Reforming the monetary system of Lebanon: A prerequisite to getting out of the debt trap - Dr. Georges Corm (Financial consultant and former Minister of Finance) - I. Monthly, Analysis Issue No 16, Oct 2003

Few analyses of the Lebanese financial and monetary system have focused on its strange and perverse main features. This system is largely responsible for the huge amount of debt that has plagued Lebanon since 1994-1995. It is true that we hear calls from time to time to devalue the Lebanese pound as a magic remedy for all our economic ills. But the social and political costs of liberating the price of the pound from the Central Bank administered exchange rate will be so high that it is doubtful that any government will take, by its own will, such a measure. Where would the decline of the pound stop if the Bank of Lebanon refrains, as it did in 1992, from administering the exchange rate? Wild speculation might bring a total collapse of our monetary and payment system.

In fact, it is our feeling that the problem of the exchange rate of the Lebanese pound is not being tackled properly. The question is not the supposed overvaluation of the pound, because such an overvaluation cannot be calculated properly when the economy is largely dollarized, as is the case in Lebanon. In addition, there is no guarantee that a sharp devaluation of the pound will give a boost to our exports. In 1992, in spite of the pound declining from LL 850 to LL 2,800 to the dollar, our exports were not boosted. This confirms that in a dollarized economy devaluation is no real cure. It only curtails the spending power of the poor strata of the population and increases the cost of living, aggravating the overall lack of competitiveness of the economy; it also make growth even more elusive.

The real problem in our country is in the structure of the monetary system and the use of public debt management by the Bank of Lebanon to reach monetary goals at the expense of the Treasury. I discussed this point at length when I was minister of finance with both the Central Bank and the Association of Banks, but few would listen. At the core of our problems is the simultaneous use of two currencies in our economy with a fixed price for the domestic currency vis à vis the US dollar, while at the same time creating a huge interest rate differential between deposits in domestic currency and deposits in dollars, as well as between Treasury securities issued in pounds and in dollars or euros.

This huge differential is both immoral (permanent windfall gains from depositing in LL or subscribing to T-bills in LL **1**) and financially inefficient. If the exchange rate is guaranteed by the Central Bank, why should a saver in LL be remunerated at higher rates than savers in dollars, especially taking into account the rather short term of LL deposits or T-bill maturities. By granting such high interest rates on T-bills in LL, the Central Bank and the Ministry of Finance are signaling to depositors or T-bill subscribers that there is a great danger in keeping savings in the domestic currency, while at the same time guaranteeing the exchange risk **2**. The interest rate differential would have been justified if the pound was floating freely and the Central Bank did not interfere in guaranteeing a fixed exchange rate. The result has been an overshooting of the debt service from LL 784 billion in 1993 to LL 4,900 billion in 2002.

While in 1992 and 1993 the ratio of debt service to total expenses was standing at the level 23%-25%, in 2002 it reached 42.6%. The part of the deficit due to the debt service, which was standing at the level of 50%-60% of the total deficit, reached the range of 70%-86% during the last four years (see Table 1). This simply means that whatever efforts are made to curtail the various types of public expenses, those efforts will not yield substantial results as long as the debt service is so high in Lebanon. The solution is totally in the hands of the Central Bank and the banking sector, owing to the fact that both the exchange rate and the interest rates are tightly administered by the Central Bank in consultation with the largest banks in town.

EVOLUTION OF PRIMARY DEFICIT AND DEBT SERVICE FROM 1992–2002

Table 1

(In billions of LL)

