Recent evolution of the main banking and monetary indicators - I. Monthly, Analysis Issue No 13, Jul 2003

Discrepancies in figures published by the Central Bank and the Banker's Association

The asset/liability structure of the Lebanese banking system has changed substantially in the last two years. Although data are becoming less transparent and appear to contain some contradictions, we will try to assess the evolution that has occurred.

Let me begin by pointing to some of these discrepancies. It is regrettable that neither the Bank of Lebanon (BOL) nor the Ministry of Finance (MOF) have explained the technical reasons behind some large changes in published figures that have taken place from time to time. Nor have they explained the important differences in data that we can find between the same figures in the consolidated balance sheet of the banking system and the BOL balance sheet.

As an example of the significant discrepancies in the data series, we can point out that, while the BOL balance sheet, as published bimonthly in Lebanese newspapers, indicates that commercial bank deposits with the BOL stood at LL 13, 708 billion in December 2002, the deposits figure shown in the consolidated balance sheet of the banking system, as published in the Monthly Economic Letter of the Association of Banks, was only LL 11, 794 billion at the same date (see Table 2). The LL 2, 000 billion difference is not negligible. It could represent the deposits made by some Arab countries through their national banks to assist Lebanon, but as shown Table 2, this difference is not consistent within the statistical series.

Bank of Lebanon Financial Position

Table 1

(In billions of LL)	1998	1999	Jun'00	Dec'00	Jun'01	Dec'01	Jun'02	Dec'02	Apr'03	May 15'03
Gross FX reserves	9,656	11,451	10,136	5,746	7,809	7,112	6,532	10,472	15,080	15,272
Bank deposits	6,540	6,817	7,034	7,202	10,135	12,299	13,244	13,708	19,228	20,337
of which deposits in FC*	5,886	6,135	6,331	6,482	9,122	11,069	11,920	12,337	16,344	17,286
Difference between gross reserves and total deposits	3,116	4,634	3,102	-1,456	-2,326	-5,187	6,712	-3,236	-4,148	-5,065
Difference between gross reserves and deposits in FC	3,770	5,316	3,805	-736	-1,313	-3,957	-5,388	-1,856	-1,264	-2,014
T-bill portfolio**	662	729	1,384	2,683	4,764	7,001	7,169	1,796	2,557	4,358

* We have estimated deposits in FC from 1998 to 2002 as 90% of total deposits – including official deposits from certain Arab countries made in 1997 – and then at 85% for 2003, taking into account the fact that part of the $4 billion interest fee to the State is being effected in LL.

** It is to be noted that for this item there is a big difference between figures of the BOL balance sheet and the figures in the *Economic Letter of the Bankers Association* (See Table 2)

Source: Bank of Lebanon's bi-monthly balance sheet

Evolution of Treasury and BOL Liabilities (total and to the banking sector)

Table 2

(In billions of LL)

