Mobilizing capital for development

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THE BANKING SECTOR IS PROSPEROUS AND HAS BECOME THE LEADING SECTOR IN THE ECONOMY

Growth of the banking sector and its share in the economy

The Lebanese banking sector has experienced during the past 15 years a growth of its consolidated balance sheet expressed in USD[1] at an average yearly rate of 22.4%.

The added value in the banking sector (private banks, central bank[2] and financial companies) can be estimated at around 1,800 Billions of LBP, its share in the GDP would therefore stand about 8% (since the real value of the GDP is questionable). The share of the private banks in the tax on profits amounted to 24% in 1998 (67 Billions of LBP over 281), and their share in the total declared profits by corporations amounted to 51% (670 Billions of LBP over 2810), while the banks represent only 0,9% of the corporations which presented declarations to the Ministry of Finance.

It is worth noting that since the rate of increase of the banks balance sheet exceeds the nominal rate of growth and considering the interests structure and the balance sheet structure as roughly constant, the share of the banking sector in the GDP has been and will continue rising year after year.

Lebanon has the third highest ratio of Money and quasi-money (currency and resident bank deposits) to GDP in the world (143%), and the sixth ratio of domestic credit to GDP (135%). This means that, compared to their income, the Lebanese households (on average) hold more deposits than elsewhere. This situation reflects obviously the general macro-economic structure, but it is also related to the strong preference of Lebanese households for liquid savings. This is due on one side to the narrowness and illiquidity of the stock exchange and, on the other side, to the absence or the inefficiency of social safety nets that make reliance on liquid family savings a rational attitude.

Extension of banking services

Lebanon is well bancarized. There are 770 branches all over the country, servicing an average of 5,200 persons each. The number of creditor bank accounts, at the end of 1999, was about 1.4 millions with an average of 1.6 creditor accounts per resident household. The number of debtor bank accounts was about 280,000.

	Average number of residents per branch	**Average deposits per branch (mios USD)**	**Average deposits per resident (USD)**	**Average private lending per branch (mios USD)**	**Average private credit per resident (USD)**
Beirut	*1,505*	*64.136*	*42,616*	*32.955*	*21,897*
Beirut suburbs	4,971	41.210	8,290	19.433	3,909
Other Mt-Lebanon	4,748	32.199	6,781	10.192	2,147
Bekaa	11,009	41.591	3,778	7.919	719
South Lebanon	10,833	32.100	2,963	6.960	642
North Lebanon	10,763	31.293	2,908	7.634	709
Total	**5,201**	**45.933**	**8,831**	**19.603**	**3,769**

[1] The Lebanese national currency, the Lebanese Lira (symbolized by LBP) has been almost stable against the USD for the past eight years. Presently one USD is worth 1.508 LBP.

[2] The Central bank in Lebanon is called Banque du Liban and hence abbreviated as BdL. Unless otherwise stated, statistical figures are based on BdL publications.

The table shows the regional variation of the main banking indicators (at the end of 1999, expressed in USD). It is obvious that the figures for Beirut are not very relevant for regional comparisons since the capital hosts almost all the headquarters of the banks which induces a clear upwards distortion.

Balance sheet structure

The consolidated balance sheet of the Lebanese banks can be divided in two watertight parts: one in LBP and another in foreign currencies. Apart from a specific part of their capital denominated in LBP, Lebanese banks are not allowed to take exchange positions. But they are allowed to have equity in foreign currencies through what is called "cash contributions to capital". At the end of June 2000, the consolidated balance sheet expressed in USD, can be stated (some evaluation is necessary since the banks deposits at BdL are no longer reported separately in LBP and in foreign currencies) as follows:

ASSETS			LIABILITIES
Balance sheet in foreign currencies (mios USD)			
Cash	61	17,500	Resident deposits
Deposits in BdL	2,964	4,875	Non-resident deposits
TB in forex	2,888	1,076	Non-resident banks
Private domestic credit	12,663	45	Issued bonds
Foreign assets	7,264	965	Other liabilities
Other assets	170	814	Equity
	26,009	25,275	
Balance sheet in national currency (mios USD)			
Cash	26	12,677	Resident deposits
Deposits in BdL	1,624	522	Public sector deposits
TB in LBP	11,448	556	Non-resident deposits
Private domestic credit	1,817	1,447	Other liabilities
Other assets	170	2,038	Equity
Fixed assets	1,421		
	16,506	17,240	
Total balance sheet (mios USD)			
Cash	87	30,177	Resident deposits
Deposits in BdL	4,588	522	Public sector deposits
TB	14,336	5,431	Non-resident deposits
Private domestic credit	14,480	1,076	Non-resident banks
Foreign assets	7,264	45	Issued bonds
Other assets	340	2,412	Other liabilities
Fixed assets	1,421	2,852	Equity
	42,515	42,515	

Credit channeling

The allocation of credit by economic sectors has been quite stable over years, except for a noticeable increase, during the last five years, of the personal loans. The table shows the percentages for each sector at the end of March 2000.

Agriculture	**1.47%**	Hotels & Restaurants	2.93%
Industry	**12.88%**	Educational Services	0.98%
Manufacturing	12.47%	**Fin. Intermediation**	**2.77%**
Mining & Quarrying	0.12%	**Others**	**5.01%**
Electricity & Gas	0.29%	Other Community & Personal Service	2.91%
Construction	**21.55%**	Health & Social Work	1.22%
Trade and Services	**44.54%**	Public Administration & Defense	0.82%
Wholesale Trade	23.12%	Extra Territorial Organizations	0%
Retail Trade	9.33%	Private households employers	0.06%
Transport & Storage	2.54%	**Individuals**	**11.79%**
Real Estate Renting	5.63%	**TOTAL**	**100.0%**

Apart from the negligible share of agriculture (most of credit to agriculture being channeled, generally at very high cost, through agricultural input sellers) and from the relatively high share of construction, the pattern of distribution of credit among sectors is in line with the sector structure of the Lebanese GDP.

Unfortunately, the statistics are based on the sector of activity of the debtor client and not on the object of the credit, this limits severely its validity.

The role of visible subsidies remains limited in the banking activity, though it is increasing. It follows two channels: the first one consists of exoneration for banks from the reserve requirements in LBP on the amounts (or more generally their equivalent in LBP since credit is mainly in foreign currencies) used for medium and long term loans, the second one consists of direct interest rate subsidy, from the Government budget, of 5% on loans granted to productive sectors (agriculture, industry and hotels). A third mechanism has been recently set for housing loans (in LBP this time) to the medium and low income categories in coordination with the National Housing Institute, it relies also on exoneration from reserve requirements

Productivity and staffing

The productivity (measured through the ratio of the added value to the working force in the branch) in the banking sector amounts to around 100 millions LBP, which is seven times the general productivity in the economy. This productivity is regularly increasing with a growth rate in the banking largely exceeding the growth rate in the economy and an almost constant staffing at the level of 15.000 in the banks. The Central bank counts around 1.400 working persons and their productivity is comparable to that of the private banks.

As a result, the level of monthly effective income per employee in the private banking sector amounted as an average to 2.882 millions LBP in 1997, compared to an overall average in the economy of 840 millions LBP[3], which represents 3.5 times more. The average monthly income per employee in the private banking sector increased in 1998 and in 1999 respectively to 3.098 and to 3.367 millions LBP, so about 8% yearly, widening further the gap with the wages in the other sectors. It is also well known that the level of wages in the Central Bank is well above that of the public sector in general.

It is easy to understand therefore that the level of qualification of the workforce in the financial sector is, in relative terms, very high and that the sector attracted several Lebanese expatriates (or several foreigners from Lebanese origins) with previous experience in the international financial markets. The banking sector counts also several “pure” foreigners, some of whom have been sent by the mother-banks and others came for their own. On the opposite several hundreds, and maybe a few thousands of persons of Lebanese origin work in the banking and financial fields abroad, in the Gulf countries, in Europe and the USA.

