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A NEW FINANCIAL DEAL FOR LEBANON

DEBT RELIEF AND WELL DESIGNED STIMULUS CAN PULL LEBANON OUT OF ECONOMIC MALAISE

Instead of continuing to support unaffordable housing prices, Lebanon's central bank needs to lead a drive for public debt relief and remodel its stimulus packages to serve the public interest.

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SUMMARY:

In recent years, the Banque du Liban (BDL), Lebanon's central bank, has introduced a number of stimulus packages in an attempt to catalyse the Lebanese economy. Through subsidising loans to specific sectors in Lebanese Pounds (LBP), the BDL claimed the low interest rates would spur growth, support small and medium-sized enterprises and create new jobs. However, there is scant evidence that the stimuli have achieved any of their purported objectives.

By pouring subsidised loans into the market, the BDL encouraged banks to inflate the housing sector, which took up the lion's share of subsidised loans. In effect, the stimuli fended off a much-needed correction in housing prices, priced the majority of Lebanese out of the market, and provided commercial banks with secure and collateralised profits. In turn, the banks continue to fund Lebanon's crippling public debt, and offer relatively high interest rates on local currency deposits to support the pound.

This financial triangle of real estate loans, public debt and customer deposits persists because it provides profits to another triangle: politicians (who own banks and real estate firms), bankers (who profit from subsidised loans) and other elites (who make interest off deposits). The result is decrepit public services and rotting infrastructure, neither of which are addressed because the state needs to pay off its debts first. This pocket-to-pocket system has functioned relatively well, until now.

Political turmoil, consistent lack of reform, and economic fundamentals have quashed demand for overpriced real estate, creating a perfect storm which threatens the financial status quo. For the first time in over a decade, pressure is mounting on the USD-LBP currency peg. Currency devaluation is on the horizon, and the folly of placing all your economic eggs in a basket full of empty tower blocks has become all too apparent.

To reverse decades of botched financial policies, Lebanon needs a New Financial Deal: one that trades debt relief for public sector reforms which spur economic growth in job-producing sectors. The deal would see the BDL and commercial banks forgive a significant part of their public debt holdings, which would free up money for public investment in physical and social infrastructure.

In return, the government would commit to a package of public sector reforms which spur sustainable economic growth, open up non-housing loan opportunities for the banking sector, and produce lasting benefits for all—the citizenry, the banks and the state. It is no doubt a tall order. But the alternative is an eventual crash of the real estate sector, the national currency, deep economic depression and, inevitably, social upheaval—all of which would be much worse than a little forgiveness.

> *"The folly of placing all your economic eggs in a basket full of empty tower blocks has become all too apparent."*

INTRODUCTION:

LEBANON'S VERSION OF QUANTITATIVE EASING

Since the 1990s the BDL has been stimulating demand in the loan market through indirect injections denominated in LBP.

The most notable interventions were the introduction of a subsidy scheme for medium and long-term loans (1997), introducing loan categories against which commercial banks could employ their reserve requirements (2001), extending the amount of reserves banks can tap into to 75% (2009)[1], and later upping that amount to 90% (2011) of the qualifying loan.

The sector prioritised by the BDL is clear from the composition of these exemptions: the majority of the loan categories eligible for reserve reduction are for housing (12 out of the 16 categories).[2] By 2013, banks could no longer benefit from these exemptions.[3] In response the BDL introduced a direct line of credit to commercial banks through an annual stimulus package which allows banks to offer subsidised loans in areas such as tourism, agriculture, industry, IT, the environment, education and, most significantly, housing.[4]

The first stimulus package introduced in early 2013 allocated USD 1.46 billion (LBP 2.21 trillion) to subsidised loans, followed by some USD 0.92 billion (LBP 1.4 trillion) in 2014,[5] and finally a total amount of some USD 0.95 billion (LBP 1.5 trillion) for each year between 2015 and 2017.[6] Subsidised loans offered to commercial banks on a first come, first serve basis carried an interest rate of 1%, which was increased in early 2018 to 1.5%.[7] Banks could then pass the loans onto consumers at almost half the cost of a conventional market loan, averaging some 4% across commercial banks.[8]