	1998	1999	Jun'00	Dec'00	Jun'01	Dec'01	Jun'02	Dec'02	Feb'03
Tbs&bonds held by banks	17,796	21,499	21,611	22,504	21,706	22,151	21,958	26,523	27,906
of which in FX	3,008	4,205	4,353	5,675	6,871	8,246	8,533	10,309	11,315
of which in LL	14,788	17,924	17,258	16,829	14,835	13,905	13,425	16,214	16,591
Bank deposits at BOL	6,402	6,680	6,916	7,132	7,783	10,510	10,222	11,794	13,055
of which in FX*	5,570	5,812	6,017	6,205	6,771	9,144	8,893	10,261	10,444
of which in LL	832	868	899	927	1,012	1,366	1,329	1,533	2,611
Total obligations to banks	**24,198**	**28,179**	**28,527**	**29,636**	**29,489**	**32,661**	**32,180**	**38,317**	**40,961**
Eurobonds outside the banking sector	1,600	2,321	2,546	2,891	3,410	4,131	6,591	9,450	8,614
Bilateral & multilateral debt	1,675	1,853	1,946	1,913	1,962	2,042	2,156	2,160	2,160
Other T-bill holdings (Central Bank & others)	5,553	6,417	7,199	8,425	11,121	12,384	12,735	8,091	7,766
Other deposits at BOL**	138	137	118	70	2,352	1,789	3,022	1,914	6,173
Total state & BOL financial obligations	**33,164**	**38,907**	**40,336**	**42,935**	**48,334**	**53,007**	**56,684**	**59,932**	**65,674**
% of liabilities to domestic banking system	**73%**	**72.4%**	**70.7%**	**69%**	**61%**	**61.6%**	**56.8%**	**63.9%**	**62.4%**
State & BOL obligations in FX	11,991	14,328	14,980	16,754	21,366	25,352	29,195	34,094	38,706
Net state & BOL obligations in FX (minus FX reserves)	2,335	2,877	4,844	11,008	13,557	18,240	22,663	23,622	23,626
% of Eurobonds outside local banks	35%	36%	37%	34%	33%	33%	44%	48%	43%
% of deposits at BOL to total	26%	24%	24%	24%	26%	32%	32%	31%	32%
% of banks exposure in FX to total exposure	35.4%	35.5%	36.4%	40.1%	46.3%	53.2%	54.2%	53.7%	53.1%
% of gross FX in total liabilities of the State and BOL	36.2%	36.8%	37.1%	39%	44.2%	47.8%	51.5%	56.9%	58.9%
% of net FX in total liabilities of the State and BOL	7%	7.4%	12%	25.6%	28%	34.4%	40%	39.4%	36%

* We have estimated that FX deposits represented 87% of all deposits from 1998 to 2002, and then 80% for Feb. 03

** It is difficult to understand this big jump in deposits, which are not from the domestic banking system; this item should also include the Arab deposits, but it is not before June 2001 that we see a difference between what the banks declare as their deposits with the BOL and what the BOL declares as declares as deposits of the financial sector with it, that could account for these deposits.

We find two other important discrepancies in the figures concerning T-bill and Eurobond holdings by Lebanese banks, as follows:

• As shown in the Economic Newsletter of the Banker's Association, the banks' holdings of T-bills denominated in Lebanese pounds stood at 16, 214 billion pounds in December 2002 in the consolidated balance sheet, but are stated at LL 17, 211 billion pounds in the statistics about "outstanding public debt by type of holder".

• In the same source, the amount of outstanding Eurobonds in December 2002 is reported at LL 10, 309 billion in the consolidated balance sheet, while the total outstanding amount of Eurobonds in the statistics by type of holders was LL 19, 759 billion at the same date.

This would imply that commercial banks held only 52% of outstanding Eurobonds and that the other 48% were held by non-resident institutions or individual residents or possibly BOL. This is difficult to believe. In the good days, when sovereign Lebanese bonds were selling well, non-residents did not subscribe to more than 15% of any issue. How can one explain the rise in the proportion of non-bank holdings in view of all the pressure on the price of those bonds in 2002. One explanation may be that the amounts that were committed by Paris II donors, and paid, are now included in this figure.

These discrepancies complicate the task of analyzing the data available. However, some noticeable trend fluctuations in monetary and banking figures could be identified.

The pressures on foreign exchange reserves during 2001–2002

Owing to the lack of transparency in the data available, as well as the lack of commentary by concerned entities on published figures, a lot of monetary and financial rumors have circulated during the last two years. In fact, between the summer of 2001 and the summer of 2002, we seem to have witnessed a replay of the artificial 1995 crisis, when depositors became very anxious about the fate of their savings, especially those in domestic currency. The specter of a general payment crisis on the Argentinian model loomed heavily on the behavior of depositors and T-bills, or Eurobond holders.

The low point in this crisis appears to have occurred at the end of September 2002, when:

