THE LEBANESE ECONOMY AND THE LEBANESE BANKING SECTOR

FACTS AND FIGURES

I. ECONOMIC GROWTH

I-1 Lebanon had an impressive and strong economic growth from 2007 till 2010 with real output growing at an average rate of 8.25 percent.

Domestic political uncertainty and regional unrest heavily impacted economic activity in 2011 and 2012 and led to a deceleration in the growth rate to an estimated average of 4.1 percent, which is still considered decent especially when compared to the MENA region. The outlook for the coming few years remains positive, with moderate growth prospects (3 to 4 percent), and hinges on regional stability and improving domestic operating environment.

Chart 1- Lebanon: Real GDP Growth Rate (%)

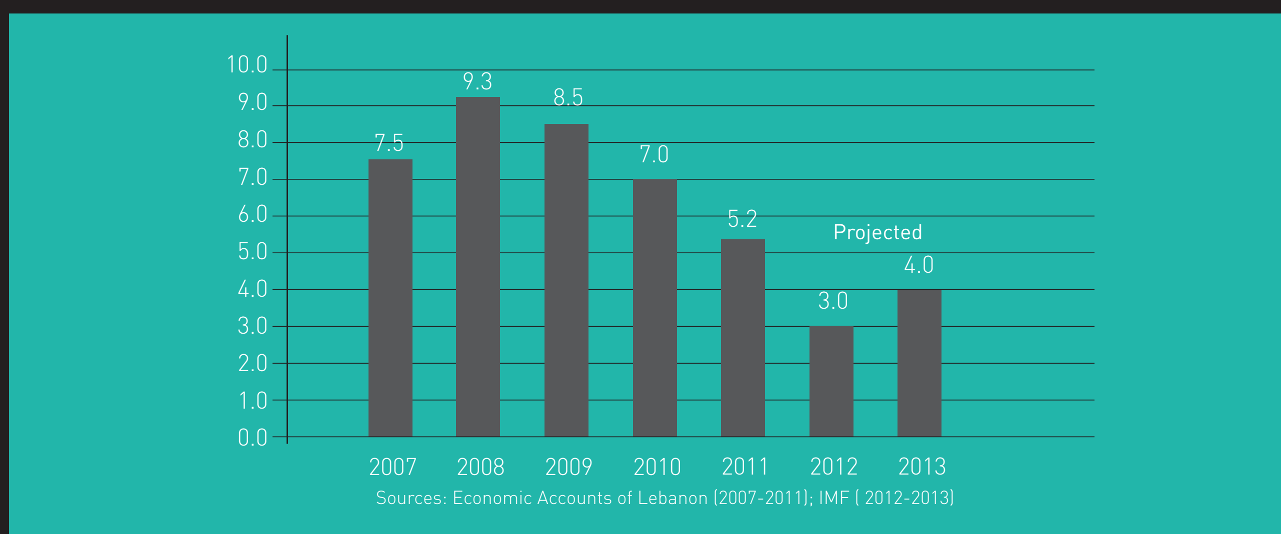


Chart 2 - Regional Real GDP Growth Comparison (%)