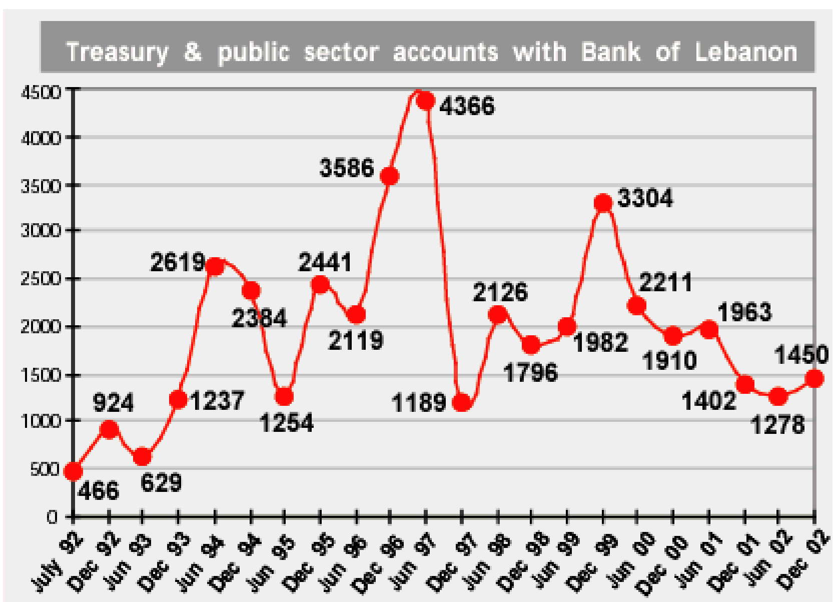
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Receipts	1,138	1,742	2,105	2,849	3,318	3,518	4,503	4,885	4,651	5,075	5,786
Expenses without debt service	1,701	2,285	3,891	4,467	5,305	6,623	5,395	5,845	6,537	7,077	6,597
Primary deficit	-563	-543	-1,786	-1,618	-1,987	-3,105	-892	-960	-1,886	-2,002	-811
% primary deficit to expenses	-33.1%	-23.8%	-45.9%	-36.2%	-37.5%	-46.9%	-16.5%	-16.4%	-28.9%	-28.3%	-12.3%
Debt service	518	784	1,503	1,875	2,653	3,378	3,352	3,624	4,197	4,373	4,900
Total expenses	2,219	3,069	5,394	6,342	7,958	10,001	8,747	9,469	10,734	11,450	11,497
Debt service to total expenses ratio	23.3%	25.5%	27.9%	29.6%	33.3%	33.8%	38.3%	38.3%	39.1%	38.2%	42.6%
Total deficit	1,081	1,327	3,289	3,493	4,640	6,483	4,244	4,584	6,083	6,357	5,711
Total deficit to expenses	-48.7%	-43.2%	-61%	-55.1%	-58.3%	-64.8%	-48.5%	-48.4%	-56.7%	-55.7%	-49.7%
Part of deficit due to debt service	47.9%	59.1%	45.7%	53.7%	57.2%	52.1%	79%	79.1%	69%	68.6%	85.8%

Source: Figures from Dr. Abdullah Attieh as an annex to his paper on "Ten years of financial policy 1993–2002", presented at the Conference of the Federation of Bank Employees Trade Unions on July 3, 2002

To get out of the debt trap, the country badly needs a plan to reshape its monetary and financial system. I do not believe that we can change our monetary habits in 24 hours. We need to cure ourselves from being addicted to a very high interest rate structure in the country (both in dollars and in LL) and being addicted to playing a “casino” game by shifting from the US dollar to LL according to rumors and the mood of key players in the banking and political markets. This is why a gradual set of measures is needed to return to normalcy.

• First, the system should stop encouraging the dollarization of the economy. Clearing of checks issued locally in US dollars, acceptance of supplier bills denominated in US dollars by public entities and acceptance of companies (like SOLIDERE) with a capital denominated in dollars should stop. The dual system of using dollars for most transactions and using the domestic currency only to pay public sector salaries or to cash huge amounts of interest on savings kept temporarily in LL should be progressively phased out. The use of LL should be encouraged instead of discouraged on the pretext of monetary stabilization. Let us remember that up to 2001, the Central Bank was penalizing the use of LL by imposing compulsory reserves on the banks on their LL deposits, while dollar deposits were exempted from such reserves. If the LL is reinstated as a main transaction currency, then many depositors will come back to it and stop maintaining accounts in both currencies, which is an additional cost to the citizen who has to make or receive payments in both currencies.

