Lebanese Forces Economic Brief

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General Overview: Time is running out, challenges growing

"There is no money left in the budget reserve. Where will I bring money from? Finance Minister Ali Hassan Khalil," said during a recent parliamentary discussion

"Stakeholders in Lebanon have so far failed to make tangible progress to form a government, as some still refuse to budge on their position for more representation." The prolonged delay in forming a government, much to the astonishment of most of the country's political analysts, comes at a time Lebanon still struggles to address the most pressing economic and policy challenges to reverse an economic downturn that has left many Lebanese unemployed or in poorer economic conditions.
As Lebanon's vulnerabilities are becoming more apparent, the release of a recent World Bank report warning that "Lebanon's macro-financial conditions are currently under heavy scrutiny as the country faces increasing challenges.
The risk profile for Lebanon is rising sharply…" came as a sort of warning of what might happen if stakeholders fail to take necessary measures. For starters, the delay in forming a government is holding up economic reform and costing dearly both in actual and opportunity costs. Some 2200 companies have closed down since January 2018 according to Head of the Chamber of Commerce, Agriculture and Industry Mohammed Choucair; growth is revised to just 1% in 2018; and the opportunity cost is worth no less than $180m per month if GDP growth were to reach 5%.

Still, the irony is in the country's public finances. Stakeholders initially forecast the salary scale increase would cost around $800m, only to find out later that the actual cost reached around $1.4bn.
The budget deficit, already 250% more than in 2017, is even expected to grow further in 2019, which will require higher capital inflows or more debt borne by the government. But attracting sufficient capital, and particularly deposits, is proving challenging for Lebanon, because of a slower deposit growth and unfavorable international conditions. What makes matters worse is that Lebanon can ill afford to wait furthermore; Gross Public Debt has already reached about 148 percent of GDP by end of 2017, and debt servicing is expected to exceed 10 percent of GDP, consuming about half of revenues and hardly leaving any room left for spending on infrastructure and social goods and services. What is more troubling is that a key constituent group in Lebanon, in conjunction with foreign support, has recently come out to block the formation of a new government. If Lebanon fails to undertake reforms in due course, it will lose the opportunity to capitalize on the support offered by the international community to benefit from $11bn in soft loans and grants. In a recent visit to Lebanon, the World Bank Vice President for the Middle East and North Africa Ferid Belhaj spoke about the "urgent" need to enact reforms committed to at CEDRE.
Although the recent approval on a dozen of draft laws, including solid waste, healthcare and fiscal management, offered some kind of respite, the parliament still has a lot to do. Along with the next cabinet, it will have to put policy back on track to restore consumer and business confidence, measures that will be essential to shoulder its part of responsibility instead of the Central Bank having to bear the burden every time Lebanon is caught up in a deadlock or faced with a political crisis. To be sure, the Central Bank will still have to assume its monetary policy responsibility to keep inflation in check, protect the national currency, effectively regulate and oversee the financial sector, and introduce a new stimulus package – but gradually reduce its scope and size over the coming years.

Eurobonds dismal performance reveals a deeper crisis

The prolonged impasse in cabinet formation caused a net international selling on the Eurobond market. International institutional investors have reportedly been net sellers of the Eurobonds during the past months. The recent performance was a 23 bps increase with a weighted average yield reaching 10, 11%.

But this actually represents Lebanon's worst bond market shock in a decade, a development that raised worries about whether banks are willing and able to bankroll the government in the absence of any meaningful reforms or a positive political shock that could boost confidence.

Earlier in September of this year, Reuters reported that "when Lebanon's international bonds have fallen in the past, local banks could typically be relied upon to buy up the securities. Not so this time."

It quoted Jason Turvey at Capital Economics as saying that "FX debts amounted to 50 percent of the country's GDP and a rush to the exit by foreign investors could tip the small country into a deeper crisis. Sustained capital flight would quickly drain foreign exchange reserves and ultimately force the authorities to devalue the pound."

This is especially relevant given that the traditional sources of foreign exchange, such as tourism and foreign direct investment, have all nearly dried up or become stagnant amid regional tension, war in neighboring Syria, and political deadlock in Lebanon. The only remaining source – albeit growing at a slower place – is expatriate Lebanese funds flows to local banks. This has produced a competition among banks in Lebanon to attract hard currency deposits, which in turn resulted in crowding out private investments.