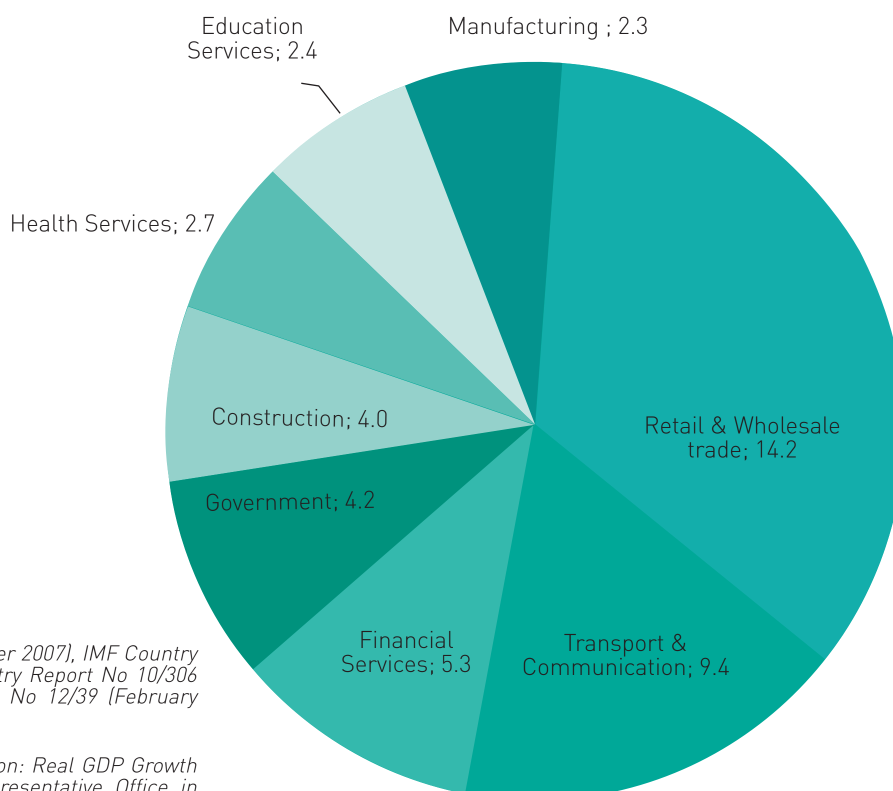
1-2 The rapid growth was stimulated by post war reconstruction spending following the July 2006 war, the rapid rise in regional oil revenue and abundant liquidity, and reinstated confidence following the Doha agreement and the resulting election of a new president, the formation of a national unity government, and the restoration of the legislative activity.

All of these factors created a favorable business climate and reduced uncertainties and thus fueled foreign inflows and aggregate demand, which was mainly driven by buoyant tourism and real estate activities. According to various IMF article IV reports for Lebanon[1], retail and wholesale trade, tourism and construction/real estate were the key drivers of this rapid growth accounting for more than half of GDP. The outbreak of the global financial crisis and the ensuing global recession had also a positive impact on the Lebanese economy with Lebanese Diaspora assets fleeing for safe havens under rising international uncertainties and declining international financial markets, prices and rates.

1-3 It is well known and has been shown that the services sector is and remains the main driver of growth in Lebanon.

In a recent study (March 2011) entitled Lebanon: Real GDP Growth Analysis, 1997-2009, published by the IMF representative office in Lebanon[2], it has been shown that between 1997 and 2009, growth was mainly driven by 3 sectors: retail and wholesale trade (14.2% contribution to real GDP growth), Telecom (9.4%) and banks (5.3%). Government spending and construction also contributed significantly with a share of 4.2 and 4.0 percent respectively.

Chart 3-Contribution to Real GDP Growth, 1998-2009 (%)



[1] *IMF Country Report No 07/382 (December 2007), IMF Country Report No 09/131 (April 2009), IMF Country Report No 10/306 (October 2010), and IMF Country Report No 12/39 (February 2012).*

[2] *Mottu, E, and Nakhle, N. (2011), 'Lebanon: Real GDP Growth Analysis, 1997-2009', IMF Resident Representative Office in Lebanon*

I-4- Lebanon has historically strong economic and financial relations with the Gulf Cooperating Council (GCC) countries, particularly in terms of remittances, exports, tourism, and foreign direct investment.

According to the IMF country report No 09/131[3]: share of 4.2 and 4.0 percent respectively.

- Remittances from largely well educated professional Lebanese residing in the GCC amount to around half of total gross remittances to Lebanon.
- The GCC countries are Lebanese exports' largest market.
- Tourists from GCC are a significant fraction of total tourists to Lebanon.
- Direct investment flows from the GCC have accounted for around 60 percent of total FDI to Lebanon over the period 2002-2007, more than half of which has been in real estate.

