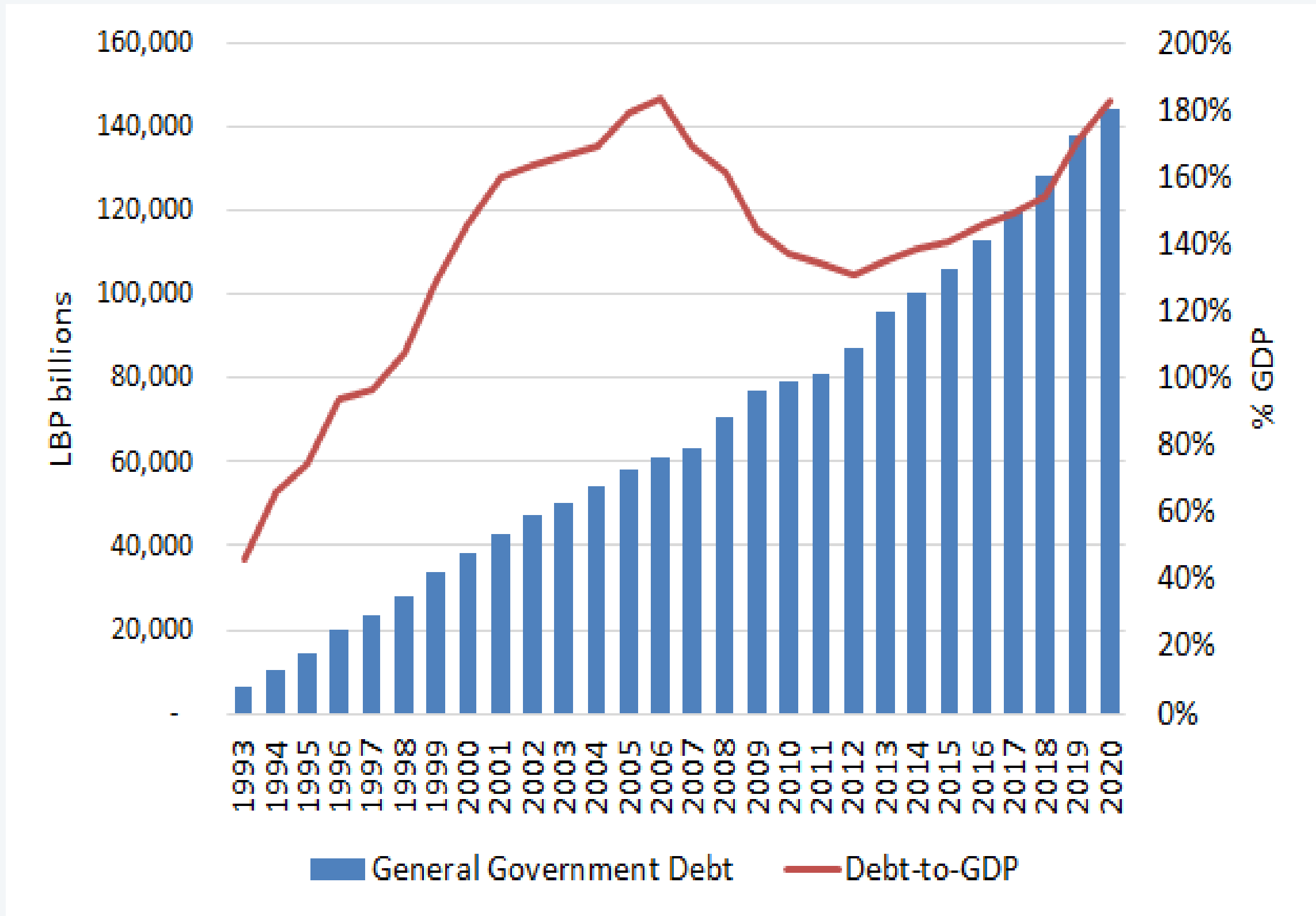
Remittances (% of GDP)



