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OP-ED

Lebanon's rentier economy and creative destruction (by Dan Azzi*)

When Judgment Day for our country arrives, and it's very close, the results will be cataclysmic and painful, but we should stand ready to exploit this and unleash Schumpeter's Creative Destruction process.

Last week, a state of apprehension proliferated in the economic and banking circles in Lebanon, as they watched with horror Lebanese government Eurobond yields rise from 10 to up to 14% within a couple of days. Eurobonds, notwithstanding their name, are actually Lebanese government debt denominated in US Dollars. A senior banker even described the situation using the term "hushed panic."

Simultaneously, Credit Default Swap (CDS) rates rose from 600 basis points in November (when Prime Minister Saad Hariri 'resigned') to 1,300 basis points last week. For those of you who don't know what a CDS is, it is basically the cost of ensuring our debt against a government default. Let me explain it in laymen's terms. Think of life insurance. If you were to buy \$100,000 of term life insurance on a healthy ten-year-old kid, it might cost you \$2 a month. On the other hand, if you try to buy the same for a healthy forty-year-old male, it might cost you \$20 per month.

Sometimes, insurance companies might give you a medical exam, which invariably will raise that rate, if your cholesterol and triglyceride levels, for example, are high. Now back to the CDS; let's just say that investment banks today are pricing these as if Lebanon were an eighty-year-old who's had two heart attacks, a malignant cancerous tumor, and is HIV positive. In fact, our CDS levels are now higher than Argentina or Turkey ... and you know what just happened there in the recent past.

In Lira, the rates are even worse, at 16-17% and higher for five-year deposits, which detracts anyone with capital from investing in expanding a company or setting up a startup and employing our youth, whose unemployment rate is 37%, according to the World Bank.

At those rates, an investor would double his money every 5 years, without the aggravation of designing a business plan or managing people or dealing with the National Social Security Fund known as Daman and the tax authorities. And this is one of the symptoms of our economy turning into a rentier, lazy economy, spreading like cancer and infecting the other, productive sectors, like manufacturing, agriculture, and innovation.

Of course, I won't even get into the self-evident question which every depositor should ask himself (or his banker)? Where are our banking geniuses investing these deposits to earn a rate greater than 20%, which would put Warren Buffet to shame, in order to pay you, the depositor, 17%?

So how did we get to this sorry state? It all started a decade or two ago, when the banking business model morphed from lending deposits to people and businesses, to lending the government to finance its budget and trade deficits. Due to their fast growth, in contrast with the anemic growth in the economy, deposits have now reached a staggering nearly four times the size of the Lebanese economy.

This is a source of pride among the Lebanese Intelligentsia and the Not-So-Intelligentsia, who believe this provides stability to the economy and is a positive deviant relative to most other "inferior" countries. In fact, this has created the opposite effect, and addicted us to some very bad habits. Think of a waiter, Samir, who works in a fancy downtown restaurant, and who gets paid a low wage,



but he can get as much free leftover food as he wants.

Samir can't resist all this fancy food, with an entrée costing more than a week's salary. A bite here, a meal there, and pretty soon, Samir is obese, with some serious health problems. So what did our government do when it saw all this free fancy food, i.e. piles of dollar deposits from the expats? It did exactly the same as our friend Samir. It started to spend way more than it collects in taxes, and very inefficiently, with little to show for it.

At the same time, the real estate bubble also redistributed our financial and human capital from other parts of the economy, erecting these huge and vacant towers all over the place.

But that wasn't the only damage caused by this idiotic and short-sighted indulgence. This also came at the expense of the environment, with our beautiful mountains systematically consumed, destroyed, and converted into concrete blocks, with business models still assuming the return of the ludicrous 2010 prices, which will never come back in our lifetime, thereby guaranteeing they'll collect cobwebs for decades. Naturally, the real estate sector sucked in the other part of our deposits, with loans directly or indirectly linked to properties consuming 90% of bank lending to the private sector, according to a 2017 IMF report.

In short, our bank deposits have gone primarily towards financing the government twin deficits or the property sector. So what is the optimal alternative destination for us to deploy our financial and human capital? Most people normally regurgitate the obvious tourism, manufacturing, and agriculture, but that answer is appropriate for someone who graduated from high school in 1970. The right answer, without a doubt, is to invest in the knowledge economy, especially software development.