According to the same source, Lebanon receives around one third of all GCC investments to MENA countries. In addition Gulf investors are thought to hold a large number of the high value deposits at Lebanese banks.

II. FINANCIAL FLOWS

II.1- Large financial Inflows to Lebanon are structural and do not relate to specific periods or eras though certain events can amplify or reduce their scale.

They have always existed even before the civil strife (1975-1990). During the golden era between 1960 and 1974, such inflows were around 36 percent of GDP and contributed to deposit growth of banks of around 20 percent annually. In a recent World Bank paper (January 2012) entitled "Using Lebanon's Large Capital Inflows to Foster Sustainable Long-Term Growth[4]", it has been mentioned that Lebanon has been consistently attracting inflows from the region over the past few decades and these inflows are related to regional oil wealth, the attractiveness of Lebanon's real estate assets, the perception of the Lebanese banking sector as safe haven in times of crises, and the existence of a large Lebanese Diaspora. The paper argues also that inflows to Lebanon have witnessed a strong acceleration in the years 2007-2010 due to increases in oil prices followed by a strong confidence crisis in the international and regional financial and capital markets. The World Bank paper also found that oil price is a key determinant of foreign inflows as well as the accumulation of foreign currency reserves. The spread between domestic rates and international rates, the exchange rate regime and economic dollarization contribute as well to the determination of foreign financial flows to Lebanon.

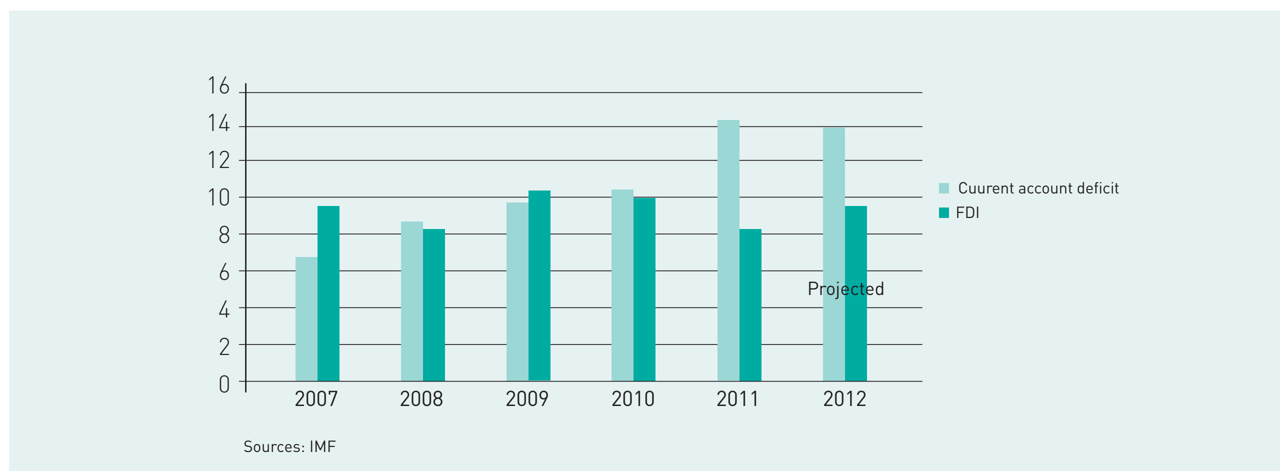
II.2- Though Lebanon suffers traditionally from a relatively high current account deficit, the latter however is largely financed by Foreign Direct Investment.

The Lebanese current account balance is chiefly influenced by a relatively outsized trade balance deficit given the heavy reliance on imports for consumption and investment in a highly open economy. The current account deficit reached a peak 14 percent of GDP in 2011 against an average of 9.2 percent for the previous 4 years, noting that this broadening is closely linked to rising food and commodity prices (mainly oil). This current account deficit is for the most part financed by foreign direct investment into Lebanon which accounted for 9.7 of GDP for the period 2009-2011.

