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# Can Lebanon Defy Gravity Forever?

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## Can Lebanon Defy Gravity Forever?

By Uwe Böwer

### Abstract

Lebanon's new government was finally agreed in January 2019, after an almost 9-month deadlock over political representation. As much of the reform momentum stemming from an international investors' conference in April 2018 has faded, the government is now facing the challenge to reinvigorate the reform agenda and make credible steps towards fiscal consolidation. While Lebanon has long been able to maintain a surprising level of resilience amidst high economic volatility and a tumultuous geopolitical environment, the pressure has been rising to tackle the large twin deficits, the very high level of public debt, and the protracted lack of competitiveness. As life-sustaining financial inflows have slowed down, Lebanon's past business model has come under scrutiny. Substantial fiscal consolidation and a credible plan for growth-enhancing structural and governance reforms would play an important role in rebuilding investors' confidence and pave the way for an economic recovery built on a solid foundation.

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## Moving Closer to the Brink

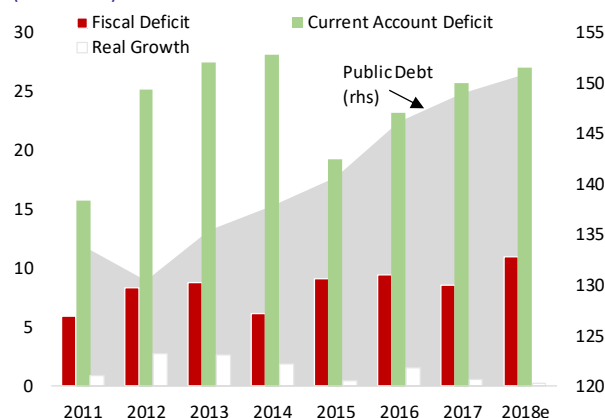
### Political turbulence, dwindling confidence and structural problems have turned up the heat.

Lebanon's economic situation has become increasingly alarming. Economic growth, at only 1.4% on average since 2011, slumped to an estimated 0.3% in 2018 – a far cry from the pre-Syrian crisis average of 6.3% between 2003-2010. The nearly nine-month political vacuum between the May 2018 election and eventual government formation on 31 January 2019 weighed on business confidence. The purchasing managers' index has been glued in contractionary territory since 2013. Although the new government recommitted to a reform and consolidation agenda first presented in April 2018, investor confidence remains subdued, as concrete reform measures keep getting stuck in the pipeline. Meanwhile, the fiscal deficit is expected to have reached double-digits in 2018, pushing public debt above the 150% of GDP mark. The current account deficit stands at around an astonishing 27% of GDP, with financing on a knife-edge as foreign deposit inflows have slowed over recent years, and turned negative over the first two months of 2019 month-on-month. While the central bank continues to defend the currency peg to the US dollar, interest rates and financial market volatility have risen. Country risk has increased sharply. Structural problems such as the heavily loss-making and unreliable power sector, coupled with widespread corruption, have accumulated. Sovereign downgrades testify to the rising pressure.

### Reinvigorating the reform agenda is a major challenge for the new government.

The government intends to pick up its 'Vision for Stabilisation, Growth and Employment', a reform programme presented at the April 2018 Paris 'Conférence économique pour le développement, par les réformes et avec les entreprises' (CEDRE) and largely endorsed by the EU. The concept encapsulated a comprehensive Capital Investment Plan (CIP), assessed as generally appropriate by the World Bank. The government now hopes to unlock the USD 11 billion pledged by international donors. On the fiscal side, the Vision vows to reduce public debt by slashing the budget deficit by one percentage point of GDP per year over five years. The new government aims to start implementing this plan this year. While this goal is going to be difficult enough to reach politically, it may no longer be sufficient after an additional year of slippages.

Graph 1: **Growth, Public Debt and Twin Deficits** (Percent)



Sources: Banque du Liban (BdL), IMF.

Graph 2: **CDS for 5-Year USD-Denominated Bonds** (Mid-Spread)



Source: Bloomberg.

Graph 3: **Sovereign Ratings**



Source: Bloomberg.

**These developments cast doubts on Lebanon’s track record of resilience.** Historically, Lebanon has long been able to withstand the pressure of high public debt and persistent twin deficits, thanks to significant deposit inflows attracted by competitive interest rates and a tightly regulated banking environment. Unemployment and inflation have typically remained below regional averages. In the words of Ferid Belhaj, World Bank Vice-President for the MENA region, ‘Lebanon has been defying gravity.’ However, the recent trends of slowing deposit inflows, coupled with ongoing political quarrels in the face of ever more pressing fiscal and structural problems, suggest that Lebanon’s past business model may no longer be viable.