We would then convert the products of our imagination into a series of zeroes and ones, to sell overseas in return for dollars and other hard currencies, instead of using financial acrobatics.

To achieve this, we would need to set up startups modeled on the likes of Google, Uber, and Facebook. Is there any intrinsic geographic advantage that the US has for all these companies to start there? Is it related to the presence of oil or minerals or other natural resources? Of course not. It's strictly related to their culture of innovation, educational system, and nurturing culture and business environment, all within our capabilities to emulate.

The first thing we would need to do is to increase the speed and efficiency of our internet and communications infrastructure and reduce their cost, instead of using them as a latent government tax. We would also need to reform our educational system and aspirations, from this silly cultural bias to push our sons and daughters to become physicians, engineers, or lawyers. We would also need to re-educate our youth to use the Internet to unleash their innovative capabilities, instead of porn, Facebook, and WhatsApp jokes being the biggest consumer of internet bandwidth in our country.





When Judgment Day for our country arrives, and it's very close, the results will be cataclysmic and painful, but we should stand ready to exploit this and unleash Schumpeter's Creative Destruction to wipe out any remnants of our old economic model represented by the following transaction: "Buy a piece of land, sell it for double the price in two years, and buy a Porsche 911. We should replace this Madoffian economic model with a modern, knowledge-based economy that creates high-quality jobs, especially for our underutilized youth.

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Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Lebanese Forces.



Economic Overview: Delay in government formation costing Lebanon dearly

Though consensus among the country's major political blocs offered the chance for the parliament to convene for a two-day legislative session, most of the 15 draft laws that were passed can't be implemented unless a functioning government is formed or the current caretaker government assumes exceptional powers. Either way, the delay in the formation of a government is raising doubts about Lebanon's ability to reverse its economic downturn, as many Lebanese expect the upcoming government to avoid political deadlock and work efficiently to reassure investors and citizens. Without a new government, no meaningful reform can be implemented to gradually unlock \$11bn in investments pledged under CEDRE 1. As such, the opportunity cost of the delay is growing by the day, with around \$180m in forgone output per month, according to a best-case scenario in which growth can potentially reach 5%.

While Lebanon's monetary conditions remain relatively stable and the banking sector resilient, deteriorating public finances are complicating efforts to keep the economy afloat. Figures released by the Finance Ministry show the fiscal deficit has reached \$1.9bn in the first 4 months of 2018, which constitutes an increase of 126.5% from the \$844m deficit posted in 2017, and thus a substantial rise of the funding needs. All this comes against the backdrop of \$1.5bn of bond maturities in the rest of 2018, and some \$5bn in 2019 – a principal of \$2.9bn and interests of \$2.1bn – constituting a record level of bond payments worth 7.7% of GDP and thus marking a critical juncture in the government's ability to servicing its debt.

A recent IIF report says the economy is suffering from protracted economic stagnation, and political bickering is



delaying reforms that otherwise could have put Lebanon on a growth trajectory. The delay in the formation of a government, as already mentioned, is causing huge losses, and should this delay lingers, Lebanon might well be entering into recession.

But if any government is to be formed, it has to be a functioning government with the political will to enact a range of key structural and fiscal reforms beyond working to meet the required 1% reduction of fiscal deficit each year over the next 5 years. These reforms include, inter alia:

1. Restructuring the electricity sector;
2. Limiting tax evasions;
3. Reforming the public-sector pension system;
4. Reforming the public investment; management and procurement laws
5. Instituting efficient anti-corruption and transparency mechanisms; and above all;
6. reconsidering the role and size of the public sector.

Reconsidering the public sector's role and size is especially relevant in light of a recent CNBC interview in which BDL Governor said: "what is needed is to stop enlarging the public sector and start enhancing the private sector to become more productive...Before its 15-year civil war which ended in 1990, Lebanon was essentially driven by the private sector... The public sector represented 17 percent of GDP — now it represents 35 percent of GDP."

Under a best case scenario of 5% growth rate, which entails forming a functioning government by no later than one month and gradually but efficiently enacting and implementing said reforms, substantial gains can be achieved, including an expected upgrade of Lebanon's credit ratings, and most especially putting Lebanon's back on the radar of international investors.



S&P: Downgrade expected if Lebanon cannot access international markets

International rating agency Standards & Poor's maintained its "B-/B" long- and short-term sovereign credit ratings on Lebanon with a stable outlook because of expectations that deposit inflows to the financial system will remain sufficient to support the government's borrowing needs and cover Lebanon's external deficit over the next 12 months. A "B-/B", however, remains a highly speculative grade that is classified within the non-investment category.