[3] *Lebanon: 2007 Article IV Consultation- Staff Report, IMF Country Report No 7/382, December 2007.*

[4] *Using Lebanon's Large Capital Inflows to Foster Sustainable Long-Term Growth', Document of the World Bank, January 2012*

Chart 4- Lebanon: Current Account Defict and Incoming FDI as Percent of GDP



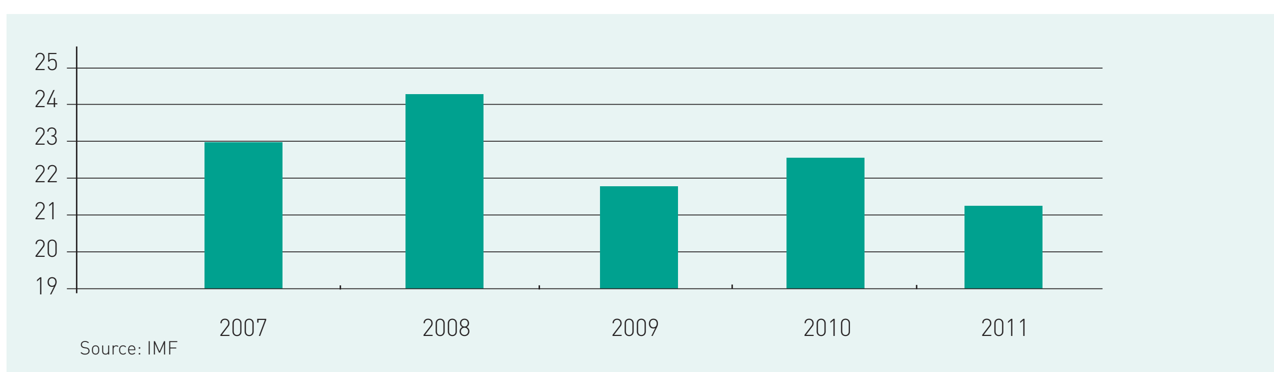
II.3-The main source of foreign direct investment into Lebanon is Arab countries, mostly GCC economies.

The share of GCC from total FDI to Lebanon fluctuates around an average of 60 percent and is followed by that of Europe (France, Germany, Italy, the Netherland…) and the USA.

II.4-Remittances to Lebanon as a share of GDP are among the highest in the world according to the IMF country report No 09/131[5] , reflecting the size of Lebanese Diaspora and rising global trend.

The same source argues that around 54 percent of remittances to Lebanon originate in the GCC and another 16 percent in Australia, the US and Canada. The remaining comes mostly from Africa. Remittances inflows averaged 23 percent of GDP over the last five years. Remittances inflows net of remittance outflows ranged however between 3 to 3.5 billion USD annually over the last five years and constituted around 8.8 percent of GDP for the same period.

Chart 5-Remittances Inflows as a percent of GDP



[5] *Lebanon: 2007 Article IV Consultation- Staff Report, IMF Country Report No 7/382, December 2007*

II-5 - The large number of emigrants is the chief determinant of the volume of remittances in addition to other factors such as abroad business cycle conditions and the exchange rate.

In a study on emigration from Lebanon between 1992 and 2007 conducted by a leading Lebanese education institution[6], it was found that the number of emigrants during this period was close to half a million and that around 50 percent of households in Lebanon have at least one family member who has emigrated during the covered period. Around 77 percent of emigrants are between 18 and 35 years old, the bulk consisting of skilled labor.

III. PUBLIC DEBT

III.1- Lebanon came out of the civil war in 1991 with a debt burden of around 50 percent of GDP but reconstruction and conciliation costs and the rebuilding of infrastructure contributed to the steady increase in the debt burden in the following decade or so.

Soft loans financing from bilateral and multilateral sources such as the European Investment Bank, the World Bank, Abu-Dhabi Fund for Development, Agence Française de Développement, Arab Fund for Economic & Social Development and others have been complemented with domestic financing through domestic banks and others. Soon after this process of reconstruction came to completion, efforts intensified to address the debt overhang and were manifested by the different programs presented at Paris II and Paris III meetings to contain the budget deficit and the public debt and maintain financial stability.