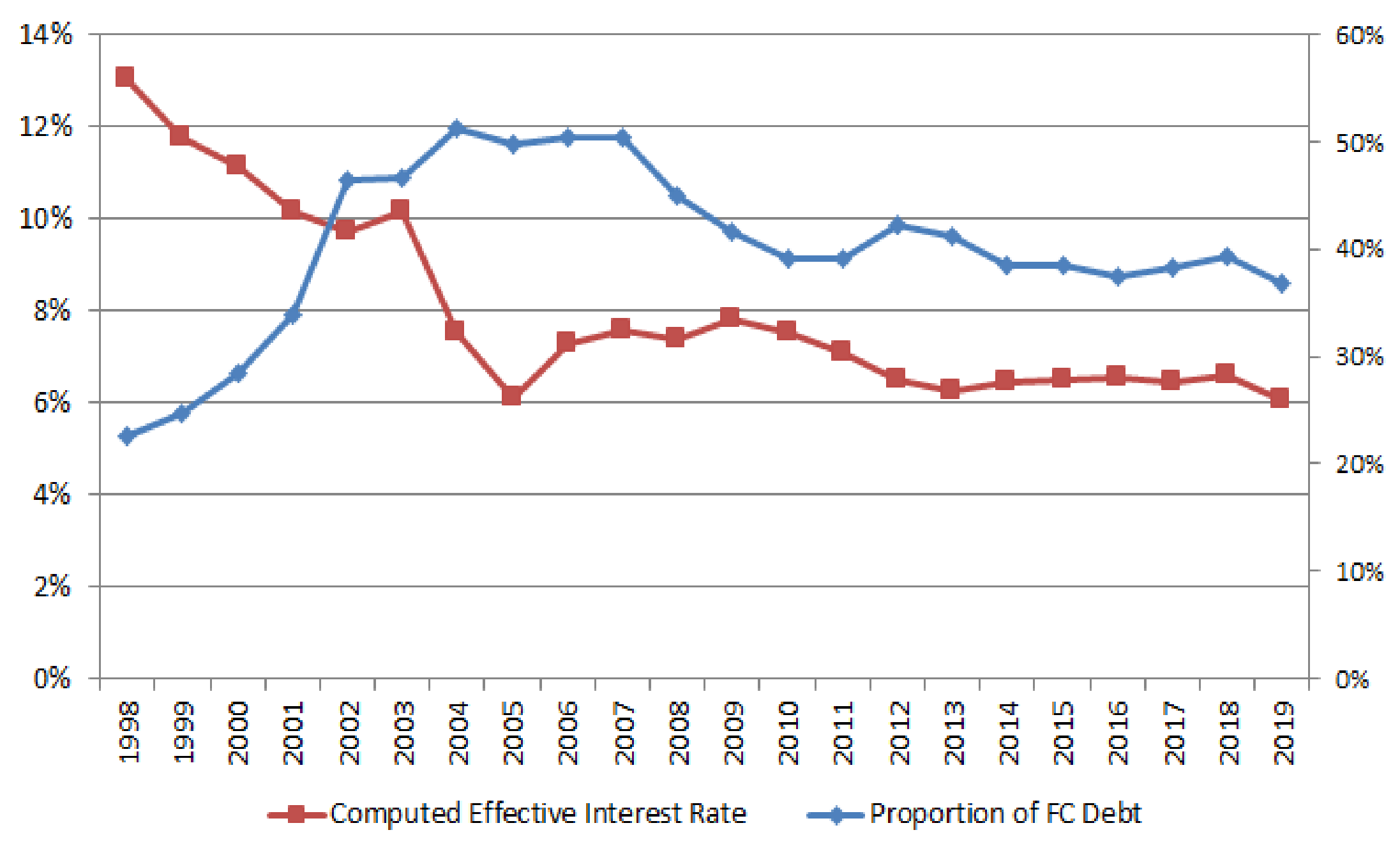
Fiscal Imbalances

- The Lebanese government has been steadily accumulating debt since the end of the civil war
- Lebanon was able to maintain a primary fiscal surplus in most years between 1998 and 2018
- The year 2011 marks the start of the civil war in neighboring Syria, which saw Lebanon take in over 1.5 million Syrian refugees
- Accounting for the interest on debt means that Lebanon's total fiscal expenditures far outweigh its fiscal revenues → Fiscal deficit of 10% for the period from 1998 to 2018 on average