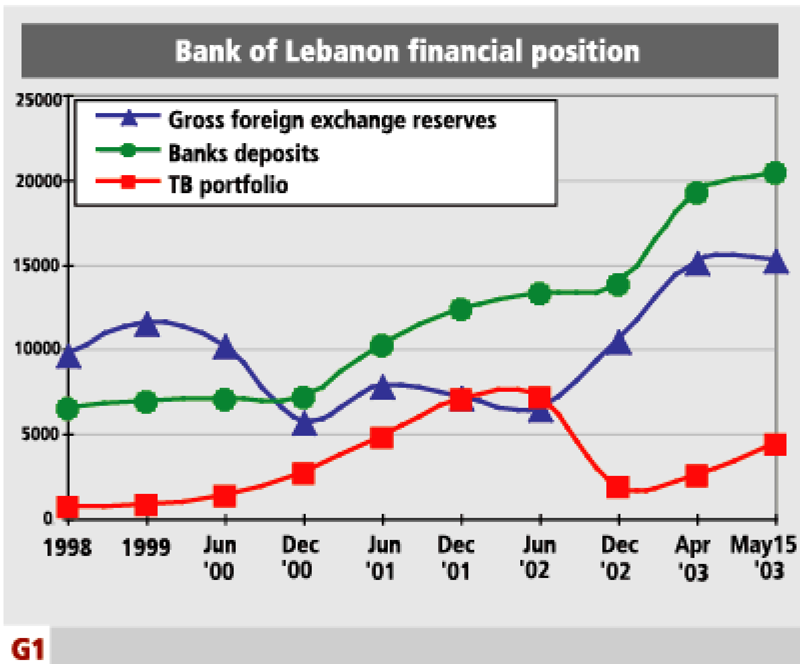
• The price of Lebanese Eurobonds declined under 80% of face value.
• The ratio of dollar deposits to total deposits increased to 75%, from 62% in 1999.
• The banks refused to roll over their maturing T-bills in domestic currency, obliging the BOL to raise its own holdings to more than LL 8,000 billion.
• Gross foreign exchange reserves of the BOL declined to LL 5,800 billion in September 2001 and were artificially boosted by imposing a compulsory reserve requirement of 15% on dollar deposits with the banking system.

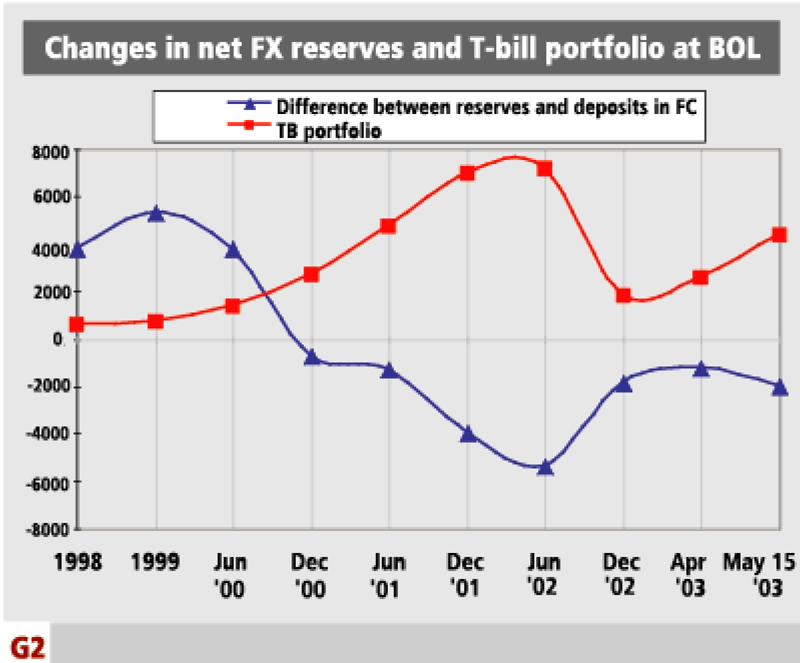
Through one of their brilliant communication campaigns, however, the the Lebanese authorities were able to halt the conversion of domestic currency to US dollars, as well as the large capital outflows that the country was experiencing. The campaign had two main themes:

• The first focused on the objective of the draft State Budget for the year 2003 to boldly reduce the deficit from the range of 40% – 50% in previous years to only 25% of total expenditures.
• The second spoke loudly about the anticipated success of the planned international gathering to assist Lebanon (what came to be known as Paris II).

As in the earlier campaigns to justify the creation of SOLIDERE, or to give glamour to the gathering in Washington in 1996 to finance Lebanon's reconstruction, or the numerous campaigns to destabilize the Hoss government and prevent the implementation of financial reforms, the Prime Minister's media campaign was very successful.