According to the BDL, the stimuli are intended to "create new job opportunities for the Lebanese youth and stimulate the Lebanese economy through ensuring the necessary financing for small and medium-sized enterprises."[9] In total, between exemptions to reserve requirements and subsidised loans, the BDL's governor has stated that by mid-July 2017 almost USD 14 billon was injected into the market.[10]

that does exist on the actual amount of subsidised loans in the market, 42% of the amount allocated in 2013 for the first stimulus (some USD 613 million or LBP 919 billion) was used solely for housing loans.[11,12] After 2013, how much and how many loans went to SMEs or job producing sectors has never been revealed by the BDL; neither has the proportion of the stimulus earmarked or dispensed for both housing and non-housing segments.[13] Reports from institutions with greater access to the BDL data, such as the World Bank, have put the proportion of the stimulus provided to non-real estate sectors in the single digits.[14] Indeed, when the stimulus was first introduced, the World Bank said its ultimate effects on GDP growth would be limited to 0.2 to 0.3 percentage points.[15]

"All available evidence points to the stimuli overwhelmingly supporting the housing portfolios of the banking sector instead of any real economic growth or job creation."

However, all available evidence points to the stimuli overwhelmingly supporting the housing portfolios of the banking sector instead of any real economic growth or job creation. Indeed, from the scant information

The BDL did not respond to repeated requests from Triangle for information on the stimulus programme, its components, or its actual disbursements and effects. The lack of transparency notwithstanding, in February 2018 the BDL broke with its policy of obfuscating of how the stimulus is allocated and spent when it announced a USD 1 billion (LBP 1.5 trillion) package split into five tranches:[16]

Type	USD	LBP
1. Housing Loans	500	750
2. Productive Sectors	5.3	8
3. Education	14.6	22
4. Microcredit	19.9	30
5. Various Sectors	460	690

(Amounts in millions)

The BDL also mandated that the first tranche, for housing loans, would have a minimum interest rate of 4.75%.[17] By early spring, the amount was insufficient to support demand for subsidised housing loans and many commercial banks froze their subsidised loan offerings.[18]

ANALYSIS:

NO GROWTH, NO HOUSING

It is not specifically the role of any central bank to create jobs and grow the economy. But when an institution such as the BDL sets out to do so, it is worth wondering how, whether and why it chooses to do so through housing loans. According to the World Bank: "little evidence exists regarding the effects of the BDL stimulus packages on economic growth or job creation."[19] Indeed, the economy only started to recover in 2016 (the latest figures available) and since then, growth has remained lacklustre at best (See Figure 1). The actual cause of this eventual recovery is likely to be the cyclical nature of economic boom and bust, rather than any effect of the stimulus. In fact, Lebanon's expected growth rates in 2017 and 2018 are expected to range between 1-1.5%, indicating yet another cyclical downturn.[20]

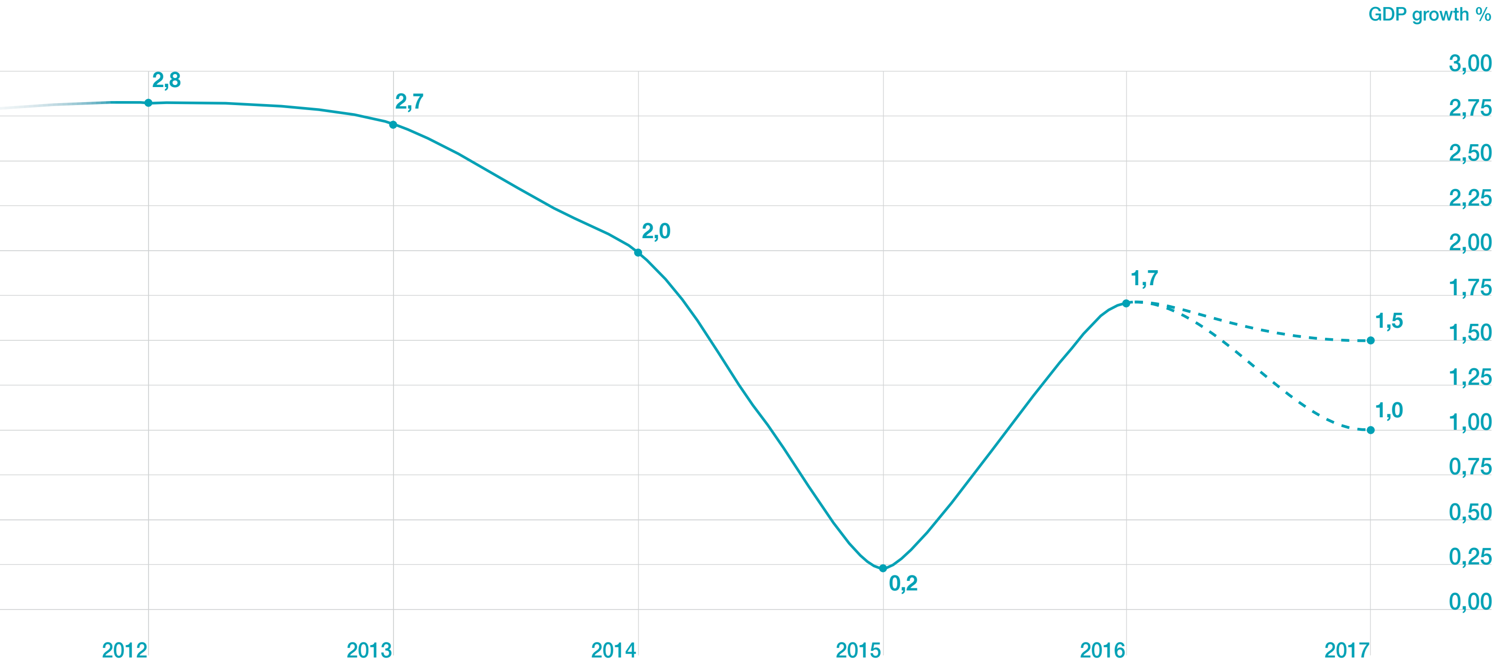
> *"Bottom line: the stimulus had little or no effect on growth and kept housing prices rising through cheap access to credit."*

