MENA ECONOMICS FOCUS

Why Lebanon is heading for a debt restructuring

- The recent protests in Lebanon highlight that it is politically impossible to push through the fiscal austerity needed to stabilise the government’s debt-to-GDP ratio. A debt restructuring is inevitable. There are lots of ways that this could play out. But one important point to make is that the combination of an overvalued currency and widespread holdings of government FX debt in the local financial sector means that there’s the risk of a messy default accompanied by currency and banking crises.

- Lebanon’s public finances are among the worst in the world. The budget deficit has averaged 11% of GDP since the turn of the millennium. Government debt has climbed to more than 150% of GDP – the sixth highest ratio in the world. And around a third of total government debt is denominated in foreign currencies.

- Until now, the authorities have financed the budget deficit by leaning on local banks to purchase government debt as well undertaking debt swaps with the central bank. But the former has crowded out lending to the private sector and, in turn, contributed to weak economic growth. And the swap operations have resulted in a large chunk of government FX debt being held by local banks.

- The underlying problem is that the authorities have continually failed to tackle the wide budget shortfall. Wage and subsidy bills are large and the government has struggled to raise revenues. A crunch point is approaching fast. The government faces hefty debt repayments next year and investors are rapidly losing confidence in policymakers’ ability to meet their debt obligations.

- There are four main routes available for the government to address the debt problem: faster growth, higher inflation, austerity and restructuring (or default). It’s difficult to see how Lebanon can generate faster (and sustained) economic growth – the economy is set to contract this year. Trying to inflate the debt away would (further) undermine the sustainability of the dollar peg.

- Austerity is one possible option. The government did recently sign off on a number of steps to address the dire public finances. But the recent protests highlight that the government will find it extremely difficult to push through the 5-6% of GDP fiscal squeeze that we estimate is needed to stabilise the debt ratio.

- Of course, foreign governments could once again ride to Lebanon’s rescue. But it’s not clear that financing from the Gulf will be as forthcoming as it has been in the past. In particular, there appear to be growing concerns about the increasingly influential role of Iran-backed Hezbollah in the government.

- In the absence of financing, the authorities would quickly find that the cost of rolling over debt at current borrowing rates is unsustainable. And politically, default might prove to be palatable – not servicing debts would allow the authorities to raise spending in other areas or avoid hiking taxes.

- There are clearly lots of ways that all of this could play out. The least disruptive would be a restructuring that came alongside financial and technical support from the IMF. The Fund has opened the door for Lebanon to negotiate a bailout. The biggest risk, however, is that events unfold in a disorderly manner. In the absence of an IMF deal, the uncertainty over the economic outlook would lead to a bout of capital flight. And the central bank has limited resources with which to mount a defence of the dollar peg.

- A messy devaluation and default could follow. The IMF estimates that the pound is overvalued by around 50% and that investors in Lebanese bonds could face losses of up to 75%. This would be enough to wipe out banks’ capital and result in severe strains in the financial system. Past experience shows that economies which have suffered debt, currency and banking crises simultaneously have, on average, contracted by 8% from peak to trough.
Why Lebanon is heading for a debt restructuring

The recent protests in Lebanon highlight that it is politically impossible to push through the fiscal austerity needed to stabilise the government’s debt-to-GDP ratio. In this Focus, we explain why a debt restructuring appears to be the only plausible way out of the debt problem and highlight the risk that this comes alongside a messy devaluation and severe strains in the banking sector.

Dire public finances…

Lebanon’s public finances are among the worst in the world. The budget deficit has averaged 8.8% of GDP since 2005 (see Chart 1) – it came in at 11.4% of GDP last year, the largest shortfall in 15 years. And government debt has climbed to more than 150% of GDP – only Eritrea, Venezuela, Greece, Sudan and Japan have higher debt ratios. (See Chart 2.)

As well as its size, one of the long-standing concerns over Lebanon’s debt burden is the currency composition. Figures from the Ministry of Finance show that just over 60% of total debt is denominated in Lebanese pound and the rest is in foreign currencies. According to figures from Bloomberg, the Lebanese government’s foreign currency debt amounts to more than $30bn, similar to Brazil and the Philippines. (See Chart 3.)

Until now, the government has managed to muddle through. It has leaned on local banks to purchase government debt and they are now the main creditors of the government. (See Chart 4.) The majority of this is local currency-denominated debt, but banks also hold around half of the government’s Eurobond’s (equal to 30% of GDP).

But heavy purchases of government debt by local banks have crowded out lending to the private sector. As banks’ claims on the government have risen at a quicker pace than they could secure new funding, this has squeezed out holdings of other
assets, namely private sector credit. In turn, this has contributed to weak economic growth – GDP growth has averaged just 1.4% over the past decade.

In addition to this, the government has undertaken debt swap operations with the central bank (BdL), the second largest holder of government debt. This has involved swapping pound-denominated debt for FX debt in an effort to reduce the government’s interest costs and lengthen the debt maturity profile, thus easing the government’s debt repayment burden. However, the swaps have resulted in a large chunk of government FX debt being held by local banks. (See here.)

