A Proposal to help Lebanon overcome its financial crisis

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Background

- Lebanon is going through a double crisis due to the over-indebtedness of the State and the dollarization of the economy.
- Both matters need to be dealt with simultaneously to restore the confidence of investors and depositors.
- The proposed plan aims to address this dual problem. This is a “rescue plan”, not an “economic plan”.
- The most important feature of the proposed plan is that It can be implemented in as little as 6 months.

❖ It should be noted that tax-led plan would further exacerbate the economic recession and should be avoided.

Our Understanding

- The State owes $91.6 bn, of which $33.7 bn is in foreign currency.
- GDP is $58.5 bn, thus a Debt-to-GDP ratio of 157%.
- Debt service was >$5 bn in 2019 – almost 10% of GDP.
- The Government is running a deficit of almost 10% of GDP.
- Bank deposits total $167 bn, of which $120 bn in foreign currency.
- Tax levy is about 17% of GDP.
- Oil and gas revenues, if they exist, cannot be expected before 10 years.

❖ Any plan should be comprehensive and address 1) The national debt; 2) The health of the banking system; 3) The best interest of depositors; and 4) The exchange rate. It should also 1) Restore liquidity; 2) Restore confidence; and 3) Create the basis for a sound economic recovery.

Desired Objectives

- Find ways to address the $50 bn loss, which is due to budget overruns and accumulated interest.
- Reduce the ratio of indebtedness to around 70% of GDP. This is necessary for a return to confidence and to reduce the external debt service burden to <1% of GDP.
- Facilitate the development of a productive economy by restoring the competitiveness of Lebanese enterprises, especially vis-à-vis the geopolitical environment.
- Protect depositors' deposits (including foreign and diaspora depositors), which is essential to the well-being of Lebanon's economy.
- Give the banks time to absorb their losses and adapt their business model.
- Protect the economic well-being of Lebanon's citizens.
- Avoid the tutelage of external bodies.

Preamble

- Lebanon does not have the capacity to repay its debt estimated at more than $90 bn with a debt service of more than $5 bn per year.
- The extension of debt repayments does not reduce debt in any way. Even at 0% interest, it remains fiscally unsustainable.
- Lebanon needs a debt reduction of at least $50 bn to restore economic balance and general confidence. This corresponds to a debt of around 70% of GDP and a debt service of around 2% of GDP (nearby $1 bn per year).
- Not doing what we propose here, will lead to a $50 bn haircut, which will be supported mostly by the banks, as they hold most of the Government debt. We estimate the impact to be about 2x the banks' capital. Consequently, depositors will have to bear at least half of the burden and the banks will need to be totally recapitalized. Worse still, they will be unable to accompany any economic recovery.
- There is no doubt that such an approach will drastically reduce the size of diaspora remittances to the bare minimum and destroy any hope of attracting future foreign deposits. There will be legal disputes and possible asset seizures.

Preamble

- A sequenced approach of devaluation, privatization and haircut is not recommended either because the simultaneity of events, necessary for the return to stability, will be jeopardized.
- A privatization per lot or through a fund or holding company that owns State assets will take a long time because of the financial and legal documentation required for proper valuation and/or for listings on the stock exchange. It should be noted that State income from such privatizations will be largely absorbed by debt service in the interim and the Government will miss the chance to turn around the Lebanese economy.
- Moreover, the conditions for a proper valuation of those assets will not be possible until the conditions necessary for the restoration of trust are in place.
- The concept we propose corresponds to a 75% reduction of sovereign foreign currency debt in order to have a debt service in currency of less than 1% of GDP and without the need to recur to a haircut on the domestic debt.
- It will restore economic balance immediately while giving economic actors time to absorb losses. It is this principle that was successfully implemented in the debt restructuring of Latin American countries in the 1980s.

Establish a Defeasance Company

- The Government should pass legislation to establish a company (the “Defeasance Company”), which holds the main State assets (excluding oil, gas and gold):
  - Ogero, MIC 1, MIC 2
  - MEA, MEAS, MEAG
  - EDL Generation and Distribution
  - Casino
  - Régie des Tabac
  - Real Estate holdings
- The Government would effect a debt-for-equity swap by swapping the shares of the Defeasance Company for $25 bn of sovereign debt at nominal value. This mechanism is the only way to achieve the simultaneity of actions, which is indispensable to resolve the debt problem. It also allows the banks to avoid having to provision for bad debt at this stage.
- The Defeasance Company’s shares would be listed on the Beirut Stock Exchange and possibly other exchanges.
- It would have an obligation to restructure each company and privatize it by floating it within 5 to 10 years’ time.
- Its shareholders would have the option to exchange their shares for shares of the privatized companies, all at market price.
- It would ideally have a governance model like that of German companies, i.e. an Executive Board composed of independent top-level professionals, and a Supervisory Board representing the banks, civil society and international financial institutions.