The report said the government's debt servicing capacity depends on the financial sector's willingness and ability to continue to subscribe to securities, and thus on steady capital inflows. It warned that it could downgrade its ratings for Lebanon if the government was unable to access the international debt capital markets for an extended period, or if the political and economic situations worsened, leading to capital outflows and slower deposit growth rates. It said that Lebanon still suffers from weak public finances, and from the government's reliance on the banking sector's willingness and ability to finance its needs. In contrast, if the country's policymaking framework becomes more predictable and effective, leading to higher-than-expected economic activity and improving fiscal and external imbalances, Standards & Poor's can upgrade its ratings for Lebanon, which will pave way for lower interest rates.



Eurobonds falling to an all-time low

Structural imbalances and dependence on external financing are still affecting the performance of the Lebanese Eurobonds, which are also impacted by the twin current account and budget deficits, a deteriorating confidence from international investors and the delay in the formation of a government.

These factors have triggered a downward spiral of government bond prices, which have fallen to levels the market has not seen before. CDS spreads have subsequently widened to levels investors last witnessed during the 2008 global financial crisis. In addition, the yield curve, which was flat during the past weeks, started to invert, raising doubts about Lebanon's falling into recession, among other risks (i.e. higher yields for short-term maturities compared to yields for long-term maturities)

- The 10Y Lebanese Eurobonds yield reached 11.42% on September 17, before dropping back to 10.48% by September 21.
- The 5Y Lebanese Eurobonds yield reached 11.87% on September 17, before dropping back to 10.57% by September 21.
- The 1Y Lebanese Eurobond yield reached a historical high of 13.25% before dropping back to 10.33% by September 21.
- As for the cost of insuring debt, Lebanon's five-year CDS spreads, reached 829 basis points before contracting by 119 basis points to 710 basis points.
- Lebanon 1Y CDS reached 1105 basis points before contracting to 858 basis points by September 21.



Media adds fuel to controversy

Earlier this month, the London-based Economist made a big fuss by publishing a controversial article that says a crisis is looming in Lebanon, with real estate and banking to blame. At least four local newspapers picked up the story to question the accuracy of Economist's views, citing more credible international reports, such as one from Standards & Poor's that paint a somewhat "brighter" picture of the economy, especially on the monetary front. True: Lebanon's inflation is kept in check, and unlike other crisis-ridden countries, our domestic currency isn't forced into devaluation yet, mainly because the Central Bank has built enough cushions to keep it afloat, at least on the short term. But the news about Lebanon's alarming economic conditions has already been on everyone's lips for a while, largely due to persistent economic mismanagement, wide corruption, and a dismal growth. In fact, negative perceptions about investment and growth fueled what many people have come to see as Lebanon's near descent into economic collapse, just as the Economist tried to convey, despite a number of fundamentals remaining relatively acceptable.



Remittances hurting growth

Lebanon is one of the leading recipients of remittances, with inflows averaging \$6bn to \$7bn a year and equaling around 16 percent of GDP. Remittances play a crucial role in that they provide a safety net for Lebanese families, but are also considered a trap for growth and development. This is what a recent IMF report indicates, with findings pointing out to inflows causing economies to get on a lower-growth, higher-emigration trend. Indeed, as the amount of remittances increases, workers, especially the highly skilled, find it more appealing to drop out of the labor force or emigrate, causing a brain drain and leading to an increase in wages that in turn put upward pressure on prices and further deteriorates competitiveness. Better-paid, high-skill jobs that are typically in the tradable sector, would thus be replaced by the low-skill, poorly paid jobs in the non-tradable sector. The loss in competitiveness means that more products must be imported, hurting economic growth. Brain drain, alternatively, is found to be one of the reasons why Lebanon cannot diversify its economy away from tourism, construction, and real estate, and into the tradable sector of manufacturing for instance. The crowding out of the tradable sectors is also an outcome of the Dutch Disease, which refers to an economic situation in which deindustrialization occurs when the revenues drawn from natural resources raises the value of the currency. The IMF report also points to serious implications on the political-governance front; the Lebanese citizens who receive remittances become less motivated to question or hold their government accountable, while the government feels no responsibility to be accountable to its citizens.

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