Lebanon still does not have a national real estate pricing index to compare prices over time, despite global financial institutions repeated recommendations to institute one.[21] Yet recent price transmission studies show that the upward housing price effects of the stimuli came into effect just after the price of homes was beginning to flatten out in 2011.[22] What these studies show is a positive correlation between total value of loans to private sector and the average value of real estate price.[23] In detail, an increase in liabilities of 1% to the private sector increases the average value of real estate prices by 0.18%.[24] Bottom line: the stimulus had little or no effect on growth and kept housing prices rising through cheap access to credit.

HOUSING WON'T SAVE US

Since the BDL has decided to support housing prices through its stimulus package, it is important to understand the sector's size, its effects on job creation, as well as its usefulness to the economy and, ultimately, this policy's effect on the public. According to the latest breakdown of GDP, in 2016 the real estate industry (real estate, construction and mining) constituted around 20% of all production in the economy (See Figure 2), essentially indicating the extent to which GDP is dependent on the sector.

■ **Figure 1: GDP growth in Lebanon**



Source: Central Administration of Statistics, National Accounts, 2016
International Monetary Fund, Lebanon: Staff Concluding Statement of the 2018 Article IV Mission, 2018

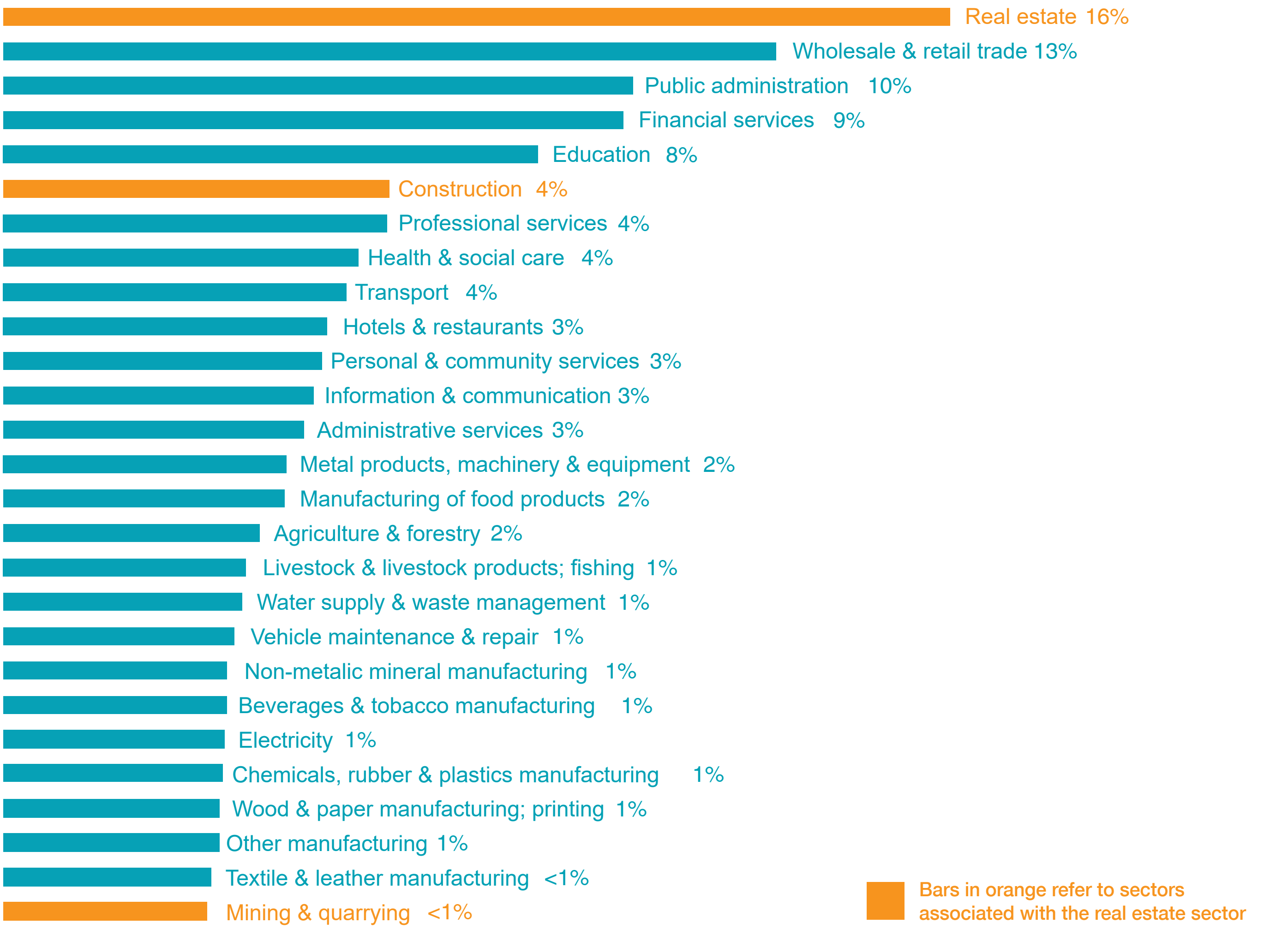
The amount of loans which go towards fuelling different sectors and their growth, however, paints a starkly different picture. According to the BDL, the real estate industry (housing loans, construction, trade and services in real estate, rent and employment) took up 41% of all loans in the economy in December 2017 (See Figure 3).[25]