Restore Liquidity

- The price of the Lebanese Pound would be initially set at LL3,000/$1 and then allowed to float at least for an interim period before instating a crawling peg policy, thus contributing some $20 bn in liquidity. Shortly thereafter, three zeros would be eliminated to result in an exchange rate of LL3/$1.)
  - The devaluation (free float) will restore competitiveness to the Lebanese economy, stabilize the exchange rate at a real level, and encourage depositors to return to LBP deposits.
  - It should be accompanied by 1) Strict price controls; 2) Reassessment of the minimum wage by taking in consideration the average cost of living; 3) BDL aid for $ borrowers who do not have $ revenues to convert their borrowings into LBP.
- The same legislation that creates the Defeasance Company would also amend the existing law to allow the use of the gold reserves as collateral for a liquidity line of some $10 bn.
  - This will give the Central Bank an additional ability to provide liquidity to the market to restore confidence.

Make the Banks and major Depositors Shoulder Part of the Burden

The banks and major depositors must assume responsibility for their role in creating the financial crisis and shoulder some of the burden. Specifically:

- The banks will need to bear the impact of the LBP devaluation on their equity, as well as the estimated $12 bn cost of the recovery effort, namely:
    a. $2.7 bn loss of interest on debt converted into Defeasance Company equity;
    b. $3 bn for a stabilization fund to help support the Defeasance Company' stock price when floated – which should be done as early as practicably possible;
    c. $6.3 bn cost to smooth the charge of interest for debtor in $ loans with revenues in LBP.
- Depositors who took advantage of artificially high returns during the last 3 years will be asked to convert their excessive earnings into permanent bank capital instruments totaling up to $10 bn if the above measures are not sufficient to cover the gap.
- Bank shareholders will also need to recapitalize the banks to acceptable Basel III capital adequacy levels over 5 years.

Restore Confidence and Credit Rating

- The Government must announce all the measures herein simultaneously as ONE package:
  1. Legislation to establish a Defeasance Company, authorize the use of gold as collateral and enact measures to accompany the devaluation.
  2. A 10-year plan based on a $31 bn investment over a decade, including:
     - A welfare fund to help employees affected by the restructuring of privatized companies ($11 bn split over the 10 years).
     - An economic recovery program to move the country to a productive economy over the life of the plan ($10 bn split over the 10 years).
     - A commitment to use international financial assistance (e.g. CEDRE funds) strictly for investing in infrastructure and economic development ($10 bn to be drawn over the 10 years).
     - A budget deficit over the decade, including debt service, not exceding 3% of GDP while maintaining a tax levy of <20% of GDP and the ratio of debts to GDP lower than 80%.
  3. Measures affecting the banks, as described in the previous slide.

Main Parameters of the resulting Budget Forecast

- Devaluation of the to LL3/$1.
- Sale of $25 bn of State-owned a Lebanese Pound assets.
- Inflation affecting essential products: 10% in 2020, 5% in 2021, and 3% per year thereafter.
- A collapse of GDP by 15% in 2020 and then economic growth of 3% in 2021 and 2% in the following years, to rise finally to 10% in 2030 with the start of the inflow of hydrocarbon revenues.
- A yearly 3% depreciation of the LBP, in line with projected inflation.
- A budgetary revenue of 17% of GDP in 2020 and 2021, gradually increasing to 20% in 2028.
- A slight budget surplus before debt service, while including social support and economic recovery spending.
- A foreign currency debt service of about 1% of GDP slowing down to 0.75% of GDP.
- A deficit of 4.57% in 2020 reduced to 2.94% in 2021 and then gradually decreasing to 0.8% in 2030.
- A debt ratio of 74% in 2020, after restructuring, then maintained at less than 80% over the decade, with a significant reduction in 2030 due to revenues from hydrocarbons.