• Second, the management of the public debt should be made much more coherent. Since 1993, the Central Bank has continuously issued T-bills over the needs of the Treasury, even when the liquidity position of the public sector did not require immediate funding. The pretext has always been the need to sterilize Lebanese pounds for monetary stabilization. Graph 1, which describes the evolution of the Treasury and public sector accounts with the Bank of Lebanon, clearly shows that the liquidity position of the State and the public sector has been almost continuously above LL 1,500 billion; and several times it reached more than LL 2,500 billion (with a peak for several months during 1997 of LL 4,500 billion), while the Treasury was compelled by the Central Bank to borrow at such high rates. The overcost of such strange monetary management can be estimated at more than LL 3,000 billion during the last ten years (without including composed interests) **3**. In addition, the most costly two-year T-bills became predominant in the management of the public debt, at the expense of the three, six and twelve month T-bills. Of course, this type of management has tremendously boosted the profits of the banking sector.



G1 Source: BOL Quarterly Bulletin

• Third, the structure of interest rates should be carefully reviewed. Certainly the Beirut dollar should yield a premium over what is being paid in Western markets. But the point is to determine how large this premium should be. When we consider that most deposits remain placed at short-term maturities and that large depositors are allowed most of the time to break their deposits at no cost or at minimal cost, should the premium paid by Lebanese banks to large depositors be more than two to three percent? As we know, until recently, banks were paying premiums of more than 5% or 6% to attract dollar deposits. Stranger, the Bank of Lebanon was offering very substantial premiums to attract bank's deposits and boost its foreign exchange reserves, thus contributing to raising interest rates in the country! [4]

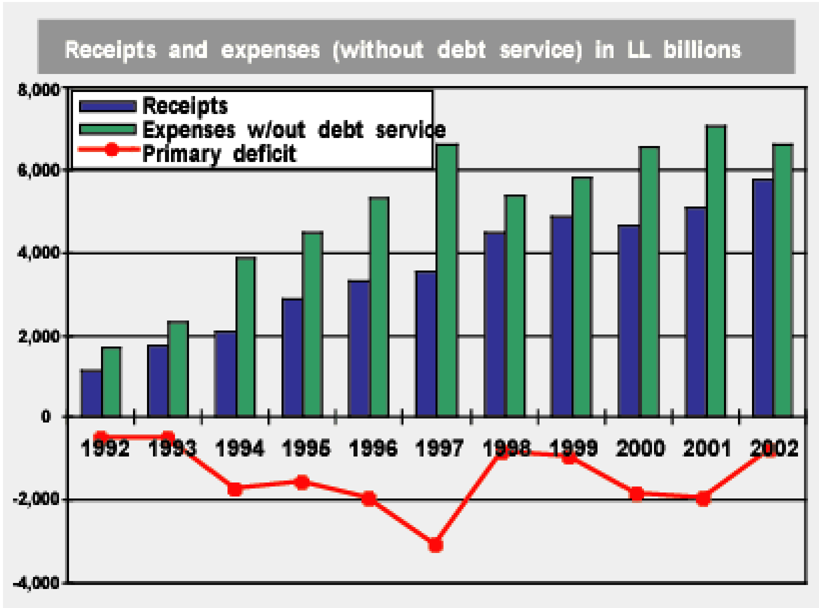
As for the rates on LL, depending on circumstances, they are usually fixed with a premium ranging between 6% and 20% above the rates of interest paid on Beirut dollar deposits. This is a suicidal policy. In addition to inflating the State debt service, it has created acute financial pain for the private sector to the point where there is now talk of rescheduling some of its banking indebtedness.

Certainly banking profits are good for the reputation of a financial market, but in the case of Lebanon these profits have been almost entirely generated by a policy that killed the growth potential of this country and played havoc with its public finances.

