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Abstract

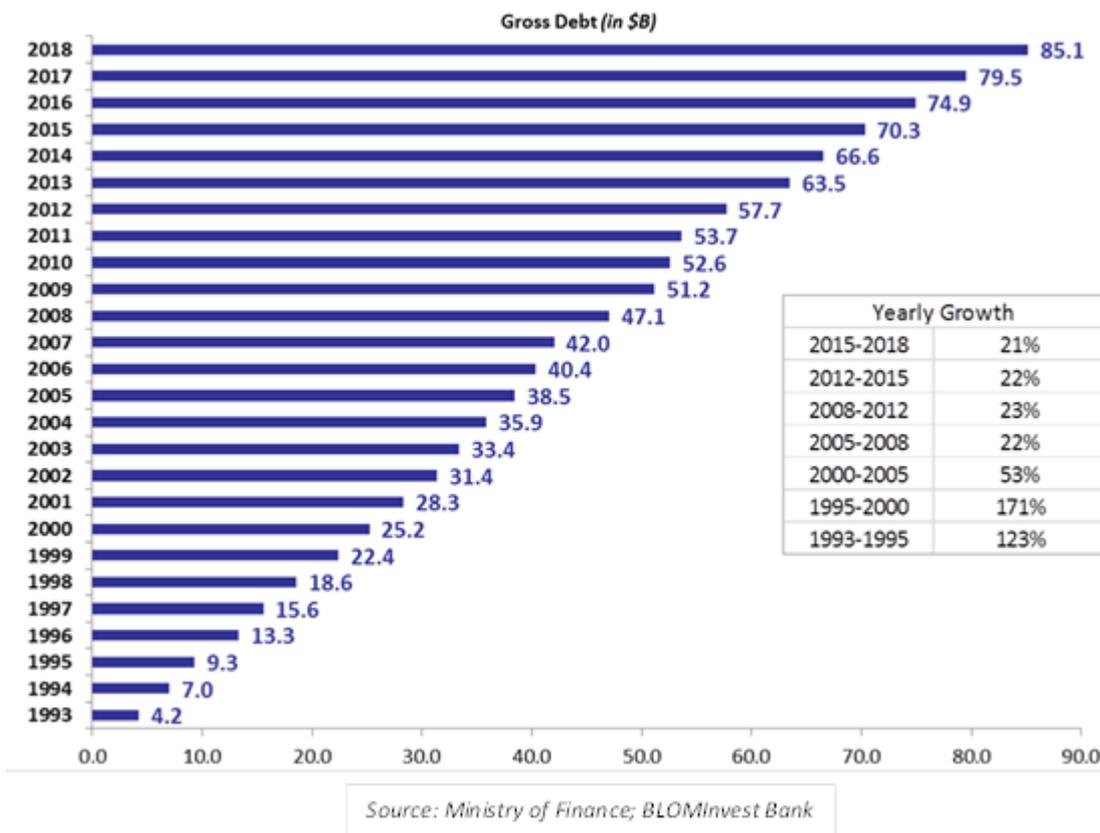
This study traces back Lebanon's public debt levels, debt composition and the incurred costs of debt to infer the main cycle that has driven the country to its current downturn. Since September 2018, Lebanon's indices on the fixed income and stock markets hit unprecedented lows which unveiled the urgency of immediate fiscal reforms and the need to lift up economic growth. Lebanon's limited fiscal space and, in fact, the government's narrow maneuvering space absent fiscal policy and the now-limited monetary policy options, exposes the risks of government financing, debt sustainability, as well as the scale of fiscal adjustments needed. Furthermore, the interlinkage between the government's debt and the financial sector balance sheets has emerged to the forefront. A closer look also reveals the absence of prudent spending policies, which engendered historical fiscal vulnerabilities and fueled macroeconomic imbalances.

