

# LEBANON

## An upcoming liquidity crisis? 2019

---

On the October 17<sup>th</sup>, the Lebanese Government had announced the introduction of a tax on voice calls made through applications like WhatsApp. This announcement pulls the trigger for massive protestations from the Lebanese people, the largest in the country in 14 years.

The day after the government went back on its announce and delete the tax. Despite this fact, there are still thousands in streets that keep protesting and asking for the political elite demission. Days after days tensions are rising and the movement becomes more and more violent. This shows to the world a malaise deeper than just a political crisis.

OCTOBER 28

---

Tristan RICHEFEU-COSTA  
Baptiste BERGOUGNOU  
Pierre CAILLER  
Leyti DIENG-SARKISSIAN



# Outlook

The political crisis is just the tip of the iceberg coming from more structural issues:

- The structural budget deficit is around 11.5% of GDP (World Bank).
- The government is indebted at 150% of GDP (World Bank).
- There is a strong political instability due to historical reason but also to recent events such as the Syrian migration (¼ of the total Lebanese population come from Syrian refugees).
- There is a crisis of confidence within the country between the population and the Government.
- Strong shortfall of dollar reserve and liquidity crisis.

In order to fulfill the growing social demand, start structural reforms and shoring up Lebanon's public finances, a Eurobond of around \$2 billion is being prepared for sale this month.

***“Lebanon was going through an unprecedented, difficult time” Prime minister Saad Hariri.***

We analyze Lebanon's political, economic and financial situation to assess if there is a good investment opportunity in this emission. By looking deeply into different subjects such as the current political system, the economic situation, the balance of payments, the insurance cost of this investment, we are going to give precise advice about Lebanon's near future.



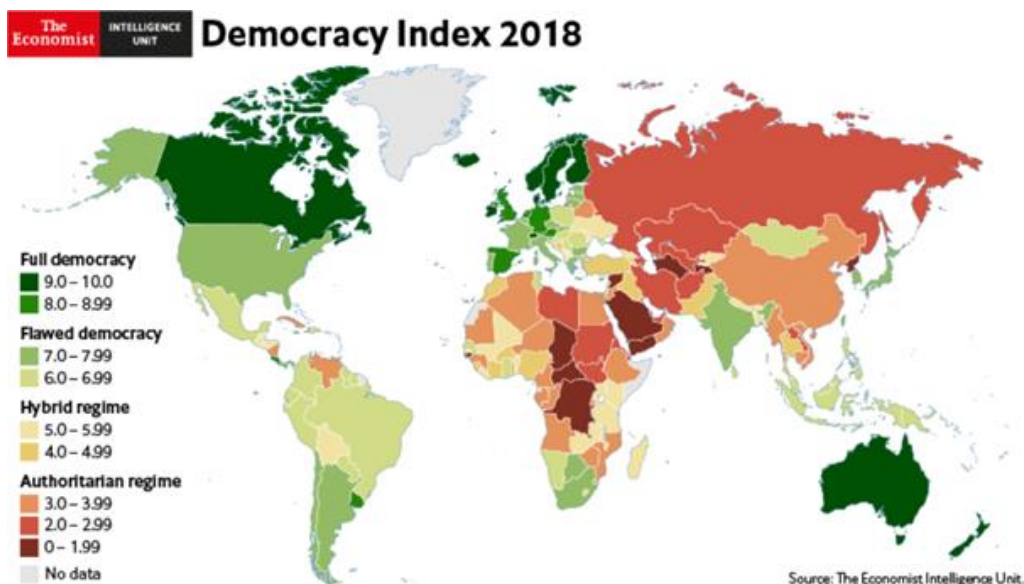
Photo credit: The Guardian - Photograph: Sam Tarling 10/18/2019

# Internal Policy

To analyze whether one should invest in a debt emission, the first step is to take a glance into the political life of the country. It allows the investors to have a quick look at the situation and may understand the risks of the investment. With the current situation in Lebanon, the socio-political environment is under a lot of pressure. We will first oversee the recent news highlighting the country, then describe its role in the broader scope of the Middle East. Finally, we will be able, based on socio-political factors to have a first idea concerning the proposed investment.