The remainder of this paper will in turn analyse the main challenges pertaining to fiscal sustainability, external rebalancing, financial stability, growth & investment, and public sector governance.

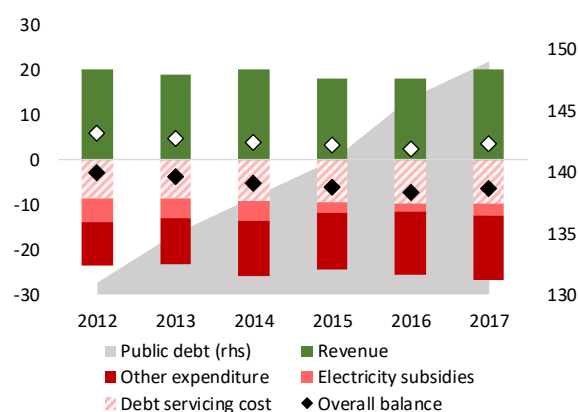
### Fiscal Sustainability

**The fiscal deficit has reached double digits.** The overall balance recorded an estimated deficit of 10.9% of GDP in 2018, a significant deterioration from the 6% deficit recorded the year before, and far from the annual one percentage point consolidation commitment made at CEDRE. With debt service eating up around half of revenues, and electricity subsidies chipping away another 15%, expenditures are rigid and vulnerable to changes in interest rates and oil prices. Pensions are costly and unevenly distributed, amounting to around 2½% of GDP over the last decade while covering only 2% of the population, according to World Bank estimates (World Bank, 2018). The large number of refugees has further strained public services and infrastructure. Recent UNHCR figures put the number of Syrian refugees registered in Lebanon at around 950,000 while NGOs consider 1.5 million a more realistic estimate.

**Public debt appears unsustainable under current policies.** The debt-to-GDP ratio climbed to an estimated 151% of GDP in 2018, one of the highest in the world. In its baseline scenario, the IMF expects debt to increase to 180% by 2023 and to continue rising thereafter, a path considered unsustainable (IMF, 2018). Remarks by the finance minister in January 2019 about a government plan for debt restructuring or rescheduling, although rapidly denied, fuelled the spread on Lebanon’s

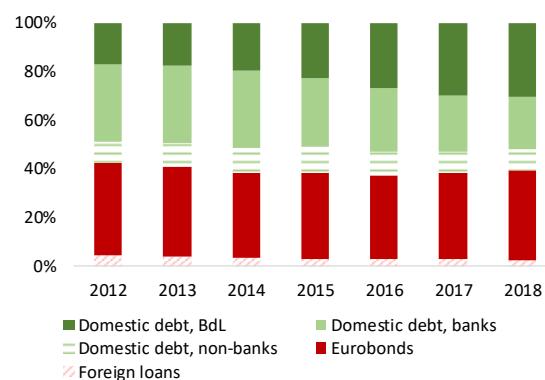
credit default swaps. Qatar’s subsequent announcement to purchase USD 500 million in Lebanese government bonds, matched by a hasty assurance of unspecified support from Saudi Arabia, calmed markets temporarily but remains a drop in the ocean and leaves the fundamental malaise of Lebanon’s public finances untouched. A mitigating factor from the point of view of the government is the large share of public debt in the hands of the central bank and domestic commercial banks, amounting to around 50% combined, although it raises the risk profile of the financial sector.

Graph 4: **Fiscal Balance Composition** (Percent of GDP)



Sources: Ministry of Finance, CAS.

Graph 5: **Public Debt Composition** (Percent of total)



Source: Ministry of Finance.

**Strong front-loaded fiscal consolidation seems inevitable.** Despite the potentially adverse effect of fiscal tightening on economic growth, comprehensive fiscal consolidation would be an important signal for Lebanon to reassure investors and return to fiscal viability. The government’s five-year consolidation path of five percentage points of GDP presented at CEDRE in April 2018 would have

been just enough to stabilise public debt at its level at the time. One year on, as public debt has continued to grow, an even more ambitious adjustment will be necessary. Options on the table include raising VAT, reinstating fuel excises, phasing out the electricity subsidy, and containing the public wage bill. While the government announced subsidy cutting and a hiring freeze in an initial statement, it ruled out any tax hikes. This will unlikely be enough to do the job.

