LEBANON

AN ECONOMY ON THE BRINK OF COLLAPSE

Lebanese GDP could fall by a quarter in 2020 under the combined effect of the deep economic crisis that has taken place since 2019 and the Beirut port explosion. In the short term, hopes of a recovery are limited. The economic system that closely links the public finances, commercial banks and the central bank appears to be on its last legs. The system of multiple exchange rates will not prevent the exhaustion of foreign currency reserves in the near future. Meanwhile, the government, which is in default on its foreign currency debt, has been forced to monetize its fiscal deficit. Commercial banks have built up record exposure to sovereign debt and substantial external liabilities.

A COLLAPSE OF ECONOMIC ACTIVITY

The chemicals explosion in the port of Beirut on 4 August, was the latest chapter of an economic collapse that has been happening over many years. Since 2015, economic growth has fallen back significantly (down by 1.1% per year on average since 2015), and the recession in 2019 could be as much as 6.5% according to the IMF. The Lebanese economy depends on market services (around 50% of GDP) and geographically on its immediate neighbourhood (tourism, investment). As a result, it has suffered the consequences of the economic depression in the Gulf which has followed the lasting fall in oil prices and regional political tensions. After two consecutive years of recession, the contraction of economic activity in 2020 is likely to be very severe. Since the beginning of the year, the balance of payments crisis has resulted in significant restrictions on imports and pushed inflation to record levels (110% y/y in July). Against this background, domestic demand has plummeted as the government was not in a position to support the economy. On top of this, although the country was initially unaffected by the Covid-19 pandemic, the number of new cases has risen sharply since the summer. For the moment, constraints on economic activity have moderated, having eased somewhat in early September.

The World Bank estimates that the damage from the chemical explosion in August can be put at between USD3.8 billion and USD 4.6 billion for physical damage and between USD2.9 billion and USD 3.5 billion for lost production. Thus the total cost of the explosion could be equivalent to 15% of 2019 GDP. The cost of rebuilding is estimated at around USD 2 billion over 2020 and 2021.

In the absence of up-to-date national accounts, a number of indicators highlight the scale of the economic crisis. For instance, arrivals at Beirut Airport collapsed by 98% in Q2 2020 (y/y), cement deliveries and area covered by construction permits were both down around 50% in H1 2020 (y/y), whilst new documentary letters of credit for imports virtually dried up altogether (-90% in H1 2020 y/y). In all, we estimate that GDP will contract by at least 25% in 2020. In the short term, any economic recovery is conditional on a rebuilding of foreign currency liquidity.

FOREIGN CURRENCY LIQUIDITY DRIES UP

By restricting access to foreign currencies, the balance of payments crisis has had a significant effect on economic activity. The Lebanese economy is very highly dependent on imports. Imports of goods and services represent roughly 70% of GDP, compared to 23% in Egypt for example. The widening of the balance of payments deficit since 2018, and the desire to maintain the pound's peg to the dollar, put increasing pressure on currency reserves at the Banque du Liban (BdL). This led to the introduction of non-official capital controls and limited access to foreign currencies by preventing depositors from accessing foreign currency deposit accounts (around 80% of total deposits). The direct consequence of this was the development of a parallel currency market, and the difference between official and unofficial exchange rates exceeded 85%. In 2020, an official multiple exchange

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	-1.9	-6.5	-25.0	4.0
Inflation (CPI, year average, %)	6.1	3.1	85.0	50.0
Central. Gov. balance / GDP (%)	-11.0	-13.3	-10.0	-8.0
Central. Gov. debt / GDP (%)	151	169	257	256
Current account balance / GDP (%)	-27.0	-21.0	-10.0	-12.0
External debt / GDP (%)	119	116	255	290
Forex reserves (USD bn)	32	30	-	-
Forex reserves, in months of imports	12.0	11.0	-	-
Exchange rate USDLBP (year end)	1507	1507	-	-

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

A WIDENING EXTERNAL DEFICIT

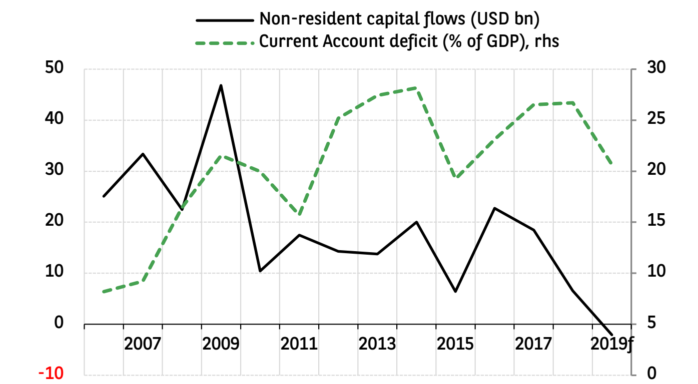

CHART 1

SOURCE: BDL, BNP PARIBAS

rate system was introduced, with an official base rate (LBP1,507/USD) for imports of essential goods and an official parallel rate (LBP3,900/USD) for other transactions. The unofficial parallel market rate has slightly appreciated since July, with the discount currently running at 80%, putting it at LBP7,700/USD. Given the current situation in foreign currency liquidity, this system is not sustainable as it threatens to strangle the economy step by step.