With a life Esperance of 81,52 years for women, a 94% rate of alphabetization and infantile mortality of 7,10%, one could expect to see Lebanon as a safe haven in the Middle East. But as soon as you see the news, the strike, the threat of revolution, you could expect to get some explanation.

The reason is simple: a stagnant environment where corruption is everywhere. According to the Transparency international CPI, Lebanon stands at 138 places over 180. The same parties have dominated the political spectrum for decades and the population sees a widening gap between a minority of favored people and the rest of the population. People are not only protesting against a tax on WhatsApp which launched the strike in October, but more against a system that fails to bring the life necessities to its people: water shortages, an inefficient health care system, etc.



In response, since mid-October, people have starting to get into the street to demand some major reforms and the demission of every member of the government with slogans like “the people want the downfall of the regime” a reminder to the Arab springs.

We actually managed to get an interview from a 23-year-old Lebanese who told us that:

***“People in the streets don’t actually manifest, they are launching a revolution. We want all the politicians to step down, and from there we want a single neutral individual that can form a new government, for the people, with the people.”***

In response, Saad Hariri withdrew the tax on WhatsApp and decided to reduce wages from members of the government, but people fear that with such a high level of corruption, the parties in place will not want to let go of their privilege that easily. There is high tension that may even lead to a revolution if the government in place doesn’t find a proper way of changing things. The challenge for an investor is here to guess if the strike can go on and launch a revolution or if the government will find a way to calm its people.

There is high tension within the country, showing that an investment in Lebanon, disregarding of the asset class, is risky, meaning that it has to be compensated by high returns to be worth it. As said earlier, reforming the country will not be an easy task, the question is whether Lebanon is able to adopt concrete reforms on its own or will it need help from other countries to calm its people.

## External Policy



As part of the Middle East, Lebanon has a good relationship with the powerful nation in the region. For instance, Saudi Arabia has agreed to open a new line of credit of about \$1 Billion. This could help Lebanon in case of a deep crisis by giving them quick and cheap access to dollar. But this relation between Lebanon and Gulf countries is also endangered by various factors.

The next step in our analysis is thus expanding our scope to look for the situation in Lebanon both with its region and within the world. As one of the only democracies in the Middle East, and also one of the most developed countries in the region its role is really important, both on the economic side and socio-political one. However, as our analysis is about the new debt emission by Lebanon, we will focus on the relationship that can directly affect this subject. relationship between Lebanon and the Hezbollah, a pro-Iran militia. To put into context, Israel invaded southern-Lebanon following the Lebanon Civil War

---

(1982), following the Taif Agreement, the situation was settled, and Hezbollah was left the only militia in Lebanon.

However, as you should know, there is tension between Saudi Arabia and the Republic of Iran. Thus, Saudi Arabia is logically against the presence of Hezbollah in an ally territory. In 2017, in visit to Riyadh, the prime minister of Lebanon decided to step down, assuming there was an attempt to his life by Hezbollah militia. For many people including the president of Lebanon Michel Aoun this situation was a hostile situation plotted by Saudi Arabia. This event has tensed the bilateral relationship between the two countries.

On a broader scale, following the 2017 incident in Riyadh, Emmanuel Macron canceled his trip to Saudi Arabia showing the strong bilateral relationship between France and Lebanon. France has also promised to give Lebanon (€200 million of donation and a loan of €900 million). This added to its objective of strengthening the democracy in the country shows the role of France not on an economic side but can also from preventing a revolution that can do more harm than benefits for investors.

As for the political perspective, we see little chance of major reforms in the near-medium term. Corruption is too rooted in the core of the system to make changes possible. Even a revolution would not be a relief for investors as it should come with major economic turbulences, assuming that the revolution manage to bring a more democratic and economically safe environment, which, seeing the example of the Arab spring is not always the case. On a broader scope, we have seen that Lebanon can count on international aid from several countries but we are not sure that this help packages will be able to support its economy. Before getting to a conclusion, we will now look deeper into the economic side of the question to see whether or not you should invest in Lebanese new Eurobond emission.

Political instability often goes with pair with economic chaos. Given the previous assumptions, will Lebanese Economy counterbalance the current framework?

# Economic Analysis

To understand the Lebanese economy, it is crucial to observe the Balance Of Payments and some economical ratios.