In essence the stimulus supports housing prices in a sector that already accounts for over two times the value it contributes to the national economy. It could be argued, as those in the real estate sector do, that the sector creates a multiplier effect. However, that logic is the same across value chains throughout the economy, many of which produce higher multiplier effects and more local jobs.[26]

Indeed, the notion that the sector is a driver of jobs for Lebanese is illogical, given that the construction sector mainly employs informal Syrian labourers, and has done so long before the current refugee crisis.[27] Again, there is no reliable or representative data on labour market sectors in Lebanon because unemployment surveys are rarely carried out. Unemployment figures range anywhere from the official 10% (from 2009), to an as yet unsubstantiated claim by the President that unemployment has reached 46%.[28]

From the scant data that is available, the estimated number of jobs created each year does not

■ **Figure 2: Contribution of different sectors to GDP**



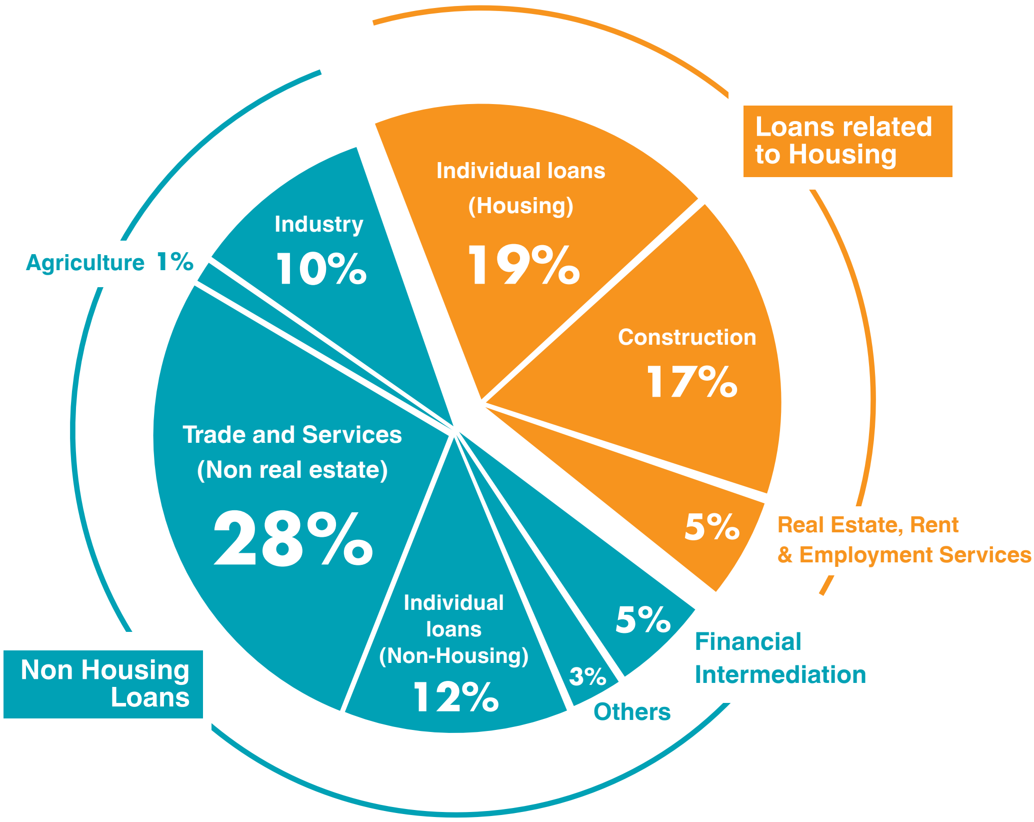
Source: Central Administration of Statistics, National Accounts, 2016

