## Contents



# Report | **Lebanon's Macro Economy For The First Quarter 2020**

## Introduction

During the first quarter of 2020, the socio-economic and financial conditions have further aggravated in Lebanon: GDP contraction, higher inflation, private-sector paralysis, higher unemployment, greater poverty, lower sovereign ratings, continued fiscal deficits, higher public debt, further pressures on the banking system (Central Bank and banks), continued devaluation of the Lebanese pound, seizure of capital inflows, inactive capital market, and deficits in the balance of payments. The emergence of the COVID-19 and its spread in Lebanon has led to a major shutdown, which reflected negatively on all economic sectors, aggregate economic activity, and social conditions.

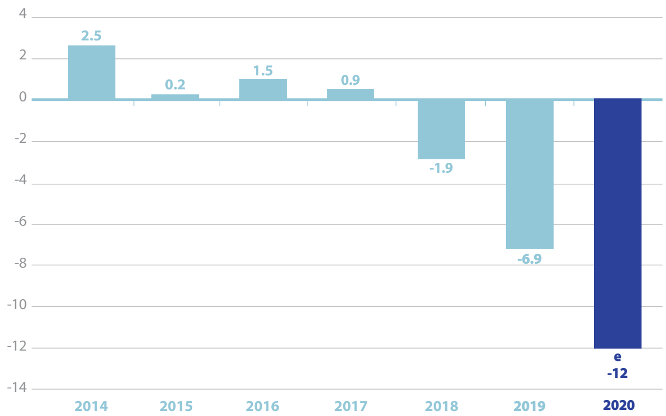
## I. Socio-Economic Prospects and Performance of Economic Sectors

Lebanon's economy has slumped into a deep contraction, thereby recording negative growth rates since 2019. Social conditions have aggravated in 2020 with critical living conditions. The performance of the economic sectors and economic activity retarded during the first quarter of 2020.

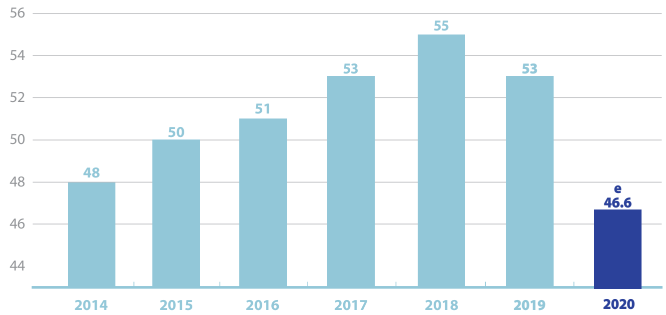
### A- Economic Prospects

It is obvious that Lebanon has recently entered into a deep economic contraction since its growth rates are now negative. According to the Ministry of Finance Statistics, real GDP growth rate was -6.9% in 2019 and is expected to record nearly -12% in 2020. Accordingly, real GDP is projected to fall from USD 53 billion in 2019 to USD 46.6 billion in 2020. Inflation is expected to rise to 25% or even above in 2020, affected mainly by weak price control, and continued deterioration in the exchange rate of the LBP vis-à-vis the USD.

**Real GDP Growth** (%)



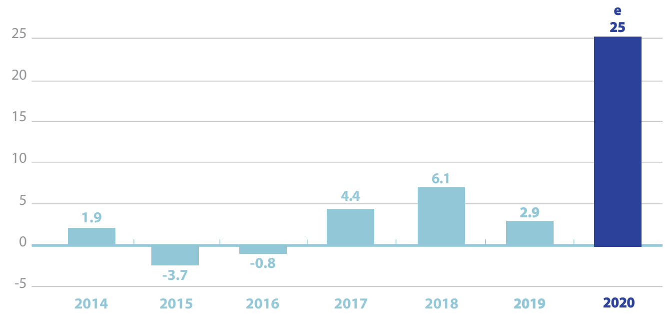

**Nominal GDP** (USD, billion)




The deterioration in the exchange rate is due to the critical level of foreign exchange reserves of the Central Bank which currently stands at USD 29 billion, of which USD 22 billion are liquid and out of which USD 18 billion are mandatory reserves held by the Central Bank for regulatory considerations (legal reserve requirements on commercial banks). In addition, this exchange rate deterioration is caused by the sharp shortage in the supply of US dollar in the local market, and uncontrolled dealings by exchange dealing houses.

The continued depletion of the Central Bank's foreign-exchange reserves is caused mainly by the high deficit in the country's trade account (well above 30% of GDP), lower capital inflows, and high deficits in the balance of payments. Lebanon is facing severe fiscal conditions with continued drops in overall revenues and high levels of overall expenditures, leading to high fiscal-deficit ratios that stood at more than 11-12% of GDP, and high levels of debt-to-GDP ratio that stood at more than 178% in 2019. The debt servicing continues to absorb more than 50% of public revenues, with a high cost of nearly 7%. Lebanon's gross public debt is now in the excess of USD 90 billion distributed as follows: Eurobonds USD 31.3 billion, bilateral/multilateral loans USD 2.1 billion, and T-bills and bonds USD 57.1 billion. The country has to finance USD 4.6 billion of Eurobonds and interest this year, besides USD 10.3 billion of T-bills.