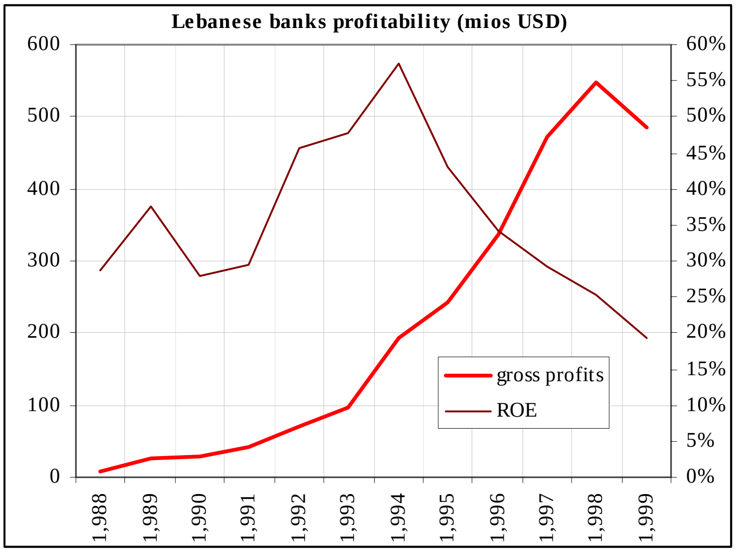
Historically, banking skills were introduced in Lebanon by the French and the Italian. Until very recently most of the banking elite had been trained through its work in those institutions. In the late sixties and the early seventies, the rising importance of Lebanese banks and the opening of several American banks, on one side, and the introduction of specialized university curricula training, on the other side, introduced a deep change in the banking community by raising the percentage of university degrees holders and favoring the progressive shifting from the usage of French towards English. The new trends went broadening during the war period and with the intense emigration of Lebanese youth and professionals. The ABL[4] manages also active training cycles.

At the level of the skilled workforce in the financial sector, the Lebanese are extremely “globalized”. While most of the other sectors are “globalized” one way, through the permanent emigration of Lebanese professionals, the globalization of the financial sector acts both ways: emigration of Lebanese and immigration of foreigners and of former expatriates.

Profitability and capitalization

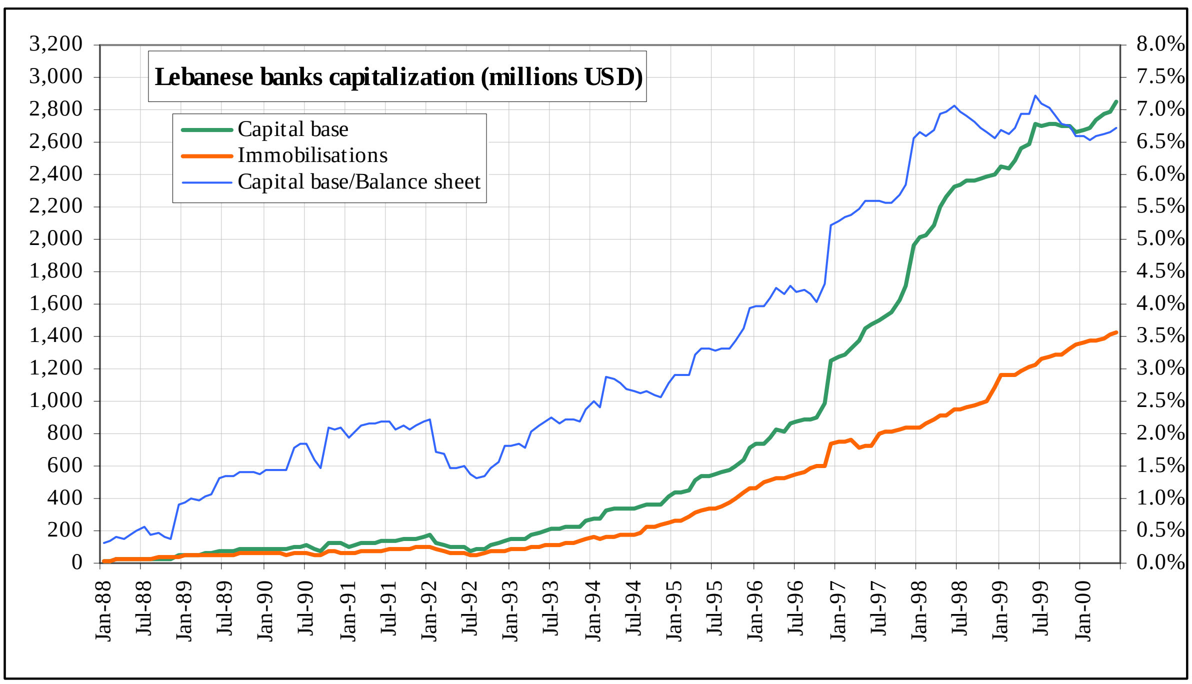
The banking sector has successfully reconstituted its capital base in a short period and reached international standards in terms on capitalization, after having almost completely lost its capital because of the devaluation of the LBP in the eighties. Important investments have been made in various fields: head-offices, new branches opening, computers, ATM’s, communications, new products design, mainly in the retail market, etc....

[3] based on « Conditions de vie des ménages » survey, published in 1998 by the Central Administration of Statistics.
[4] ABL stands for « Association des Banques au Liban »



This successful recapitalization was encouraged by the Central Bank through the adoption of the Basle agreements criteria on solvency, and through the issuance of several technical directives facilitating the process of meeting them. It was made possible by the high level of profitability the Lebanese banks witnessed through the 90's. The cumulative gross profits between 1989 and 1999 amounted to 2.55 bios USD, the average Return on Equity exceeding 35%, and the return on assets exceeding 1.5%. The net profits amounted to 2.30 billions and the increase in equity to 2.65 bios USD. The reevaluation of assets accounted for more than the difference.

Nevertheless, it is right to say that the profits of the banking sector have mainly been dedicated to the increase of its capital base. Some public offerings for the increase of capital did happen, either directly or through issuance of GDRs (mainly because of the dollarization and of some specific regulations concerning the control of the Central Bank on the ownership of banks shares, that have been eased since).



International and regional positioning

The Lebanese banking sector has acknowledged two waves of international expansion: the first dates back to the sixties and most of the branches and affiliate banks created in that period, in the Middle East or Europe or Africa, did not survive because of legal changes in the host countries and/or financial difficulties encountered by the mother institutions in Lebanon; the second wave began in the late seventies in a period where the security situation at home was negative but the Lebanese expatriates were accumulating large amounts of capital mainly because of the oil booms: it was mainly directed towards Europe (France, United Kingdom, Belgium and Luxembourg) and towards Cyprus whose off-shore regulations and proximity to Lebanon enabled it to act as a convenient proxy for Beirut; some branches were opened in the Gulf area and few others in emigration countries such as the United States and Canada.

After the stabilization of the internal situation in Lebanon, most of the Lebanese banks restructured their sister or affiliate banks under the mother Lebanese bank that regained its relative importance and its predominance within the various banking groups.

The main skill of the Lebanese banks has been historically trade financing, this basic fact, added to the mobility of the Lebanese bankers helped the banking sector in maintaining a broad international network of relations. Several banks in Lebanon are owned, partially or totally by international and Arab banking groups.

Among the Western presence, the French have maintained their presence during the war period (1975-1990) while the Americans withdrew almost completely. In recent years several European banks and a few American and Canadian banks came to Lebanon, or came back. The Arab presence in the Lebanese banking sector was maintained and increased, but the relationship has become clearly asymmetrical, since the Lebanese banks do not have any significant presence in the Arab countries and their size is still insufficient to allow them to compete with the large Gulf banks, in spite of several acquisitions by larger Lebanese banks of small and medium sized banks.

Essential role during war and in the period after and ability to manage crises

Both the Central Bank and the private banks proved a remarkable ability to manage crises. The Lebanese banking sector has succeeded in achieving two main results:

First, it was able to maintain effective contact with, if not control over, the increasing amounts of money the Lebanese (mainly expatriates) succeeded in gathering. On due time, this ability allowed the Lebanese banks to drain large amounts of capital into the country.

Second, in spite of crises and difficulties, the Lebanese banking system financed the needs of the Lebanese government during the period of the war, when public revenues went down to almost zero, and during the following period, in spite of the huge deficits. This made possible the survival and the recovery of the State and prevented, until now, the country from tackling significantly the international financial markets.

Quality of management and clarity of reporting

Finally the banking sector is by far the most transparent sector in the Lebanese economy. International accounting and reporting standards are observed and the sector is globally in conformity with international banking regulations. The supervision of the Banking Control Commission is regular and its quality is improving constantly. The Central Bank enjoys a large autonomy vis-à-vis the Government and its statistics are practically the only regular source of information on the whole economy.

SPECIFICITIES OF THE FINANCIAL ENVIRONMENT IN LEBANON

A free and stable legal and operational environment

The Lebanese financial system has been characterized since the early fifties by a complete liberty of exchange and of transfer.

The Central Bank (Banque du Liban) was created in 1963 as a result of the adoption of the “Code de la Monnaie et du Crédit” which still regulates the whole banking system. It enjoys a large autonomy and is endowed with a special quasi-judiciary body to deal with banks infringements. Following the Intra Bank crisis, in 1966, a law issued in 1967 established the Bank Control Commission.