LEBANON: HISTORICAL SNAPSHOT

In 1975, the civil war broke out in Lebanon. By 1989, national leaders signed the Taef Accord which put an end to the civil war and amended the Lebanese Constitution. The 15-year war and social strife had incurred substantial human and physical costs. Meanwhile, the private sector was reluctant to engage in an extensive post war framework that also lacked legality, accountability, and a formal structure. This left the government to face the major downturn with primary efforts to kick-start the economy. Moreover, by 1992, the Lebanese lira (LBP) underwent a major devaluation with the currency pair settling at LBP/\$2,300.

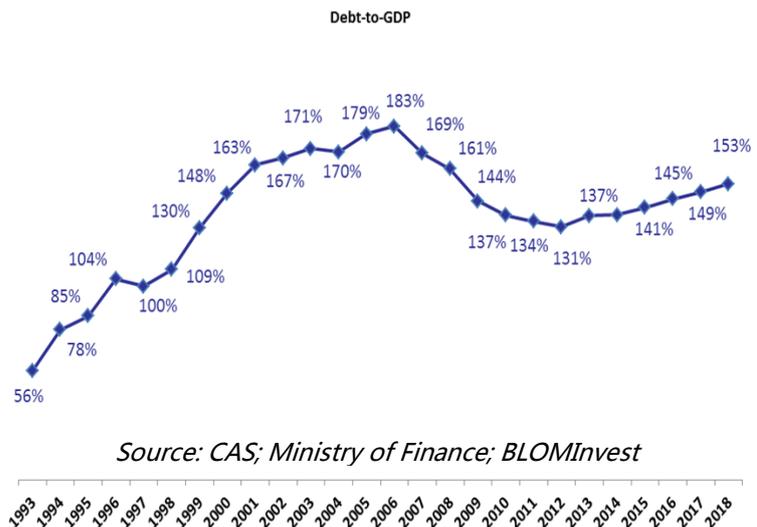
Reconstruction efforts came at a high cost, with the country amassing a huge debt overhang. From 1992-2004, the Hariri government was the first post-war government whose purpose was to spearhead the national urge for "reconstructing post-war Lebanon". Shortly after, the LBP was pegged to the USD. In turn,

Lebanon amassed a huge debt overhang, as it aimed to rehabilitate its infrastructure by resorting to external and internal borrowing. However, to engage the private sector in the rebuilding of the nation, the government was forced to offer a high *risk premia* as will be detailed in the next section of the study.



DEBT: FISCAL POLICY & INTEREST PAYMENTS

Debt is at the core of any government's operations, including Lebanon's. Fiscal policy is used as a stabilization tool. In fact, debt grows as a result of accumulated national fiscal deficits in a country. Moreover, the interests also magnify debt levels, especially if the interest rates are high. It is also noteworthy to mention that even countries with a primary surplus may witness an increase in public debt if the



surplus does not cover the total interest payments. As such, both, a primary deficit as well as interest payments are direct factors that can magnify the debt of a nation.

In addition, debt is expected to increase during periods of below-average economic growth. In general, within an environment of low growth, government revenues do not increase much while public expenditures (especially on social spending and/or capital spending) rises as the government needs to intervene more and therefore spend more to kick start the economy. Accordingly, growth stalls in a debt-ridden economy primarily because elevated leveraging threatens the government's ability to set budget priorities, but also because debt tends to restrict a nation's policy functions.