• | **Evolution of Average Annual Inflation Rate (%)**




e: estimate

## • Major Macro Economic Indicators

| Indicators | 2018 | 2019 | 2020 e |
|---|---|---|---|
| GDP (in nominal terms, USD billion) | 55.0 | 53.0 | 46.6 |
| Real GDP growth (%) | 1.5 | (6.9) | (12.0) |
| Inflation rate (%) | 6.1 | 2.9 | 25.0 |
| Share of population under poverty line (%) | 25.0 | 33.3 | 50.0 |
| General unemployment (%) | 20.0 | 30.0 | 40.0 |
| Unemployment among the youth (%) | 30.0 | 40.0 | 45.0 |
| Immigrated Lebanese | 33.841 | 66.806 | n.a. |

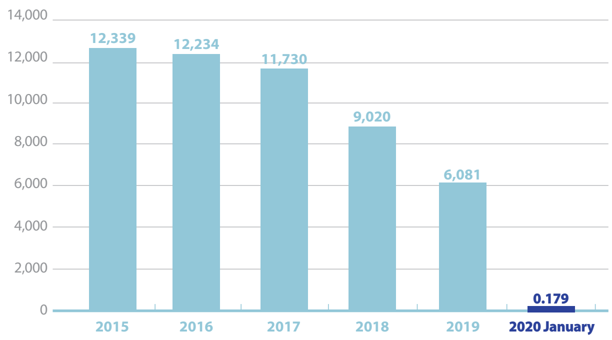
**Sources:** Estimates of Domestic and International Institutions, IIF, and Al-Daoliyah Lil-Maaloumat

## B- Performance of Economic Sectors

The economic sectors continue to suffer and try to survive as long as possible, in hopes that the government recovery plan would restore economic growth.

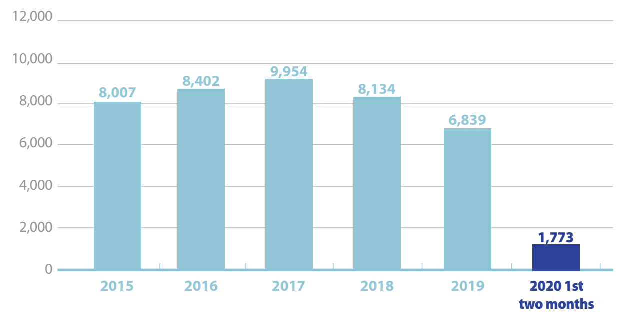
The **construction sector** experienced a retarding activity, with the area of construction permits falling by annual rate of 64.6% to 178,775 square meters in the first month of 2020. In addition, cement deliveries fell by 60.8% during this period.

• | **Area of Construction Permits** (Thousand SQM)



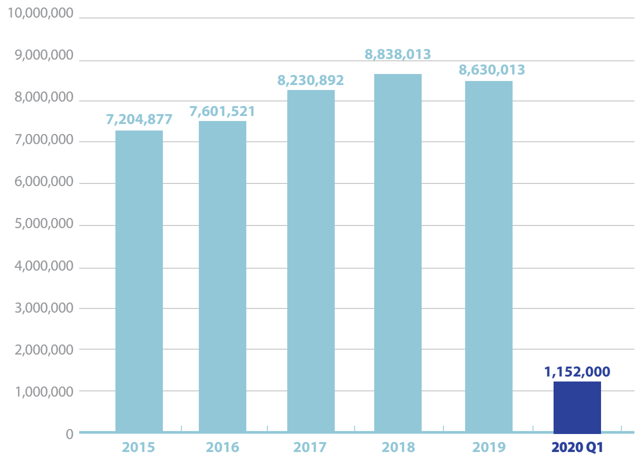
The **property sector** witnessed a relative improvement, with the numbers of sales operations increasing by an annual rate of 37.9% to 10,834 operations in the first two months of 2020, the sales to foreigners growing by 11.4% to USD 166 operations, and the value of property sales transactions surged by 67.9% to USD 1.8 billion during the same period.