## Current Account Balance:

Exports	4228
Imports	-18939
Trade Balance	-14711
Services Revenues	1929
Income	-3441
Transfers	772
Current account Balance	-15451
Capital Account	1551
FDI	1757
Portfolio	7387
E&Os	0
Overall Balance	-4756
GDP	58565
Current Account/GDP	26.4%
Exports/GDP	7.2%
Imports/GDP	-32.3%
Trade openness ratio	39.6%

According to the IMF and their country report, the projected trade balance over 2019 is highly negative. Lebanon is a net importer country that relies a lot on China (12% share of total imports by destination in Lebanon) and oil (17% share of total imports by product). Its main trade partners - United Arab Emirates, Saudi Arabia, Syria, and Iraq - have lowered their importation of Lebanese products. Like all Chinese partners, Lebanon has also been impacted by the giant country's economic slowdown.

Slightly positive services revenues and transfers can't balance the large negative net income (high debit and approx. 700 interest payments). Total Current Account Deficit reaches a level of \$15,450 Million. IMF projections show that the situation will go deeper in deficit territory over the next 5 years.

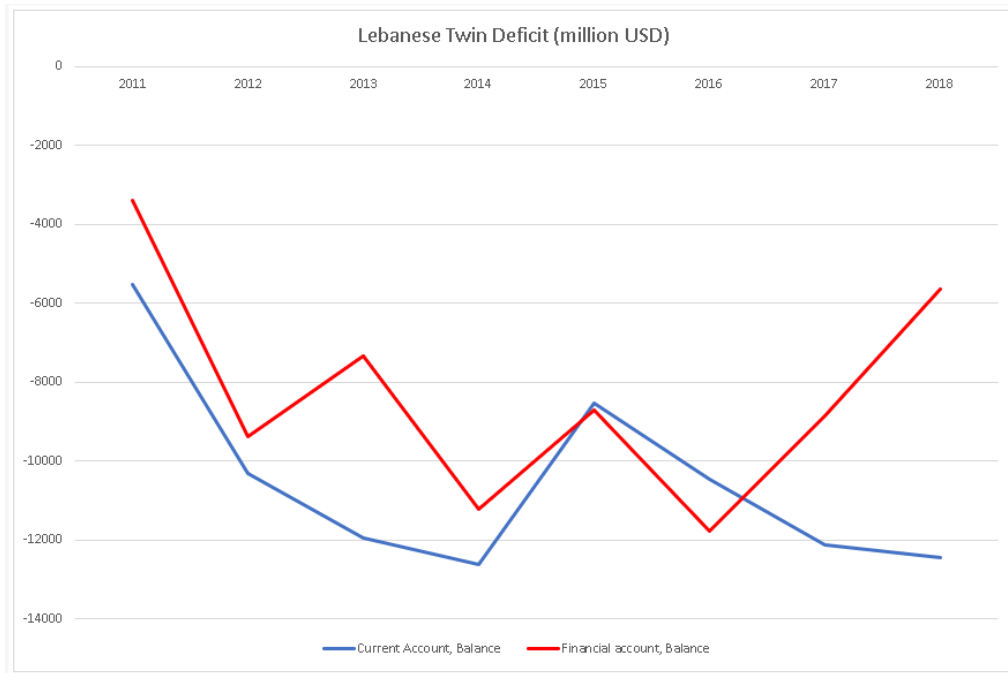
The Current Account situation is a major problem in Lebanon due to the rigidity of the pound. Lebanon can't easily play on its currency to engage

competitiveness on Trade Balance. With a \$58,565 Million GDP in 2019, the deficit reaches a 26% deficit compared to a 7% export to GDP ratio. Lebanon has to find a way to finance its deficit either by lowering its debit or trying to re-evaluate the US dollar/pound pair. This last strategy seems not likely to happen according to the current liquidity crisis and dollar shorting. Lebanon's Dilemma will be to choose between austerity measures in order to improve the balance of payment and the people's riots asking for more social spending.