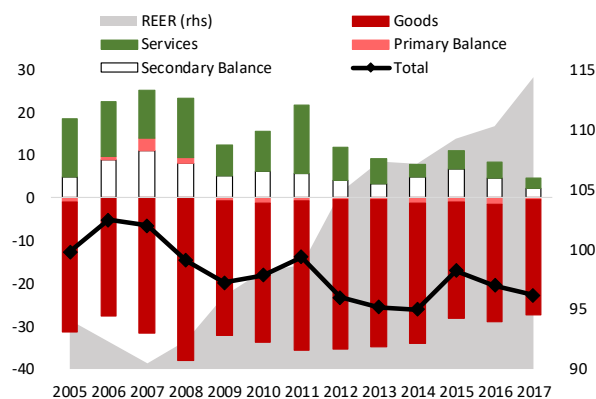
**Resuming tax reform would strengthen revenue collection.** The rigid structure of the expenditure side calls for enhanced structural revenue measures to achieve sustained fiscal adjustment. In 2017, the government adopted a first tax reform package including modest increases in VAT, taxes on financial institutions, taxes on interest income, taxes on lottery gains, and import excises on alcohol and tobacco. It also introduced a tax on capital gains from disposal of fixed assets, an advance payment on real estate contracts and fees on seaborne freight. However, the expected revenue increase from these measures was largely neutralised by a public sector pay rise at the time. Further efforts to improve revenue collection could include better compliance efforts and VAT base broadening. Closing the non-compliance component of the VAT gap alone could generate an estimated 3.3% of GDP. Eliminating VAT exemptions and reduced rates for certain goods and services could yield another 4.1% of GDP (IMF, 2017a). Additional tax reforms could aim at cutting down the number of personal income tax bands and implementing higher rates on higher incomes while protecting lower income earners.

## External Sector Rebalancing

**The currency peg has been an anchor of stability, although there are signs of overvaluation.** The Lebanese Pound has been pegged to the US dollar at LBP 1507.5 per USD since December 1997. The peg has acted as the main pillar of economic stability for Lebanon, and maintaining its credibility has been of the highest priority for the Banque du Liban (BdL). However, the real effective exchange rate may be significantly overvalued, putting pressure on reserves. Gross foreign reserves declined to USD 39.7 billion at end-2018, covering around 12 months of imports, from USD 40.6 billion or 14 months of imports at end-2017. Redemptions of Eurobonds worth USD 2.2 billion in 2018, as well as currency conversions in the wake of political uncertainty,

offset the BdL's financial engineering operation in early 2018 which had shifted net foreign asset positions from commercial banks to the central bank (see Box 1). Lebanon's Net International Investment Position is estimated at around 130% of GDP, largely related to foreign direct investment. Overall, the assessment of external vulnerabilities suffers from limited data availability.

Graph 6: **Current Account Composition**  
(Percent of GDP)



Sources: Ministry of Finance, CAS.

**The protracted current account deficit and steady real appreciation point to losses in competitiveness.** The current account deficit has been hovering at 20% of GDP in recent years and is expected to have reached around 27% in 2018. Large goods trade deficits have weighed on the current account, fuelled by weak exports and strong imports. Tourism and other services have generated comparably small, and shrinking, surpluses in services. While primary incomes have been negligible, the secondary income balance has been positive on the back of remittances, although these have also shown some declines in recent years. Export competitiveness has suffered from strong increases in the real effective exchange rate since 2007, attaching a hefty price tag to the currency peg.

**Exports would benefit from better exploiting trade agreements with the EU.** The EU-Lebanon Association Agreement provides for preferential trade arrangements. Lebanon could better reap its trade potential with the EU, for instance by improving compliance with technical requirements and quality standards. The Single Support Framework of the EU's European Neighbourhood Instrument points to sanitary and phytosanitary standards in particular (EEAS and European Commission, 2017). The EU offers technical assistance and advice on legal and regulatory issues,

as laid out in its 2018 Annual Action Programme, to help Lebanese companies capitalise more on the preferential trade opportunities that the Association Agreement offers (European Commission, 2018). Furthermore, the EU continues to support Lebanon towards membership of the World Trade Organisation and adherence to the Agadir Agreement, which could be completed in 2019.

**Currency devaluation could boost export competitiveness but would inflate the import bill and FX liabilities in domestic-currency terms.** In view of the significant estimated overvaluation in real effective terms, a downward adjustment of the peg, or a free float with ensuing market-driven depreciation, could ignite exports and make Lebanon more attractive to tourists. However, before this positive impact would kick in, the large amount of imported goods for consumption and investment would immediately experience a sharp price increase, push up inflation and induce a strong contractionary monetary policy response, driving lending rates into prohibitive territory and induce a sharp recession. The large share of loans denominated in foreign currencies would aggravate the public and external debt burdens in the case of a devaluation, as the value of the FX debt in LBP terms would increase.<sup>1</sup> Since debt sustainability is problematic even on the current pegged exchange rate, a devaluation would in all likelihood tip Lebanon into a sovereign default. In turn, the stability of the banking sector would be acutely threatened.