…and no one willing to tackle them

The underlying problem is that the authorities have continually failed to tackle the wide budget shortfall. In particular, politicians have been hesitant to reduce the large public sector wage bill – which accounts for almost two-fifths of total government expenditure (see Chart 5) – for fear of stoking unrest.

For similar reasons, little headway has been made with subsidy reform. This is most pertinent to the electricity sector, where household tariffs have been unchanged for the past 25 years. At the same time, a dearth of investment means that the electricity grid is reliant on aging power plants that run on more expensive diesel and fuel oil. The overall result is that government transfers to cover losses at the state electricity company, Electricité du Liban (EdL), averaged 3.1% of GDP per annum between 2000 and 2018.

Alongside rampant government spending, the authorities have persistently struggled to raise revenues. As a share of GDP, revenues amount to just 20% – compared with an average of more than 28% in other EMs. Part of this reflects relatively low tax rates. For instance, the corporate tax rate stands at just 17%. The tax base is also narrow – local banks apparently account for 60% of all tax receipts. And tax evasion is also considered to be a major issue.

The debt position is clearly on an unsustainable trajectory – in the absence of fiscal consolidation, we estimate that debt will rise to around 200% of GDP by 2025 (see Chart 6) and, clearly, it can’t keep rising forever. Admittedly, government debt reached similar levels in the early 2000s without the government having to subsequently resort to a restructuring. But that was only because the country experienced a period of rapid economic growth which, as we will explain later, is unlikely to be repeated.

A crunch point is approaching fast. In 2020, we estimate that the government’s financing needs are equal to around $19.5bn, or more than 30% of GDP – one of the highest ratios in the emerging world.
What’s more, investors are rapidly losing faith in the government’s ability to get on top of the public finances and borrowing costs have surged. Dollar bond spreads have widened by almost 500bp since the start of this year and, over this period, the probability of default over the next five years implied by CDS markets has risen from 30% to around 65%. (See Chart 7.)

**Four routes out of debt problem, only one viable**

Taking a step back, there are four main avenues available to a government to address a debt problem: faster growth, higher inflation, fiscal austerity and restructuring (or default). Looking at it from this perspective, Lebanon’s options appear to be extremely limited.

GDP growth has been extremely weak over the past decade and the data available for this year suggest that the economy is contracting. (See Chart 8.) **It’s difficult to foresee how Lebanon can generate faster (and, crucially, sustained) economic growth.** Geopolitical tensions are elevated and there’s a major risk that Lebanon gets caught in the crosshairs in a conflict involving Iran. (See our Focus.)

Even if this is ultimately avoided, wide-ranging reforms to improve the dire business environment and clamp down on rampant corruption are needed to significantly improve the outlook for Lebanon’s economy. At present, though, these don’t appear to be towards the top of the government’s agenda.

Economic growth is also held back by the overvalued exchange rate. According to the IMF, Lebanon’s real effective exchange rate (that is, the nominal exchange rate adjusted for inflation differentials) is overvalued by around 50%. This has dampened exports and encouraged consumption of imports over domestically-produced goods.

But the dollar peg is heralded as a hallmark of economic stability – it has been in place for more than 20 years and survived numerous conflicts. And in any case, given the large proportion of foreign currency debt, a devaluation would merely exacerbate the government’s debt problem.

For the same reason, the government can’t inflate its way out of the debt problem as this would undermine the dollar peg. Higher inflation would push up Lebanon’s real effective exchange rate, erode the external competitiveness and cause the current account deficit – which already stands at around 25% of GDP, one of the largest shortfalls in the emerging world (see Chart 9) – to widen.

This would put downward pressure on the pound and the central bank would be forced to drain its FX reserves. While FX reserves appear to be relatively large, at $50bn they are far less than banks’ gross external financing requirement (that is, the sum of the current account deficit and short-term external debt), which the IMF estimates to be around $100bn.

A third option would be to undertake fiscal austerity. We estimate that the authorities need to undertake a fiscal squeeze of 5-6% of GDP in order to stabilise the debt-to-GDP ratio. To bring the debt ratio down would require even more tightening. Following the recent protests, the government outlined a number of steps to address the dire public finances. These included a 50% reduction in salaries for current and former presidents, ministers and
parliamentarians, as well as pushing ahead with an overhaul of the state electricity company (EdL) and privatisating the telecoms sector.

But we think that the government will struggle to push through austerity. As we’ve argued before, the reform of EdL outlined by the government earlier this year would not result in a sufficient improvement in the public finances. (See here.) Meanwhile, failure to force through the so-called WhatsApp tax – the trigger of the recent protests – doesn’t bode well for the more difficult decisions regarding cuts to the public sector wage bill. And comments from officials of all ilk suggest that any major revenue-raising measures are off the table.

Debt restructuring appears inevitable

The upshot is that debt restructuring appears to be the government’s only viable route out of its debt problem. Earlier this year, officials let slip that this has already been considered, triggering a sell-off in local financial markets.