In practice, the currency reserves that are usable to the central bank are shrinking fast. Gross reserves currently stand at around USD 42 billion. The status of the gold held by the BdL is ambiguous. Its lower liquidity suggests that it should not be included in available reserves. However, it accounts for more than 40% of total gross reserves. Using a strict definition that excludes gold stocks and commercial banks' required reserves, the foreign currency reserves that are truly available were less than USD2 billion on 15 September. On the basis of the BdL's parallel exchange rate for non-essential imports (3,900), these reserves covered less than 6 months of goods imports. This figure remains theoretical, as it does not take account of the other lines of current payments and assumes that the government will remain in default on its foreign currency debt. Since the beginning of 2020, the government defaulted on three repayments of foreign currency bonds, totalling USD 2.5 billion. In 2021, repayments of principal alone totalling USD 2.1 billion will fall due.

THE BANKING SECTOR IN A STALEMATE

The specificity of the breakdown in the foreign currency financing circuit for the Lebanese economy has made the balance of payments position unsustainable over the short term. Given the very high structural current account deficit (around 24% of GDP on average since 2010), the flows of foreign currency deposits from non-residents, which allowed the BdL to underpin the peg to the dollar and the government to meet its international obligations, have dried up since September 2019. With the economic crisis worsening and in view of the risks relating to exchange rate controls, non-resident deposits fell by 24% y/y in July 2020, with total deposits down by 18%. The decline in bank assets has been on a similar scale, and has affected all counterparties, both private and public. It is no longer possible for banks to finance a portion of the fiscal deficit. Moreover, the net external position of banks continues to be a sizeable deficit (USD30 billion, or 15% of bank assets). This deficit has narrowed a little since March, but this has been primarily due to increasingly limited access to external financing for Lebanese banks.

Lebanon's banks have significant exposure to sovereign debt. Although direct loans to the government are limited and stable (at around 12% of assets), exposure to the BdL is more than 57% of assets. Since the introduction of "financial engineering" mechanisms by the BdL, the central bank has played a key role as an intermediary in the financing of the budget deficit; in total, therefore, commercial banks' exposure to sovereign debt (including via the BdL) is equal to around 70% of their total assets. This financing system has done little more than shift part of the deficit to the central bank (which is still awaiting audit) and to commercial banks, whose net external liabilities have increased.

POLITICAL DEADLOCK

The main source of imbalance in the Lebanese economy remains the public finances, and the recurrent and substantial deficit. The primary balance has been in deficit since 2018 (3.1% of GDP in 2019) and debt interest payments account for nearly 50% of total government revenues.

COMMERCIAL BANKS: SIMPLIFIED BALANCE SHEET (Y/Y %)

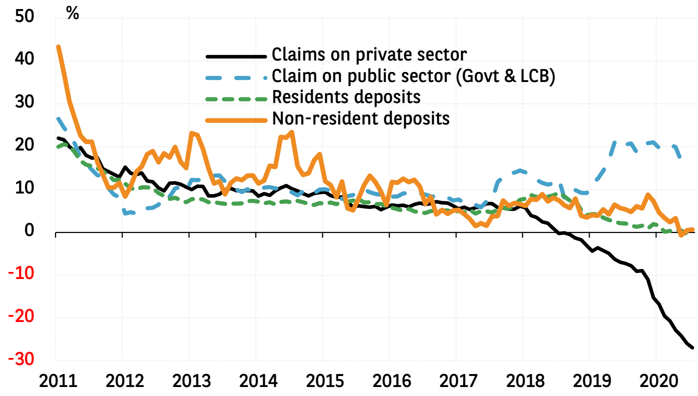

CHART 2

SOURCE: BDL, BNP PARIBAS

The government deficit has averaged 9.8% of GDP since 2015. Government debt was around 160% of GDP in 2019. With external debt representing 35% of total debt, the depreciation of the currency and the collapse of GDP will push this debt to GDP ratio up to 257% of GDP in 2020, despite the very high level of inflation.

For the time being, the political deadlock and the lack of a local consensus on the reforms needed have prevented the development of any programme of international financial support. Rescuing the Lebanese economy will require more than just restructuring government debt, reforming the public finances and making the exchange rate regime more flexible. It will also require the upgrading of basic infrastructure (notably in the energy sector), as the first stage of improving the productive base, and restoring the attractiveness of the Lebanese economy. Foreign direct investment (FDI) into Lebanon was equivalent to 4.7% of GDP in 2018. This seemingly favourable figure masks the fact that nearly 80% of FDI has come in the real estate sector, with greenfield FDIs accounting for only 5.6% of the total. In the absence of reforms that will increase potential growth, any improvement in macroeconomic balances thanks to international support will only be a short-lived solution.

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