### Financial Stability

**Banks have been resilient so far.** With assets worth 440% of GDP in 2018, Lebanon’s banking system is very large. The financial system is almost entirely composed of banks, while nonbanks hold only a negligible share of assets. Banks are well capitalised, with a capital adequacy ratio of 17%, and have maintained profitability. Thanks to prudent regulation, banks have enjoyed a strong reputation among regional investors and the Lebanese diaspora.

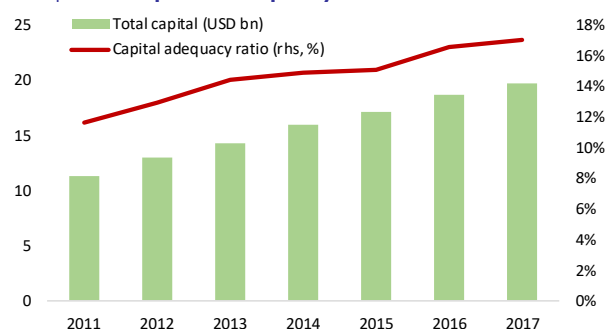
#### Risks in the banking sector are rising.

- Banks are vulnerable to maturity mismatch, as banks’ investments in longer-term BdL instruments have increased while deposits tend to have short maturities and high

concentration. To counter this mismatch, the BdL has raised the maturity profile of deposits at commercial banks with a mix of incentives and withdrawal restrictions.

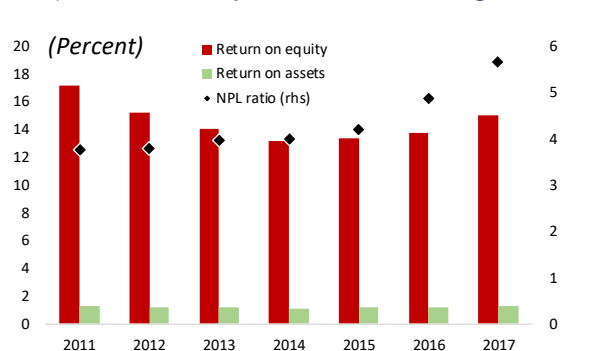
- Deposits are highly dollarised, with the share of foreign currency deposits in total deposits over 70% since December 2018, for the first time in 10 years.
- Banks’ exposure to the public sector and the central bank has increased to more than two thirds of assets, combined with a heightened risk profile of these assets.

Graph 7: **Capital Adequacy**



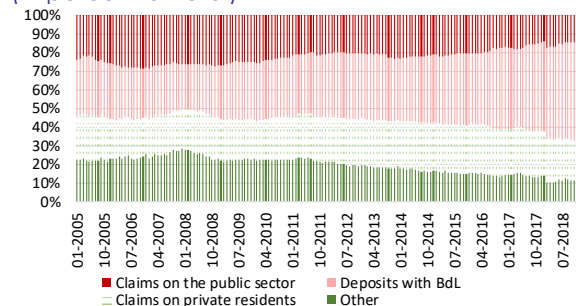
Source: BdL. The capital adequacy ratio is defined as regulatory capital over risk-weighted assets.

Graph 8: **Profitability and Non-Performing Loans**



Source: IMF.

Graph 9: **Bank Assets**  
(In percent of total)



Source: BdL.

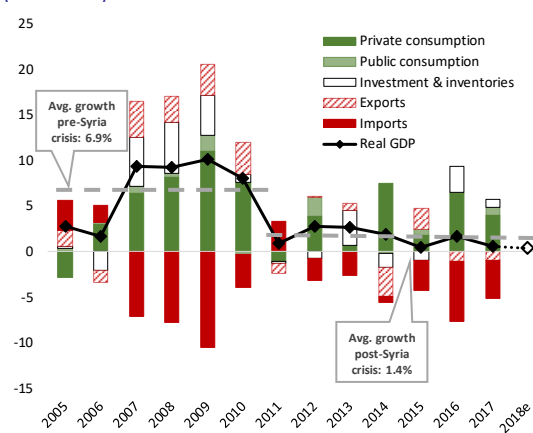
<sup>1</sup> Due to data limitations, there is no information on the currency mismatch of the economy as a whole.