Of course, the public finances have been in a dire state for some time and a similar argument could have been made at any point over the past couple of decades. And there is a chance that, once again, foreign governments come to the rescue by providing Lebanon with billions of dollars in loans and grants. Both Saudi Arabia and the UAE have also recently said that they would provide financing. And $11bn of support was pledged at last year’s CEDRE conference in Paris – albeit dependent on the implementation of economic reforms.

But it’s not clear that financing from the Gulf will be as forthcoming as it has been in the past. In particular, there appear to be growing concerns about the increasingly influential role of Iran-backed Hezbollah in the Lebanese government.

If financial support from foreign governments is less forthcoming, sooner rather than later the authorities would quickly find that the cost of rolling over its debt at current borrowing rates is unsustainable. And politically at least, default might turn out to be palatable – not servicing debts could allow the authorities to raise spending in other areas or avoid hiking taxes.

Orderly or disorderly – that is the question

There are clearly lots of ways that all of this could play out. The least disruptive would be a restructuring that came alongside financial and technical support from the IMF. In light of the recent protests, the Fund has opened the door for Lebanon to obtain a financing package. But the IMF’s legal framework means that it would be precluded from lending to Lebanon unless it can deem government debt to be sustainable. This seems unlikely and thus it would be obliged to request a debt restructuring. The Fund might also insist that the Lebanese authorities devalue the pound as a pre-condition to any agreement.

Debt restructuring would by no means be straightforward. Unlike other countries that have been forced to restructure their debts in recent years, such as Angola, Lebanon cannot rely on renegotiating bilateral or multilateral loans to deal with the debt problem. Even if these loans were cancelled, it would knock only 4%-pts off the debt-to-GDP ratio. Instead, a restructuring will have to focus on a combination of the government’s local currency debt (i.e. Treasury bills) and the Eurobonds.

The main issue is that, as we mentioned earlier, local banks are significant holders of both local currency and foreign currency debt. As such, a restructuring would have to be managed in a way that minimises losses on banks’ balance sheets or, alternatively, ensures that funds are available to recapitalise the banking sector in the event of a wide-ranging default. This task would be made much easier with IMF support. One possible route would be to impose larger losses on foreign investors than local banks.

History suggests that IMF involvement would not necessarily mean that the recovery values from any restructuring would be significantly higher. One of the most reliable indicators of recovery values has been the public debt ratio. (See Chart 10.) Note that “investor losses” in the Chart are calculated by Moody’s and, in most cases, are based on the trading prices of the old bonds just before the restructuring. (For more detail, see this paper). Lebanon’s debt ratio of around 150% would imply recovery values of 30-40%.
The biggest risk, however, is that events unfold in a disorderly manner. In the absence of an IMF deal, capital flight would accelerate. This would be exacerbated in the event of a shock, such as the outbreak of a proxy conflict in the country. It’s worth noting that non-resident deposits into the banking sector – the main source of financing for the large current account deficit – have already slowed to a crawl this year. (See Chart 11.) And as we mentioned earlier, the central bank has limited resources with which to sustain a strong defence of the dollar peg.

A devaluation would make it more expensive for the government to service its large FX debts. All else equal, every 10% fall in the pound against the dollar would push up the debt-to-GDP ratio by around 5-pts. (See Chart 12.) If the currency were to fall 50%, in line with the IMF’s estimate of overvaluation, the debt ratio would reach 175% of GDP. This would imply recovery values of closer to 25%.

A sharp fall in the currency could simply make it too expensive for the government to service its foreign currency debts and it may have little other option but to default. This could potentially result in severe strains in the banking sector. By our estimates, a 33% haircut on Lebanese government debt would be enough to push banks’ tier 1 capital ratios below the minimum regulatory requirement of 8%, prompting a round of recapitalisations. A haircut of 75% would wipe out banks’ capital.

Conclusion
All told, we think that the Lebanese government will eventually resort to some form of debt restructuring. Given the vulnerabilities within the banking sector, our central scenario is that the authorities seek support from the IMF and that things will play out in an orderly manner.

However, the toxic combination of an overvalued currency and large foreign currency debts spread through the economy means that there is a significant risk of a more disorderly outcome. A full-blown currency, debt and banking crisis could ensue. Economies which have suffered all three types of crisis simultaneously have, on average, contracted by 8% from peak to trough. (See Chart 13.)
Disclaimer: While every effort has been made to ensure that the data quoted and used for the research behind this document is reliable, there is no guarantee that it is correct, and Capital Economics Limited and its subsidiaries can accept no liability whatsoever in respect of any errors or omissions. This document is a piece of economic research and is not intended to constitute investment advice, nor to solicit dealing in securities or investments.

Distribution: Subscribers are free to make copies of our publications for their own use, and for the use of members of the subscribing team at their business location. No other form of copying or distribution of our publications is permitted without our explicit permission. This includes but is not limited to internal distribution to non-subscribing employees or teams.