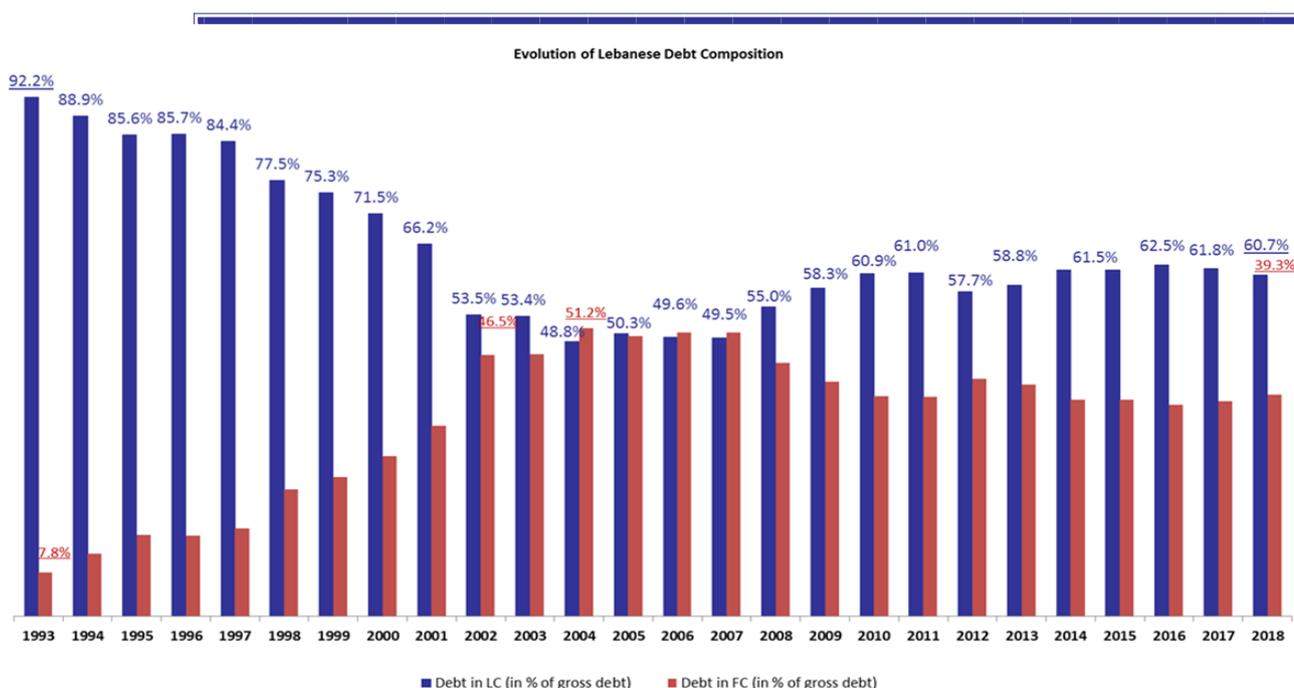
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
%GDP growth (IMF)	1.1%	3.9%	3.4%	1.7%	7.5%	2.7%	1.7%	9.3%	9.2%	10.1%	8.0%	0.9%	2.8%	2.7%	2.0%	0.2%	1.7%	1.5%	1.0%
Interest Payments (in %GDP)	NA	NA	16.6%	16.8%	12.3%	10.5%	13.2%	12.6%	11.3%	10.8%	10.2%	9.4%	8.2%	8.2%	8.6%	8.9%	9.3%	9.2%	9.0%
Interest Payments (in % total revenues)	NA	NA	80.60%	74.91%	52.38%	46.05%	58.49%	54.42%	46.98%	45.52%	46.46%	40.19%	38.53%	40.23%	38.50%	46.57%	48.03%	42.92%	39.35%

Source: Ministry of Finance; IMF; BLOMInvest Bank

Lebanon's fiscal policy rendered the interest burden paid on its debt unsustainable. The ratio of outstanding gross public debt to GDP in Lebanon is among the highest in the world. In 2006, Lebanon's debt-to-gdp peaked at 183%. By 2007-2012, the ratio gradually retreated to stand at 131% in 2012. However, from 2013 onwards, debt-to-gdp in Lebanon was on an upward trend, reaching 153% in 2018. Other European countries have also accumulated public debt levels that exceed their national outputs. Nonetheless, what really renders Lebanon's debt simply unsustainable is the elevated interest burden amid an environment of subdued growth, as depicted in the table above.