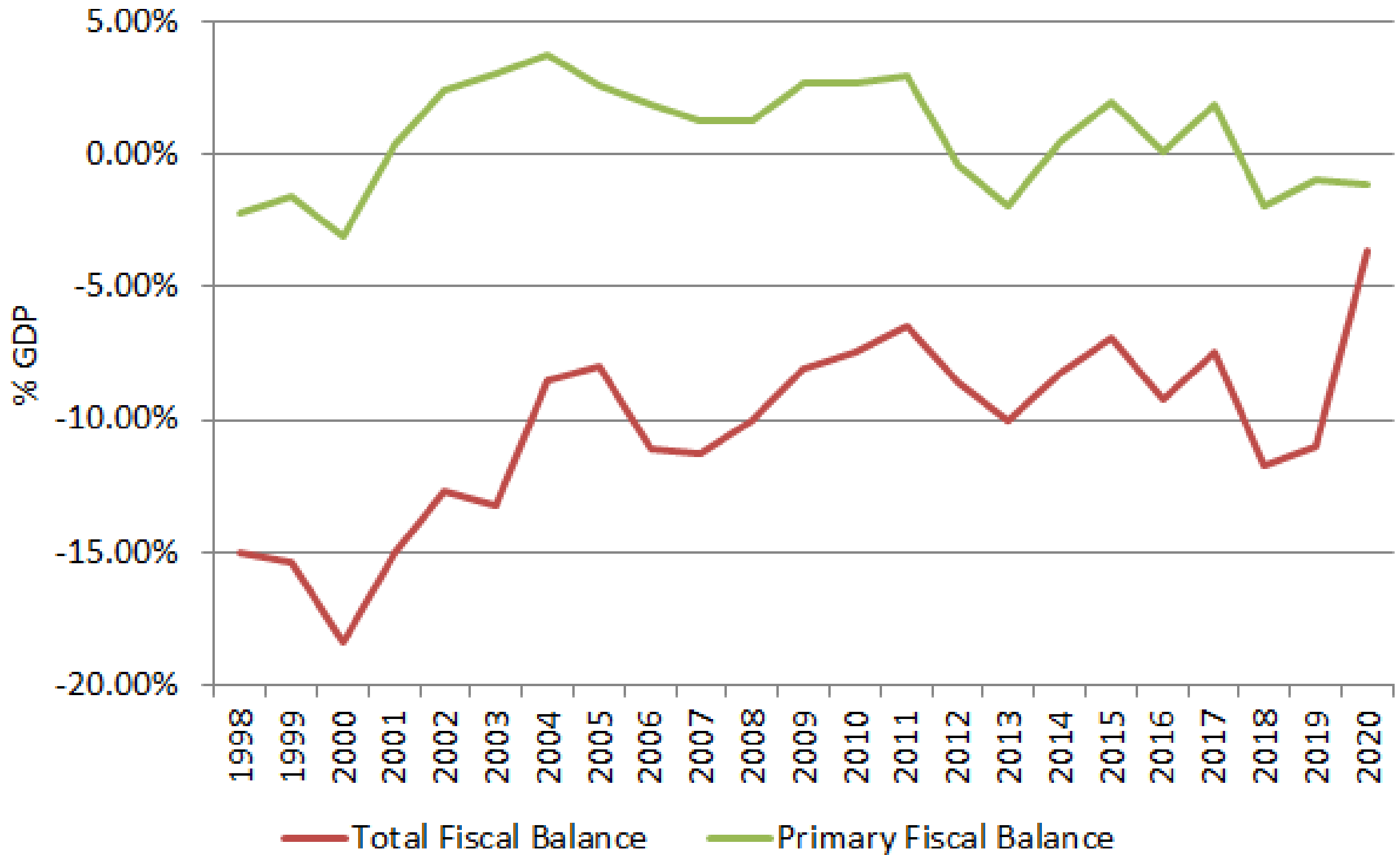
Government Debt



Sovereign Debt Proportion in Foreign Currency and Interest Rate Expense



Primary and Total Fiscal Balance



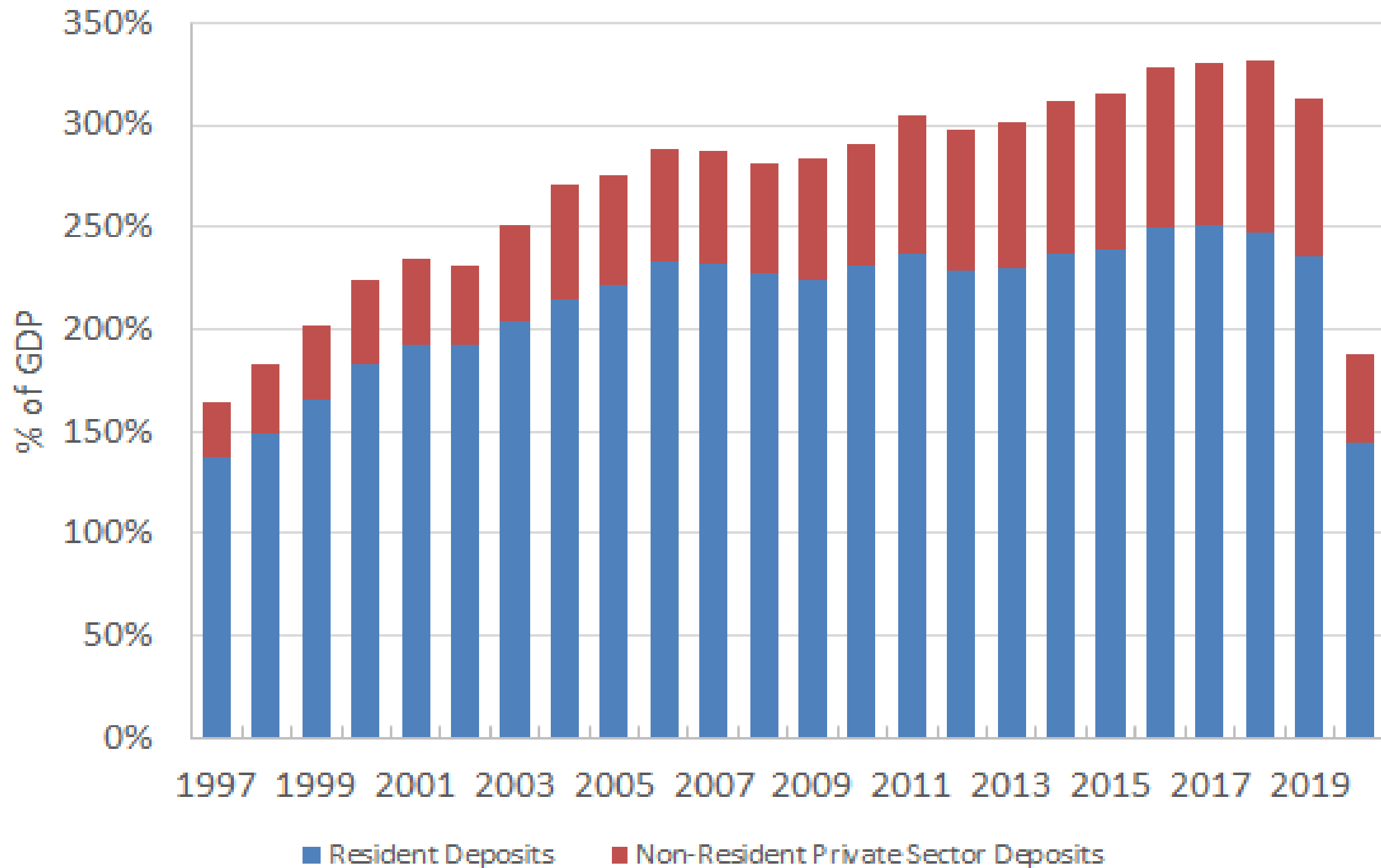
Fiscal Decomposition

- Low fiscal revenues (mainly from tax) averaged 19% of GDP
 - Salaries and Social Benefits: 38%
 - Subsidies and Grants: 14%
 - Capital Expenditures: 7%
 - Interest on Debt: 34%
 - Other: 5%
- Salaries and social transfers and interest rate cost (foreign currency debt rising) largest
- Not so much for reconstruction effort

