Lebanon in Crisis: An Unusual Money Supply Process!

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Contact Information

Head of Research Department

Dr. Ali Bolbol

Ali.bolbol@blominvestbank.com

It has been a very unusual one-and a half- year for the Lebanese economy. From an economy that was perfectly liberal and home to a vibrant banking sector, it turned almost overnight to an economy mired with informal capital controls, multiple exchange rates, and struggling banks, let alone an unprecedented economic depression. As if that was not enough, the process of money creation/contraction has also undergone very uncommon changes, in that the main driver behind these changes was not one of the fundamental determinants that we usually associate changes in the money supply with but a minor one.

To see what is going on, we have to analyze the money supply process neither from an accounting point view (as the sum of the monetary aggregates like currency and deposits), nor from a multiplier point of view (as the product of the money multiplier and reserve money). Instead, we will arrive at the determinants of the money supply from the components of the monetary survey, which consolidates the balance sheet of the central bank with that of the commercial banks. Let us assume that the prototype balance sheet of the *central bank* looks as follows:

Assets	**Liabilities**
Foreign Assets (FA)	Reserves
Credit to the Public Sector (CPS)	Currency
Credit to Commercial Banks	Foreign Liabilities (FL)
Other Items	Public Deposits
	Other Items

Whereas the typical balance sheet of *commercial banks* is as follows:

Assets	**Liabilities**
Reserves	Deposits
Foreign Assets (FA)	Foreign Liabilities (FL)
Credit to the Public Sector (CPS)	Loans from Central Bank
Credit to the Private Sector (CPVS)	Other Items
Other Items	

If we consolidate the two balance sheets, we will notice the following: reserves are cancelled on both sides; the same is true for credit to commercial banks/loans from central bank; the sum of foreign assets is netted from the sum of foreign liabilities to arrive at net foreign assets NFA; the sum of credit to the public sector is netted from public deposits to arrive at net credit to the public sector NCPS; the sum of other items are netted to get other items net OIN. Notice also that the sum of currency and deposits is money, or M3 in Lebanon which is the sum of currency in circulation and deposits in LBP and USD. More important, this makes money on the consolidated liabilities side equal to the sum of the others -- net foreign assets, credit to the private sector, net credit to the public sector, and other items net -- on the consolidated assets side, or:

(1) M3 = NFA + CPVS + NCPS + OIN

Table 1 $Billion	**M3**	**NFA**	**CPVS**	**NCPS**	**OIN**	**CC**	**Deposits[1]**
Nov-19	136.50	26.94	49.37	48.91	12.81	5.41	129.46
Dec-19	134.57	26.61	46.98	47.31	15.20	6.51	126.47
Jan-20	132.58	27.07	45.32	45.45	16.26	7.12	123.82
Feb-20	130.99	26.61	43.66	44.66	16.99	7.94	121.43
Mar-20	130.39	24.95	42.73	44.39	18.25	8.77	120.01
Apr-20	129.60	25.75	41.27	43.20	19.31	9.66	118.38
May-20	129.73	24.88	40.41	43.13	21.17	10.90	117.25
Jun-20	129.53	25.02	39.35	42.60	22.50	11.82	116.21
Jul-20	129.53	23.69	38.42	40.41	26.94	12.68	115.39
Aug-20	130.59	21.77	37.89	40.08	30.86	13.72	115.31
Sep-20	130.99	18.91	36.89	40.28	34.90	14.69	114.78
Oct-20	131.25	18.45	36.10	39.81	36.83	16.09	113.73
Nov-20	131.98	17.32	35.57	40.28	38.75	17.58	112.82

[1] Resident deposits

Equation (1) above is a very good one, and it shows that changes in M3 are determined by changes in its fundamental constituencies NFA (external source), CPVS, NCPS, and OIN (internal sources). In addition, historically, changes in M3 were dominated by the crucial changes in the first three variables but not anymore: recently, they have been dominated by changes in OIN.

We can see that by investigating Table (1) above. From November 2019 to November 2020 (the period marking roughly the beginning of the crisis till the latest available data), we observe that M3 fell by $4.52 billion only, from $136.5 to $131.98 billion; NFA *fell* by $9.62 billion, from $26.94 to $17.32 billion; CPVS *fell* by $13.8 billion, from $49.37 to $35.57 billion; NCPS *fell* by $8.63 billion, from $48.91 to $40.28 billion; whereas OIN *rose* by $25.94 billion, from $12.81 to $38.75 billion.

More important, the change in NFA equals the *balance of payments deficits* that the country has incurred during the period; whereas the change in CPVS reflects *loan reductions* -- through paybacks by clients, primarily real estate developers – and the fact that hardly any new loans were extended; and the change in NCPS indicates the amount of *government bonds that commercial banks have shed from their holdings*, given that new deficits were financed mostly by public deposits and partially through the central bank.[2]

The most interesting and biggest change, though, is in OIN, which is dominated by BDL's item "Other Assets"[3] that in turn increased by $23.16 billion during the period to settle at $48.3 billion in November 2020. Granted, this is a "controversial" item in BDL's balance sheet, but suffice to say here that included in it is the price support that BDL provides on USD withdrawals that are exchanged at the rate of 3,900 LBP per USD instead of the official 1,500. And it is partly the resulting extra liquidity from this measure that has caused the currency component in the money supply to increase by $12.17 billion, from $5.41 to $17.58 billion, in addition to people's preference to be more liquid in times of crisis and uncertainty.

We can derive four important implications from the above analysis. First, the money supply M3 changed very little (fell by 3.3% only) despite the severe economic contraction that should have reduced it. What caused the counter increase is not deficit monetization -- because not much was done of that – but the unconventional increase in liquidity due to BDL's exchange rate conversion policies.

[2] See Bolbol, A. and Hatchiti, S. (2020). "Lebanese Budget Deficit Financing in H1 2020: A Critical Look", *Lebanon Brief, September 18.*

[3] According to BDL, it officially includes "open market operations and seigniorage".

Second, this unconventional policy contributed to the increase in currency that compensated for the fall in deposits and kept M3 largely the same (see Table 1). What is interesting is that currency has increased by 225% whereas inflation has increased by 145% only. The reason for this discrepancy is partly because the *velocity of money must have decreased* due to the Corona lockdowns, and partly because of essential goods' price subsidization by BDL.

Third, the casualty of this process is disintermediation and the demise of the credit extension process, which made the money supply process largely independent of its fundamental determinants. This is sidelining banks and the indispensable role that they play in funding the economy.

Fourth, notwithstanding the increase in currency, the fact that M3 has hardly changed, means that the exchange rate depreciations that the country is going through are not strictly a monetary phenomenon. They have more to do with the crisis of confidence afflicting the country and the viability of its economy, and perhaps above all the quality of its politicians.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department

Bab Idriss, Weygand Str.

POBOX 11-1540 Riad El Soloh

Beirut 1107 2080 Lebanon

Research Department

Tel: +961 1 991 784

research@blominvestbank.com

Head of Research Department

Dr. Ali Bolbol

Ali.bolbol@blominvestbank.com