DEBT COMPOSITION

Most of the Lebanese debt is of domestic origin. In fact, Lebanon's local currency debt is mostly held by the Lebanese banking sector and is constituted of a portfolio of Eurobonds of short-term, medium-term, and long-term maturities. Lebanon's foreign currency debt and that in local currency have historically incurred their respective costs, noting that public debt's composition has changed over the years as follows:

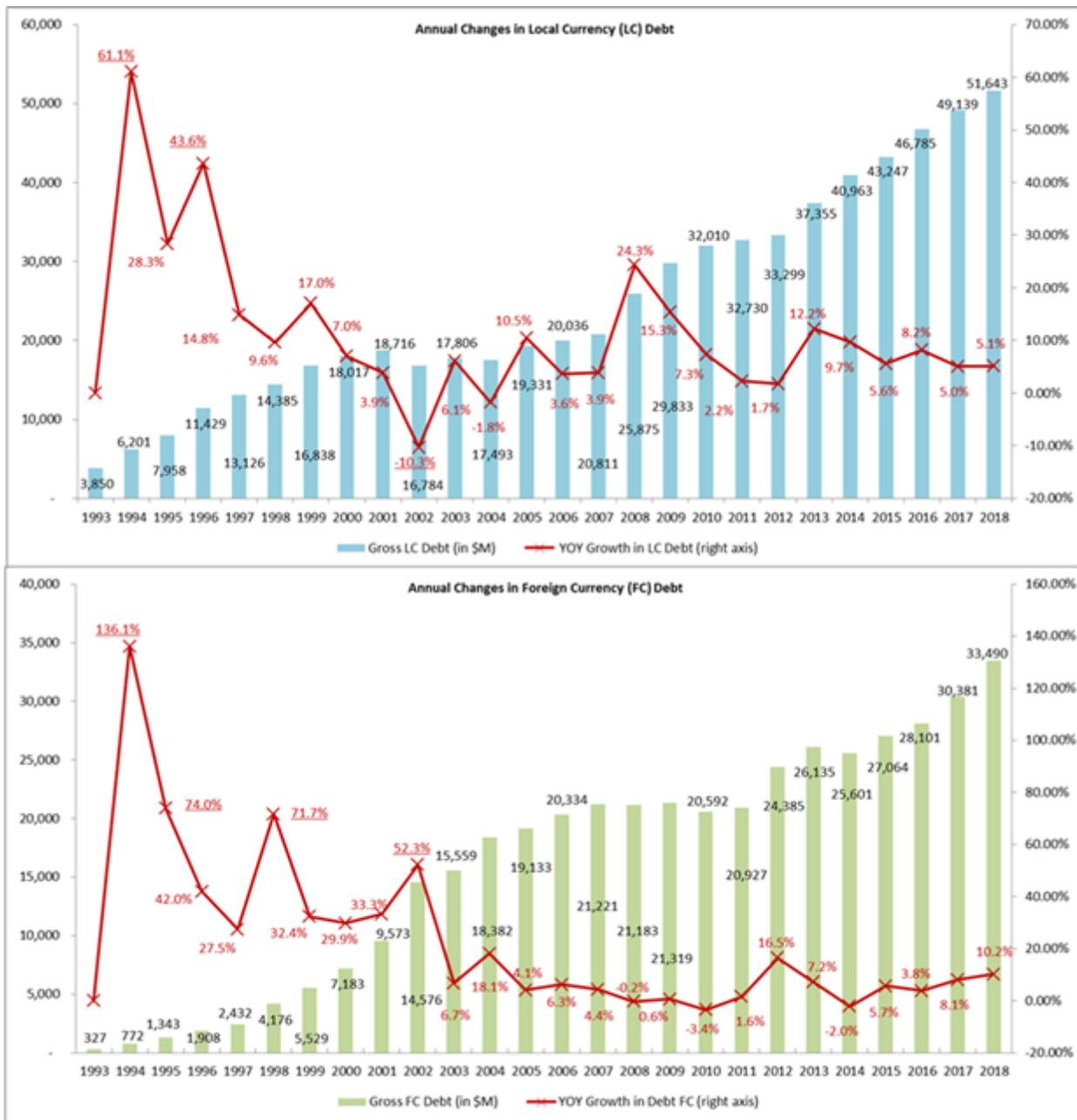


Source: Ministry of Finance; BLOMInvest Bank

Early on in the post-war reconstruction era, the Lebanese government relied on domestic market borrowing. The cost of rebuilding Lebanon’s physical and human capacity post the 1975-1990 civil war shot up public debt to \$7B by 1994, which represented a 67% annual growth. In fact, between 1993 and 2001, the Lebanese Government initially relied on heavy borrowing from the domestic market and thereby amassed more local currency (LC) debt to meet its overall financing requirements. As such, LC debt constituted on average 81.3% of total gross debt during the aforementioned period. Most of the local currency debt came with high interest rates, given the risk premia demanded by investors to finance the government leading the reconstruction efforts. With high costs of borrowing, the overall fiscal deficit expanded rapidly over the years. Today, the fiscal deficit hit \$5.8B by Nov. 2018.