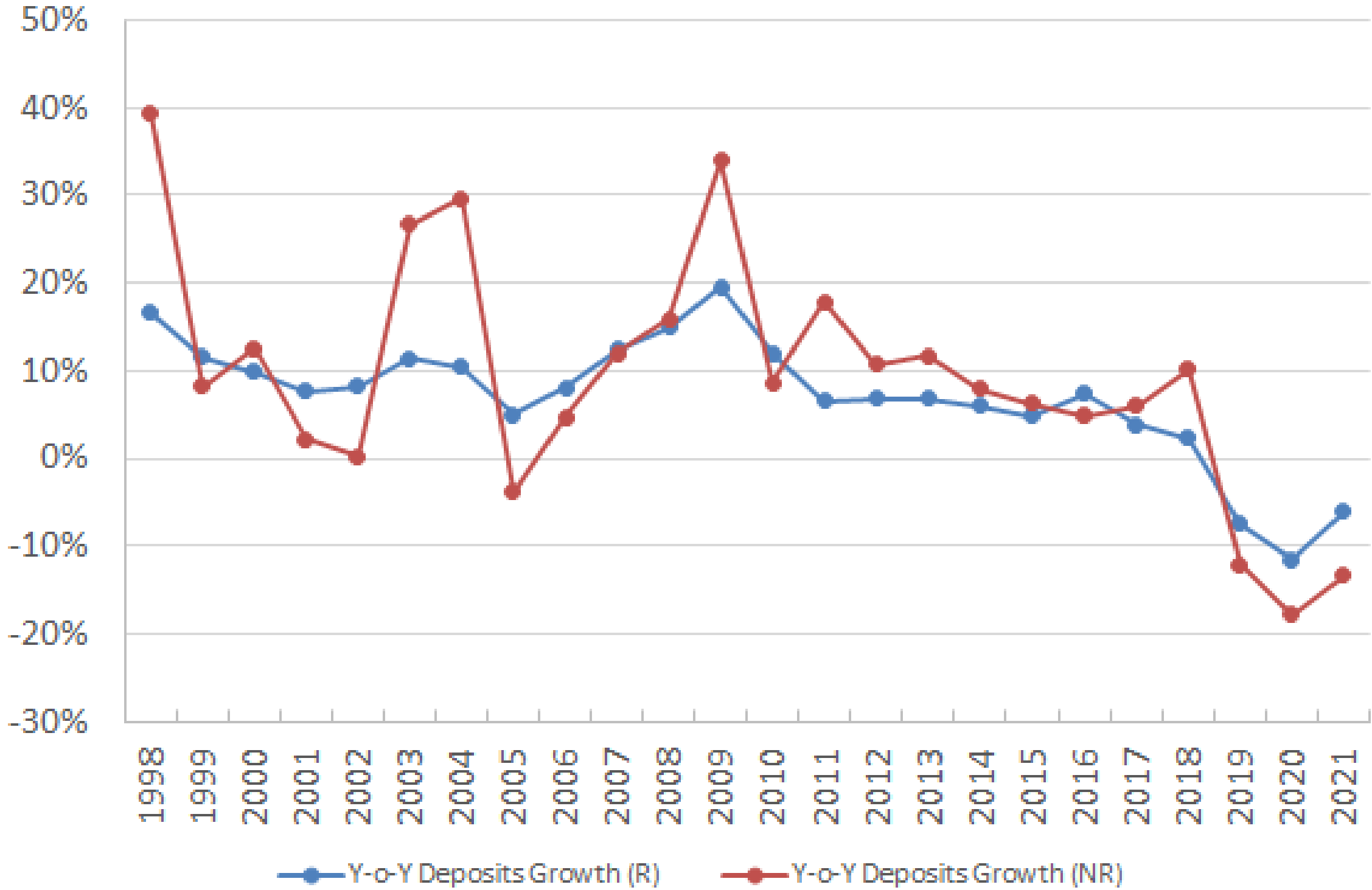
Banking Imbalances

- Lebanese commercial banks have gradually succeeded in attracting more and more deposits, both from residents and non-residents
- Deposits grew from 164% of GDP in 1997 to 332% in 2018 → One of largest in world
- The reasons for this growth:
 1. Favourable banking secrecy laws
 2. High interest rates
 3. High remittances
- Sharp decrease in 2019 owing to capital flight with the onset of the crisis

Size of banking sector



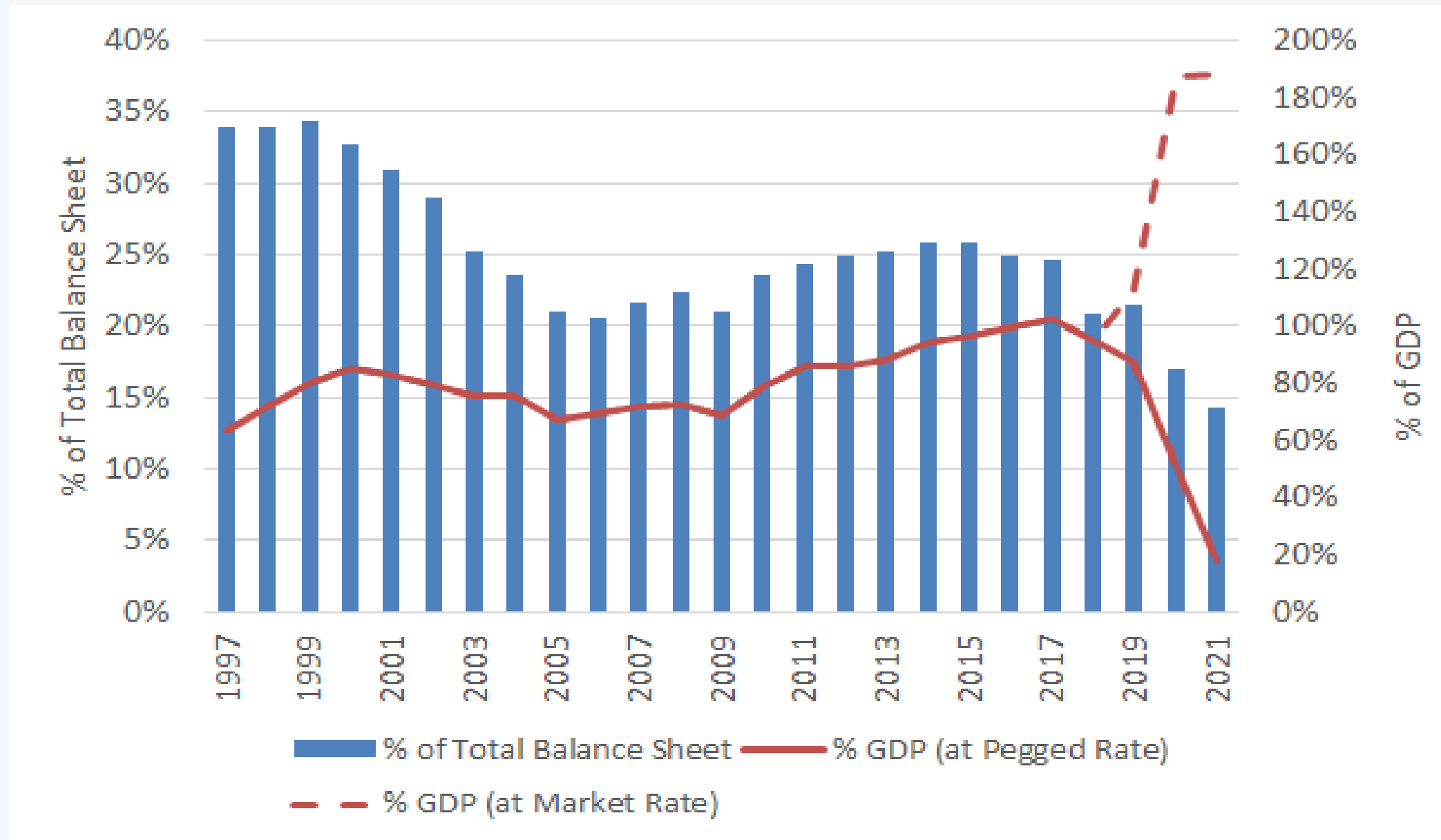
Volatile funding sources



Size of Bank Balance Sheets

- Lebanese commercial banks grew to 450% of GDP in 2018, before sharply decreasing in subsequent years
- Two assets made up 70% of total balance sheet:
 1. Government bonds
 2. Deposits with BdL
- No legal requirement forces banks to have a high exposure to sovereign debt but many banks in many countries invest in local sovereign debt for various reasons (Ongena, Popov and Van Horen (2019))
- A natural consequence of these banking investment choices was lower credit given to the private sector
- Nevertheless, classic currency mismatch still existed, even though deposits to BdL in USD

