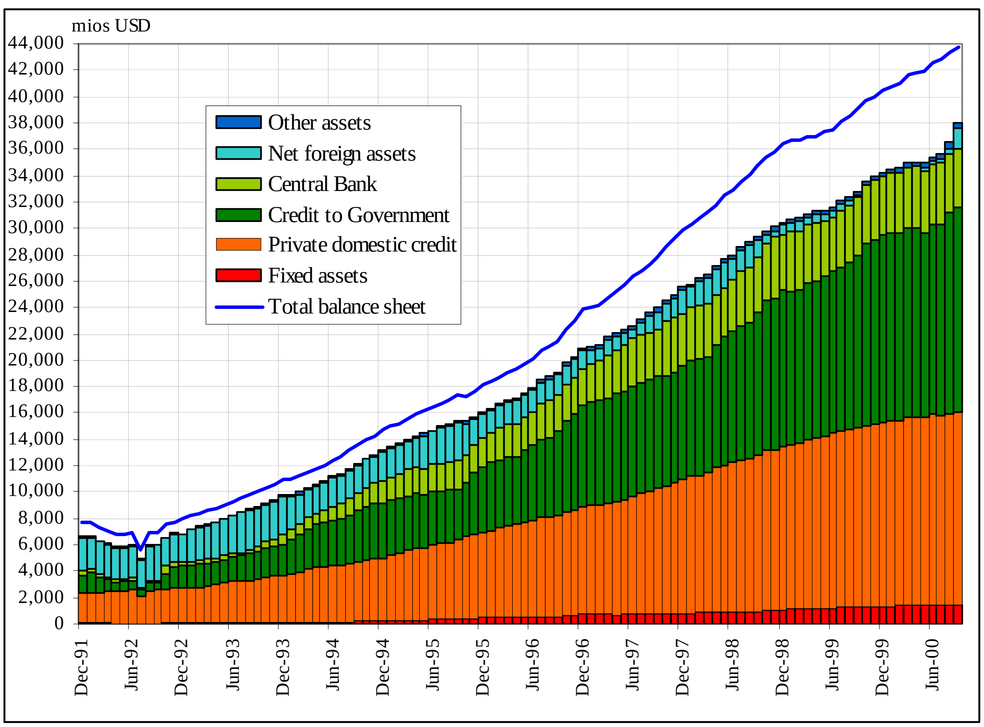
The Lebanese financial sector: its economic function, its risks and its potential

This paper is intended to present the situation of the Lebanese financial sector in view of its function within the macro-economic framework of the country and to point out the systemic risks it is facing and its possible role in a voluntary corrective action for economic recovery.

Economic function and apparent performance of the Lebanese banking sector

The Lebanese banking sector (both the central bank and commercial banks) has played an essential and very peculiar role: that of financing the structural current account deficit of the Lebanese economy.

Since this financing took the form of attracting deposits and increasing lending, that dominant function resulted in a remarkable apparent growth that cannot be explained otherwise: the Lebanese banking sector has experienced during the past 10 years a growth of its consolidated balance sheet expressed in USD at an average yearly rate of 22.4%. As a consequence, the added value in the banking sector reached around 1,800 Billions of LBP, its share in the GDP reached between 8 and 9%. The share of the private banks in the tax on profits amounted to 24% in 1998 and their share in the total declared profits by corporations amounted to 51% while the banks represent only 0,9% of the corporations which presented declarations to the Ministry of Finance. The vital function assumed by the banking sector made it dominant in the Lebanese economy.



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 therefore reached 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%).

It is also worth noting that beside the regular growth of the financial sector, a regular change in the structure of assets is taking place: more internal risks, both private and public (contradicting therefore any alleged crowding-out effect), and less net foreign assets.

Essential role during war and 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 major but paradoxical 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.
- Second, in spite of crises and difficulties, the Lebanese banking system financed the huge needs of the Lebanese economy during the period of the war, and during the following period, thus preventing, until now, the country from tackling significantly the international financial markets.

Professional achievements

The performance of the Lebanese banking sector was only possible because of high commercial and professional proficiency. The banks have also successfully reconstituted their capital base in a short period and reached international standards in terms on capitalization, after having almost completely lost their capital because of the devaluation of the LBP in the eighties. This successful recapitalization 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 ROE 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.