**Private sector asset quality has worsened.** The dire macroeconomic situation amid a slowdown in the real estate sector suggests a deterioration in asset quality. Non-performing loans rose to 5.7% of gross loans in 2017. Although data on housing prices and bank exposure to the property market is limited, NPLs seem mostly driven by loans to real estate developers. Stress tests run for the 2016 Financial Sector Assessment Program (FSAP) conducted by the World Bank and IMF pointed to significant capital restoration needs in case of severe shocks to growth, interest rates and real estate prices, on the back of the large size of the banking sector and the difficult baseline environment (IMF, 2017b). In 2018, the IMF reiterated its advice to strengthen banks’ buffers to cushion against sovereign risks by aligning risk weights with the Basel Accord, and to address NPLs more effectively by adopting international best practice regulation and encouraging sustainable restructuring (IMF, 2018).

### Growth and Investment

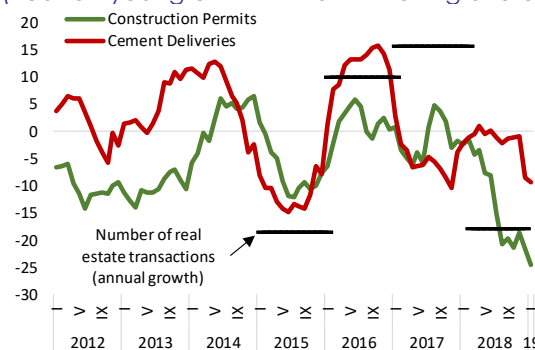
**Potential growth is restrained by the economy’s heavy reliance on non-productive services.** Services account for 87% of gross value added, with one quarter alone on largely public services including administration, education and health. The three main service sector pillars of the private sector pertain to construction, financial services and tourism, with a combined share of around 36%. While these sectors fuelled Lebanon’s higher growth rates during the period before the Syrian crisis, they have done little to enhance the productive capacity of the economy and lay foundations for potential growth. Construction is still struggling following the removal of BdL subsidies for lending to the real estate sector, reflected in shrinking numbers for cement deliveries and construction permits. Tourism has recorded a partial recovery from the 2011 breakdown. However, recent growth rates have not only remained below pre-crisis rates but have also slowed considerably. Manufacturing suffers from underinvestment, poor electricity supply and weak productivity growth. While the agricultural sector has earned a good-quality reputation and enjoys higher productivity, it makes up only 3% of gross value added (GVA) and suffers from poor transport and power networks.

Graph 10: **Real GDP Growth Contributions** (Percent)



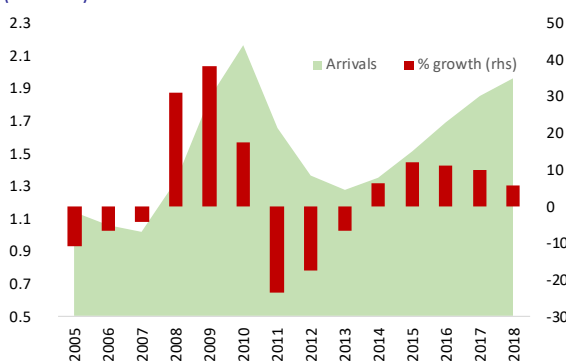
Sources: CAS, IMF.

Graph 11: **Construction Sector** (Year-on-year growth 12-month moving average)



Source: BdL, Land Registry, Bank Audi.

Graph 12: **International Tourist Arrivals** (Million)

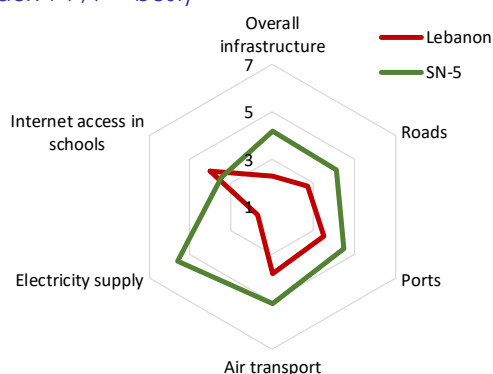


Source: World Bank, Ministry of Tourism.