Loans to private sector in local currency



Role of the Central Bank

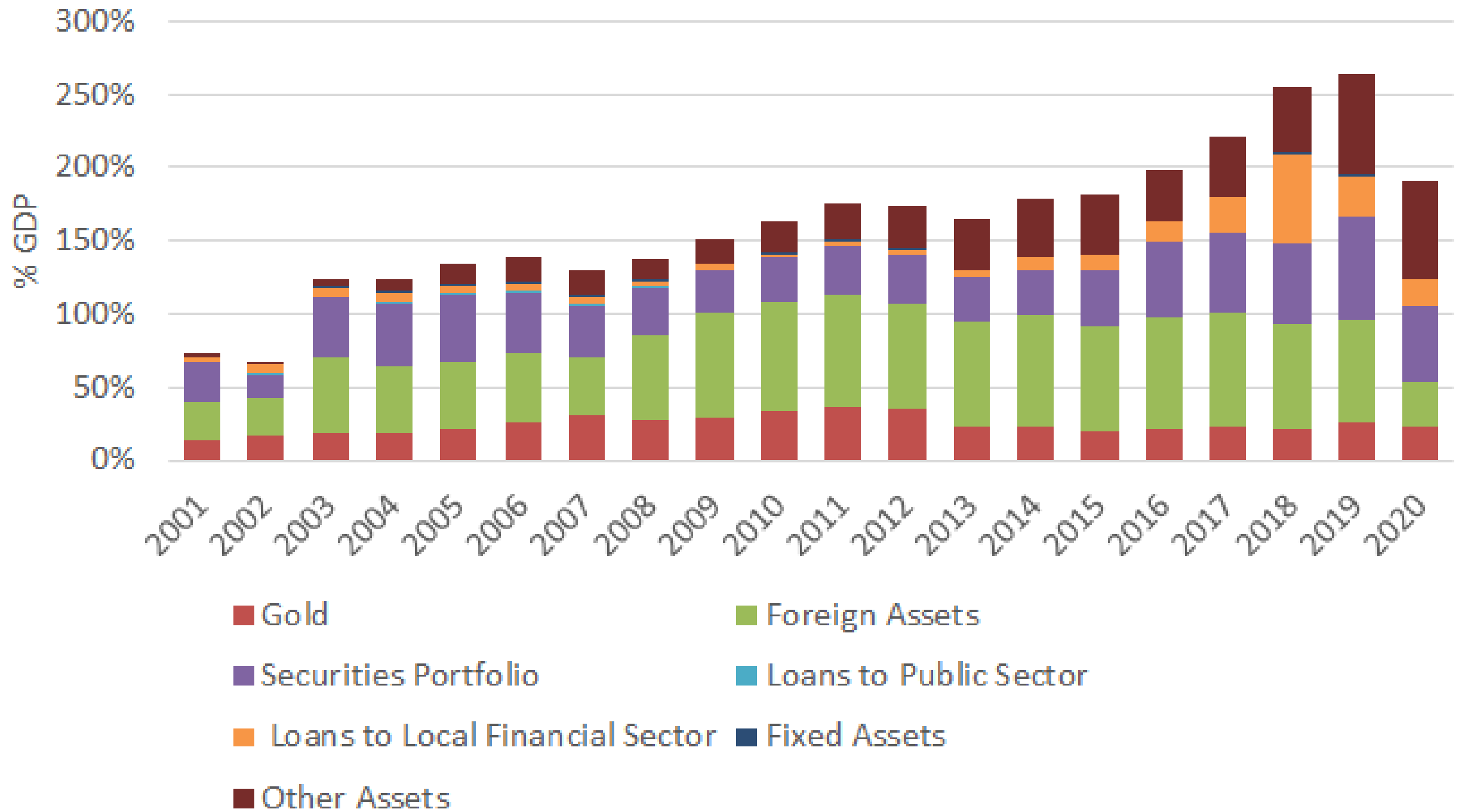
- BdL played a significant role in the Lebanese economic crisis
- The balance sheet of BdL grew faster than the Lebanese economy: going from 73% of GDP in 2001 to 264% of GDP in 2019
- The growth in the BdL balance sheet mainly reflects the increase of banks' deposits at BdL
- BdL was able to attract those funds from the banks by offering very generous interest rates (well above international rates).

→ What did the central bank do with these deposits?