In 1956, the Parliament voted a law establishing a high level of bank secrecy. Considering the political stability and the liberal business environment that Lebanon has preserved until the seventies, while the neighboring states were experiencing several political upheavals and nationalization processes, it is thought that the bank secrecy had a real impact on attracting large amounts of capital. Presently the Lebanese bank secrecy is questioned by several international institutions (and namely the OECD and the IMF) in the wave of fighting against money laundering. Because of that law, Lebanon was classified as one of the “non-cooperative countries” by the Financial Action Task Force on Money Laundering (FATF) created by the OECD; the Work is going between the Central Bank and the Lebanese Banks Association, on drafting legal documents in order to set procedures which make Lebanon comply with the international requirements in fighting money laundering, while preserving the basic advantages of bank secrecy.

A diversified corporate organization

The banking sector is nominally composed of three categories of banks: commercial banks, specialized banks and long and medium term banks. The legal framework for off-shore banking units was established in the 1995 budget law but has never been effectively used. There are also special dispositions for off-shore banking operations within banks; they also had little applications.

Commercial banking is ruled by the “Code la Monnaie et du Crédit” issued in 1963 and constitutes the bulk of the sector. There are 71 commercial banks in Lebanon. 49 of them are incorporated as Lebanese companies (of which 11 are under Arab control and 5 under non-Arab foreign control) and 15 are branches of foreign banks (6 Arab and 9 non-Arab).

The second category is composed of banks created by specific laws, with some form of public involvement in order to promote some sectors of the economy. Most of them have collapsed during the eighties because of the annihilation of the real value of their equity and balance sheet which were all in Lebanese pounds. Only remains the Housing Bank which has been restructured and recapitalized in 1995.

The third category counts 7 banks. It was created by a special law issued in 1977 in order to promote long term and investment banking activities. For that purpose it was given the exemption of statutory reserves of 13% of the Lebanese pound deposits imposed to commercial banks, for all deposits exceeding six months.. In practice, with the rise of the returns on Lebanese pound T-bills, this technical exemption turned out to become their real raison d’être, since control on the maturity of deposits is quite difficult a posteriori. Several commercial banks created medium and long-term subsidiaries only to take profit of this lucrative advantage. The BdL has recently issued regulations to limit abuses in this field.

There are about 15 representative offices of foreign banks.

Apart from the banking sector, the financial sector includes a number of other actors namely 25 financial companies and 5 financial brokerage firms. Three companies are specialized in the financial leasing, for which a law was voted in 1998.

Finally, the National Institute for the Guarantee of deposits (owned for one half by the Government and for the other half by the Lebanese banks) covers all deposits in Lebanese banks in case of failure, up to 5 mios LBP. It enjoys a stable activity since it receives from all banks a yearly percentage of 0.05%(this percentage is not fixed and can be changed by decree, it was previously 0.10% and even 0.15%) of their deposits and an equivalent amount from the Government. It has not been called during the past years to cover deposits in defaulting banks since the BdL has managed to resolve banks difficulties through favoring their absorption by other banks that were granted substantial subsidies through low-interest loans from the Central Bank that were placed in Treasury Bills.

Recently, a subsidiary of the Institute was created in order to give the banks credit guarantees for loans granted to medium and small enterprises.

Historical references

The LBP was until the forties linked to the French Franc. After World War Two, it became an independent currency and enjoyed a high level of stability until the end of the seventies. The Lebanese government accumulated significant reserves of gold (about 10 million ounces) due to the surpluses in the public accounts and to a positive balance of payments.

The immediate pre-war period, which witnessed the oil boom, was marked by a rapid growth and a significant level of inflation. In 1973 and 1974, the growth of the nominal GDP in USD was 34% and 25% respectively, the consolidated balance sheet of banks in USD grew by 53% and 39%, foreign currencies deposits grew by 57% and 46% and the effective exchange rate of the LBP in USD appreciated by 22% and 5%. This phenomenon will be repeated.

The war period

The first years of the war, between 1975 1982 were a kind of miraculous delay on the financial scene because of the accumulated wealth, of the massive transfers that continued to come to the country, of the compulsory restrain on spending and importation and probably of “political” money. That apparent immunity probably eased the continuation of the conflict and maybe fueled it.

In 1982 and 1983, after the Israeli invasion, the eviction of the PLO and the arrival of the multinational western forces, the same financial inflation as in the pre-war period occurred: in six months only, massive inflows of capital increased by 40% the size of the banking sector and pushed the effective exchange rate by 35%. But the collapse of the central Government authority in 1984-1985 was soon followed by the collapse of the national currency, the main reason being the withdrawal of the large amounts of capital which entered the country in the previous wave. The USD appreciated from 4 LBP in 1984 to 1000 LBP in 1990; the transfers of wealth were massive and their social impact is still visible today.

In reaction to that evolution, the Lebanese economy, taking profit of its openness, went into dollarisation. In 1987, the dollarisation was already complete. The Central Bank and the Lebanese banks have progressively institutionalized it: corporate accounting was done in dollars, goods and assets were valued in dollars and checks in dollars were compensated locally. This is still the case. The LBP was restricted to the financing of the public sector, the depositors increasing or decreasing their holdings in LBP according to their expectations of the evolution of its exchange rate and to the level of interest.

The after-war period

In 1992, following a controversial exchange rate crisis, the stabilization of the exchange rate at a very favorable level together with high interest rates created the necessary conditions for a new acceleration phase and for large inflows of capital that allowed an expansionary fiscal policy.

The pace was maintained until the end of 1997. The monetary aggregates witnessed a tremendous increase (in 5 years after the end of 1992 the money supply in LBP (M2) increased seven times from 2,151 billions LBP to 14,530 billions LBP; the broader money aggregate incorporating dollar deposits increased 3.3 times from 14,056 billions LBP to 46,037 billions LBP). All the LBP were practically financing the public debt.

The reverse side of this trend was the decrease of the ratio of the Central Bank reserves in gold[5] and foreign currencies to the money supply in LBP from about 160% at the end of 1992 to 33% at the end of 1997.

The present configuration

Since 1997, a large number of Lebanese banks went into subscribing in the euro-bonds issues in dollars and euros of the Lebanese Government. This close collaboration between the banks and the Central Bank allowed the Central Bank to replenish its reserves regularly by getting back the dollars it was and to maintain its policy of fixed exchange rate that would have become unbearable otherwise.

But this new behavior added a new type of medium-term risks to the banking sector. It has been paid for by an immediate increase in its profits.

This innovation made possible the continuation of the Pound-Dollar mechanism, allowing the Treasury to finance its increasing needs and the holders of liquid capital to realize very appealing real returns with a limited technical risk on the short run.

The stabilization of the exchange rate of the LBP has been presented as the major political and economic achievement, even though its cost was huge.

ABUNDANCE OF FINANCIAL CAPITAL AND SCARCITY OF PRODUCTIVE INVESTMENT

The Lebanese economy shows persistent and heavy imbalances

According to the available sources[6], the Lebanese economy has shown persistent and heavy imbalances. The most important pertain to the exterior accounts. The current account balance has been marked by yearly deficits amounting to about 6 billions US$ which represent about 40% of the GDP. This ratio is one of the highest in the world. Nevertheless, the balance of payments has been balanced or even in surplus.

The current account deficit is due for one half to the public sector that spends almost twice its revenues and for the other half to the private sector that consumes and invests far more than its income.

[5] Any use of the Central Bank reserves in gold has been blocked by law in the late eighties.

[6] And most notably, the recent correction by the Central Bank of the external accounts figures previously published for the period 1995-1998, as per its annual report for 1999 published in June 2000.

The financing of this deficit in the current account is due[7] only for 30% to foreign direct investments (almost exclusively in real estate), the rest is financed through short-term capital inflows transiting through the Lebanese banking sector, recalling that real estate transactions end generally by additional deposits from the seller in the Lebanese banks.

	Corrected figures				*Old figures*
In millions of US$	1995	1996	1997	1998	*1997*
Trade balance	**-5947**	**-6209**	**-6274**	**-5858**	***-6248***
Services balance	149	-100	-150	-189	*635*
Unilateral transfers	-97	269	619	151	*1460*
Current account balance	**-5895**	**-6040**	**-5805**	**-5896**	***-4153***
Capital account balance	**6151**	**6826**	**6223**	**5408**	***4573***
Foreign direct investments net inflow	2933	2513	1712	971	*2672*
In real-estate	2455	2359	1757	1237	*2359*
Others	478	154	-45	-266	*313*
Portfolio investments					
External financing	590	495	1009	320	*995*
Amortization of external public debt	-59	-58	-439	-81	*-449*
Short-term non banks capital inflow	450	186	488	-350	*186*
Other capital accounts	2237	3690	3453	4548	*1099*
Balance of payments	**256**	**786**	**418**	**-488**	***420***

Concerning the public sector indebtedness, it has grown steadily from 4,475 billions LBP at the end of 1992 (47% of the GDP) to 34,580 billions LBP in June 2000 (probably 148% of the GDP) at an annual average yearly rate of 30%.