exceed 5,000, while the number of new labour market entrants is around 32,000.[29] Additionally, from the data available, construction jobs (the only quantifiable jobs directly attributed to real estate) contribute to only 10% of the meagre amount of jobs created in the economy, relative to sectors such as trade (61%) and services (33%).[30] Some existing jobs associated with real estate are created in low-productivity sectors of the economy, but these remain unclearly identified as they are lumped together with other low-productivity job classifications.[31]

Of course, Lebanon doesn't need more low-skilled, low-wage, low-productivity employment, which is what every development agency and international financial institution has been saying for years.[32]

In fact, studies in developed economies such as the United States show that for every USD 1 billion invested in job creation, 26,700 direct and indirect jobs

■ **Figure 3: Sectorial distribution of loans**



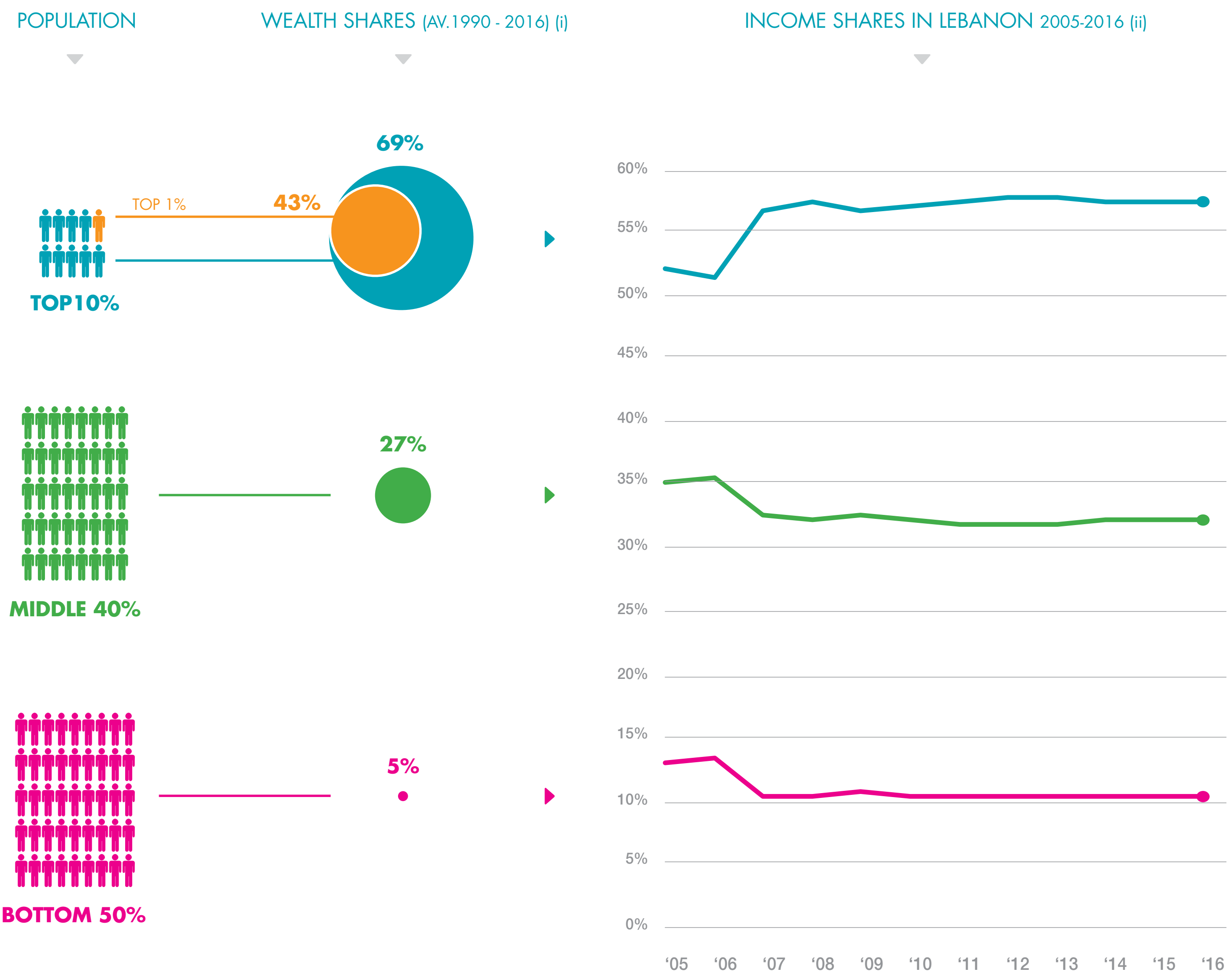
Source: The BDL Quarterly, December 2017