Loans and Grants Ratified, Signed and Approved

Distribution by funding source, million USD 1992-2010

	Value	% Share
World Bank (IDA), (IBRD)	948.27	9.84
Arab Fund for Economic & Social Development AFESD	1327.93	13.78
European Investment Bank EIB	1148.26	11.92
European Union EU	602.78	6.26
France (AFD, French protocols,...)	464.77	4.82
Islamic Corporation for the Development of the private sector IDBG	960.56	9.97
Kuwait , KFAED	1007.26	10.46
Saudi (KSA, SFD)	939.92	9.76
Qatar	327.14	3.40
Italy	559.37	5.81
Germany (KFW, GIZ)	202.18	2.10
Japan	149.01	1.55
USA (USAID, USA)	161.13	1.67
Others	835.25	8.67
Total	**9633.83**	**100.00**

Source: CDR

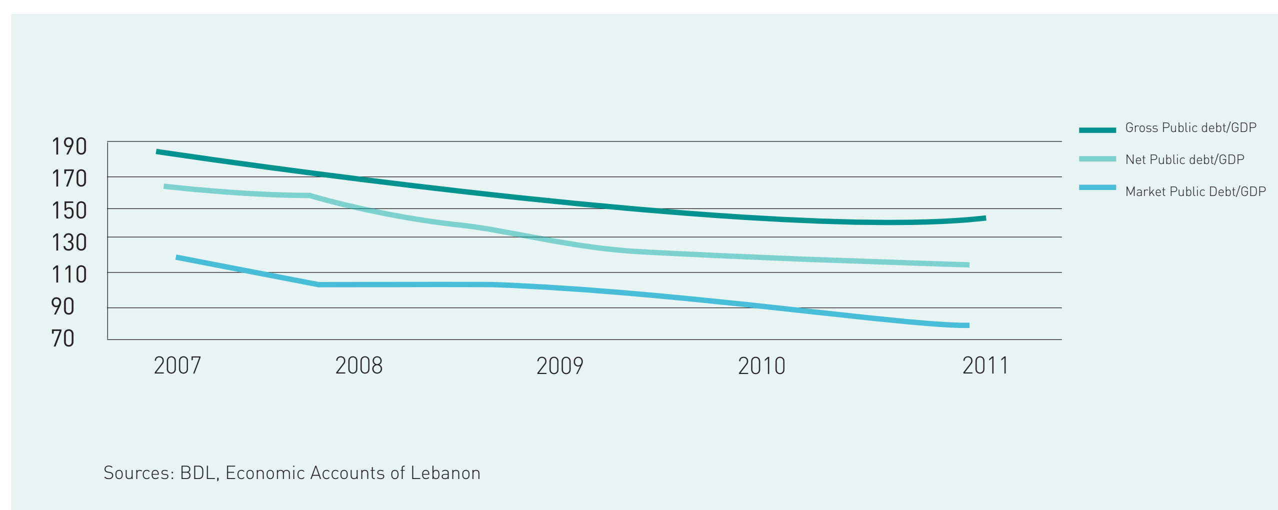
[6] *Kasparian, C 2009, L'émigration des jeunes libanais et leurs projets d'avenir, Observatoire de la Réalité Socio-Économique, UniversitéSaint-Joseph, Presses de l'Université Saint-Joseph, vol 2.*

Paris II and Paris III External Financial Support	
Paris II	4.3 bill USD
o/w	3.1 bill for debt restructuring
	1.3 bill soft loans
Paris III	7.5 bill USD
o/w	5.9 bill signed
	3.7 bill received

III-2 -Lebanon succeeded during the last few years in sharply reducing the debt burden, and the Lebanese government remains committed to cut further the debt to GDP ratio over the medium term.