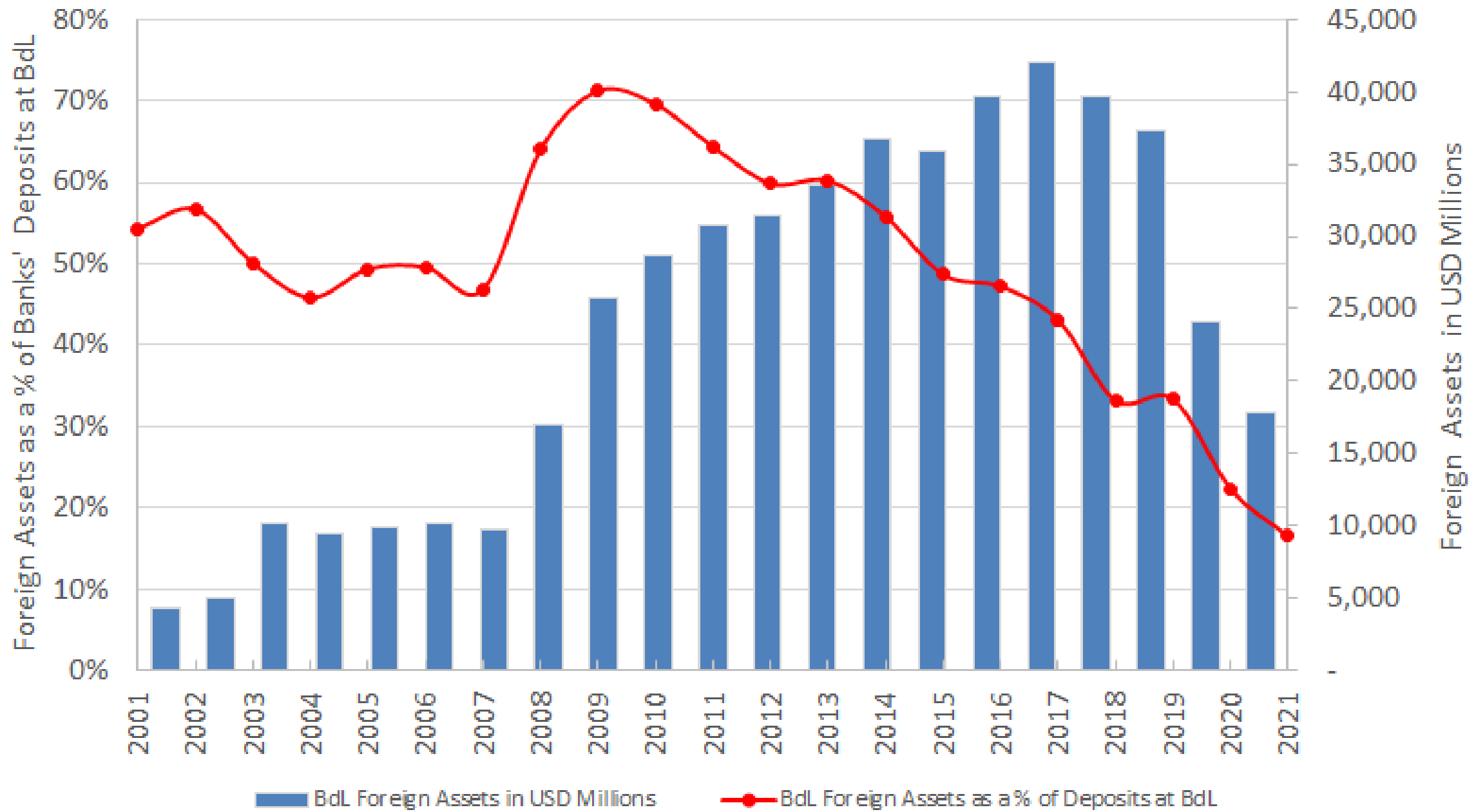
BdL Balance Sheet

- Foreign currency reserves decreased from 71% of assets in 2009 (peak) to 17% in 2021
 - This reflects both the large cost of deposit interest rates paid to the banking system, but also the increasingly unsustainable currency peg
 - Another account that should be highlighted is “Other Assets” which increased from 7% to 45% of the balance sheet between 2004 and 2021
- This is where the losses have been debited (FT article dated 2020 discusses this accounting treatment at length)

BdL Assets (% of GDP)