The table summarizes the situation of the public finance over the past seven years.

Billions LBP	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**Total**	**%**
Revenues	1659	2004	2713	3160	3262	3962	4464	**21224**	**42,8**
Borrowing	1732	3088	3486	5301	6347	4512	3864	**28330**	**57,2**
Resources = Expenses	**3391**	**5092**	**6199**	**8461**	**9609**	**8474**	**8328**	**49554**	**100**
Debt service	784	1488	1875	2653	3378	3352	3625	**17017**	**34,3**
Current expenses	2475	2839	3277	4767	5146	4193	4200	**26898**	**54,3**
Investment (incl CDR)	132	765	1047	1040	1085	1066	503	**5638**	**11,4**
Primary balance	-948	-1600	-1611	-2647	-2969	-1297	-239	**-11311**	
Deficit/expenses	51%	61%	56%	63%	66%	53%	46%	**57%**	
Public deficit/GDP	**13%**	**21%**	**20%**	**26%**	**29%**	**19%**	**16%**		
Total Public debt	**6669**	**11007**	**14556**	**21026**	**24908**	**30156**	**33713**		
Public debt/GDP	**51%**	**73%**	**82%**	**103%**	**113%**	**129%**	**144%**		

*Source: Five-year program for fiscal adjustment and actualization for 1999

Concerning the private sector indebtedness, it can only be measured through the domestic lending of the Lebanese banks. Expressed in USD, that lending increased 5.6 times, from 2,614 mios at the end of 1992 to 14,553 mios in June 2000, at an average yearly rate of 26%:

(mios USD)	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**Jun 00**
Credit to private sector	**2.614**	**3.447**	**4.736**	**6.466**	**8.175**	**10.119**	**12.389**	**13.926**	**14.553**
Domestic credit/GDP	**51%**	**45%**	**52%**	**58%**	**62%**	**70%**	**80%**	**90%**	**93%**

Inflation or real growth of the GDP, the deviated function of the financial sector

As a result of the financing by capital inflows of the large public and private deficits, both of them being mainly due to excess of consumption, the internal prices continued to rise during the whole period The CPI[8] expressed in LBP (the base year being 1988) rose from 349 at the end of 1990 to 1020 at the end of 1992, to

[7] As an average over the period 1995-1998, according to the Central Bank annual report (1999)
[8] The CPI is published on a monthly basis by a private institution « Consultation and Research Institute, SARL »

1595 at the end of 1998 and decreased slightly to 1552 at the end of 1999. If we express the same index in USD, the rise is much more regular and apparent: from 240 at the end of 1990 to 300 at the end of 1992, to 576 at the end of 1998 and back to 561 at the end of 1999. Considering that a very large part of the basket of consumption is imported and knowing that the variation of international prices was relatively limited during the period, this means that the prices of the goods and services produced locally increased at much higher rates. The application of the CPI for the calculation of the real growth of the GDP instead of a deflator restricted to the basket of domestic added value has therefore led to greatly overestimate growth rates during that period in the official publications.

Annual rates	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**average**
Official real growth rates of the GDP	**7,0%**	**8,0%**	**6,5%**	**4,0%**	**4,0%**	**3,0%**	**5,4%**
CPI (in LBP) annual variation	24,7%	7,9%	10,6%	8,9%	7,7%	4,6%	**10,6%**
Corrected GDP deflator annual variation[9]	37,9%	10,7%	14,5%	8,0%	12,3%	5,4%	**14,4%**
Corrected real growth rates of the GDP	**0,1%**	**5,3%**	**2,9%**	**4,9%**	**-0,2%**	**1,6%**	**2,4%**
GDP growth rate excluding Public Administration	-1,7%	5,2%	2,5%	3,7%	-0,9%	1,2%	**1,6%**

This basic fact of a permanent and important, though hidden, inflation had many major implications on the role of the financial sector in mobilizing capital for development:

- The competitiveness of the Lebanese production has been negatively affected by the rise of the real effective exchange rate by more than 70% during the past seven years, hampering exports, encouraging imports and giving support for increased tariff protection.
- Because of the small size of the Lebanese economy, the global inflation reflected very little on the tradable goods while its impact on non-tradables was amplified. This situation made the available resources (capital and labor and especially qualified labor) to retreat from the sectors which produce tradable goods towards those which produce non-tradable goods and services. It produced also a sizeable appreciation in the value of domestic assets, mainly land.
- The hidden inflation created an illusion of growth while in reality a significant part of the apparent income was indirectly financed by external capital resources and therefore the valuation of the internal assets, claims and businesses was to various extents artificially inflated.

These three effects created a severe limitation on the opportunities for productive and financially sound investments and businesses and trapped the financial sector itself in a single dominant function of financing, not only the public deficit but, more generally, the deficit of the external accounts of the whole economy.

Distorted criteria of appreciation

Several indirect indicators were hinting at the fact that real growth was much less than announced: the steady flow of emigration, the levels and the structure of income of the households as they appeared in surveys, the indicators of poverty in several areas of the country, ...

Nevertheless the structural inflation was partly hidden because of distortions which affected several publicized economic criteria: the use of the CPI index as a deflator for GDP increased substantially the real growth rates, the inflation of the financial sector was presented as a sign that Beirut was regaining its role as a regional financial center, the increase in bank deposits was used to assess the savings of the resident households denying the importance of the short-term capital inflows, the low apparent rise of the consumer prices (measured in an LBP which was appreciating against the US$ which was itself appreciating towards the Euro) after a period of rapid increase was presented as a victory over inflation while the reality, in a dollarised economy, was an increase of inflation measured in dollars, the percentage of deposits held in LBP was used to measure he alleged “de-dollarisation” of the economy, etc...

Assessment of the financial flows in National accounting

The amount of interests paid in Lebanon to banks and to private Treasury-Bills holders (not considering the interests paid to non-banks in the retail or in general distribution which are not negligible) amounted to 3.3 billions USD in 1997, 3.8 billions USD in 1998 and to 4.1 billions USD in 1999, 58% being paid by the Government and 42% by the private households and firms. This burden of interests is mechanically

[9] Correction is based on the structure of Production, Consumption and Imports as per the publications of the Central Administration of Statistics for 1994 and 1995 and on extrapolations for the other years.

increasing year after year since the recurring deficit in the current account implies the accumulation of debt and a tendency to the increase of interest rates. The amount of interest paid by the private sector in 1998 (2.456 billions LBP) is equivalent to 80% of the total tax revenues of the Government (3.075 billions LBP).

This means on the opposite hand that interest income represented 25% to 30% of the GDP. Knowing the extreme concentration of deposits in the Lebanese banks (0.6% of the number of accounts, and therefore a very small number of households, holding more than 40% of total deposits) and noting that interest income is free of all taxes while corporate profits and salaries are subject to tax, it is easy to understand the heavy negative effect of this situation on the distribution of income and on the competitiveness of businesses.

It is possible, at the expense of some limited assumptions, to attempt to draw a global table representing the financial flows among the main economic actors. For 1999, and expressed in millions of USD, the results would be as per the table.

To From	Private domestic borrowers 1	Govrnment 2	Central Bank 3	Banks 4	Resident capital 5	Foreign Placements 6	Foreign borrowing 7	Non-resident capital 8	Total paid	Paid internally
Domestic borrowers				1629	*150*		*50*		1829	1779
Government				1663	507		133	*100*	2403	2170
Central Bank		*50*		395			*20*		465	445
Banks			*40*		2440		98	265	2843	2480
Resident capital									0	0
Foreign placements			420	365					785	
Foreign borrowing									0	
Non-resident capital									0	
Internally received	0	50	40	3687	3097					6874
Internally paid	-1779	-2170	-445	-2480	0					-6874
Net internal flow	-1779	-2120	-405	1207	3097					0
Total received	0	50	460	4052	3097	0	301	365	8325	
Total paid	-1829	-2403	-465	-2843	0	-785	0	0	-8325	
Net total flow	-1829	-2353	-5	1209	3097	-785	301	365	0	

The figures in red are estimates

	Private domestic borrowers 1	Govrnment +BdL 2+3	Banks 4	Resident capital 5	External sector 6+7+8	Total
Total received	0	510	4052	3097	666	8325
Total paid	-1829	-2868	-2843	0	-785	-8325
Net total flow	-1829	-2358	1209	3097	-119	0

	Private domestic borrowers 1	Govrnment +BdL 2+3	Banks 4	Resident and non resident Capital 5+8	External financial institutions 6+7	Total
Total received	0	510	4052	3462	301	8325
Total paid	-1829	-2868	-2843	0	-785	-8325
Net total flow	-1829	-2358	1209	3462	-484	0

	Private domestic borrowers 1	Governmen t+BdL 2+3	Capital and financial institutions 4+5+6+7+8	Total
Total received	0	510	7815	8325
Total paid	-1829	-2868	-3628	-8325
Net total flow	-1829	-2358	4187	0
%	-43.7%	-56.3%	100.0%	

Assessment of counterparts, assets and collaterals

At the level of the banking sector assets, the internal claims have increased between the end of 1992 and the end of 1999 by 28.0 billions USD, 16.7 billions on the public sector and 11.3 billions on the private sector. If the financing of the public deficit and the types of public expenditure are known with enough precision, it remains of great importance to evaluate the uses made of those amounts by the private borrowers and to therefore measure the impact of the credit on investment and development and assess the quality of the private credit portfolio of the Lebanese banks.