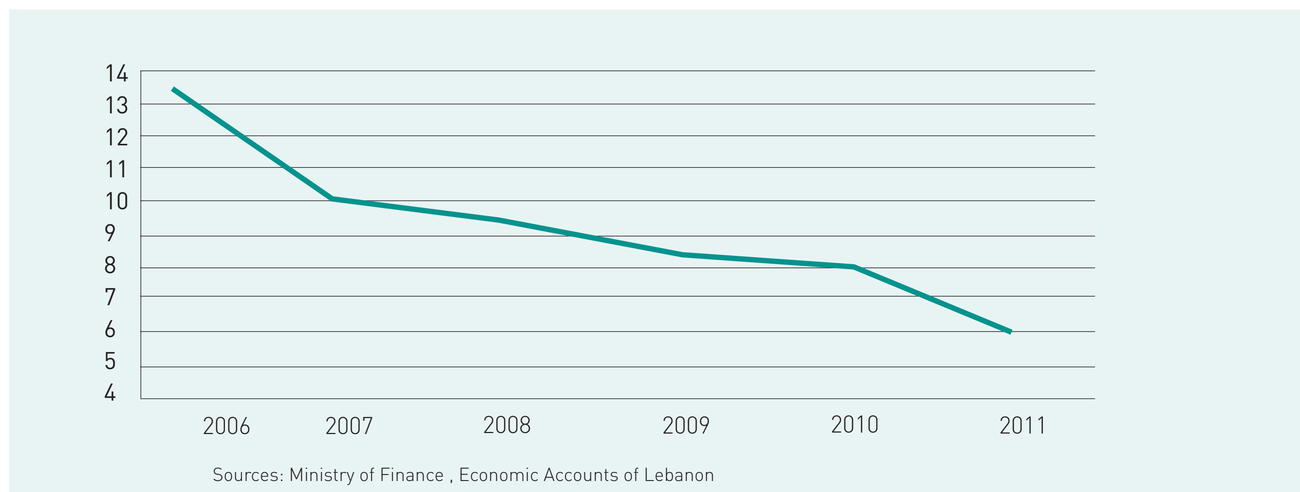
Given strong economic growth and sizeable primary surpluses, the (Gross) debt to GDP ratio plunged from 179.9% in 2006 to 134.8% in 2011. The IMF expects that under a baseline scenario, involving no policy change, this ratio would stay at around 130 percent in the medium term but could fall below 100 percent of GDP by 2020 under a reform scenario targeting improvement in government revenues and expenditures management and rationalization. More importantly, market debt to GDP (debt held by the market), dropped from 114.3 percent in 2006 to 83.7 percent in 2012. Deficit to GDP plummeted as well from 13.5 percent to 5.9 percent, the debt service to GDP recoiled from 13.5 percent to 10.1 percent, and the primary surplus to GDP averaged 3 percent for the period 2006-2011.

Chart 7-Lebanon: Public Debt/GDP (%)



Sources: BDL, Economic Accounts of Lebanon

Chart 8-Lebanon: Public Deficit/GDP (%)



III-3 -Though the gross debt to GDP ratio remains among the highest in the world, the underlying elements of risk and macroeconomic variability are considered low, explaining debt sustainability.

The share of non traded domestic currency debt (with no secondary market) has been rising lately and currently constitutes 61 percent of total debt, with an average maturity of 2.6 years and it is almost held evenly between market (mainly commercial banks) and non market institutions. Whereas the share of foreign currency debt is 39 percent with an average maturity of 5.2 years, out of which 62 percent is traded and in the hand of market holders and thus not held by bilateral and multilateral parties. This is to say that Lebanese government Eurobonds held by the market represent 29 percent of total debt and 39 percent of GDP and that the total debt held by non residents is relatively low, around 12 percent of total debt.

IV. INTEREST RATES

IV.1- Since Lebanon has a pegged currency, theoretically monetary authorities will not have any say in determining interest rates as Lebanese rates will follow foreign ones and specifically the US.

Lebanon, interest rates are in fact affected by international rates and this is demonstrated by the declining interest rates in Lebanon following the decline in the Libor short after the global financial crisis. Moreover, the monetary authorities have a say in the level and the magnitude of change of interest rates.