From 2002 to 2008, foreign currency (FC) debt gained thrust. From 2001 onwards, the above graph shows Lebanon successfully began to tap international capital markets. In fact, the first Paris Donor conference which took place in Feb. 2001 aimed to help discipline the country’s growing fiscal deficit and put debt on a sustainable trajectory, all of which catapulted the annual growth rates witnessed in FC debt. In details, foreign currency debt, on average, constituted 49.1% of gross debt from 2002 to 2008.

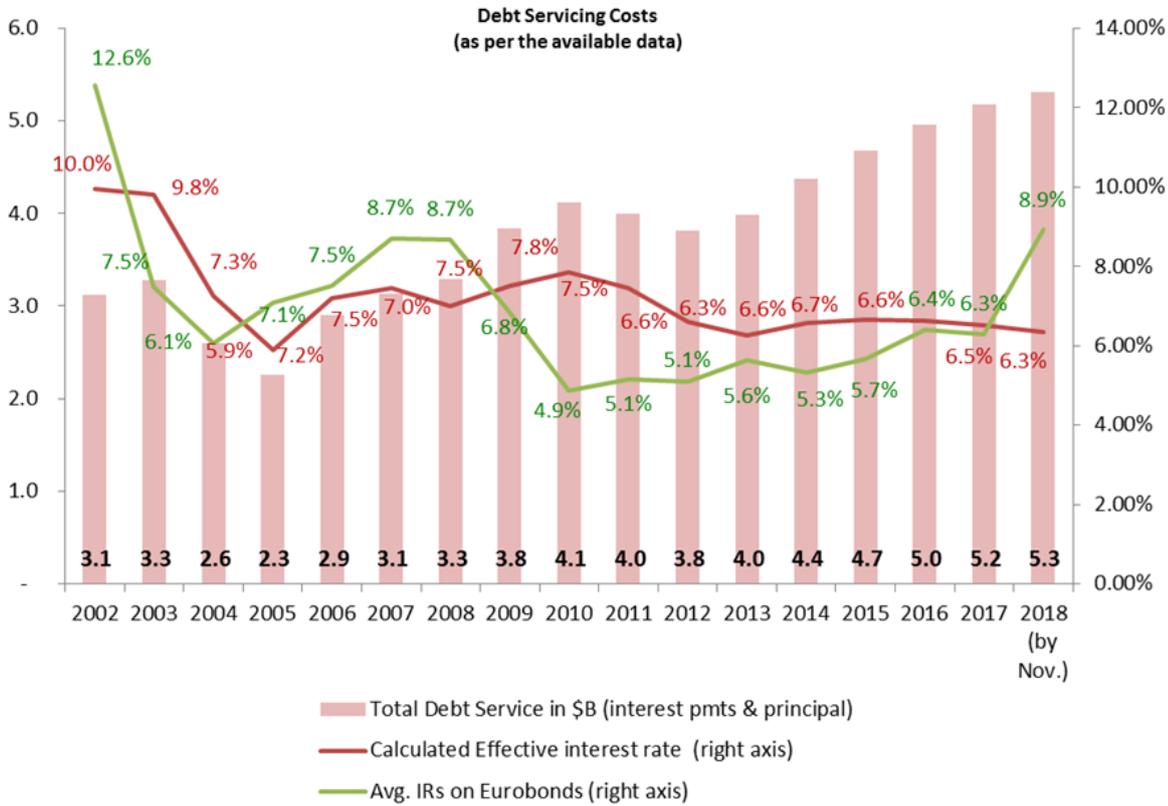
Yet, LC debt grew again from 2009-to date. By 2009, LC debt comprised 58.3% of gross debt while FC captured the remaining share of the total. As such, LC from 2010 to 2018 captured a stake of 60.25%, on average, for the period. The government’s reliance on LC debt again can be partly attributed to BDL’s intervention via monetary policy tools, absent a local government which faced prolonged periods of political stalemate. In details, BDL’s intermediation schemes with commercial banks, alongside its financial engineering operations were the main tools used to reduce fiscal deficits and discipline debt levels.



