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Abstract

A lot of questions are being asked in these past few months on “where the Lebanese economy is headed; or how critical is it this time?”, given the prolonged political impasse still ongoing which triggered a loss of confidence towards the country. The report analyses the current developments in Lebanon’s real, financial, monetary, fiscal, and external sectors in comparison to previous years. It also highlights the emergence of 5 “recessionary facets” in 2018 and how these are mirrored on Lebanon’s capital markets. The study concludes with an urgent call for tangible “economic achievements”, given practical and implemented reforms must immediately begin supporting investors’ confidence and contributing to the real GDP growth.

Overview

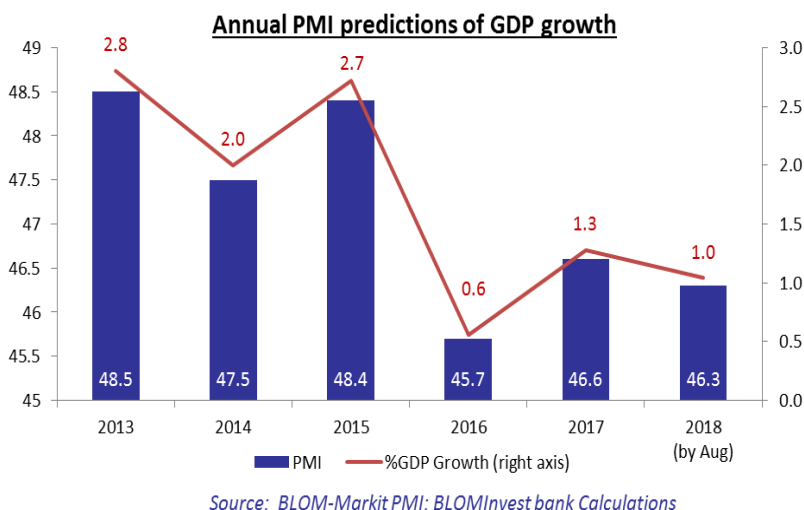
The political vacuum extending over four months now is weighing down on investors’ confidence in the economy and has led to the rise of several recessionary facets. First, the weakened tourism and real estate sectors created an environment of stifling growth. Second, the large cumulative outflows in Lebanon’ s BOP post-2011 to date are hurting the economy. Thirdly, BDL is using unorthodox financial tools to safeguard the peg and financial stability, leading to higher interest rates and the crowding out of the private sector, while the country’ s fiscal policy is still failing to discipline deficits which is a necessary condition to restore confidence. Lastly, the slightly inverted yield curve in the Eurobonds market and the deteriorating stock market index further reflect a grim outlook.

The external environment has also been non-supportive of Lebanon’ s latest internal economic developments. To begin with, Bloomberg data indicates that oil prices grew by 38.1% year-on-year (y-

o-y) to \$71.99 per barrel in the first 8 months of 2018. For an oil-dependent economy, this translates into higher costs and thus larger deficits, but also escalating inflation undermining the purchasing power of citizens. In addition, the growing geopolitical tensions in the region (namely the GCCs), along with the slowdown in other economies, continue to dilute the performance of the country’s economic drivers.

Current Economic Indicators

The growth of the Gross Domestic Product (GDP) stalled in the past few years. In 2017, GDP growth stood at the low rate of 1.2% while the IMF projects growth in 2018 to stand at 1.5%. In fact, a [previous study](#) by BLOMInvest Bank proved the Purchasing Managers’ Index (BLOM-Markit PMI) i.e. a measure of the activity of the private sector, is a credible and accurate parameter to project GDP growth in the country.