IV.2- The Lebanese Central Bank is controlling to a certain extent interest rates by buying government treasury bills and Eurobonds at a given rate in order to keep rates low.

So the central bank is offsetting any decline in the appetite of banks to buy domestic treasury bills by intervening on the primary market and buying these bills. By transmission, rates on Eurobonds follow rates on the Treasury bills.

IV.3-Hence, in order to deduce the interest rates that the government should have been paying on its local and foreign denominated debt, it will be important to look at the rates the Central Bank pays on its CDs.

This constitutes one of the main reasons why Lebanon is paying less than what is suggested by its rating especially when the BOP is negative and when the political situation is precarious: the Central Bank has been bearing the costs by buying government bills at a low rate and selling CDs to Banks at a higher rate.

V. SOVEREIGN SECURITIES

V.1-Sovereign bonds held by domestic banks do not exceed 17 percent of total foreign currency deposits and these bonds are trading at tight spreads when risk perception is low and at large spreads when risk is high.

Government bond spreads reflect the risk perception of bond holders (mainly domestic banks) who are willing to take this risk, are well acquainted with it, and don't wait for the first sign of unrest to exit. CDS spreads reveal the risk perception and assessment of guaranteeing parties and these are well reputable international banks and institutions such as Deutsche Bank and HSBC. Accordingly, government bond spreads and CDS spreads may differ or intersect depending on the undertaken risk appraisal.

V.2-The yield on the Lebanese sovereign bonds is partly tied to the sovereign credit rating by international credit rating agencies such as Moody's, Standard & Poor's and Fitch.

There is no one to one relation in the sense that sovereign bonds of countries with same maturity and rating should have the same yield. It is well known that the cost of debt is a function of a number of factors among which credit risk, liquidity risk, inflation risk, and exchange rate risk and these tend to differ from one country to another. Though rating agencies may take into account all these factors in allocating a rating to a country, the weighting and assessment, however, of each factor may differ between foreign and domestic individuals and institutional investors. Among other things, the well anchored fixed exchange rate in Lebanon and the relative price stability could be highly weighted by banks and others and thus can contribute to lowering the spread and yield on the Lebanese government securities in reference to peers where such conditions may or may not apply. It would be worth mentioning also that in real terms, the yield on Lebanese sovereign securities is currently higher by around 50 basis points than that of peers.

VI. LEBANESE BANKS

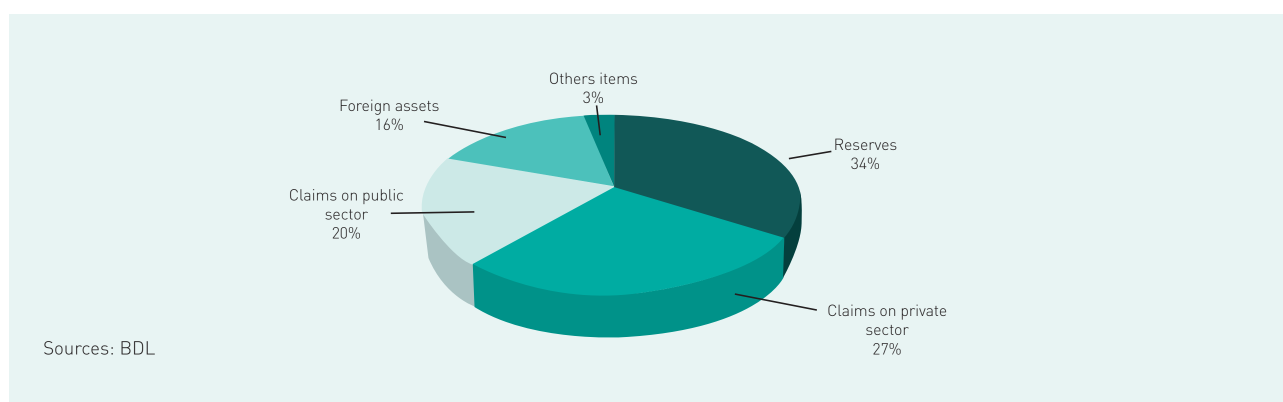
VI.1-Many would see that banks are investing in the government Eurobonds while rates are well below what is suggested by the sovereign rating and there are many reasons for that.