Monetary and financial environment

The ability of the banking sector to achieve its dominant function was not sudden and the type of reaction of the economy to this type of financing is not new.

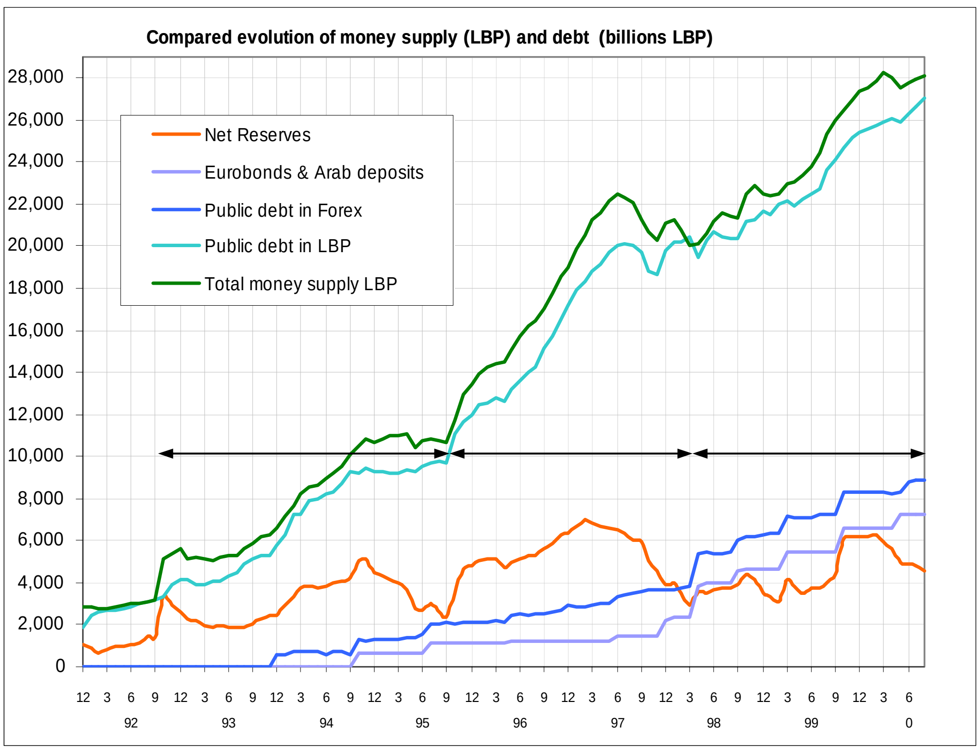
The immediate pre-war period, which witnessed the oil boom, was marked by a rapid growth and a significant level of inflation. In 1973 and 1974, the growth of the nominal GDP in USD was 34% and 25% respectively, the consolidated balance sheet of banks in USD grew by 53% and 39%, foreign currencies deposits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

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. In 1982 and 1983, , 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 that 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 deep and extensive dollarisation. In 1987, it was already complete. The Central Bank and the Lebanese banks progressively institutionalized it: corporate accounting is since done in dollars, goods and assets are valued in dollars and checks in dollars are compensated locally. The LBP has been 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.

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.