in education can be created, in addition to 17,200 jobs in healthcare and 16,800 jobs in clean energy. While the USA's and Lebanon's economies are not overly comparable, nonetheless a significant number of jobs could have been created from the nearly USD 14 billion in stimulus packages provided by the BDL if the money had been focused on sectors other than real estate.[33]

In short, instead of significantly supporting job creation and contributing to bolstering the productivity of the workforce, the stimulus targets a sector that does the opposite. Making matters worse is the fact that the stimulus contributes to wiping out people's real wages through inflation, which is now once again starting to spiral out of control. In the year to August 2018, inflation has risen by 6.53%.[34] Using rent inflation (the only price proxy available for housing prices), we can observe that since the BDL enacted its stimulus policy in 2013, real rents paid by tenants have increased by 29%.[35]

Of course, those who rent are not those who own, and thus many of those who suffer from higher rental prices are bound to be from the lower echelons of society. This begs another

Figure 4: Wealth and income shares in Lebanon



Sources: (i) Assouad, Lydia, Rethinking the Lebanese Economic Miracle: The Extreme Concentration of Income and Wealth in Lebanon 2005-2014, 19 September 2018
(ii) Estimates obtained by combining billionaire data for Lebanon, generalized Pareto interpolation and normalized World Inequality Database distributions.

question: How much of the population actually benefits from the housing subsidy? According to the most recent figures available, mortgage penetration, or the proportion of the population that has a mortgage, is estimated at 6%, meaning nearly all Lebanese have no access to housing loans in the first place.[36]

Keeping people out of the housing market while rents continue to increase is bound to have negative effects on inequality. Recent studies have shown that Lebanon suffers from one of the widest disparities in both income and wealth inequality: the richest 10% of Lebanese took in 56% of national income between 2005 and 2014, while the richest 1% take in 23% of total national income.[37] By contrast, the bottom 50% of the population have an income of around half of what the top 1% does.[38] And it gets worse: the richest 0.1% of Lebanese makes as much income as half the country.[39]

As a result, wealth concentration in the upper echelons of society has mushroomed: the richest 10% of the population holds around 70% of the country's wealth while the richest 1% holds a whopping 45% (See Figure 4).[40] By comparison, the richest 1% of Lebanese holds more national wealth than the richest 1% in the United States, Russia, China or France.[41]

OF BANKS & BILLIONAIRES

One could make the argument that support to the real estate sector is, in itself, a sound policy given that it is currently the largest sector of the economy—were it to falter so too would the rest of the economy. Indeed, that is the more plausible and understandable objective of the stimulus: the BDL is keen to support the loan portfolios and profitability of the banking sector due to the sector's direct and indirect exposure to the real estate through housing loans and real estate collateral.

During the boom years from 2001 to 2011, three-fourths of the current real estate portfolios accrued, while housing and construction loans increased by 278% and 112% respectively.[42] The banking sector is also indirectly exposed to real estate markets through collateral obligations and lending to developers, meaning 90% of all loans in the country are exposed to real estate in one form or another.[43]

As this brief has shown, by supporting real estate prices, the BDL is not creating any significant number of jobs, but propping up unaffordable housing prices and fuelling inflation which slashes real wages. At the same time, the stimulus maintains artificial housing prices against market forces. And for the BDL, there seems to be no viable alternative to this vicious cycle until a serious reconsideration of the post-war relationship between the state and the banking sector materialises.