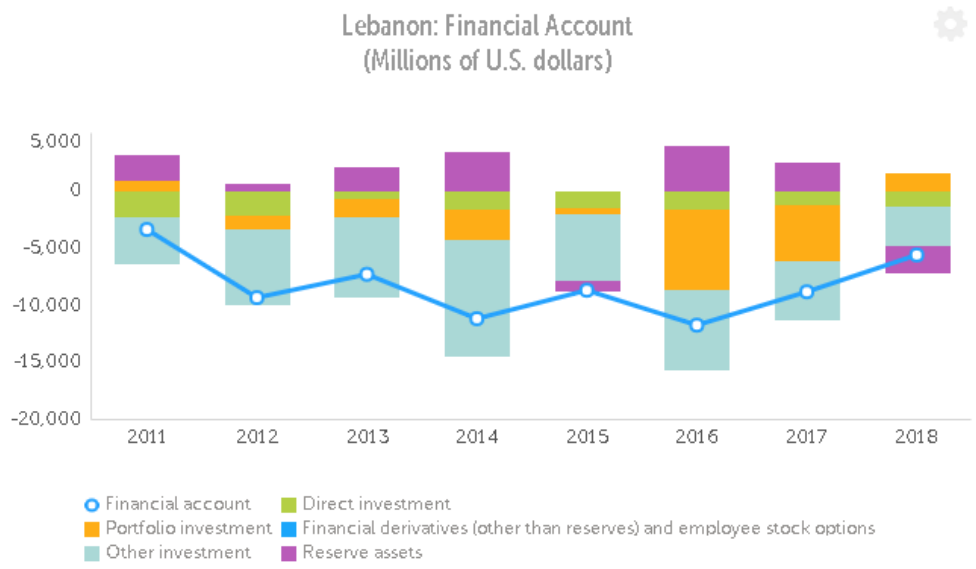
## Studying the Balance of Payments shows a significant twin deficit in Lebanon:

The Capital and Fiscal Account are not strong enough to compensate for the Current Account Deficit. After Lebanese Middle East partners decided to lower their Foreign Direct Investment to Lebanon, the inflows of FDI only represents less than 10% of fiscal inflows. Current instability will likely imply decreasing banks' non-resident deposits that represents more than half of the Lebanese Portfolio. The Diaspora, one of the Lebanese strengths, seems slightly unarmed to answer such reserve needs.

The budget deficit reached 11.2% of GDP in 2018 with a public debt at around 150% of GDP. While the



government made announces of reducing debt servicing costs and set a 9% target in 2019, the political uncertainty and economic instability forced the government to emit \$2 billion Eurobonds to refinance near-maturity debt and shore public finances. (IMF graph)



# Liquidity Crisis

The actual global slowdown due to Sino-US trade war and uncertainty over Brexit mixed with intern political tensions raised questions on the current situation in Lebanon. With the third-highest debt to GDP ratio in the world (152.8% - Bloomberg), investors are now less confident in the robustness of the country to face the current situation.

This reluctance can be seen in the left graph below with the negative correlation between the debt ratio and FDI (Foreign Direct Investment) inflow. Despite a high-Interest rate (about 7.7%) and the appetite for risk from investors due to negative rates in western countries, deposits of hard currency fell in May for the first time in decades.

Adding to that, as described above, the geopolitical situation does not promote tourism in the country. This sector was before a huge source of foreign exchange.



To top it all rating agency Moody's on Tuesday warned that government reliance on BdL (Banque du Liban) reserves to pay off forthcoming debt obligations "risks destabilizing the BdL's ability to sustain the currency peg" (USD/LBP = 1511). The country has a heavy schedule of FX debt payments coming up, with \$1.5 billion due in November and a further \$2.5 billion between March and June next year, according to Reuters.

Another fact that illustrates the pressure on Lebanon's monetary system is the foreign exchange measure introduced at the beginning of October which offers a fixed exchange rate and access facility to importers of essential goods (oil, medicine & wheat mostly) after business owners have complained that banks are increasingly unwilling to convert Lebanese pounds into dollars and that market demand for dollars is driving up the cost of converting at more informal foreign exchange brokers.

Lebanon is a large importer country with a widening balance of payments deficit. These incompressible dollar outflows are putting more and more pressure on the FX reserve.

Sami Atallah, director at the Lebanese Center for Policy Studies think-tank in Beirut, said: “We’ve basically been living beyond our means and importing as if there’s no tomorrow. “We need to rebalance the economy.”



The foreign exchange reserves are melting and quickly. The strong necessity of dollar, at least for maintaining the peg currency, is more than crucial. Some banks began telephoning customers asking if they had foreign currencies they could deposit to earn interest rates of up to 15 percent on five-year term Lebanese pound deposits. Others have limited the daily withdrawal of dollar per day.