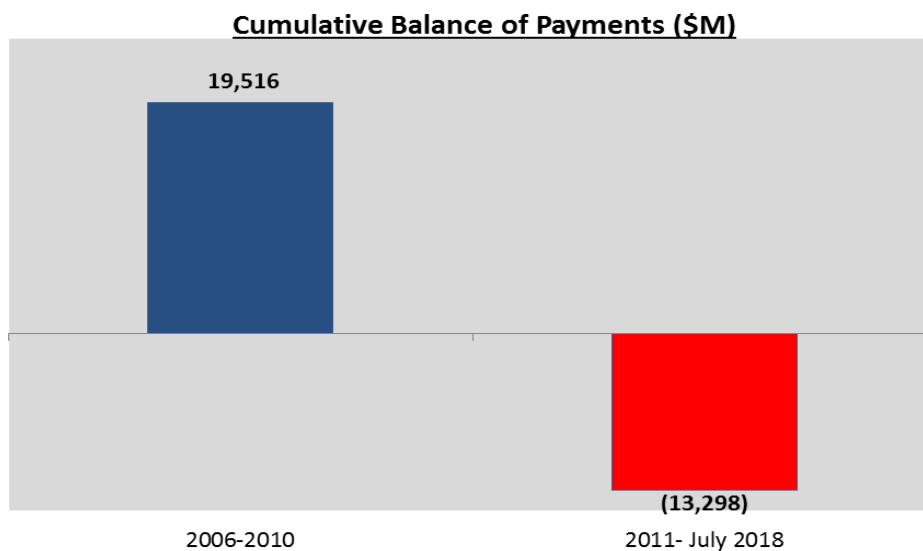


With rising interest rates and commercial banks preferring to place their money with the central bank (BDL) to benefit from the attractive yields it is offering, credits to the private sector fell (as will be detailed in the study) and the entity was crowded out of the economy. Accordingly, we project (adjacent graph) economic growth will remain subdued at 1% by end 2018.

The two main growth drivers of the economy, namely tourism and real estate, slowed down in 2018. Real estate& construction (denoted by RE, 19.2% of GDP) and tourism (14.5% of GDP) are the essential growth drivers in Lebanon. The former went into recession in 2018 as prices of sold properties plummeted largely due to BDL cutting off the subsidies extended on housing loans since 2013, leading to a decline in the number and value of construction permits. Meanwhile, tourism was unable to offset the slump in RE in 2018. The number of tourists visiting Lebanon added a marginal 3.26% y-o-y to 853,087 by June 2018, but Arab visitors had dropped by a yearly 7.7% to 244,800 over the same period. Given Arabs are the country’s largest spenders, tourist spending in its turn did not rise to a level that can compensate for the lost RE revenues. In fact, spending grew by 5% in H1 2018 compared to 6% in H1 2017.

The environment of low growth is accompanied by rising inflationary pressures undermining consumers’ purchasing power. In 2017, the average inflation rate stood at 4.44% (up from -0.77% in 2016) largely driven by rising oil prices and the country’ s approved salary scale for public servants that is expected to incur high costs. In the first 7 months of 2018, average inflation was at 6.23%, with July alone reading an inflation rate as high as 7.6%. Lebanon is a dollarized, oil-importing economy whose local currency is pegged to the dollar. Therefore, the higher price of oil, costs of the new salaries, and a weaker US dollar all triggered inflationary pressures. In details, the US dollar index according to Reuters went from 98.20 points by August 2017 to 92.36 points by August this year. This partly rendered imports from the main European trade partners more expensive, while in its turn, the price of a barrel of oil added 38.1% year-on-year (y-o-y) to reach \$71.99 per barrel in the first 8 months of 2018.

Lebanon’ s cumulative balance of payments (BOP) shows a substantial \$13.3B worth of transactions flew out of the country since 2011, from the \$19.5B worth of inflows pre-2011. Since the Syrian Crisis in 2011, Lebanon grappled with a major BOP difficulty as it consistently recorded large deficits underpinned by stifled growth rates, which means the country was importing more goods, services, and capital than it exported. It is important to mention that the one-off BOP surplus of \$1.24B registered in 2016 came as a result of the swap operation performed by BDL with the national commercial banks.