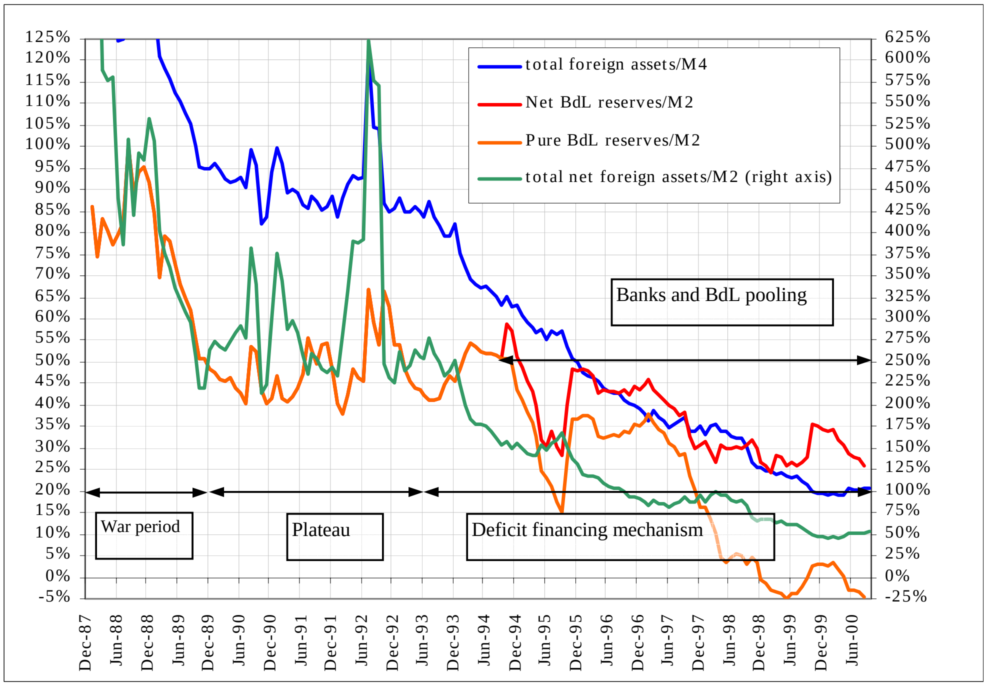
The pace was maintained until the end of 1997 after overcoming a major crisis in mid 1995 through huge interest rate increases. The monetary aggregates witnessed a tremendous increase (in 5 years after the end of 1992 the money supply in LBP (M2) increased seven times from 2,151 billions LBP to 14,530 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.



If this trend seems complicated and marked by three clearly different phases:

- phase 1, between September 1992 and September 1995 was triggered by the initial under-valuation of the LBP
- phase 2, between September 1995 and March 1998 was triggered by increase in interests and sustained by USD deposits of banks in the Central Bank,
- phase3, since March 1998 was triggered and fueled by successive contributions of Lebanese banks to reconstituting Central Bank reserves through subscription to "eurobonds" issuing,

its reverse side is much clearer and shows regular trends that meet the regularity of the growth in the volume of the banking sector and of the modification of its assets structure and confirm the macro-economic diagnosis.



Reading becomes much clearer if two points are initially left aside, first because they only play a technical role, and second because they lure vision and are misleading:

- the distinction between central bank and commercial banks (which became absolutely irrelevant since 1995),
- the distinction between LBP and foreign currencies (on the basis that the LBP does not fulfill any of the functions of money and is effectively a derivative from the USD).

The real trend consists of the decrease of the ratio of total net foreign assets (excluding BdL gold that is sterilized by virtue of a law since 1986) to M4 from a plateau of about 90% until end of 1993 to 20%. Compared to M2, the ratio fell from 250% to 50%. Both ratios clearly show the illusionary aspects of the 1992 crisis.

On the opposite, the ratio the Central Bank reserves in foreign currencies to the money supply in LBP was masked since 1994 by the pooling of resources of the BdL and the banks, which aimed at maintaining it apparently constant, while in its “pure sense” it went negative at the end of 1998.

The real object and effect of the monetary policy appears therefore clearly based on three elements:

- a persistent increase in volumes (accounting both for the incremental financing of the current account deficit and for credit multiplier),
- a regular structural change (both in structure of assets of the financial system and in covering ratios),
- an artificial stability of key apparent risk indicators.

Cooperation or pooling with BdL

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 permanently selling 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.

Since the risks began accumulating in the mid-nineties, the emphasis was put on the short-term objectives. 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,....

Economic consequences of the role of the banking sector

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.

The consolidated balance sheet of the Lebanese banks can be divided in two watertight parts: one in LBP and another in foreign currencies.

But 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.

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 as compared to 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 taken by USD deposits holders 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

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) is channeled through current debtor accounts. Structured corporate finance remains very limited. Surprisingly, structured loans are taxed while current debtor accounts are free of 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.

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.

Generated flows of transfers

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 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.

This means on the opposite side 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.

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. In terms of constant USD of 1998, the figures are even comparable.

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.
- 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.
- 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.

Induced costs and patterns of intermediation

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) 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.

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).

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.

Systemic risk and sustainability

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.

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 and/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 dollarization. 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.

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.

The dynamic trap, management of time in 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.

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.

Axes of correction, 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.

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 constraints on growth and deepens 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 and monetary policies. It includes also several sector rationalization policies. 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 the risks 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. 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.

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.