Since the end of the civil war, the banking sector has funded the state, sometimes at exorbitant interest rates of over 30%.[44] The model of using debt instead of taxes to finance reconstruction was questioned at the time and, rather predictably, turned out to be a policy that contributed to Lebanon holding a debt-to-GDP ratio of some 160%, third behind Greece and Japan, which are of course already developed economies.

> *"The richest 10% of the population holds around 70% of the country's wealth while the richest 1% holds a whopping 45%."*

Yet unlike its Mediterranean cousin in Greece, the vast majority of the debt is held locally.[45] Local ownership of public debt is often heralded as positive, given that it binds the holders to the fate of the country —but there is, of course, a catch. The BDL itself holds more of the public debt than any other entity. Indeed, Lebanon's central bank holds 48% of local currency debt (USD 23.6 billion) in its vaults and, because it does not publish the amount, an unknown amount of foreign currency debt. The BDL does publish a vague statement about 'claims on the public sector', which do not necessarily represent the actual debt. Using a crude method of subtracting the central bank's foreign currency holdings from its foreign assets, one can get an idea of the BDL's debt in foreign currencies, which came to USD 20.6 billion in 2017. That brings the total proportion of public debt the BDL holds to some 55% (USD 44.2 billion), relative to some 40% held by commercial banks and 5% held by other financial institutions and debtors.[46]

In sum, the institution that manages the debt of the state holds the majority of that very same debt and, along with the commercial banks it offers subsidised loans to, makes a healthy profit off the interest charged: as of September 2018 one-year treasury bills (T-bills) in LBP yielded around 5.35%, while five-year T-bills yielded 6.47%.[47] Interest rate payments to service the public debt make up around a third of the state's total budget (around USD 5 billion/year),[48] effectively impeding the state's ability to fund public services, and leaving the Lebanese at the mercy of private service providers to cover everything from electricity, to water, to adequate healthcare.[49]

By the end of August 2018, public debt stood USD 84 billion, constituting an increase of 5.2% from USD 79.5 billion at the end of 2017. The continual ballooning of public debt–which has doubled over the past decade–requires a continuous injection of capital from remittances and deposits. Indeed, local and expatriate Lebanese are eager to invest their money in deposit accounts in LBP to benefit from slightly higher interest rates relative to the public debt (the average interest rate on deposits was 7.12% on LBP and 4.23% on USD in September 2018).[50]

But as commercial banks have to get their profit from somewhere, the stimulus provides a sure shot way for banks to have cheap access to credit, solid collateral from mortgages, and thus healthy and secure profits—the difference between what banks pay out to depositors is covered by what they receive from the government and from their largest portfolio, the real estate sector. Since 2011, there has continually been some USD 400 million in mortgages performing in the market.[51] This has all translated into healthy profits for the banking sector. In 2017, Lebanon's top banks[52]—which account for almost 90% of banking sector assets—made a total of USD 2.4 billion in profits and held assets of USD 233 billion, or some four times the size of the economy.[53]

As long as deposits flow in and there is confidence in the pound, the system works well: the BDL is able to offer subsidised loans in LBP, guarantee itself and the banks a healthy profit margin across their portfolios, the interest (never the principal) on public debt is paid, and everyone goes about their business. But it is never that simple in Lebanon.

When the current Prime Minister-designate Saad Hariri unexpectedly resigned from office in November 2017, there was a run on the pound. Some commercial banks started to offer interest rates on LBP deposits of up to 15% to keep LBP in the vaults.[54]

> *"The continual ballooning of public debt–which has doubled over the past decade–requires a continuous injection of capital from remittances and deposits."*

Perhaps, not by complete coincidence, this is also when the BDL, quite rightly, began to reconsider its stimulus policy. By continuing to artificially inflate housing prices, the BDL knows it is only prolonging the pain of an eventual correction that is already taking place in the housing market. Of course, there is pressure on the BDL not to withdraw its support, and it's not hard to figure out where that pressure really comes from: 18 out of 20 major local banks have major shareholders linked to the political elites in Lebanon and 43% of banking assets in the sector can be attributed to political figures who either were or are currently in public office.[55]

CONCLUSION:

TIME TO BALANCE THE BOOKS

Whether through subsidising real estate or raising interest rates, the BDL and the Government of Lebanon (GoL) are only prolonging the inevitable moment when the numbers won't add up anymore. Yet fears that the LBP will devalue are likely to be unfounded: the central bank has USD 56.66 billion in foreign reserves to support the LBP,[56] of which USD 11.36 billion (LBP 17.12 trillion) is gold bullion.[57] But what is perhaps even more of a risk to the public good could be what is yet to come.