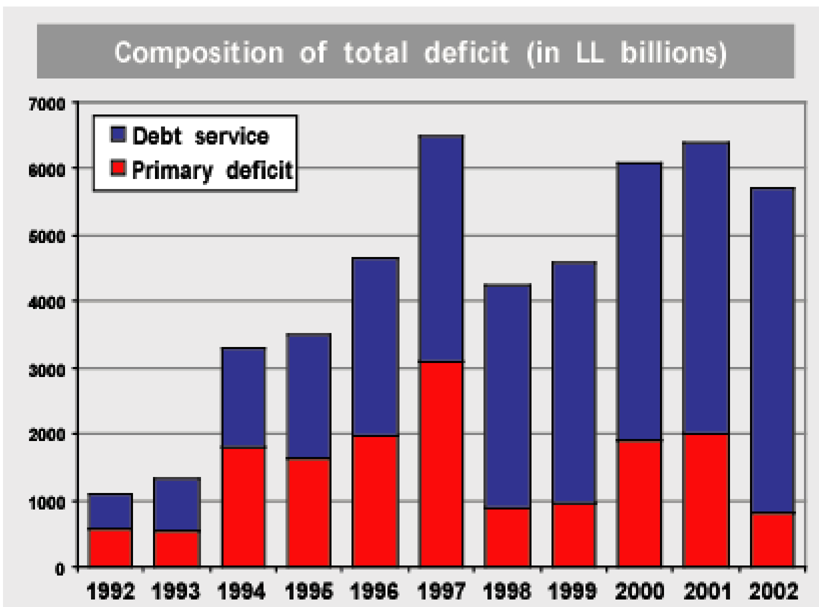
Getting out of the debt trap and recovering growth will require fundamental changes in the monetary and banking management of our country, as well as in the management of its public debt. Phasing out the present system with a progressive and well-designed approach is a first step to avoiding collapse in the future. When we enter into a new management style of our finances, then we will safely be able to widen progressively the margin of fluctuations of the pound vis à vis other currencies and introduce the much-needed flexibility in our monetary system. We will, of course, need to peg the pound to a basket of the main international currencies.

Other restructuring measures will also be needed to deflate the strongly negative impact of private and public debt on the economy. However, for these measures to be taken will require a new consensus to be built in the banking community and for the Central Bank to move away from the present costly and inefficient management of our monetary and financial system. We hope that, to avoid a crisis, the time will not be too long before it is realized that maintaining the high level of banking profits cannot be the exclusive aim of our economic policy. Banking profits are fine, as long as they originate from real economic growth and entrepreneurial dynamism. When their exclusive source comes from over-borrowing the Treasury and charging both the public and the private sectors unrealistically high interest rates, these profits become a killer to the economy. In the long term, even the banking sector will fall into the trap it is still enjoying today.

Let us remember the good old days, before the war, when our currency was freely floating and appreciating by the natural strength of our economy; dollarization was then standing at only 30% of deposits, while all credits were denominated in the domestic currency. Those days can come back, provided the present immoral and inefficient system is profoundly reformed.



G2 Source: BOL Quarterly Bulletin



G3 Source: BOL Quarterly Bulletin

1 *Gains have been maximized by big local or non-resident depositors by borrowing relatively low-cost dollars and using the proceeds to buy pounds for very high-yielding T-bill subscriptions.*

2 *We should remember that the Central Bank gave an additional bonus to depositors or subscribers to T-bills in LL by increasing the price of the pound each year by 2.5% to 3%. This practice was stopped upon my request at the beginning of 1999.*

3 As minister of finance, I strongly protested to the Central Bank when it renewed all T-bill maturities with interest due, contrary to my instructions as minister to renew only 80% of the nominal of the matured bonds. Prime Minister Hoss also stated, based on the MOF figures, the fact that contrary to article 6 of the Budget Law there have been more bonds issued than needed to fund the Treasury (for more details, see my book, Al foursa al daïa fil islah al mali fi lubnan).

4 Central banks do not accept deposits from commercial banks. In fact, they do not seek deposits in foreign currencies, as this is a sign of acute shortage of foreign exchange and it badly affects the credit rating of the country. They usually try to make swap arrangements with other central banks to face emergency needs.