A main reason is the narrow opportunities for investment in Lebanon. Since the stock exchange is not well developed and there are no corporate bonds market, add to it that banks investments outside Lebanon are constrained by the regulations of the central bank and by the conservative policies and culture of the Lebanese banks, these are left with limited diversification instruments that include Eurobonds, Treasury bills, Central Bank CDs, and loans to the private sector.

VI.2-Banks exposure to the public sector (government) has been on a downward path recently while credits to the private sector were rising steadily.

Claims on the public sector as a percent of total assets reached 20 percent at the end of May 2012, compared to 26 percent at the end of 2007. Conversely, the share of claims on the private sector attained 29 percent of total assets against 25 percent for the two mentioned periods respectively. It is worth mentioning that banks in Lebanon are not, and were not, allowed to invest in what is known as structured or exotic products and that was one of the main factors that kept Lebanon and its banking system immune from the repercussions of the global financial crisis.

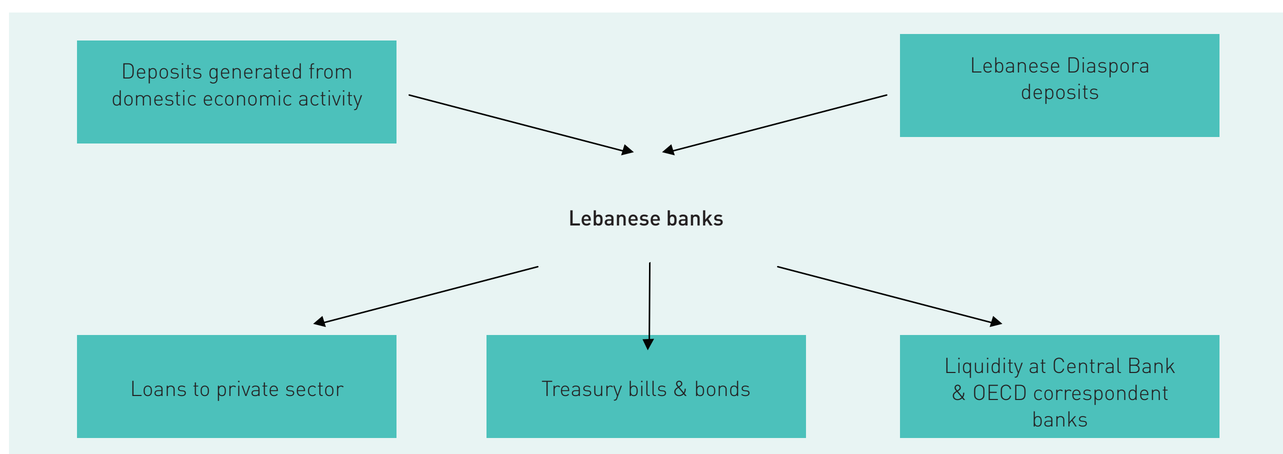
Chart 9-Commercial Banks Assets Structure in % (end of May 2012)



Sources: BDL

VI.3-The growth of banking deposits, and thus money supply, is explained by domestic and external macroeconomic variables as well as bank specific factors.

In fact, in a recent IMF working paper[7] , it was found that domestic factors such as economic activity, prices and the interest differential between the Lebanese pound and the US dollar are significant in explaining deposit demand as are external factors including the business cycle in advanced countries, the availability of funds from the GCC, and global financial market conditions. It was found also that risk perception of individual banks, their liquidity buffers, loan exposure, and interest margins, bear a significant influence on the demand for deposits.



[7] *Finger, H and Hesse, H (2009), 'Lebanon-determinants of Commercial Bank Deposits in a Regional Financial Center' IMF Working Paper WP/09/195, 2009*