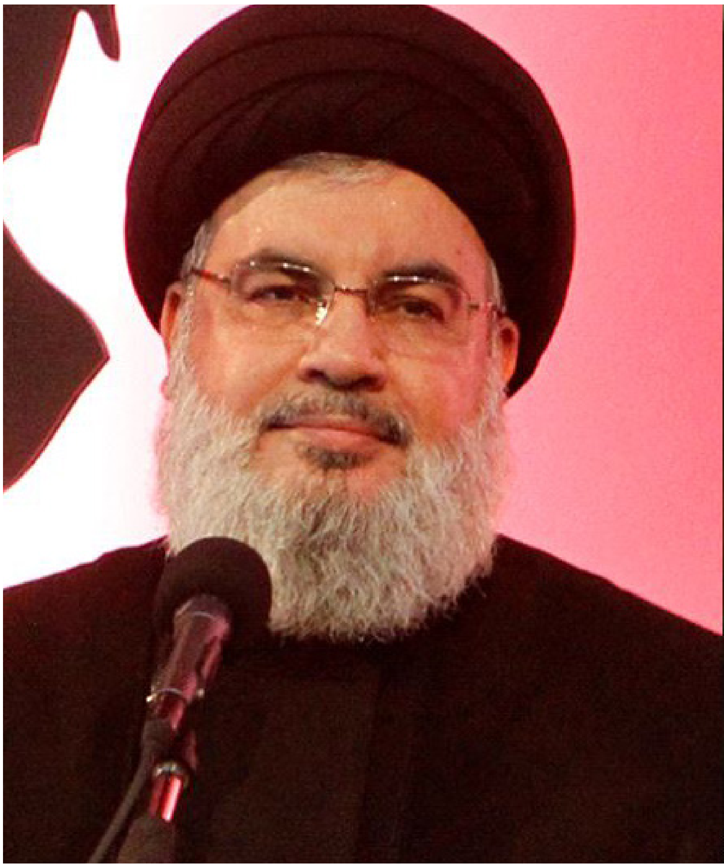
New sanctions against Hezbollah add more pressure

The Trump administration imposed new sanctions on Hezbollah, by approving the Hezbollah International Financing Prevention Amendments Act of 2018. This Act ramps up sanctions against the Party of God and those who support it, including four men reported to have had conducted and led operational, intelligence and financial activities in Iraq. It later added Jawad Nasrallah, the son of the group's leader, to its list of individuals. In a recent event, President Trump said: "I signed legislation imposing even more hard-hitting sanctions on Hezbollah to further starve them of their funds. And they are starving for them….We will target, disrupt and dismantle their operational and financing efforts."
The Trump administration's move is but a step the American administration is taking to step up economic pressure on Hezbollah and Iran, arguably to rein in Tehran's influence in the Middle East and force it to make concessions and settle for a less favorable deal if the US wishes to ever negotiate a new settlement after it pulled from the one it concluded in 2015.

By targeting foreign persons and government agencies that assist or support Hezbollah, the Trump administration believes it can further isolate the group from the international financial system and reduce its funding.

While the impact on the Lebanese financial system remains to be seen, Lebanese Banks are at risk of fines and even expulsion from the U.S. financial system if they are caught enabling transactions for Hezbollah, as recently reported by the Wall Street Journal. "They need to root out Hezbollah from their financial system," said Ms. Mandelker, U.S. Treasury undersecretary for terrorism and financial intelligence, in reference to Lebanese banks.

It is to note that the Trump administration estimates that Iran spends more than $700m a year supporting Hezbollah.




The risk of Lebanon getting trapped by 'Presource Curse'

A recent policy paper published by the Lebanese Oil and Gas Initiative (LOGI) recommends that political institutions in Lebanon should adopt a prudent policy with regard the development of the Oil and Gas sector, or risk having dismal economic growth between the phase of oil discovery and that of production. The logic is that Lebanon, much like other countries with weak economic institutions (i.e. Ghana, Mozambique), is prone to substantially increase its expenditures and/or levels of borrowing in anticipation of higher revenues – due to public institutions heightened expectations. By so doing, Lebanon could be falling into the trap of the "Presource Curse". The policy paper, entitled "Is Lebanon preordained to become a presource curse country?" draws on a study published by the World Bank in 2017 and recommends that the government should refrain from creating premature sector institutions prior to any oil commercial discovery.

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