Source: Ministry of Finance; BLOMInvest Bank

Any form of debt whether internal or external may become harmful to an economy. Recapping, the reliance of Lebanese authorities on LC debt pre-2002 is apparent in the yearly growth rates registered, while upticks in FC debt outweighed those in LC starting 2003, as per the above two comparative figures. With local banks being the bearers of most of the local debt, the country's sovereignty is protected from external pressures, given the repayment is less directly tied to other governments. Nevertheless, the burden of debt servicing persists on both, local and foreign debt.

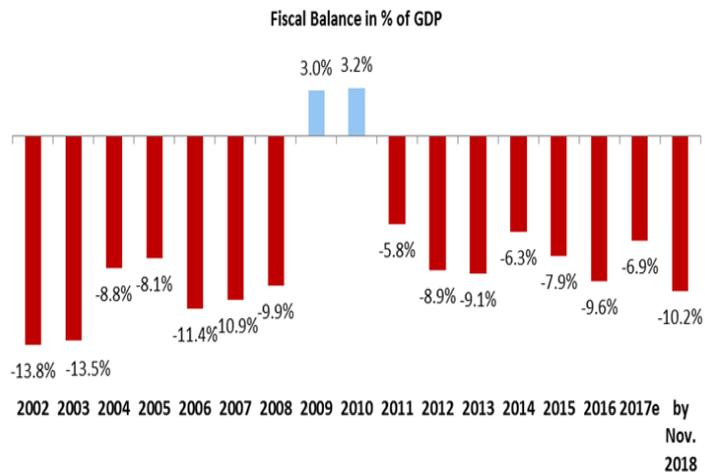
COST OF DEBT



Source: Ministry of Finance; BLOMInvest Bank

Costs of servicing the debt are a key parameter. Lebanon's debt servicing costs, inclusive of total interest and principal repayments, rose over the years, as per the above figures. To be sustainable, debt interest must be comfortably payable from the current government revenues.

However, applying this to Lebanon reveals frail revenues as per the adjacent figure that uses the most recently available data from official sources.



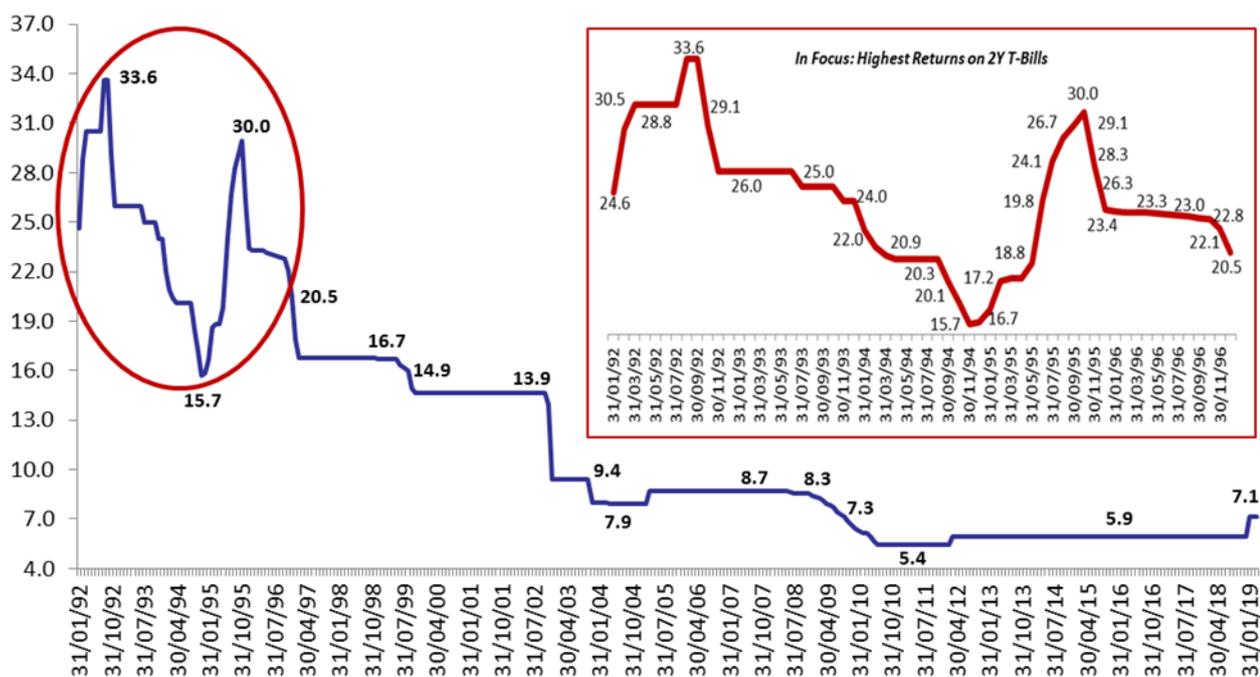
Source: Ministry of Finance; BLOMInvest Bank