BOL also provided an additional boost to expected improvements by inflating its FX reserves through the launch, during the summer of 2001, of a one billion dollar bond issue, to which it subscribed entirely, and apparently included at least part of the future proceeds of such bonds in the reserves. As was known, some bonds were sold subsequently at a very significant discount to some Arab, and possibly, also to some Lebanese institutions.





Paris II and the interest-free lending by the banks to the State

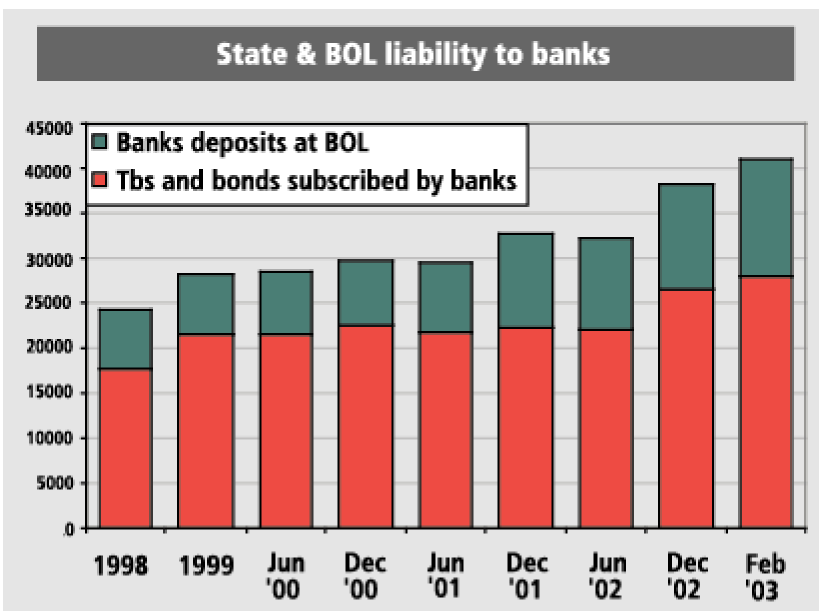
Those adverse trends were reversed following the relative success of the Paris II meeting – more specifically, when the BOL, together with the largest Lebanese banks, adopted the spectacular measure of having the commercial banks lend 10% of their deposits (or about $4 billion) to the State without interest for a two-year period. Together with the new amounts effectively committed during the Paris II meeting ($ 2.2 billion, and not $4.4 billion as was announced), this measure amounted to securing more than $6 billion for the Treasury at an average interest rate of 1.75% per annum.

Adding bravura, the BOL decided that the interest rate structure could now decline substantially. Previously, it had emphasized that this structure was determined by market forces, rather than by agreement with the banks. This was a total turnaround from previous years, when the BOL and the big banks stubbornly refused to bring about the much-needed decline in interest rates. This was the case even when inflation was subdued, the balance of payments positive and the Treasury flushed with liquidity, which was the picture during the last six months of 1999. By the end of 2002, however, the "stubborn" market suddenly turned extremely positive. (In fact, in 1999 and 2000, the banks refused totally to envisage a three- or five-year bond issue for the Treasury in Lebanese pounds at a floating rate, which the Minister of Finance was asking for so as to reduce the cost of funds to the Treasury and reduce the risk for the banks of interest rate fluctuations. Today, three-year CD issues at 9.5% constitute a very big improvement from the previous rigidity of the BOL and the banks in managing the debt and the liquidity in domestic currency. There are rumors, however, that BOL is now selling those CDs at a discount).

The release of funds from Paris II and the interest rate measures agreed upon between BOL and the commercial banks appear to have provided the financial system with some breathing space. The only regret here is that the BOL and the big banks took so much time to understand that the former "monopoly" game had to stop, at least for the time being, to avoid collapse. Probably the countries that accepted to lend to Lebanon at 5% for 15 years, and the IMF (which did not lend any funds) also have expressed their strong feelings about lending at such rates while Lebanese banks were cashing 18.5% on domestic T-bills and 10% or more when buying sovereign Lebanese Eurobonds at discount.