Now that real estate is no longer yielding as much profitability and inflation has reared its ugly head again, banks will almost undoubtedly demand higher rates to fund the government. The problem is that the government, which is connected to those same bankers, is fast becoming less able to justify a bourgeoning debt, and there are few options available.[58]

"Instead of continuing to focus on bolstering the real estate sector, the BDL, the GoL and the commercial banks need to enact a New Financial Deal for Lebanon."

Already at the top of the list of possible fixes is privatisation of the few remaining public goods: telecoms, electricity, water and so on.[59] The new public-private partnership (PPP) law is also being touted as possible fix for the problem, allowing banks to start funding public services and charging a fee for them. In tandem, there will almost certainly be calls to implement austerity in an economy which, as the past decade of austerity regimes in Europe have shown, results in economic malaise, a resurgence of (often ugly) populism, and weaker public services.

RECOMMENDATIONS:

A NEW DEAL FOR LEBANON

While perhaps designed badly in Lebanon, in principle demand side quantitative easing in the form of stimulus has proven useful across the globe. Thus, instead of continuing to focus on bolstering the real estate sector, the BDL, the GoL and the commercial banks need to come together to enact a New Financial Deal for Lebanon. Conferences such as CEDRE can be beneficial, but will not resolve the vicious cycle of debt, artificial real estate prices and reliance on customer deposits.

Instead of allowing this to happen, then clamouring for the state to sell off its assets, a New Financial Deal will need to be based on a conditional haircut of the locally-held public debt. Given that the BDL is a public entity which holds more of the national debt than any other entity, it should be the one leading a drive to write down a large portion of the debt burden crippling the state and society.

The actual amount of debt relief can be calculated against savings in interest rate payments required to fund the much needed and called for reforms that the BDL, commercial banks and international organizations have been clamouring for decades about: civil service reform, infrastructure upgrades and social safety nets. In return the government must commit to a package of public sector reforms which spur economic growth in sectors that produce jobs for the Lebanese, growth for the economy, non-housing loan opportunities for the banking sector, and benefits for everyone —the citizenry, the banks and the state. At the same time, there will need to be a downward correction in the housing market and a policy focus on affordable housing. Then talk of a stimulus can recommence as part of the wider reform process (See Box 1).

Indeed, if just half of the USD 5 billion in interest paid on the debt in 2017 were freed per year freed up, the USD 5 billon required to implement the five-year electricity sector reform programme could easily be allocated, and then some.[60] Such moves will require genuine commitment from politicians and bankers, who are often one and the same person, to look beyond their own narrow interests. Yet the alternative is an eventual crash of the real estate sector, the national currency, deep economic depression and, inevitably, social upheaval—the consequences of which would be much worse than a little debt forgiveness.

Box 1: Remodelled stimulus is key

For starters, the principle of any future stimulus should be to target job producing sectors first, and second to wean the real estate sector off cheap loans. As a reference guide, productive job-producing sectors (e.g. renewables, agri-food, industry) should eventually take up the lion's share of stimulus packages, to the tune of 70% or more. The remaining 30% of the stimulus should then be used to supporting loans solely through the Banque de l'Habitat (BDH), the Public Housing Corporation (PHC) as well as towards construction for affordable housing. Managing this type of correction over the next couple of years, while keeping an eye on inflation, would allow banks to transition loan departments towards lending to more productive sectors and ensure that the correction in real estate prices is managed sustainably.

The ultimate aim of such a transition would be to support a national housing strategy, which seeks to provide affordable housing and reliable transport options to the population. There are a raft of incentive schemes that can be employed by the GoL to promote affordable housing, and even ways to fund such a move through long-awaited and required taxes on high-end properties, particularly unoccupied residences. Such measures would allow for inflation to be kept in check, as well as produce the type of local socioeconomic development required to reverse rampant urbanisation and concentration of economic activity in the capital. A real public housing initiative could even be need-based by employing a revamped version of the National Poverty Targeting Programme's already available means testing platform.

For these reforms to be effective, the GoL and the BDL will need to be more transparent about the state of the housing market by first actually collecting and disseminating housing loan and price data. The dissemination of an index of house prices and a revamping of the real estate appraisals apparatus will be the first step in this process. That way, as this transition comes into place, the government and the BDL can actually have the tools to monitor and ensure that the majority, rather than the minority, of Lebanese can afford a home.

EDITOR'S NOTES:

Triangle has filed a freedom of information request to acquire stimulus loan data from the BDL.

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