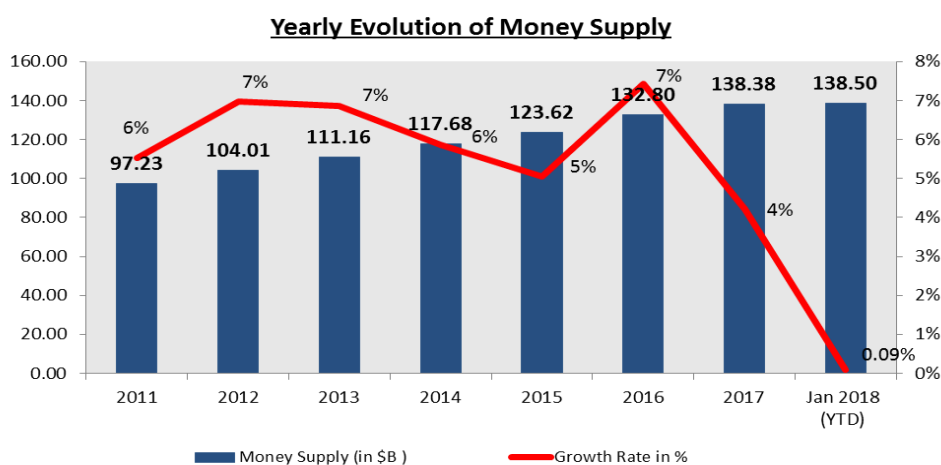


Source: BDL; BLOMInvest Bank Research Dept.

Nonetheless, by July of this year, 68.14% or \$13B of the cumulative surplus of the period 2006 to 2010 exited the country on a net basis, weighing on economic growth as it leads to the increase of interest rates.

MONETARY

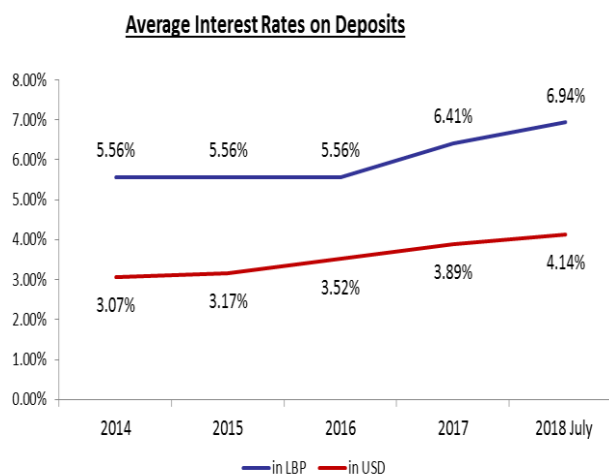
On the monetary policy front, the central bank stepped in to boost the economy. In the absence of an active and engaging fiscal policy for the past few years, BDL stepped in, namely starting 2013, to provide subsidized loans to prevent an acute slowdown in the RE market. In 2016, the central bank utilized financial engineering schemes to boost commercial banks’ capital adequacy ratios and to replenish its foreign assets. In 2017/2018, it intervened again by offering banks products with attractive returns also to maintain the financial stability. However, by 2018, BDL withdrew the housing loans subsidy scheme as it is mainly the responsibility of the government’ s economic policies and because it weighed on its balance sheet. In addition, from 2010-2017, money supply rose by 50.18%. Meanwhile, interest rates in the USA climbed, and with interest rates increasing in other emerging markets as well (namely Turkey and Egypt, & the Gulf countries to a lesser extent), Lebanon had to follow suit and increase interest rates to keep attracting deposits.



Source: BDL

Banks’ deposits growth is slower this year despite higher interest rates. Commercial banks are competing to attract deposits, mainly LBP-denominated, by offering high interest income as the adjacent graph shows.

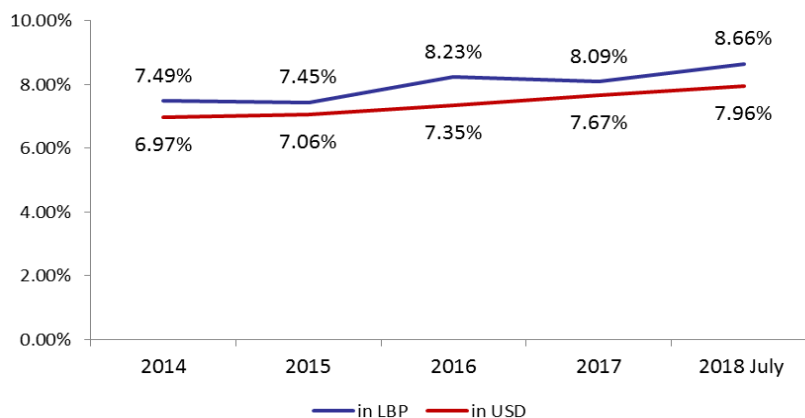
By July 2018, rates on the LBP reached highs of 6.94% to 7% and so credit to the private sector stalled as lending rates rose.