Meanwhile, depositors could be reassured that, for at least the next 12 or 18 months, there would be no liquidity problem for the Treasury, either in Lebanese pounds or in US dollars. Commercial banks have been using the proceeds of their huge portfolio of two-year T-bills yielding 18.5% to continue to pay their depositors high interest rates, in spite of the fact that the BOL has dramatically decreased new T-bill rates. Hefty profits were also made by the banks and institutions that took the risk of buying Lebanese Eurobonds when they were selling at large discounts during most of 2002. In addition, and as is well known, lending rates to the private sector did not decline, which should have been the case after the decline in T-bill rates. In fact, banks' net interest margins remain quite high and their temporary sacrifice is quite affordable, as interest rates earned on their dollar liquidity placed abroad would not yield more than 1.25%. Apparently, the banks are also continuing to enjoy high interest rates of between 8% and 9% on their dollar deposits with BOL, other than the $4 billion without interest that have not yet been entirely paid.

Even if there is no danger under present circumstances of another creeping crisis on the pound, and of renewed outflows of capital out of the banking system, this does not mean that Lebanon will not face the same old problems next year. In fact, the last figures from the BOL balance sheet published on 15 May 2003, as well as data available about the Treasury indebtedness through the February 2003 Economic newsletter of the Association of Banks, continue to show a worrying situation.



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What the recent data show

Analysis of the data presented in Tables 1 and 2 shows the following facts:

BOL's net financial position has resumed its deterioration

The difference between gross foreign exchange reserves and banks deposits with the BOL stood at "plus" LL 3,116 billion in 1998, but this figure turned negative in 2001 and 2002, reaching a high of "minus" LL 6,712 billion in June 2002. After an improvement in December 2002 to minus LL 3,236 billion, the figure rose to minus LL 5,065 billion at the most recent date of 15 May 2003. (It should be noted that the abbreviated IMF report submitted to the Paris II Conference mentioned the fact that foreign exchange reserves of the BOL were negative to the level of $ 2 billion - this figure did not take into account the one billion dollars of Arab deposits with the BOL).

This means that the BOL position, in spite of Paris II, has not improved substantially since December 2001. In addition, for unknown reasons and in spite of the $ 6.4 billion that has been put at the disposal of the Treasury, BOL is once again increasing its holdings of T-bills or Eurobonds, which amounted to LL 4,358 billion pounds in May 2003 (as against LL 1,796 billion when BOL cancelled most of the T-bill portfolio on the Treasury, corresponding to the transfer to the Treasury of FX profits on the gold stock of the Bank).

The evolution of the commercial banks' consolidated balance sheet (Tables 2, 3 and 4) shows a mixed picture

• In February 2003, banks held LL 13,055 billion in deposits with the BOL, of which at least 80% were in US dollars. If we add to this figure the banks' portfolio of Lebanese pound T-bills, amounting to LL 16,591 billion and their Eurobond portfolio of LL 11,315 billion pounds, the amount of exposure of banks to the State and BOL reaches the equivalent of LL 40,961 billion pounds (US$27 billion). This amount represents 52% of total assets of the banking sector.

• The proportion to the foreign exchange component of this exposure amounted to 35% in 1999, but rose to 43% recently. This could be considered an improvement for the banks, as they have substantially reduced their exposure to T-bills in domestic currency. At the same time, the share of commercial banks in total Treasury and BOL liabilities declined from 73% in 1998 to 62.4% most recently.

• Table 3 shows that while the State debt in T-bills and Eurobonds held by the banking system at the end of 1998 represented 66.8% of the total, this percentage declined to 57.4% at the end of 2002.

• The domestic currency/foreign currency composition of the banks' claims on the Treasury (Table 4) has substantially changed during the last two years. T-bills in Lebanese pounds represented 84% of the portfolio against 16% in Eurobonds in 1998. By February 2003, the domestic currency component of banks claims on the Treasury came down to 60%, from 84%, and the foreign currency component shot up to 40%, from 16%. Additional claims on the State due to deposits with BOL are also massively in foreign currency, so that during these last two years the banking system was able to shift from claims held principally in Lebanese pounds to claims in US dollars.