Unfortunately the information is not available for that purpose, neither at the sector level (since about 88% of the lending is not linked to a specific object but appears as permanent current account, whether pure overdraft or against personal or real-estate guarantees) nor at the national accounting level (because of the scarcity and the irregularity of the figures and, if available, because of serious contradictions among them).

Nevertheless two preliminary remarks can be drawn:

The household surveys[10] show a very large discrepancy between income and expenditure, exceeding by far the usual levels of under-declaration of income in such surveys. Income does only match expenditure for the 12% highest income households. This situation denotes a very high level of indebtedness among the households, whether towards banks or other lenders and whether labeled as personal loans or appearing under different categories.

The investments made by resident private businesses and the increase in inventories are obviously very limited as compared to the increase in indebtedness and to the amount of self-financing. This means that a very large part of the increase in banks credit has been used to finance consumption demand, whether directly or through wages paid or through delayed payments from clients or through expenditure by the business owners from the business available treasury (since most of them are family businesses, even if incorporated as companies). This explains why the Lebanese bankers rely intuitively so heavily on personal guarantees and on real estate guarantees (almost exclusively owned not by the companies that borrow the funds but by their main shareholders as private property), the reason being that a significant part of the funds borrowed has been used for consumption and that lending, even if it appears as commercial overdrafts, has turned to be personal and asset based. In this respect it is quite understandable that “everybody” has a direct interest in over-valuing real-estate assets and that any slowdown in the rate of increase of the credits creates a feeling of acute lack of liquidity as a result of the complex chain of cascade financing of the final demand which proceeds from the banks lending to both the private and the public sectors.

CORRECTION PATTERNS AND IMPACT: WHAT PRICE AND FOR WHOM

In view of the internal structure of the Lebanese banking sector and of its place and role in the economy, it is clear that the present situation is not sustainable. Corrective actions should be taken, preferably in collaboration with the banking community, to mitigate the structural risks that the sector is facing and to redirect its means and activity from financing and sustaining an unbalanced economy towards encouraging growth and development and participating actively in the process of reform. Failing to take such actions would not translate into immediate risk for the banking sector nor prevent it from enjoying good returns and solid privileges in the economy, at least for some time. But it is unconceivable that a banking sector so deeply involved in the national economy and so exposed to it could be unaffected by a serious crisis affecting that economy. Whether the crisis would begin in the public sector, in the private sector, in the exchange market or in the financial sector itself remains unknown. But such a crisis would end by provoking, in a spontaneous and disorganized manner, the correction that conscious reforms could realize, but in more orderly and less costly manner. Whether in the course of voluntary reforms or in the course of a crisis, it is always important for the concerned parties to keep in mind the very simple question: who would get the benefit and who would pay the price?

Assets risk and liabilities risk

It is important to recall that Lebanese banks do not take exchange positions, this means that their balance sheet is completely divided in two separate and balanced parts: a LBP balance sheet and a foreign currency (predominantly USD) balance sheet. During the past ten years, the first part represented almost one third of the total balance sheet and the second two thirds. The banks are therefore not directly exposed to exchange risk which is entirely passed over to the clients.

On the asset side, the structure of the LBP part of the balance sheet (apart from fixed and sundry assets) has been stable: almost 12% lent to the economy, 76% lent to the Government in the form of Treasury bills and another 12% placed with the Central Bank. The structure of the foreign currencies part of the balance sheet has experienced major changes since 1992: lending to the economy climbed from 40% to 55%, lending to the Government and placements with the Central climbed together from 0% (and that until September 93) to

[10] Notably «Conditions de vie des ménages» survey, published in 1998 by the Central Administration of Statistics.

25% (level already reached in September 1998), the lending to the Government raising from 3% in December 1997 to 13% in June 2000, at the expense of placements with the Central bank; all that made the net foreign assets go down from 60% to 20%. The late 450 mios USD euro-bond issuing in September 2000 followed in October by another 250 mios, which were subscribed for 80% by Lebanese banks further accentuated the same tendency.

Those asset structures, a stable structure in LBP and a changing structure in foreign currencies, apply to a total balance sheet that increased 7.5 times in ten years from 5.7 to 42.5 billions US$. In terms of maturity, the Treasury bills portfolio in LBP and USD and the foreign assets have clear maturities. In contrast most of the private lending (mainly in USD) does not have explicit and reliable maturities, since it takes the form of debtor current accounts.

From the liabilities side, in spite of the very important effort of capitalization and of the raising of some funds through the issuing of bonds and of certificates of deposit by several banks, the bulk of the resources is made of short term deposits, their average maturity did never exceed two months and their concentration is known to be very high.

This assets and liabilities structure (by type and by maturity) should obviously push the banks towards more caution and the monetary authorities towards a clearer appraisal of the maturity risk and towards its inclusion within the prudential ratios.

Previous corrections and their social impact

As mentioned, the phenomenon of inflation in the Lebanese banking sector witnessed since 1992 is not new. The period between 1973 and 1982 has experienced almost the same pattern of rapid growth (with the difference of a slowdown in 1975-1976 and a rocketing catching up in 1982). In terms of constant USD of 1998, the figures are even comparable: in 1972 the consolidated balance sheet was 9.7 billions and it went up to 27.2 billions in 1982, in 1992 it was 9.2 billions and it went up to 39.4 billions in 1999.

In the last five months of 1982, the exchange rate of the LBP increased by 35%, the resident deposits in LBP increased by another 35% while the resident deposits in currencies decreased by 10%. The share of the LBP deposits grew from 58% to 73%. This was the result of two phenomena: a first small wave of conversion of dollars in LBP followed by a large inflow of dollars that accentuated the conversions.

Between July 1983 and February 1984, the exchange rate of the LBP fell by 22%, the resident deposits in currencies decreased by 28% while the resident deposits in LBP increased by 12%. This reversed result was triggered by limited conversions to dollars, followed by two massive waves of transfers of dollars abroad while the bulk of the LBP deposits remained unchanged or even increased because of money creation.

After that, the devaluation of the LBP became continuous until 1990.

Several remarks can be drawn: The Lebanese banking sector proved its ability to attract large amounts of capital held by Lebanese abroad. The large inward movements are usually triggered by small initial moves on the exchange market while the outward movements leave the depositors in LBP stuck, because of the lag in reaction.

The real exchange rate of the LBP (base 100 in 1966) against the USD went up from 112 in July 1982 to 153 at the end of the year and fell back to 111 February 1984. The correction took the form of a devaluation of LBP.

The impact of the devaluation, between 1982 and mid 1987, on the redistribution of savings and income was studied by the Director of Credit at the BdL, at that time, M. Ghaleb Abu-Musleh. The study led to the conclusion that out of every 100LBP held by a depositor in 1982, the real value left for him at the end was 3.11LBP, the private borrowers gained 45.49LBP, the Treasury gained 30.61 and the banks gained 11.93. At the level of income also huge transfers of wealth took place at the disadvantage of the majority of the population. On the opposite hand, many loosing businesses and poor investments were saved because of the devaluation.

The structural changes (87, 92 and 97), new types of crises and different social impacts

In comparison, a correction or a crisis in the financial sector can no longer take the form of a blunt devaluation. This is due to the cumulative effect of three successive structural changes:

Since 1987, the dollarisation of the economy is complete and a devaluation will not really and durably affect the level of internal costs and prices expressed in USD and will not correct therefore the real exchange rate.

Since 1992, the policy of anchoring the exchange rate has deprived the market from any flexibility.

Finally, since 1997, the commitment of many Lebanese banks in foreign currencies on the Government and on the Central Bank has exposed them to new risks.