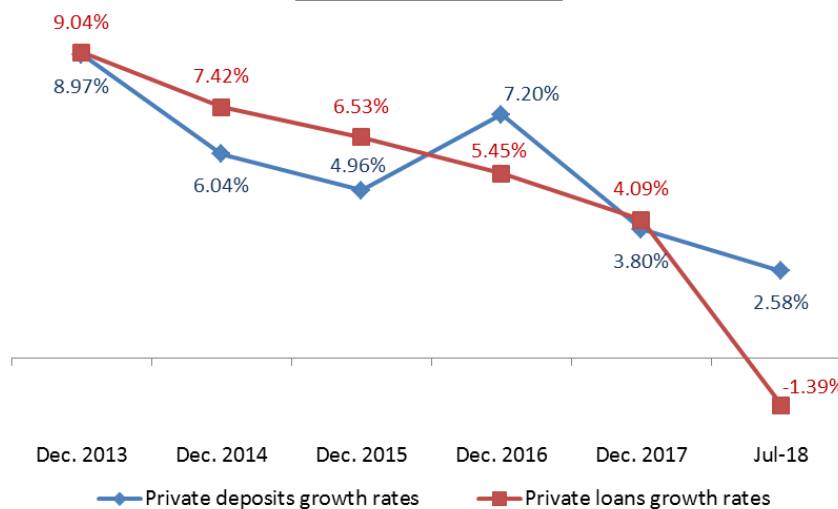
Source: BDL

Meanwhile, the cost of borrowing is on-the-rise indicating yet another recession facet. In addition to the halting of RE subsidies, borrowing rates, on the margin, have also jumped quite substantially, thus crowding out the private sector from economic activities.

Average Interest Rates on Loans



Year-to-date Growth Rates of Private Deposits & Loans at Commercial Banks



Source: BDL

As such, total credit to the private sector constituted 106% of GDP by July 2018 (totaling \$58,689M) compared to 111% of GDP by Dec. 2017 (or \$59,519M), a reduction in loans to the private sector of 1.39% since year start.

FISCAL

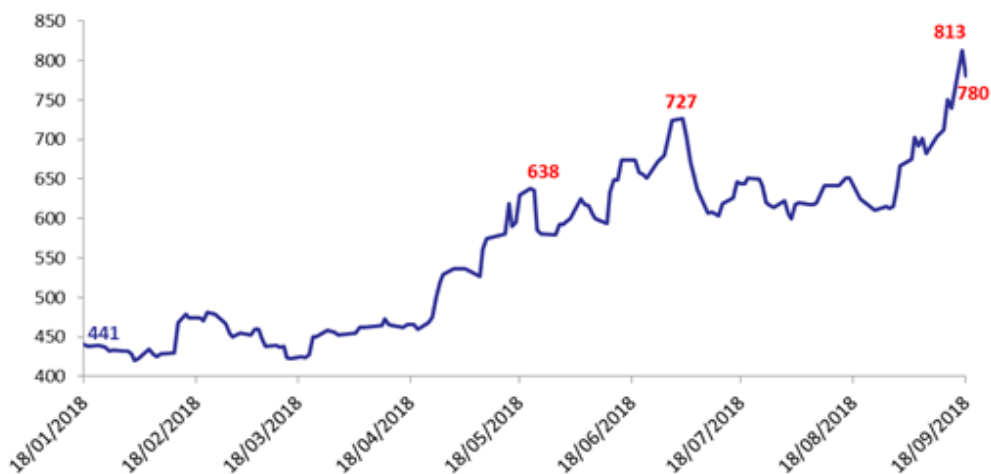
The absence of a well-thought fiscal policy is not helping the government restore investors' confidence. No achievements on the fiscal end of the economy are preventing the exacerbation of an already large deficit. The fiscal deficit is forecast to rise to 9.1% of GDP in 2018 (as per the IMF) namely

owing to the passing of the new public salary scale. The deficit actually almost doubled, rising from \$844.73M by April 2017 to \$1.91B by Apr. 2018. The debt-to-GDP ratio is also rising and expected to hit 151% of GDP by end 2018. In fact, public debt totaled \$82.95B in H1 2018.