• Another development that could be considered favorable for the banking sector is that its share in Treasury indebtedness fell from 66.8% to 57.4%, and its share in

Treasury and BOL indebtedness decreased from 73% in 1998 to 64% in December 2002.

• The foreign exchange component of this share has gone up, from 35% in 1998/1999 to 54%–55% in 2001/2002.

• When looking at the total liabilities of the State and BOL, one notices that commercial banks' deposits with the BOL represented only 21% of the banks' total claims on the State and BOL in 1998, but now amount to 34%.

Distribution of Treasury and BOL Debt between Banks and other

Table 3

(In billions of LL)

	1998	1999	Jun'00	Dec'00	Jun'01	Dec'01	Jun'02	Dec'02
Debt held by banks	17,796	21,499	21,611	22,504	21,706	22,151	21,958	26,523
Other debt holders	8,828	10,591	11,691	13,229	16,493	18,557	21,482	19,701
Total Debt	26,624	32,090	33,302	35,733	38,199	40,708	43,440	46,224
% of debt held by banks	66.8%	67%	64.9%	63%	56.8%	54.4%	50.5%	57.4%
Domestic bank deposits at BOL	6,402	6,680	6,916	7,132	7,783	10,510	10,222	11,794
Other bank deposits at BOL	138	137	118	70	2,352	1,789	3,022	1,914
Total state and BOL obligations	33,164	38,907	40,336	42,935	48,334	53,007	56,684	59,932
% of obligations to banks to total	73%	72%	71%	69%	61%	62%	57%	64%

Source: Bank of Lebanon bimonthly balance sheet

Composition of Banks claims on the Treasury

Table 4

(In billions of LL)

	1998	1999	Jun'00	Dec'00	Jun'01	Dec'01	Jun'02	Dec'02	Feb'03
Banks Tb portfolio in LL	16,133	18,965	19,122	18,736	16,868	15,830	15,273	17,211	17,118
Banks' Eurobond portfolio in FX	3,008	4,205	4,353	5,675	6,871	8,246	8,533	10,309	11,315
Total	19,141	23,170	23,475	24,411	23,557	24,076	23,806	27,520	28,433
% Tbs in LL to total	84.3%	81.9%	81.5%	76.8%	70.8%	65.8%	64.2%	62.5%	60.2%
% of Tbs in FX to total	15.7%	18.1%	18.5%	23.2%	29.2%	34.2%	35.8%	37.5%	39.8%

Source: Economic Letter, Association of Banks in Lebanon

One alarming development is the dramatic increase in the FX content of total indebtedness

• While the Hoss government, which held office from November 1998 to October 2000, had pledged to Parliament (in the course of presenting the budget for 1999) that it would not raise the ratio of State debt in foreign currencies to total debt to more than 40%, the present government has increased this ratio in just over two years from 25.1% in June 2000 to 46.8% in February 2003 (see Table 5).

• If we add the gross liabilities of the BOL in FX to the Treasury liabilities, then the FX content in this total indebtedness has increased from 35.5% in June 2000 to 58.4% in February 2003.

• The picture of what happened in the last two years is more alarming when we look at the content of FX in the net total indebtedness of the State and BOL, i.e. the gross indebtedness minus the FX reserves. The share of this component has been multiplied by three, increasing from 12% in June 2000 to 39.4% at the end of 2002 (Table 2). This indicator reflects the huge loss in FX reserves by the BOL since the return of the Hariri government.

This is not to raise alarm with depositors. The government does not seem to be under any imminent pressures regarding meeting its maturing obligations. What is of concern, however, is that the government (the one now in office, as well as the former) does not seem to have a credible set of measures to address the structural issues that will surface again by the middle of next year.

By that time, the Treasury indebtedness (excluding deposits with BOL) will have reached the equivalent of $35 billion, and total indebtedness of BOL and the State will be well above $45 billion. Even with the recent boost given to GDP figures, the situation will remain alarming. Nor has the government any plan on how to find the dollars needed to service the interest on this part of the debt, except to try to force the re-privatization of the mobile phone sector or the securitization of State receipts (phone or other), which will increase the financial pressures that Lebanon has been going through since 1995.