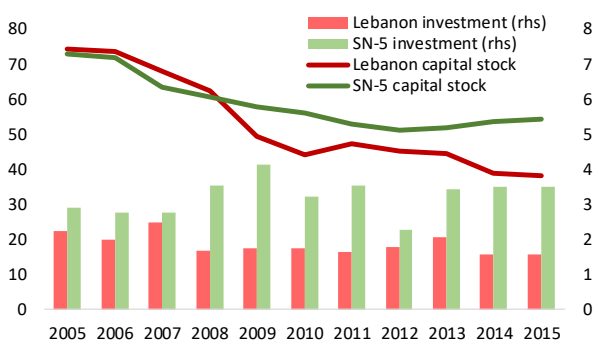
**Lebanon’s inadequate infrastructure requires significant investment.** Compared to regional peers, Lebanon’s infrastructure lags in almost all dimensions. The quality of roads, ports and air transport is perceived as significantly worse. Electricity supply is unreliable and substantially worse than in regional peers, hampering the competitiveness of Lebanon’s businesses and the ability to attract foreign direct investment. Only internet access in schools slightly exceeds the median of peer countries. Lebanon’s public investment did not keep up with economic growth during the pre-crisis years, leading to a stronger decline in the public capital stock to GDP ratio than in regional peers. The already heavy burden on Lebanon’s existing infrastructure was further exacerbated by the arrival of an estimated 1-1½ million Syrian refugees.

Graph 13: **Quality of Infrastructure**  
(Index 1-7, 7 = best)



Sources: World Economic Forum Arab World Competitiveness Report 2018, Global Competitiveness Report 2017. SN-5 denotes median values for the Southern Neighbourhood non-oil-producing and non-conflict countries Egypt, Israel, Jordan, Morocco and Tunisia.

Graph 14: **Public Investment and Capital**  
(Percent of GDP)



Source: IMF Public Investment Dataset. SN-5 as defined above.

**The European Investment Bank supports infrastructure deployment and private sector development,** for instance through its Economic Resilience Initiative, which helps to establish modern industrial zones offering businesses high-quality infrastructure and fair land prices, including in areas heavily affected by the Syrian refugee crisis. Overall, the EIB channelled around EUR 832m in signed amounts to Lebanon in 2017-2018, partly guaranteed under the EU’s External Lending Mandate (EIB, 2018).

**The government’s Capital Investment Plan is expected to spring to life.** The CIP, first presented at the CEDRE conference in April 2018, focuses on infrastructure in the energy, transport, water and waste management sectors, in line with EU-Lebanon Partnership Priorities (EU-Lebanon Association Council, 2016). The EU stands ready to contribute to the plan’s funding and to assist the government in the drafting of sector policies, prioritising of projects and through technical assistance on project design and impact assessments. However, little progress has been made so far on implementation, in light of the political impasse after the May 2018 elections and the ensuing reform delays. The new government, finally formed in late January 2019, announced in its policy statement that it intends to resume the plan and accelerate its implementation.

**Electricity sector transformation is at the centre of structural reforms.** Repairing the electricity sector has widely been called for in order to strengthen the business environment, achieve more efficient energy consumption and limit the budget drain. In April 2019, the government adopted a reform roadmap developed with World Bank support, comprising higher tariffs from 2020 alongside short-term capacity expansion and followed by greener power plants, upgrades to the inefficient transmission and distribution networks and restructuring of Électricité du Liban, the state-owned provider. The envisaged synchronicity of tariff increases towards cost recovery and higher capacity is welcome, although any ad-hoc measures will likely be costly and polluting. New plants and more reliable infrastructure require substantial investment, and the roadmap would benefit from careful harmonisation with the CIP. Important governance issues remain unresolved, as the current plan provides for neither an independent energy regulator, nor a central role for the High Council for Privatisation and Public Partnerships in tender procedures, both in breach of CEDRE commitments.

On balance, the plan appears to go in the right direction but effective implementation will make or break the reform, given that earlier attempts with similar commitments have not survived political pressure and vested interests.

**Infrastructure improvements could also unlock the larger potential of tourism.** Lebanon's tourism industry has only partly recovered from its 2011 slump and it still holds significant potential for the Lebanese economy. A recent sectoral study commissioned by the government points to unclear branding and unfocused efforts in targeting source markets as the main current shortcomings (Ministry of Economy, 2018). It recommends developing a strategy centred on entertainment, seaside and culture, complemented by regional business and medical tourism, focused on core markets in Europe, the Arab world and among diaspora Lebanese. Key enablers include infrastructure improvements, enhanced marketing and branding efforts, as well as organisational and administrative facilitation. The empirical literature has identified air transport connectivity in particular as a key driver of tourism, notably for small and otherwise inaccessible countries (Acevedo et al., 2016; Culiuc, 2014).

**Channelling diaspora investments into productive sectors would add to Lebanon's growth potential.** So far, the diaspora invests mainly in well-remunerated deposits in Lebanese banks and in real estate projects. Engaging more proactively with second and third generation Lebanese abroad, as encouraged by the EU-Lebanon Partnership Priorities, could help mobilise direct investment into productive projects that enhance Lebanon's growth potential more sustainably than existing inflows do. An open access policy with visible improvements in the business environment would underpin Lebanon's commitment and boost confidence for the diaspora to come back to their roots.