“The priority today for the central bank is to raise rates to attract capital and preserve capital in foreign currency in Lebanon so we can continue with the policy of stabilizing the pound, which is the top priority,” Raed Khoury

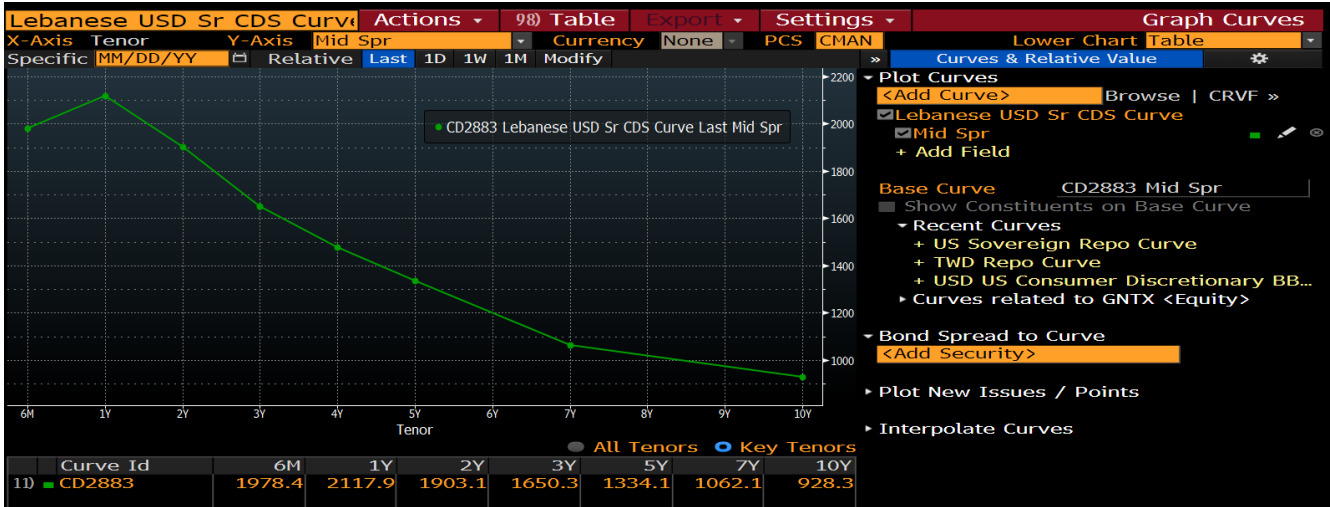
But at what cost! Plumbing the economy in a period where economic growth is harder than ever! Lebanon desperately needs structural fiscal reforms and political stability to expect to overcome this situation.

This Eurobonds emission could be interpreted as a sign of pressure to overcome the upcoming future.

## Market Analysis

In recent weeks, the markets have been very concerned by the issue of Lebanon. The CDS curve was inverted with higher spreads for the shortest maturities, demonstrating that Lebanon has entered the distressed country category. The probability of default at 1 year is obvious (CDS 1-Year at 2117.87 and the highest spread of the curve), the fear of a short-term credit event is being considered by a large number of agents due to debt payments of 4 billion by June 2020 and the issuance of a Eurobond for an amount of 2 billion.

The spread analysis between different maturities shows an increasingly pronounced gap since the beginning of the year, demonstrating a lack of confidence in the country's resources.