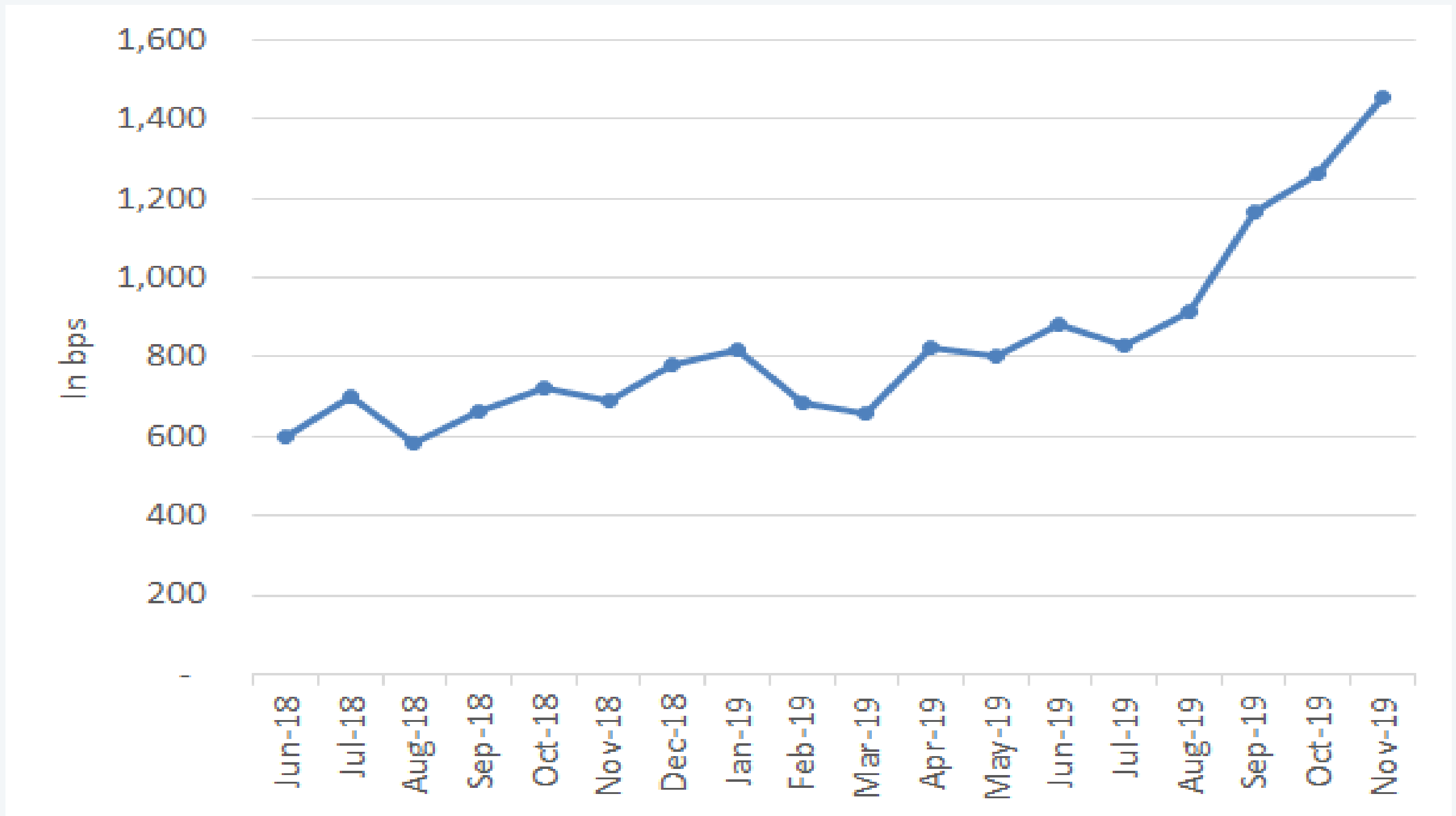
BdL Foreign Assets



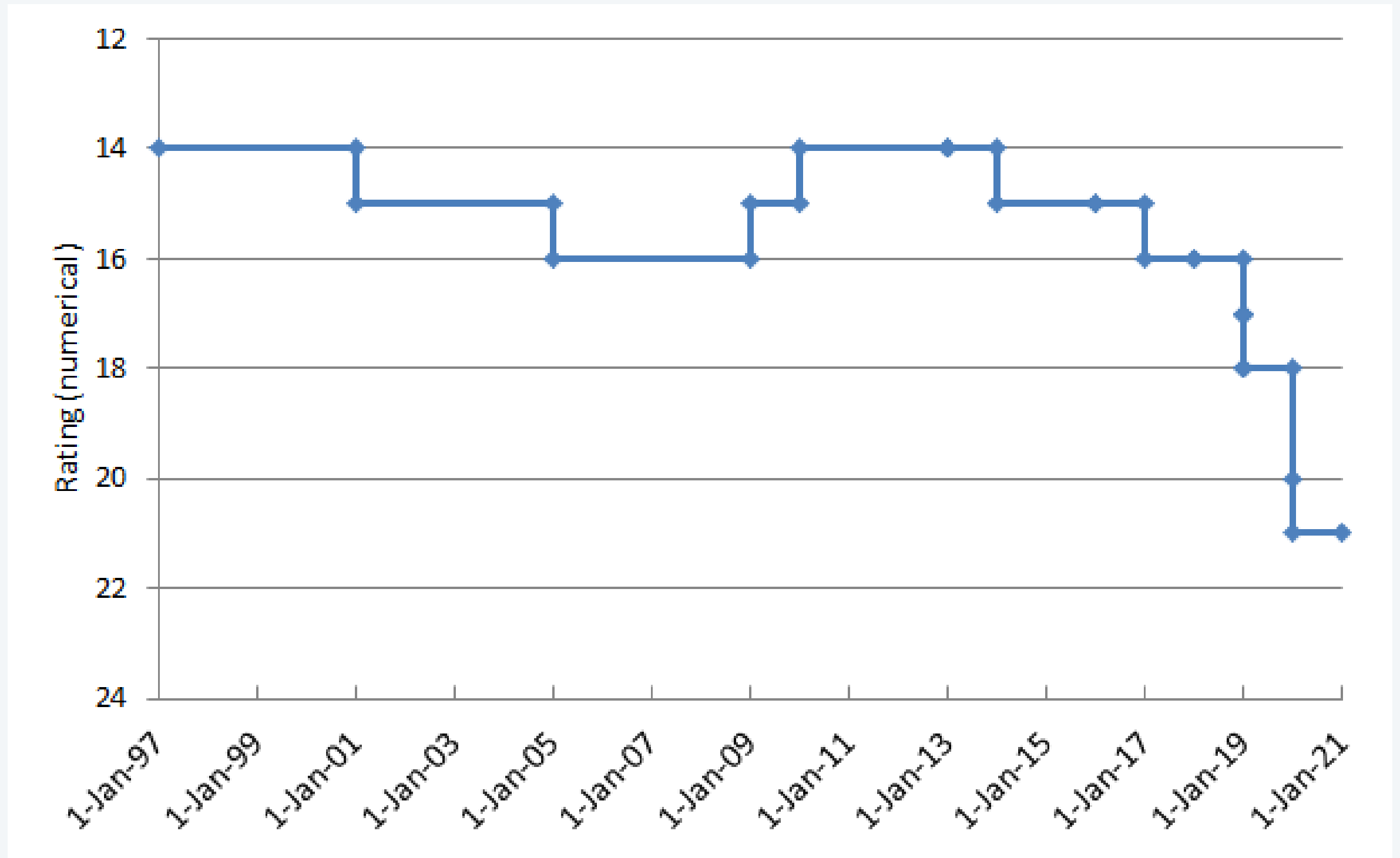
Classic Triggers and Signals

- Higher CDS spreads
- Downgrades of sovereign debt from credit rating agencies, non-investment grade (junk) already since 1997
- Fall in banking sector equity values
- Explosion in port in August 2020
- Ethnic heterogeneity/lack of political unity not allowing talks with IMF to be completed; economy worsens during this delay (no deal to this date)