In this context, the broad image of the financial sector could be described as follows: on the liabilities side, large and increasing amounts of short term deposits whose denomination or valuation basis is the USD, on the asset side, a decreasing part in foreign USD and an increasing part in Lebanese dollar, whether formally denominated in dollar or in the LBP, which is anchored to the Lebanese dollar. The equivalence of the LBP and of the local dollar is the result of the fixed exchange rate and of the dollarisation. But between the Lebanese dollar and the USD an implicit difference of value has arisen, which expresses itself in the valuation of assets and in the levels of remuneration of factors (labor, capital, land,...) for equivalent productivity. In an indirect and synthetic way, this difference could be measured by the relative indexes of the domestic GDP deflator and of the US GDP deflator. The evolution of the real exchange rate gives an underestimated idea of its value.

In this sense, it might be interesting to draw a comparison between industry and banks, since they represent the two most significant sectors who are exposed, in their daily operations, to the imbalances of the external economic relations of the Lebanese economy. Industry is exposed because its outputs are its inputs are, respectively, completely and partially tradables; banks are exposed because the dollarization of the economy and of their balance sheet and the free movement of capital make their liabilities and assets, respectively, completely and partially tradables. The other sectors are either marginalized (such as agriculture) or related to non-tradable outputs. The way each of the two sectors deals with the external economic imbalances is quite different. Industry is hardly surviving under the shade of a heavy effective protection, while banking is prospering in a liberal environment but with permanently growing liabilities The cross comparison would lead to a liberalized industrial sector benefiting from a permanent flow of subsidies, allowing it to prosper in spite of cost-productivity biases, those subsidies ending as postponed maturity liabilities, or, conversely, to an anaemic banking system protected against capital outflows by some kind of exchange control, since the mechanism of correction through currency devaluation has been blocked. It is obvious that both treatments, of subsidy and exposure or of protection and enclosure are neither sustainable nor effective in curing the basic economic biases.

The chain constituted by US Dollar – "Lebanese Dollar" – LBP is getting more and more fragile. The possible crises can affect this or that of its links and their types are multiple and not easily predictable: crisis of liquidity, of portfolio solvency or of exchange. Considering the considerable negative social impact that a severe crisis can have on the Lebanese society which is still marked by severe structural imbalances and enjoys very little social, economic and political safety nets, the challenge is obviously to avoid such a breaking in the short term while working actively to remedy, in the medium term, its profound causes, by raising as much as possible the "real" value of the financial and economic assets and trying to limit, as much as possible, the rise in the value of the overall liabilities. This challenge which is not easy in absolute terms, it is also complicated by the possible contradiction of its short-term and its medium-term objectives.

Management of crises by banks and by BdL

Since the risks began accumulating in the mid-nineties, the emphasis was put on the short-term objectives, obviously because of the urgency, but probably also because of the lack of awareness and maybe ultimately because of the absence of political will and consensus. In this context, it was evident that the Central bank would have the eminent role in the management of the situation. The success it had in bringing the banking system to fully support the monetary policy and, through it, to ensure the continuation of the financing of the twin macro-economic and public deficits, is remarkable.

This achievement has induced major implications: it allowed both the central bank and the banking sector to reach much brighter figures than what they would have reached separately, at the level of the reserves, the capital and liquidity ratios, it allowed for the anticipation of crises mainly by diluting the peaks of maturity of the Treasury bills, it permitted a smooth management of the interest rates and it pushed the banks to influence their clients in definite directions such as borrowing in dollars and holding LBP, so as to optimize the effects of the adopted monetary policy.

As a counterpart, this achievement was only possible under certain terms and conditions: a high level of profitability for the banks, a structure of the Treasury bills offer in terms of maturities and yield which preserves the role of the Lebanese banks in the intermediation between the holders of capital and the borrowing state, acting in such a way that the return on time deposits of one, three or six months in banks exceeds that of Treasury bills of the same maturity, while the effective return on the longer term Treasury bills (one and two years) remains systematically and significantly higher, allowing the banks to manage their margins through a permanent mismatching which does not reflect into effective risk as long as clear rules are observed: by the banks, concerning the levels of liquidity needed and by the Central bank, through the limitation of the cost of refinancing and through the reiterated commitment to maintain the peg of the currency as long as possible, this last condition putting a cap for the banks on their need for liquidity at any moment depending on the ratio of the central banks effective reserves to the money supply in LBP, the intervention in order to stabilize the market of the Lebanese Government eurobonds overwhelmingly subscribed by the Lebanese banks,....

HOW DID THAT WORK? CONDITIONS AND CONSEQUENCES

High sophistication behind apparent simplicity

At a first glance, the operations of the Lebanese banking sector might look simple and traditional: collecting short term deposits in USD and LBP, provide commercial overdraft lending in dollars, generally with real-estate collaterals and investing the LBP in Treasury bills.

A second look at the banking sector, through its global economic performance, leads to recognize a remarkable performance that only a sophisticated mechanism made possible. That complex mechanism would not have worked and lasted for such a long period of time, in spite of the increasing imbalances and distortions it helped keeping up, without the realization of specific conditions.

Some of these conditions are obvious and apparent, mainly the high level of profits in the banking sector and therefore the high level of capitalization it has reached. Add to that the intense marketing deployed by the sector, its high level of skills and equipment.

But the deep reasons behind are related to an intricate reallocation of risks by which high real returns, net of the cost risk, are provided for resources through specific channels and by which those resources are channeled to the government, the central bank and the private borrowers under specific conditions.

Some of the features of that reallocation of risks and returns can be briefly described, not only because of the professional or scientific interest in knowing their technicalities, but mainly because of their impact on the effectiveness of capital mobilization for growth and an the transfers of wealth they induce, both actually in the normal running of the financial mechanism and potentially in the case of financial crises.

Reallocation of risks: channels for resources

Resources come mainly in the form of bank deposits. A parallel channel is the direct investment in LBP Treasury bills. Portfolio investment in shares is completely marginal or is subject to specific conditions.

The resources are basically valued in USD. The Lebanese banks overpay USD deposits by a margin of 1 to 2%. LBP deposits for one or three months are paid between 6 to 10% over USD rate. Direct subscription in Treasury bills is not interesting for maturities of less than one year since shorter deposits have an equivalent or even a higher yield, one year T-bills usually yield 2 to 5% more than bank deposits.

Depositors are therefore offered a variety of instruments to diversify their portfolio from the basis of USD deposits outside Lebanon: USD deposits for one to three months in Lebanon, LBP deposits for one to three months and one year LBP Treasury bills. At each of those levels, yield is higher, the duration of risk is longer and the hedging is thinner. The portfolio allocation has nothing to do with dollarisation or de-dollarisation of the economy. Experience shows clearly two different strategies: small and medium deposits holders have a higher part of their owning in LBP deposits and a lower part in USD deposits, with practically no Treasury bills, while large deposits holders have funds abroad, have less LBP deposits, more USD deposits and venture selectively in Treasury bills for significant amounts. It appears also that the lower LBP interest rates become, the more small and medium deposits holders go in LBP deposits to preserve the nominal amount of interest perceived.

Globally speaking, large deposits holders are much faster in restructuring their portfolio and in readapting it to the changing levels of risks and yields, they also can afford to go to the extremes if that is felt necessary, LBP Treasury bills at one extreme, frequently leveraged by borrowing in dollars, and, at the other extreme, deposits in USD abroad or internationally managed funds by local or international operators. Their behavior can be clearly identified as cycle inducing, while that of the mass of the small and medium deposits holders is that of followers who take less profit of the peaks of interest yield or capital gains and who are more exposed to risk. This specificity has allowed several times, through specific one-off actions directed towards small numbers of large investors, to trigger the reversal of negative cycles, allowing those investors to realize substantial gains.

The high level of concentration of the deposits (which would be even greater if directly subscribed Treasury bills were accounted for) allows for the functioning of this dual-speed market.

The risk of dollar deposits in Lebanese banks is hedged by the high levels of capitalization and of liquidity of the banks (the liquidity ratio includes deposits at the Central Bank which are counted again as part of its gross reserves and, until recently, the eurobonds in dollars and in euros of the Lebanese government which constitute its net reserves). The risk of LBP depositors in banks is hedged by the gross reserves of the Central bank. The risk of the direct subscription in LBP Treasury bills is mitigated by two main factors, the first being that those subscriptions are made from outside the bidding process through which the banks purchase Treasury bills, the second and the more important being that the discount of those bills was granted with no penalty while the discount of the banks Treasury bills (in the occurrence of a wave of buying of dollars and therefore of need for LBP liquidity) becomes heavily costly for those banks who have not maintained the needed level of liquidity. This reflects in a clearly segmented market between the public and the banks.

The banks who accept to act within the normal rules of the market and who maintain a ratio of liquidity in LBP sufficient to cover the needs for buying dollars for their depositors, up to the level at which the Central bank would break the anchored exchange rate, can therefore support an unlimited maturity transformation and make substantial profits through a massive subscription in the two-years Treasury bills, at no risk for them. Above that normal margin, banks get an increased margin after crises because of the very low volatility of rates on deposits as compared to those on Treasury bills. Finally banks realize large capital gains through the swaps of their portfolio of Treasury bills whose remaining life has become short for longer bills, serving the purpose of the Central bank to smoothen peaks of maturities.