## Governance Reform

**Political stability and good governance are at the heart of Lebanon's challenges.** The nine-month political impasse after the May 2018 elections were only the most recent manifestation of a long-standing tradition of political instability. While the country's sectarian political system has helped to end the bitter civil war of the 1970s and 1980s by ensuring a place at the table for all major factions, it

has also slowed down and sometimes paralysed the decision-making policy process. All challenges addressed above, ranging from fiscal to financial to structural policies are affected by the domestic struggle for consensus and the ensuing temptation to extract privileges by threatening to block the entire process. Corruption is widespread, and anti-money laundering (AML) and countering the financing of terrorism (CFT) challenges have come to the fore. Therefore, improving political stability and creating mechanisms of good governance are widely seen as fundamental for a sustainable improvement in Lebanon's economic situation.

**Better public investment governance would benefit the budget and leverage growth.** While Lebanon's infrastructure has clearly suffered from underinvestment, vigilance is warranted when increasing public investment or pursuing public-private partnerships to avoid wasteful expenditure and risky contingent liabilities. In the EU-Lebanon Compact, supplementing the Partnership Priorities, the government committed to strengthen public finance management in public institutions and enhance the legal, regulatory, institutional and administrative capacities for quality infrastructure. In an attempt to measure the quality of public investment management, the IMF's public investment efficiency framework relates the accumulated public capital stock per capita to various qualitative and quantitative infrastructure outcome variables, pointing to an efficiency gap of 27% in emerging market countries on average. Given its vulnerabilities in this area, Lebanon asked the IMF to conduct a public investment management assessment exercise (PIMA) in mid-2018. A PIMA evaluates a large number of institutions in the public investment decision-making process from the planning to the allocation and implementation stages and recommends detailed government action to improve the process. Contrary to countries like Jordan, Lebanon has not made the PIMA report public so far. In any event, the government now has a concrete tool at hand to deliver more efficient infrastructure provision, which will be closely scrutinised by international investors.

**Safeguarding financial integrity is vital for Lebanon's banking sector.** The Lebanese banking system has enjoyed a reputation for stability and solid regulation by the BdL. The 2016 FSAP praised Lebanon for significant progress, notably by adopting a comprehensive AML/CFT law in 2015, following a National Risk Assessment. However, the

exercise identified remaining gaps including banking secrecy requirements, alignment of offences with international standards, and enforceability of AML/CFT legislation towards all professions. Concern has been expressed about curtailed provision of financial services to Lebanese banks, which might flag enhanced perceived weaknesses in Lebanon's AML/CFT regime. In early 2019, the more prominent role of Hezbollah in the government sparked new concerns that tightening US sanctions towards Iran and its proxy organisations might further aggravate the cut in correspondent banking relationships.

**Tackling corruption would address a major investment hurdle.** Government instability and corruption are the two most problematic factors for companies doing business in Lebanon, according to the World Economic Forum's Executive Opinion Survey 2017. The World Bank's Systematic Country Diagnostic highlights elite capture hidden behind the veil of confessionism as one of the two overarching constraints for Lebanon's development, next to regional violence (World Bank, 2016). The lack of sanctioning for the illegal activities of confessionally connected actors and the significant diversion of funds from the public sector into the pockets of public servants, their superiors and families are among the most prevalent corruption problems. While the government has reiterated that the fight against corruption is one of the priorities in its policy statement, concrete action will be key. This applies to anti-corruption legislation as well as the set-up and adequate resourcing of anti-corruption and external audit bodies.

## Outlook

**Without concrete reforms, Lebanon risks heading towards a combined currency, sovereign and banking crisis.** Nine months after the election,

Lebanon went back to square one. The reform and investment plan of the April 2018 CEDRE conference is all fleshed out, and international donors have been waiting for Lebanon to put the agreed preconditions in place. Bold moves are seen as essential in several areas to demonstrate the new government's commitment to the reform plans and to reinvigorate the reform momentum. Passing the 2019 budget and presenting a credible medium-term fiscal adjustment strategy will be the first of many steps to charter the path towards fiscal sustainability. Enhancing buffers and improving asset quality while dispelling concerns about Hezbollah's access to government funds will help to ensure the banking system's stability. Taking concrete steps in structural reforms, notably by completing and implementing the electricity reform agenda and fighting corruption, will be instrumental in regaining investor confidence and channelling financial inflows into more productive purposes to enhance Lebanon's long-term growth potential.