Capital Markets: Inverted Yield Curve & BLOM’s Stock Index

The economic slowdown, elevated public debt, and national and regional disruptions mirrored investors’ loss of confidence in the 5 year credit default swaps (5Y CDS) by Sept. 2018. Lebanon’s 5Y CDS today reflects investors’ heightened perceived default risk by the government. As observed, the first spike (graph below) occurred in May 2018 as the CDS shot up to 638 bps with the opening of a US embassy in Jerusalem as investors feared the spillovers of rioting Palestinians. The second spike sent the CDS to 727 bps, owing it to the new sanctions on Hezbollah leadership imposed on May 17th by the USA and Gulf partners. This was also followed by the May 21st “Ministry of Finance (MoF) - BDL exchange” of the latter’s Treasury Bills (TBs) for \$5.5B worth of Eurobonds. To-date, Lebanon’s multiple recession indications explored earlier in the report continue to materialize in the 5Y Lebanon CDS, which sharply widened to 813 bps on Sept. 17th and back to 780 bps by Sept. 18th

Latest data: Lebanon 5Y CDS in 2018

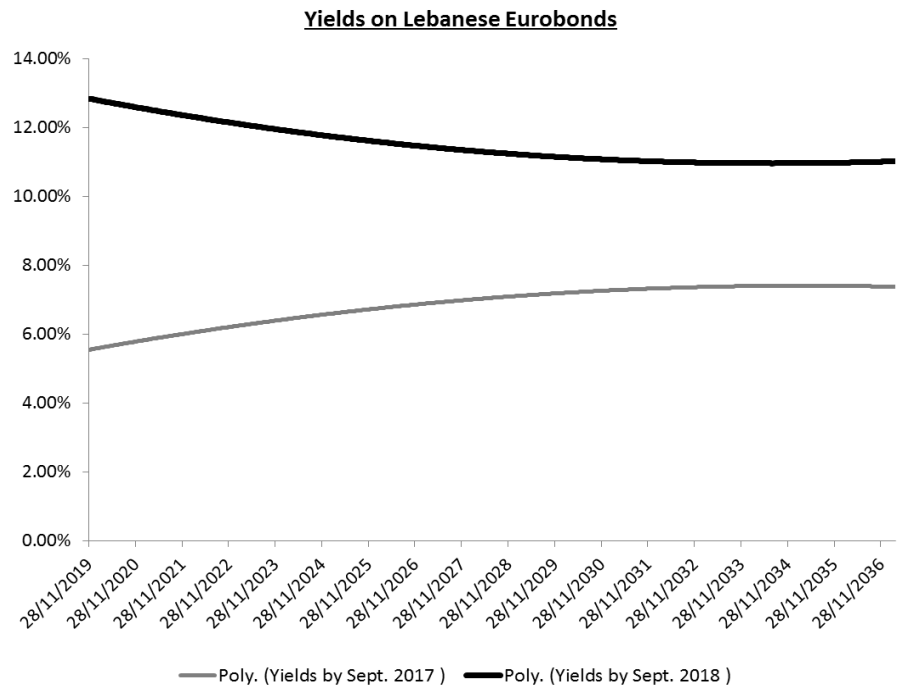


Source: BLOMInvest Bank Research Dept.

The inverted yield curve emerging by Sept. 2018 reflects a recessionary environment. The inverted yield curve (depicted below) is a prime indication of a recession too as short-term bonds yield more in interest than older ones. Bonds are usually a safe haven; thus, when investors lack the confidence in an economy, like Lebanon today, they invest in long-term bonds to lock in a return as they expect losses on the short term.

However, with an increased demand on long term bonds, their yields begin to decline.

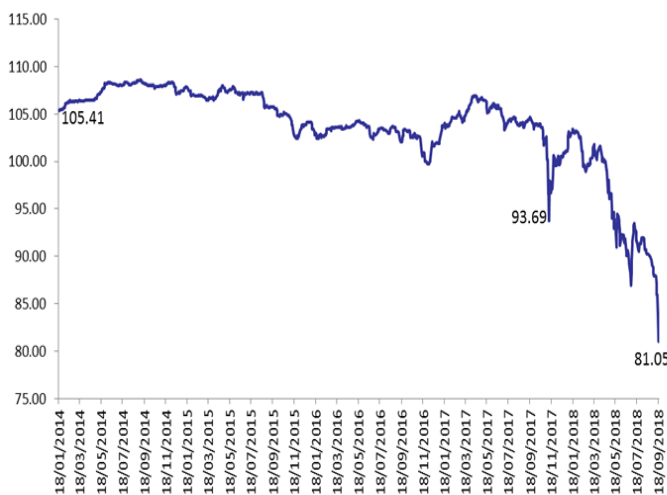
Accordingly, by Sept.18th 2018, the yields on the 1Y, 5Y, and 10Y bonds stood at 12.87%, 11.77%, and 11.48%, respectively.