This is the result of the fact that the dynamic of the LBP and of the Treasury bills markets acts always one way, with the Central bank on one side, as buyer or seller, and the banks on the other, since the LBP is restricted to the financing of the public deficit and has almost no place in financing the economy. This means that no real secondary market can emerge. It means also that the average maturity of the public debt in LBP is illusive, the effective maturity being in the final analysis that of the deposits in banks.

Reallocation of risks: channels for credit

Apart from some special subsidized lending schemes in LBP, mainly for housing, and for limited amounts, the use of the LBP will remain practically restricted to the financing of the public debt, not only because of the dollarisation of the economy and the rate differential in favor of the USD, but also because of the monetary policy itself. Under the anchored exchange rate hypothesis, a shift of 20% of the private borrowers, meaning an effective economic use of the national currency, would dry up the reserves of the central bank and/or drive the Lebanese banks towards lending an equivalent amount in USD to the Government, ending by a swing between public and private risk in USD.

Lending in USD (other foreign currencies are restricted to specific commercial operations) was until recently channeled through current debtor accounts. During the last years, personal loans have significantly increased while structured corporate finance remains very limited. Surprisingly, structured loans are taxed while current debtor accounts are free of tax and a dispute is still hanging between the Ministry of Finance and the Lebanese Banks Association on the level of that tax.

Those credits are theoretically payable at first demand, their concentration is high, the effective use of funds is undefined and the rating is linked to two considerations: the yearly turnover of the account and the level of collaterals. The first consideration is purely technical and could even push towards cavalry. The second condition is almost mechanically met because of the reevaluation of fixed assets that the rise in the real effective exchange rate and in the prices and values of non-tradables create, as a consequence of the excess of demand financed by borrowing from external sources.

The financing of the state in foreign currencies is a new but rapidly expanding phenomenon. Its amplitude is not well reflected in the consolidated balance sheet of the banking sector because several banks refused categorically to participate. Until 1999, the eurobonds were considered as part of the liquidity, now only those whose remaining duration is less than one year are considered as such. The market value of those eurobonds has been remarkably stable for the simple reason that it obeys the same one-way rule as the LBP

Treasury bills market and practically no dealing is registered. Add that the Central Bank considers that there is no reason to reevaluate the portfolio as long as the bonds are held to maturity, which is obviously the case for all of them.

As long as no major credit crash occurs, all the apparent indicators will therefore remain positive, covering the perpetuation of the financing by the banks of the structural deficit in the current account. And as long as no major exchange or liquidity crisis occurs, the market value of the eurobonds will remain stable, allowing the Lebanese banks to replenish the Central bank reserves.

Limited need for capital markets and difficulty of setting alternative financial channels

From their strictly professional point of view, and in the absence of any regulatory mechanism, banks are driven by profitability considerations (accentuated by solvency requirements which forced them to capitalize at international levels in less than three years, coming from a situation of almost zero equity, and to therefore permanently increase their equity base) to increase their lending in USD at least in the same proportion as the increase of their deposits, whether in LBP or in USD at in increasing costs. The alternative choice of refraining from overpaying foreign currency deposits above international rates, minus a normal margin, or overpaying LBP deposits above the rate of equivalent maturity lending opportunities, minus a normal margin, would mean for an individual bank accepting to withdraw from the market in terms of share and renouncing to substantial profits. This deposit driven mechanism ends to directly reflect, at the professional level, the macro-economic mechanism of financing, by short-term capital flows, the current account deficit.

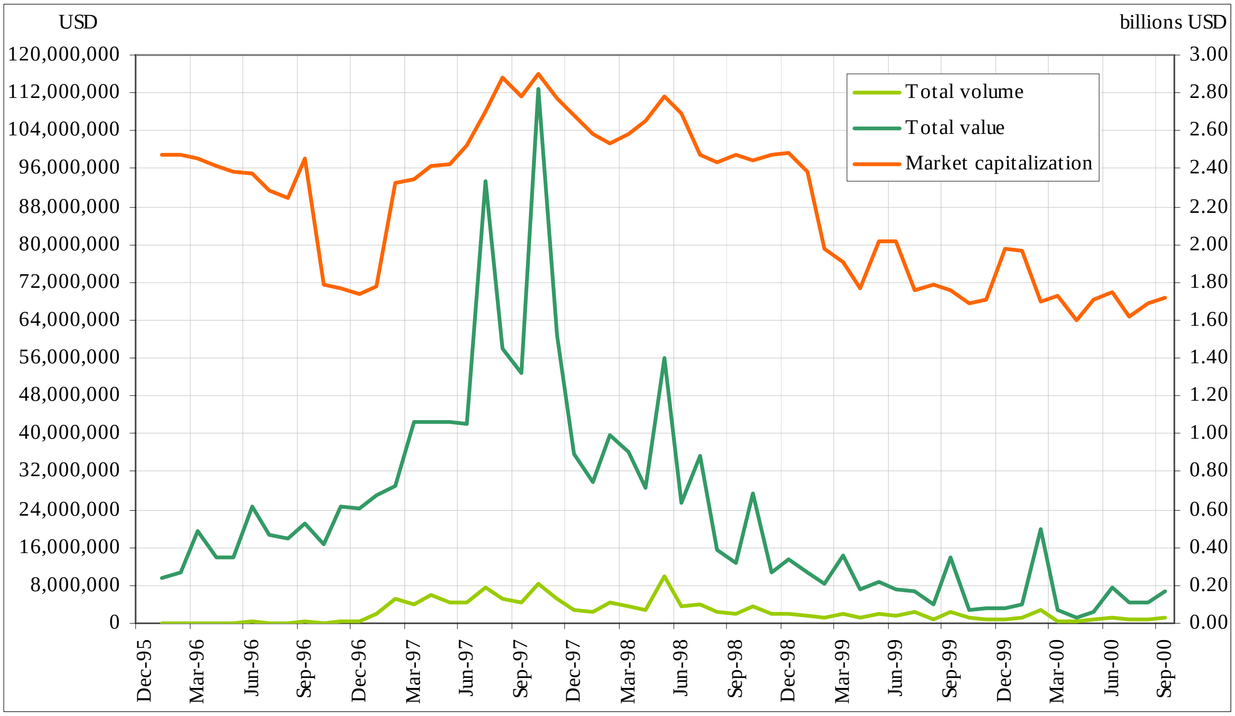
Under the prevailing circumstances of risk allocation and remuneration and because of the large availability of financing, it is obvious that there is no real need to address the capital market for raising equity funding, and no real need therefore for the emergence of a capital market. In the absence of real financial constraints, the ease of running family businesses is obvious.

Several technical factors add to this basic evidence. The Lebanese corporate businesses generally show a low profitability, mainly because of the intricate implication of private collaterals with corporate lending, the absence of formal capital requirements and the fiscal advantages for sole or for major shareholders in the absence of personal income taxation, as opposed to corporate taxation. One more complication stems from the divergence in valuation between the profit or cash-flow based approach and the net asset based approach, because of the overvaluation of fixed assets, mainly land, and their frequent original ownership, not by the companies but by their shareholders.

The listed companies appear as exceptions, their number is 13 and they can be classified in three categories:

- Businesses implying involvement of foreign corporations or needing substantial initial investment (cement factories
- One specific highly leveraged and legally forced incorporation (Solidere) which represents two-thirds of the market capitalization
- And finally five banks themselves or at least several among them, and that for two specific reasons: some banks needed capital increases that exceeded the ability of their shareholders to reinvest their dividends or had to face punctual needs for acquisitions or loss coverage; in other cases the shareholders took profit of the high returns to realize capital gains while dividend distribution was limited by the pressure of permanent capitalization needs.

This situation translated in a very narrow capital market, which is illiquid and can be therefore subject to easy manipulation. After a short boom period, the Beirut Stock Exchange activity followed a down-trend that created difficulties for the investment companies that were created. The general characteristics of the market and the downward trend are clear from the table.