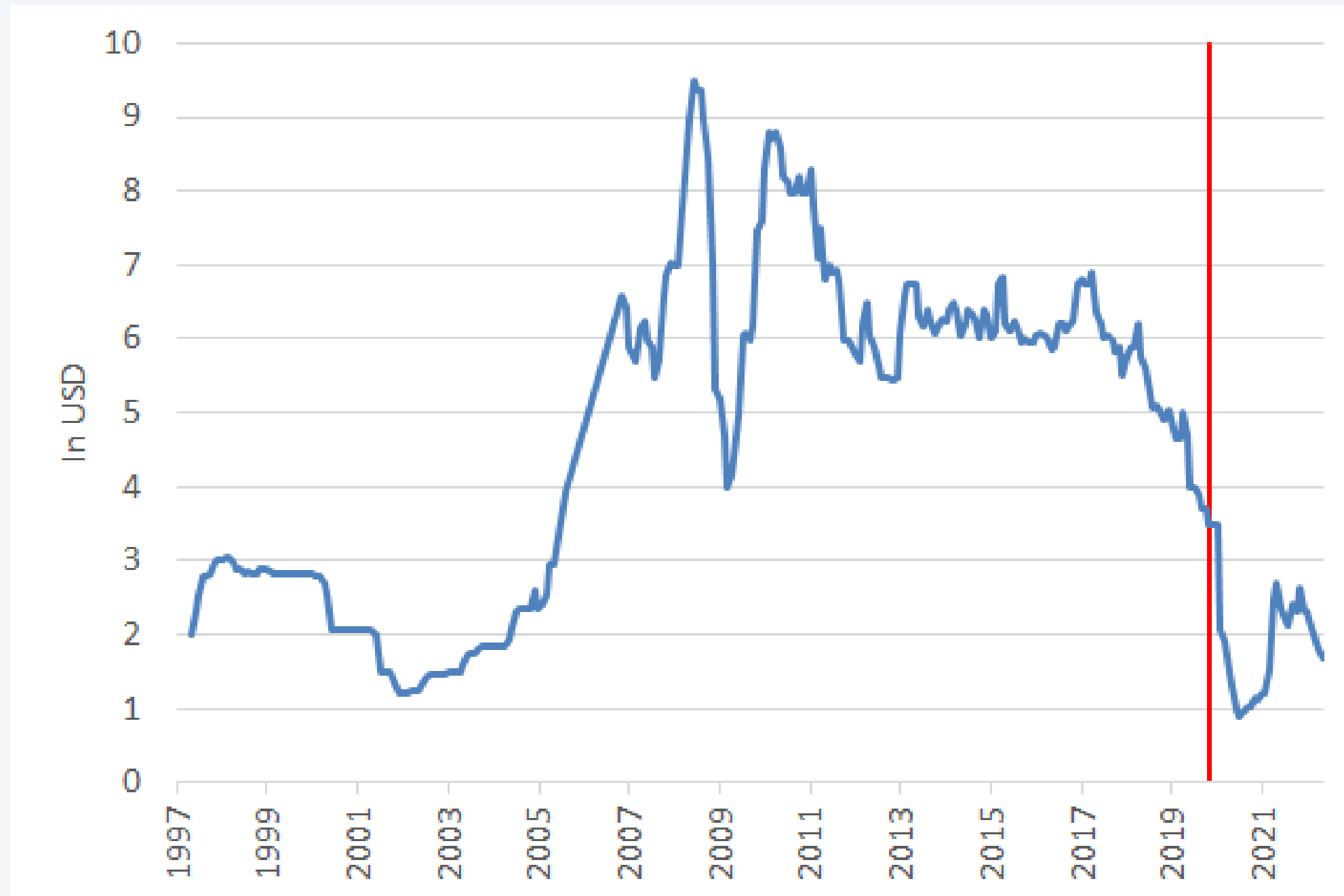
CDS 5-year sovereign debt spreads



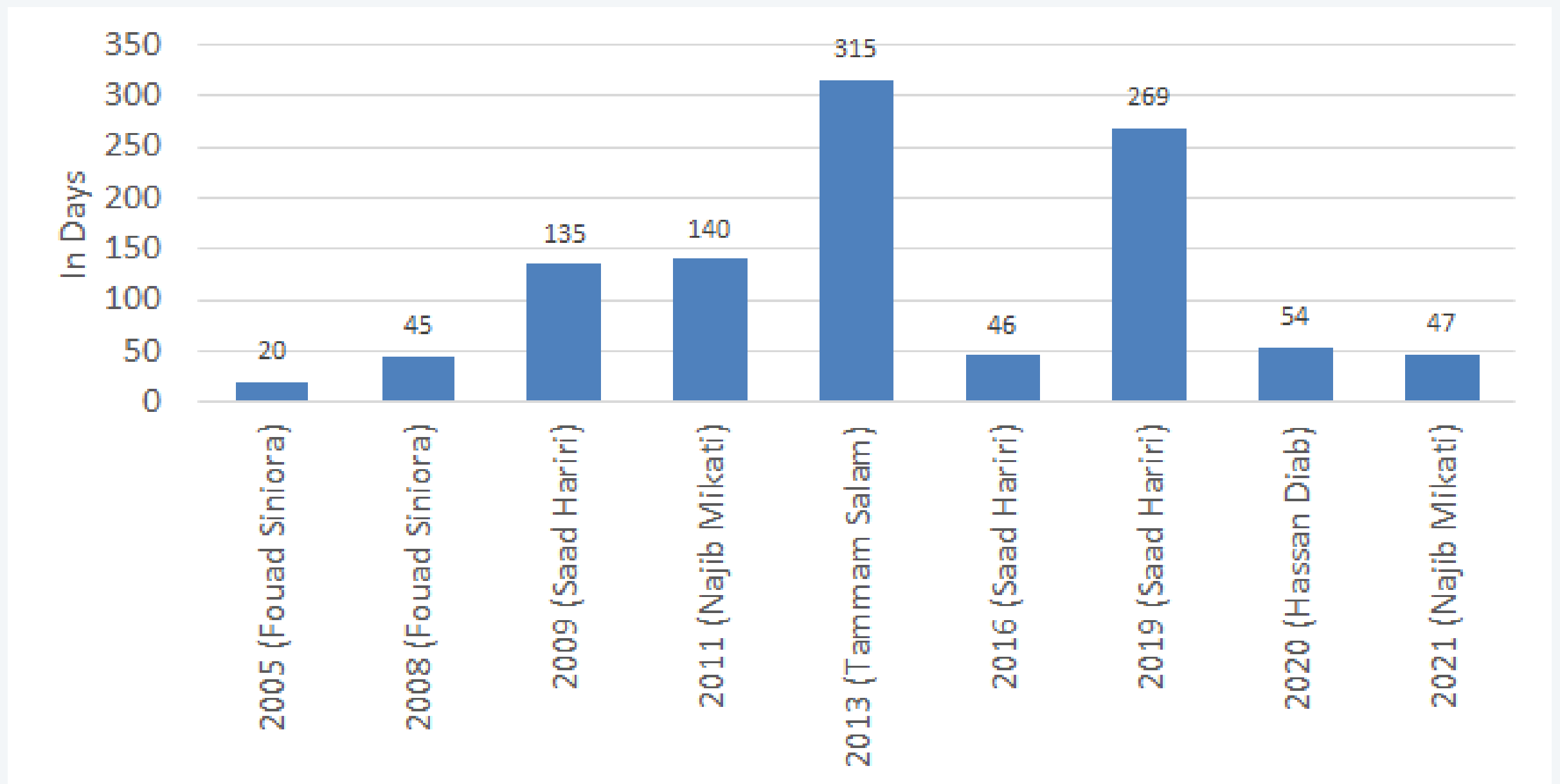
Moody's sovereign debt downgrades



Banking sector equity values: AUDI representative of sector



Political Paralysis: Days from PM appointment to Form Cabinet



Causes of Crisis/Lessons from Crisis

1. Ethno-religious fractionalization contributes to avoiding making tough economic decisions on time
2. The twin deficits (fiscal and current account) have been emphasized as vulnerabilities in describing the evolution and acceleration of the Eurozone crisis
3. It is objectively challenging to set a fixed exchange rate at the appropriate level, especially if this level is maintained over long periods of time
4. These policies and decisions generated a classic currency mismatch vulnerability on some parts of the banking balance sheet

Causes of crisis/Lessons from Crisis

5. The central bank in Lebanon faced a difficult task in a fractionalized political environment and with a currency peg that increasingly seemed unsustainable
6. The central bank attracted USD from banks at high interest rates and used them to support peg. Eventually, dollars at central bank became lollars, further reducing trust in system
7. The external environment deteriorated over time and made a small open economy like Lebanon even more vulnerable to economic shocks
8. Dollarisation could help but not in large crises/default of central bank