Currency Composition of Treasury and BOL Debt

Table 5

(In billions of LL)

	1998	1999	Jun'00	Dec'00	Jun'01	Dec'01	Jun'02	Dec'02	Feb'03
Debt in LL	21,686	25,383	26,332	27,161	27,807	28,214	28,007	25,302	24,884
Debt in FC	6,282	7,144	8,846	10,504	12,221	14,402	17,241	21,919	21,923
Total Treasury Debt	**27,968**	**32,527**	**35,178**	**37,665**	**40,028**	**42,616**	**45,248**	**47,221**	**46,807**
Bank deposits at BOL in LL	832	868	899	927	1,012	1,366	1,329	1,533	2,611
Bank deposits at BOL in FC	5,570	5,812	6,017	6,205	6,771	9,144	8,893	10,261	10,444
Other deposits at BOL	138	137	118	70	2,352	1,789	3,022	1,914	6,173
Total indebtedness*	**34,508**	**39,344**	**42,212**	**44,867**	**50,163**	**54,915**	**58,492**	**60,929**	**66,035**
of which in LL	22,518	26,251	27,231	28,088	28,819	29,580	29,336	26,835	27,495
of which in FC	11,990	13,093	14,981	16,779	21,344	25,335	29,156	34,094	38,540
% bonds in FC to total	22.5%	22%	25.1%	27.9%	30.5%	33.8%	38.1%	46.4%	46.8%
% of total indebtedness in FC	34.7%	33.3%	35.5%	37.4%	42.5%	46.1%	49.8%	56%	58.4%

* The difference between the figure in this table and the figure in Table 2 is due to the discrepancy described in outstanding T-bills with the banking system.

Source: Bank of Lebanon bimonthly balance sheet

The conclusion of this analysis could be summarized in the following key points:

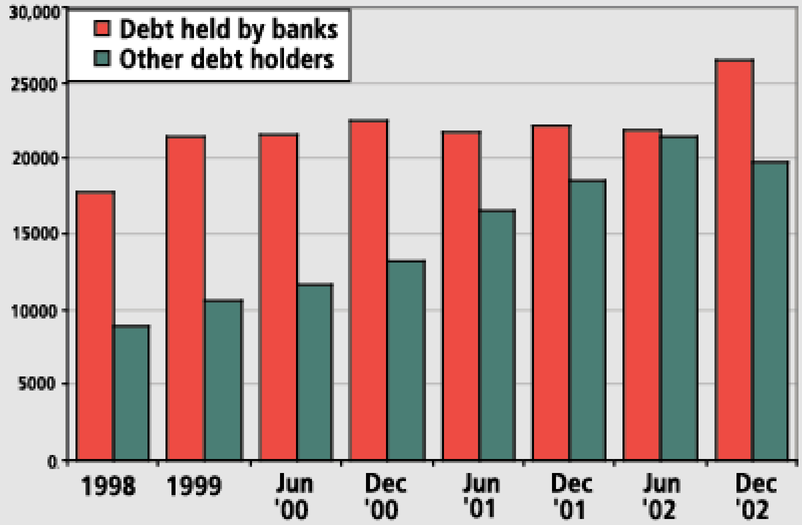
• The Lebanese economy has to increase its production considerably in order to generate the additional foreign exchange needed to service the large amount of indebtedness in foreign currency that has been accumulated in the last two years.

• To this effect, a progressive phasing out of our current monetary arrangements should be planned on a two- to three-year time span, as this monetary system has:

• Ruined the productive capacity of the country and created a complete dependence on borrowing foreign currencies to keep the economy afloat and prevent a financial crash.
• Transferred wealth and profits away from the productive sectors through the maintenance of very high interest rates on both dollars and Lebanese pounds.
• Been responsible for this formidable accumulation of private and public sector indebtedness, with the bulk of the debt having been constituted to service outrageously high interest rates.

It is time to introduce structural and well-designed measures to deal with the situation and to reactivate our dormant economy, which suffers from a financial overhang totally out of line with the size of our productive capacity. To avoid a destructive future crisis, the productive capacity of the country has to increase dramatically to be in line with the size of the existing unproductive financial wealth. We intend to revisit these issues in the coming months.

Distribution of debt holders between banks and other



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