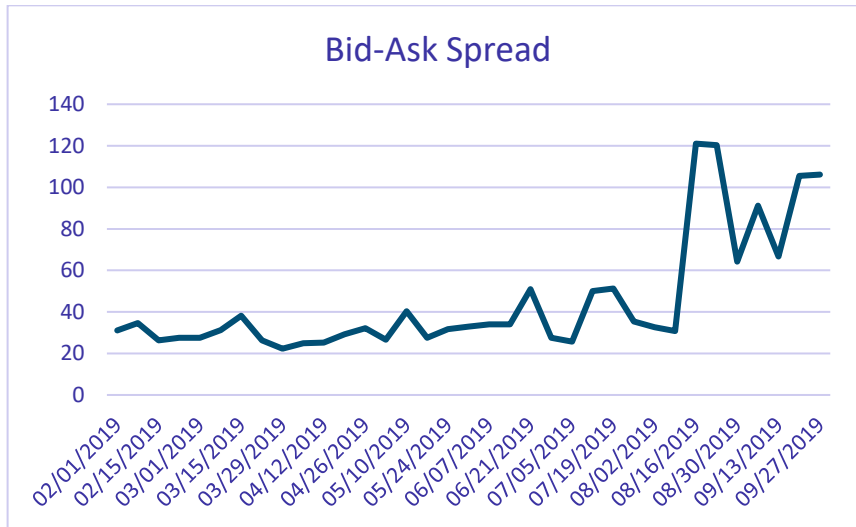


The increase in CDS prices at the shortest maturities since July 2019 increased sharply from September to reach highs from mid-October. The 5-year CDS is quoted at 1334.055, the 2-year at 1903.085 where the CDS with one year has taken 51.2% in 15 days. This reflects an increase in insurance costs against a possible default of Lebanon, reflecting the loss of market confidence in Lebanon's financial and budgetary capacities.



The bid-ask spread analysis reflects the supply and demand movements in the CDS market. It is also a measure of liquidity - lower spreads being the hallmark of a liquid market. We have analyzed these spreads on the 5-year CDS - the most traded CDS - since the beginning of 2019.

We observe a significant increase in spreads from August 2019 until we reach the 120-point gap. Over the month of September there is an average of 92.39 points of difference, proof of a financial situation that is not improving. Thus, the more the bid-ask spread increases, the more volatility increases and therefore by extension the risk associated with Lebanon.



	Mean	Median
Feb.2019	29.895	693.955
Mar. 2019	29.084	27.5
Apr. 2019	27.8925	27.21
May. 2019	31.814	31.66
Jun. 2019	36.6375	33.995
Jul.2019	40.5925	42.73
Aug. 2019	84.0375	64.17
Sep. 2019	92.395	98.39

Since the liquidity of the CDS market is closely linked to the liquidity of the equity and bond markets, the same type of problem can be observed, particularly in the bond market.

CDS spreads and bond yields are positively correlated, an increase in CDS spreads correspond to an increase in bond yield, leading to a decrease in bond prices. This reflects irregularities in Lebanon's financial health. Therefore, the emission of a bond next month concerns us: as the creditworthiness of Lebanon is questioned, the price will be seriously affected on the secondary market because investors will not be interested in paying more as they thought that the issuer will not be capable of paying the interest on the current debt and the new coming one.



---

We also notice an inversion in the yield curve with the 10-year bond yield at 14.647, the 5-year one at 18.608 and the 2-year at 24.246.

This shows that investors are demanding higher short-term yields considering the risk associated with possible late payments, or even a partial or total default on Lebanon's debt.