Returns on local currency debt, particularly on 1Y and 2Y T-Bills reached highs of 30-40% in the 1990s.

Local players mainly subscribed to local currency debt with short term maturities and thereby demanded high return to offset the high risk. As such, returns on Lebanese 2Yr T-Bills held mainly by local banks hit highs of 33.6% in August and September 1992, up from 24.6% in the beginning of the year.

Similarly, returns on the 1Y Lebanese T-bills also reached 34.2% by August and September 1992. The return rates also grew to an all-time high of 37.85% and 36.86%, respectively, by September/October 1995. During this period, growth rates staggered while such exponential interest rates on T-bills reflected the unnaturally high returns offered on government loans. This ultimately contributed to the accumulation of a large debt overhang.

Historical Returns on "2Yr Treasury Bills" (in %)



Source: Banque du Liban (BDL); BLOMInvest Bank

FINAL THOUGHTS

Lebanon's vicious borrowing cycle crowded out investment in the country's productive sectors. Lured in by the high returns offered by the government, the Lebanese financial system (namely represented by banks) was incited to invest in government debt thus crowding out the private sector. This includes foregoing industrial and agricultural projects that may on the long term increase potential growth of the

economy and improve the wealth of the nation by generating a sustainable revenue stream that can at least cover debt repayments of the nation.

Productive sectors in fact are the primary engine for any economy. These are inclusive processes, especially in Lebanon where more than 90% of businesses are SMEs. Moreover, improvement in national productivity is often synonymous to long-term sustainable growth.

Excessive debt imperils a country and its national sovereignty. Sovereign debt has to be repaid, and the lenders are usually other nations or, with Lebanon as case in point, creditors are national financial entities and institutional investors within the country itself. As such, accumulating excessive debt imperils national sovereignty. Even though Lebanon differs from Greece and other EU-indebted nations in that its indebtedness remains mostly internal, the country's economy today stands at a critical standpoint that necessitates a severe reform agenda, namely austerity measures and smart debt management strategies to overcome the sharp downturn. Nonetheless, at this current stage, Lebanon needs to resort to the international community and it must therefore agree to the 'conditions' on loans or grants offered, which may affect the country's independence.

Debt tightens the fiscal space available for the country's future generations. The burden of debt and interest payments ties the hands of the current leaders and citizens, but it also leaves the future generation with less tools at hand to maneuver any upcoming crisis of their time. In fact, from the latest data available on public debt for 2018, we calculate that every person in Lebanon has a monthly debt of \$1,580, to which we add a debt service payment of \$98/month. This makes the total debt burden on a Lebanese citizen \$1,678 per person per month, or in other words \$6,712 per month for a typical Lebanese household (family) of 4 persons.

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