	Average daily trading volume (number of shares)	Average daily trading value (USD)	Market capitalization (billions USD)	BLOM index (22-1-96=1.000)	Average annual turnover to capitalization ratio
1,997	205,061	2,218,725	2.542	1.043	24.6%
1,998	149,481	1,225,806	2.564	0.999	13.6%
1,999	63,240	349,670	1.939	0.734	5.1%
1st 6 months 2000	44,298	236,382	1.782	0.651	3.9%
1nd 9 months 2000	39,012	221,297	1.687	0.617	3.8%

Transfers of wealth between categories and over time

As stated, during the period 1984 to 1987, the transfer of wealth was from depositors in LBP towards borrowers in LBP (the private and the state), during 1992 it went successively from depositors in LBP towards speculative borrowers in LBP and back from borrowers in LBP (the state) towards the speculators who meanwhile had become depositors in LBP. Since 1992 it went from borrowers in LBP (the state) and in dollars towards depositors in LBP and in dollars. This last form is not only a matter of transfer of wealth between categories, it is also, through the indebtedness, a transfer across time by which the present actors get profit at the expense of the future actors who will have to support the burden of the debt and pay for it either directly or through the cost of an economic crisis.

Management of time en lieu of management of assets and liabilities

From this point of view, the crucial question becomes: until when is it worth staying in the game knowing that the more one stays, the more he gets profits but if he stays even one second ahead of the breakdown, he will lose all the stakes. Staying aside being in comparative terms extremely costly because of the foregone profits.

Access to information, coalitions, pacts and treachery, reciprocal testing, all become the rules of the game.

For these reasons the financial actors have become much more worried with the management of time and much less with the management of assets and liabilities risk, the latter having been assumed as inevitable and representing for everybody, the players and the abstainers alike, the final horizon.

ATTITUDES OF LEBANESE BANKERS AND HOW THINGS MIGHT MOVE?

The dynamics of equilibrium: the trap

The Lebanese bankers and among them the Central bank, did effectively find a mechanism which allowed them, together, to finance durably the twin deficit and to cover the structural imbalances of the economy, even though their success was at the expense of aggravating those imbalances.

This mechanism implies a dynamic equilibrium which would not be sustainable in a still situation. On one hand, the financing of the deficit of the current account and of the public finance necessitates to bring each year several billions of new USD from abroad and to maintain the previous stock, on the other, the financing of the deficit translates mechanically, on the assets side, in an accumulation of claims both on the government and the economy (increasing at a yearly average rate of respectively 37% and 28% between 1992 and 1999), and on the liabilities side by a symmetrical increase of the deposit base and therefore of the money supply. It implies therefore for the Central bank to impose to the Government an increasing indebtedness in foreign currencies in order to maintain a minimal acceptable level of reserves as compared to that inflating money supply.

This dynamic equilibrium is actually a trap because its financial and economic implications. Financially it implies a trend towards an increase in the interest rates on the foreign currencies (while the level of interest on the LBP can fluctuate according to the levels of reserves) directly correlated to the increasing risk in the whole system. Economically it sustains the distortions in the costs and prices structure, externally through the high real exchange rate and its implications on the external accounts imbalances, and internally through the perverse allocation of resources, both factors constituting a serious hindrance to growth, even though, temporarily covered by apparent ease in consumption.

Position to know, position to act?

The bankers, and especially in the Central bank, are well aware of the situation, if not in theoretical terms, at least in practical terms, simply because they are consciously practicing the mechanism of the dynamic equilibrium. If their position does not allow them to individually change the rules of the game, can they collectively become a decisive support for reform?

In front of the dilemma of choosing between facing an increasing danger with the fear to find oneself alone and precipitating its occurrence by the very measures taken to face it, or pretending to ignore the danger and trying to postpone its occurrence by taking the maximum profit in the meanwhile with the fear of not realizing enough advantages or not having enough time for that, the attitudes of the players will go probably the more towards the second issue the less the probability of seeing a coalition arise in favor of the first is credible. In this respect the dominant attitude of the banking community becomes more understandable and the need for a swift in the political attitude that can promote the coalition becomes more evident.

It is within this state of mind that the main features of the behavior of the banking community can be understood: the intense competition on deposits, at high interest rates, in spite of the scarcity of sound lending opportunities and in violation of the successive “pacts of honor” for curbing deposit rates, the primacy of image building over the pursuit of cost reduction and efficiency increase, the intense and efficient lobbying to maintain the monetary policies, preserve the fiscal framework and influence the designation of the key officials, the persistence in financing not only public deficit but also BdL reserves, ...

On the whole, the sector attitude is quite consistent. To be well understood, it should be read at two levels. Apparently the banking community as a whole looks at gaining time and supporting the sustainability of the monetary system, maximizing the profits it gets from it while preserving, as much as possible, its autonomy from political interference. But this attitude stands only as long as the Lebanese political and economic orientation and process of decision will be felt as unchanged; reciprocally, the banking community (or at least a large portion of it) has a clear interest in supporting a serious and credible reform of the economic and financial framework. If the traditional cautiousness of bankers does not appear sufficient towards financial risks, that is precisely because it is exacerbated towards political and economic choices and threats.

The dominant economic position of the Lebanese banking sector has undoubtedly allowed for the preservation of the Lebanese economy during fifteen years of war. If the Lebanese banks played a major role afterwards in allowing for the persistence and aggravation of distortions in the Lebanese economy, they cannot be solely or mainly blamed for the wrong choices or the postponement of the corrective choices during that period. On the contrary their potential can be seen as a valuable asset for a serious effort of reform.

Mobilizing capital for development: headlines and challenges of reform

Though its technicalities and its implementation are complex, the rationale for reform can be stated simply: capital should be treated as a scarce resource that is primarily necessary for, and normally generated through, development.

As long as capital will be seen as an unlimited resource that can be paid any price and given any use, the banking sector, including the Central bank and commercial banks, will continue being considered as solely responsible for the supporting of a distorted economic structure and for the perpetuation of short-sighted financial behavior. The obsessional need for financing will further consolidate the apparent domination of the financial sector over the economy while it increases assets inflation, hardens constrains on growth and job creation, and deepens the financial risks. The exceptional situation by which significant amounts of capital have been gathered by Lebanese nationals cannot justify using it as a consumption good.

On one hand, it should be stressed that reform can obviously not be restricted to the financial sector, since it has to face basic macro-economic imbalances. It encompasses public finance reform, at the three levels of the fiscal system and revenues, of the expenditure patterns and rules and of debt management and monetary policies. It includes also several sector rationalization policies, such as education, health, transportation, land use, social security, energy, telecommunications, etc...

But within the global scope of a serious economic reform, it is obvious, on the other hand, that the reform of the financial sector holds an important place.

From the point of view of its contents and objectives, the reform can be summarized as moving from asset-based revolving and cumulative lending and from deposit-driven growth strategies towards project, business cycle or income-based individually recordable lending practices and towards resource stabilization and risk-based rewarding policies. The reform can be seen from both ends: from the side of the banking and financial sector, banks should be driven, by the appropriate financial regulations and fiscal equalization procedures, towards matching risks effectively taken and supported, on both assets and liabilities side, with their corresponding prices; from the side of private agents, whether debtor or creditor, clear and uniform business assets and liabilities assessment and profits and losses accounting should be enforced gradually but firmly. This would probably lead towards a change in the predominant types of debtor and creditor accounts, give a strong push towards recapitalization of businesses, provoke a transformation of the intermediation role of the banks and activate the capital and assets markets.

In order to evaluate the degree of inflation in the domestic counterparts of the USD denominated bank liabilities, the difficulty of assessing the differential impact of assets and factor remuneration distortion as per the US dollar domestic and international references can be circumvented through the establishment of direct sectoral financial analysis. Its necessary steps might be foreseen as the following:

- First, redefine the effective risk counterpart or credit object as per the uses of monies lent and sources of reimbursement (cyclical merchandise or business cycle financing, investment financing, speculative asset financing, consumption income related financing, equity financing etc, …)
- Second, redefine the effective maturity of asset risks, in the light of the effective credit object and evaluate the mismatching resulting therefore
- Third establish either through international statistical comparisons or through normative evaluations, prudential ratios between the indebtedness and the debt servicing of businesses are their main operating and balance sheet data, such as EBITDA, turnover, gross margin, equity etc., so as to point out the cases where businesses are estimated financially unsound, and in that case, look at the value and liquidity of the security package attached to the loans.

From the point of view of the process of reform, extreme attention should be given to its pace and to the social balance of its costs and benefits, with regard to the vulnerable socio-political structure of Lebanon. The object of the proposed reform being to reallocate resources, to change risks and assets relative pricing and to impact financial and corporate structures and behaviors, it would be naïve to minimize the resistance or the delays of adaptation and therefore to ignore the risks of transitory imbalances or of overheating. The belief that, in case of success, the overall result will be positive for the economy does not exempt from giving necessary attention to the cost and benefits that each category would support or get. Adequate regulatory and fiscal measures should be taken at the same time with recourse stand-by dispositions to accompany the transitory period.

It remains that the sooner the reform is launched, the firmer the commitment to its success is expressed and felt, and the wider the mobilization around its objectives is achieved, the better will be its results and the lesser its risks and cost.