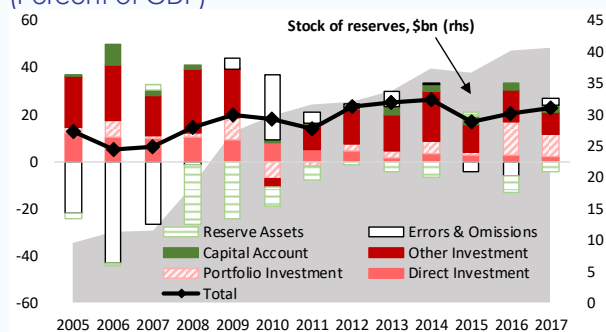
**Regional developments hold risks and opportunities.** The conflict in Syria has weighed heavily on Lebanon's economic and social fabric. Tourism took a substantial blow, and the country's already inadequate infrastructure was further stretched by the challenge of hosting large numbers of refugees. While the continuation or potential aggravation of hostilities in the region could further exacerbate Lebanon's economic woes, a stabilisation and nascent recovery in Syria could play into Lebanon's hands to the extent that the country now lays the foundations to position itself as a regional hub for reconstruction. Also in this perspective, the political capacity to act, regained fiscal space, a smoothly functioning banking system, and upgraded transport and energy infrastructure will be indispensable.

Box 1: ADDRESSING THE FISCAL-EXTERNAL-FINANCIAL NEXUS

**Financing Lebanon’s twin deficits through financial inflows has become harder.** Lebanon’s macro-financial stability crucially depends on the country’s ability to attract large-scale foreign deposits. Drawn by attractive interest rates for dollar-denominated deposits, a stable regulatory environment, and strict bank secrecy, foreign depositors including the wealthy Lebanese diaspora and investors from Gulf countries have traditionally ensured sizeable financial inflows, reflected in the financing of the current account deficit via portfolio and other investments, notably non-resident deposits.<sup>1</sup> Banks have in turn effectively used these deposits to fund onward lending to the sovereign, incentivised by the BdL. Attracting sufficient capital has been proving increasingly challenging as non-resident private sector deposit growth has been volatile and eased in recent years, amounting to 5.6% on average during 2018, down from 6.7% in 2017. In early 2019, non-resident deposits even recorded a net outflow on a month-on-month basis.

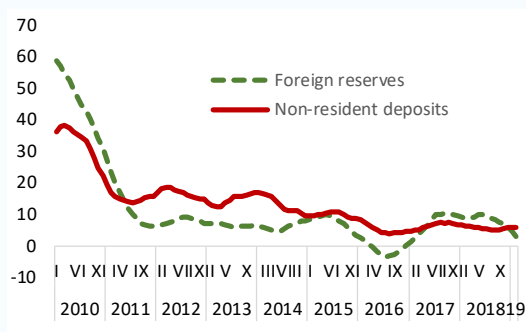
**The BdL has leaned against the wind with unconventional financial operations.** Aiming to prop up financial inflows and to beef up FX reserves, the BdL engaged in repeated swap operations starting in 2016. Swapping Eurobonds issued by the Ministry of Finance with local currency denominated bonds, and then partly selling the Eurobonds to domestic banks incentivised by a premium, the BdL succeeded in raising both its own reserves and the banking sectors’ capital base. However, the BdL’s balance sheet has paid the price for these transactions, and banks have been driving down their holdings in BIS banks abroad, effectively depriving banks of their foreign currency-denominated buffers and increasing their vulnerability by further raising their exposure to the sovereign.

Graph 15: **Capital and Financial Account** (Percent of GDP)



Source: BDL. Notes: The spike in portfolio investment in 2016-17 is due to debt issuance by the government and banks. Recent other investment divides into inflows into banks and external asset reductions by the private sector.

Graph 16: **Non-Resident Deposits and Reserves** (Year-on-year growth, 12-month moving average)



Source: Bdl

**To revive financial inflows more sustainably, renewed confidence in fiscal sustainability and financial stability will be indispensable.** The trust of foreign depositors is inextricably linked to the expectation that the currency peg will endure and that the sovereign will not default, as a sovereign default would impair two-thirds of bank asset. This could happen directly (as banks hold government bonds) or indirectly (as banks have deposits with the central bank, which holds government bonds) and could drive many banks into insolvency, thereby rendering them unable to honour their deposits. Lebanon enjoys a strong reputation for never having defaulted before, and for the strong and effective financial stabilisation role of the central bank. However, the emergence of any doubt could well trigger a self-fulfilling prophecy that would be very hard to contain. A credible, medium-term fiscal strategy is therefore vital to maintain the current funding model of the Lebanese economy.

<sup>1</sup> The precise composition of origin countries is not available.

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