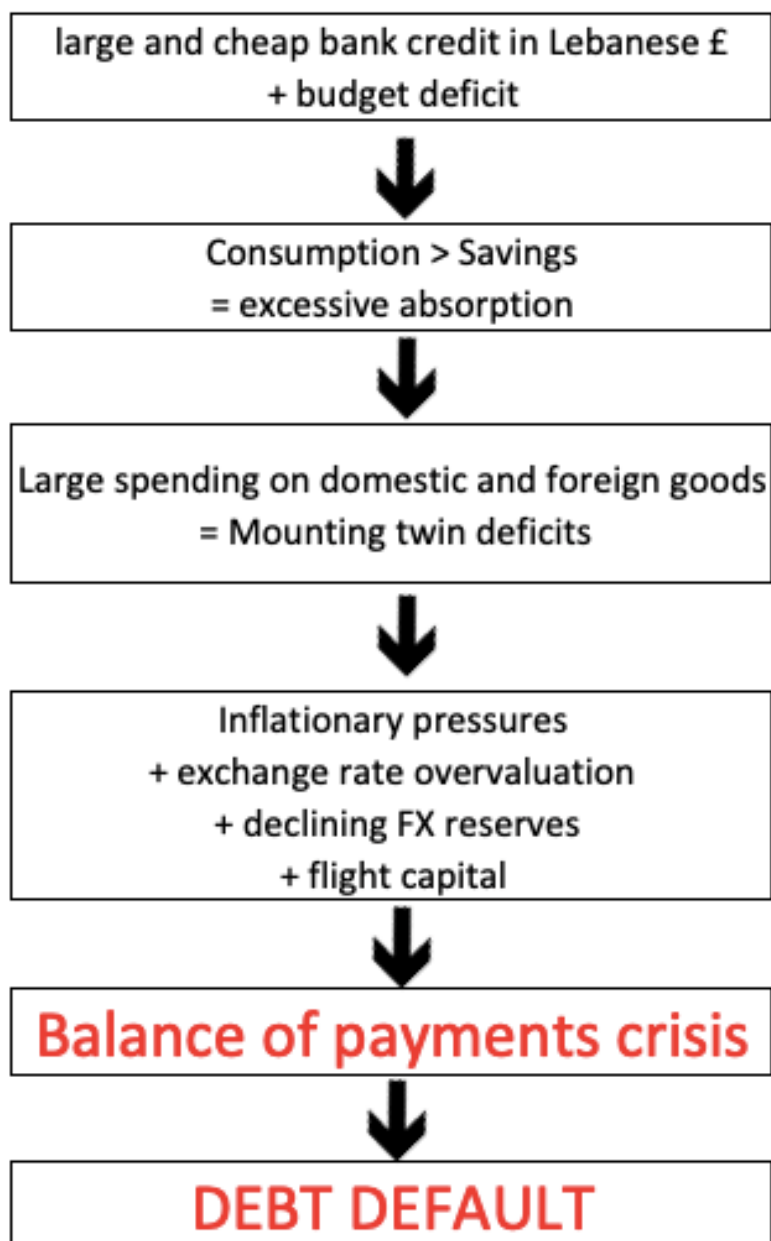
Regarding all the different issues that Lebanon is currently facing, we do not recommend to invest in the upcoming Eurobonds emission. Both politically and economically Lebanon stakeholders required strong and clear actions.

The ongoing strikes only showing years of misleading management within the country.

As analysts, our expectations about the future of Lebanon are strongly depending on how the government will handle the situation

---

Economic situation scheme



---

# Index

“Lebanon eases dollar flow for importers as crisis grows”, The Financial Times, <https://www.ft.com/content/3cc23068-e501-11e9-9743-db5a370481bc>

“Lebanon banks suck in dollars to maintain peg, but economy stagnates”, Reuters <https://www.reuters.com/article/us-lebanon-economy/lebanon-banks-suck-in-dollars-to-maintain-peg-but-economy-stagnates-idUSKBN1L11IR>

“Moody’s puts Lebanon under review for downgrade as monetary crisis deepens”, The Financial Times, <https://www.ft.com/content/fd499728-e474-11e9-9743-db5a370481bc>

“Lebanon’s crisis complicated by Gulf rivalry”, The Financial Times, <https://www.ft.com/content/aab53442-23ca-11e9-b329-c7e6ceb5ffdf>

“Lebanon could be headed for a cash crisis as banks remain shut a week into mass protests”, CNBC, <https://www.cnbc.com/2019/10/23/lebanon-protests-fears-of-a-cash-crisis-as-banks-remain-shut.html>

IMF data <http://data.imf.org/?sk=7A51304B-6426-40C0-83DD-CA473CA1FD52&sid=1484255909483>

“Le Liban, otage du Moyen Orient”, Arte Reportage <https://www.arte.tv/fr/videos/083304-000-A/le-liban-otage-du-moyen-orient/>

<https://www.worldbank.org/en/country/lebanon/overview>

Transparency International <https://www.transparency.org/country/LBN>

COFACE <https://www.coface.com/Economic-Studies-and-Country-Risks/Lebanon?fbclid=IwAR2fQ2hUpInrdjuqUp3mTOV54pQZbypli2pTxrhfFSHSmZNpuVCOpn4Xm0>

Euler Hermes [https://www.eulerhermes.com/en\\_global/economic-research/country-reports/Lebanon.html?fbclid=IwAR1C6owCnaM-4f1g-ajXj\\_bKBTfJ4pIVs0tFXrOcUooD8N4SFigAIJMAL9o](https://www.eulerhermes.com/en_global/economic-research/country-reports/Lebanon.html?fbclid=IwAR1C6owCnaM-4f1g-ajXj_bKBTfJ4pIVs0tFXrOcUooD8N4SFigAIJMAL9o)