Budget Forecast

	Present Situation (estimation)	After Restruturing	2020	2021	2023	2024	2025	2026	2027	2028	2029	2030
Total Government debt (billion)	91,20	37,58		39,91	41,44	42,79	43,91	44,75	45,51	46,30	47,12	47,65
Foreign currency debt	33,70	8,70		9,28	9,84	10,40	10,97	11,55	11,32	11,12	10,95	10,50
Internal debt	57,50	28,88		30,63	31,60	32,39	32,94	33,20	34,19	35,19	36,17	37,15
Defeasance Equity	25,00											
Rate of exchange	1507	3000	3000	3150	3245	3342	3442	3545	3652	3761	3874	3990
GDP	58,50		50,72	52,17	53,18	54,21	55,26	56,34	57,43	58,55	59,68	65,48
debt ratio	156%		74%	76%	78%	79%	79%	79%	79%	79%	79%	73%
REVENUES (billion)	9,71		8,64	9,08	9,49	9,96	10,47	10,80	11,15	11,50	11,87	13,20
Income &capital gain tax	2,22		1,95	1,23	1,27	1,30	1,34	1,38	1,43	1,47	1,51	1,56
Corporation tax	1,40		0,70	0,91	1,10	1,32	1,60	1,68	1,76	1,85	1,94	2,52
Property tax	0,76		0,84	0,88	0,91	0,93	0,96	0,99	1,02	1,05	1,08	1,11
Customs duties	0,70		0,70	1,41	1,43	1,46	1,49	1,52	1,55	1,58	1,62	1,78
TVA	2,72		2,36	2,43	2,47	2,52	2,57	2,62	2,67	2,72	2,78	3,05
Inheritance tax	0,07		0,08	0,09	0,09	0,09	0,09	0,10	0,10	0,10	0,11	0,11
Domestic tax	0,95		1,04	1,12	1,18	1,24	1,30	1,37	1,43	1,51	1,58	1,79
Other tax	0,88		0,97	1,02	1,05	1,08	1,11	1,15	1,18	1,22	1,25	1,29
Tax / GDP %	17%		17%	17%	18%	18%	19%	19%	19%	20%	20%	20%
BUDGET EXPENDITURE (without debt service)	9,86		8,64	8,52	8,86	9,21	9,58	9,96	10,37	10,79	11,23	12,31
Public service personnel expenses	6,71		5,87	4,00	4,20	4,41	4,63	4,86	5,11	5,36	5,63	6,36
Other operating expenses	2,19		1,91	2,01	2,07	2,13	2,20	2,26	2,33	2,40	2,47	2,55
capital expenditure	0,97		0,85	0,51	0,54	0,56	0,59	0,62	0,65	0,69	0,72	0,81
Economy recovery program				1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00
Social welfare				1,00	1,05	1,10	1,16	1,22	1,28	1,34	1,41	1,59
Surplus / Deficit	-0,15		0,01	0,55	0,63	0,75	0,89	0,84	0,78	0,71	0,64	0,89
DEBT SERVICE												
Debt interest in foreign currency	2,2		0,58	0,56	0,57	0,57	0,58	0,58	0,55	0,51	0,47	0,44
Public debt interet in LBP	3,4		1,74	1,53	1,42	1,30	1,15	1,00	1,00	0,99	0,99	0,98
Expenditure & debt/Revenues %			126,80%	116,89%	114,25%	111,27%	107,97%	106,79%	106,87%	106,87%	106,91%	103,96%
Expenditure & debt service / GDP %			-4,57%	-2,94%	-2,54%	-2,07%	-1,51%	-1,30%	-1,33%	-1,35%	-1,37%	-0,80%
Average interest on foreign currency	6,66%			6,00%	5,75%	5,50%	5,25%	5,00%	4,75%	4,50%	4,25%	4,00%
Average interest on TB & CD	6,03%			5,00%	4,50%	4,00%	3,50%	3,00%	3,00%	2,90%	2,80%	2,70%
Economy growth				3,00%	2,00%	2,00%	2,00%	2,00%	2,00%	2,00%	2,00%	10,00%
Inflation			10,00%	5,00%	3,00%	3,00%	3,00%	3,00%	3,00%	3,00%	3,00%	3,00%

Devaluation Impact on BDL Balance Sheet

ASSETS (in LBP billion)	(as of end Feb 2020)	
LBP / USD Exchange Rate	***1507***	***3000***
Gold	21,882	43,560
Foreign Currencies	54,549	108,591
Other Foreign Assets		
Claims on Customers		
Loans to Commercial Banks	22,372	22,372
Loans MLT Banks & Fin. Cos.		
Loans to Public Sector		
Securities Portofolio	57,559	57,559
Fixed Assets	394	784
Assets related to Swaps	18,081	18,081
Other Assets	41,705	52,034
Adjustment		
TOTAL	**216,541**	**302,981**

LIABILITIES (in LBP billion)		
	1507	***3000***
Currency in Circulation outside BDL	12,544	12,544
Deposits - Commercial Banks	169,293	253,940
Deposits - MLT Banks & Fin. Cos.		
Deposits - Customers		
Deposits - Public Sector	7,990	7,990
Valuation Adjustment	13,737	13,737
Securities other than Shares		
Foreign Liabilities		
Special Long Term Liabilities		
Capital Accounts	5,667	5,667
Other Liabilities	7,309	7,309
Adjustment		1,793
TOTAL	**216,541**	**302,981**