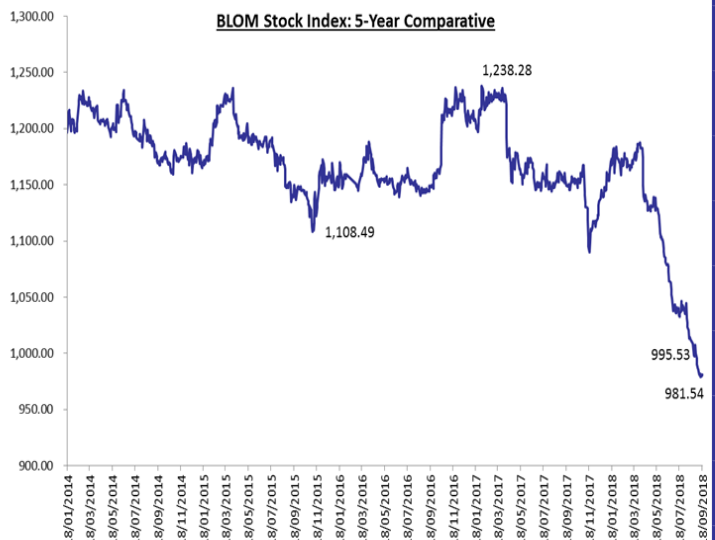
Source: BLOMInvest Bank Research Dept.

Against this backdrop, the BLOM Bond Index (BBI) and the BLOM Stock Index (BSI) have been subdued to-date. First off, the appetite for Lebanese fixed income instruments contracted as the BBI (BLOM’ s price index) dipped to lows of 81.04 points by Sept. 18th 2018, compared to 104.67 points on Sept. 18th 2017. In fact, the index has not fallen to a similar low since mid-October 2002. Similarly, the BSI fell to 981.14 points on Sept. 18th 2018, a first recording below the index’ s initial capitalization of 1,000.00 since November 2005, while the index also closed at 1,148.93 points on Sept. 18th 2017.

BLOM Bond Index: 5 Year Comparative



BLOM Stock Index: 5-Year Comparative



Source: BLOMInvest Bank

Ways Forward

Restoring investors' confidence by forming a credible government has become vital. The economy is under unprecedented recessionary pressure as presented. Thus, the formation of a government is the first milestone the country needs. The designated ministers must have names that inspire confidence across the country so that the government can begin to restore the lost trust and ease concerns of foreign investors. This will lift up the credibility of the authorities as the parliament is enabled to embark on overdue reforms that may ultimately attract fresh capital into the system.

Small political achievements are no longer sufficient to spur growth. The security and political achievements pulled off by the government since the election of a president in Q4 2017 are no longer enough to kick-start the capital market or the national economy at this stage. Investors have grown weary of the incremental and short-lived positive change following national political breakthroughs and began to seek less risky investment positions. Only a large assurance from the side of the authorities and collaboration with the private sector can turn tables.

Therefore, Lebanon is in dire need of a reform agenda that "achieve" tangible progress on the economic front. The coherent economic agenda would be accompanied by a framework of implementation for the next decade. Reforms would then be carried on the short term and others on the longer term. The former may focus on reducing the fiscal deficit and taking measures to increase public revenues and/or reducing costs by tackling problems like waste management or EDL transfers for instance, which constitute around 20% of expenditures and may save up to 2.5-3% of GDP (at least approx. \$1.5B) post-reform.

On the longer term, the authorities must work on improving the business environment and governance. Such reforms would aim to simplify the procedures, bureaucracy, and timeliness involved for the opening and closing of companies alongside the restructuring of the code of commerce. Enhancing the ease of doing business in Lebanon can give back the country the position of being a capital hub. In addition, a government with good governance on all policy fronts is of utmost importance as transparency spurs accountability, credibility, and confidence.

In its turn, the involvement of the private sector can lend legitimacy to the state within the adequate framework. The government's economic reform agenda would also ease pressures crowding out the private sector. Besides creating jobs, generating income, and harnessing business opportunities to the people, the private sector is able to share the burden with the government and lend legitimacy to the state and boost back confidence in the economy.

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