**Value of Real-Estate Transactions** (USD, million)

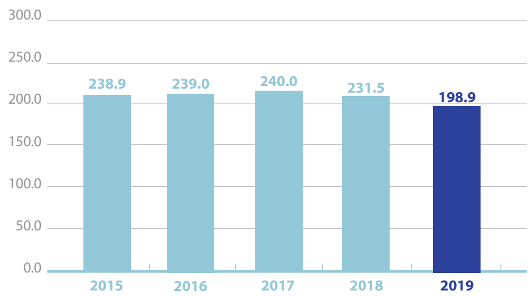



The performance of the transport sector, both the air transport and the maritime transport, was inferior in 2020 relative to 2019. Passengers via Rafic Hariri International Airport declined in number by an annual rate of 33.4% to nearly 1.2 million passengers, and in its aircraft activity by 30% to 10,805 planes in the first quarter of 2020. The Port of Beirut's number of containers, number of ships and the quantity of goods all declined by an annual rate of 45.4%, 1.5% and 16.5% respectively in the first two months of 2020.

**Passengers at the Airport**

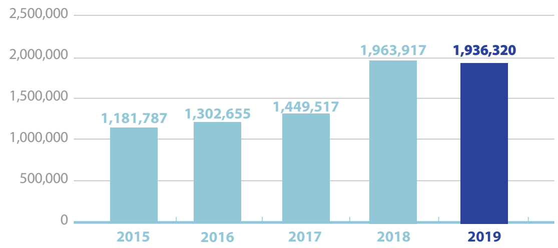



**Port of Beirut Revenues** (USD, million)



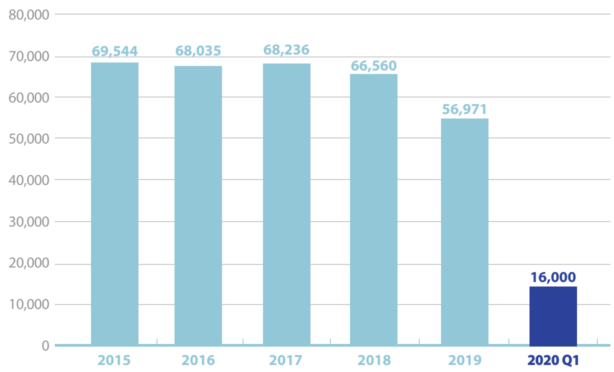
The **tourism sector** experienced a weak performance in the first quarter of 2020. The **hotel sector** was negatively affected by a retarding tourism activity, where the occupancy rate of Beirut 4 and 5 stars hotels was at nearly 20% in the first quarter of 2020, against 70% for the first three months of 2019.

**Tourists Activity in Lebanon**




The **internal trade sector** witnessed a contraction in its activity, with the number of cleared checks dropping by an annual rate of 30% to 1.9 million checks and its value by 8.5% to USD 16 billion in the first quarter of 2020. These two indicators also reflect a declining private consumption and investment spending during this period.

**Clearing Activity** (USD, million)




The **export sector** recorded a better activity in the first quarter of 2020, with total industrial and agricultural exports increasing by 26.2% on annual basis to reach USD 0.7 billion.

## • Real-Sector Indicators

| Indicators | Q1 2019 | Q1 2020 | % Change |
|---|---|---|---|
| Construction permits surface area (sqm) (January) | 504,819 | 178,775 | (64.6) |
| Value of property sales transactions (USD, billion) | 1.1 | 1.8 | 67.9 |
| Passengers activity via HIA (million) | 1.7 | 1.2 | (33.4) |
| Hotel occupancy rate (%) | 70.0 | 20.0 | - |
| Value of cleared checks (USD, billion) | 14.8 | 16.1 | 8.5 |
| Total exports (USD, billion) (February) | 0.54 | 0.68 | 26.2 |

**Source:** Official Directorates

## II. Fiscal Conditions

During the first quarter of this year, the revenues of the State experienced a drop due to the pressing living, financial, and economic conditions on the Lebanese people, which forced many of them to seize the payment of taxes and duties against public services. On the other hand, government spending has increased in recent months, mainly on healthcare and social security, due to the negative consequences of the coronavirus on the overall economy and social conditions. This is fueling further deficits and debt and thus further fiscal pressures on Lebanon's macro economy and society.

### A- Fiscal Deficit

Lebanon's fiscal balance remains largely negative, due to weakened public revenues, which fell by 10.8% over January 2020 relative to its corresponding level last year to reach USD 1 billion. In addition, this fiscal imbalance is caused by the substantial amount of public spending which increased by 39% to reach USD 1.7 billion during the same period. In this sense, public revenues represent some 60% of public expenditures.
Because of such mismatching between public revenues and spending, the fiscal deficit continues to emerge on continued basis. The level of this deficit reached USD 670 million as of end January 2020, growing by an annual rate of 820.4% during the period under consideration. The fiscal deficit constitutes nearly 39.6% of public spending which is high.
Both tax and non-tax revenues are weak, caused by people's declining incomes and lower purchasing power of these incomes in line with continued exchange rate depreciation and increasing prices of goods and services. On the other hand, the high levels of debt service and government's financial transfers to EDL are major driving factors of public spending growth.

• **Public Finances Indicators** (USD, million)

| Indicators | Jan 2019 | Jan 2020 | % Change |
|---|---|---|---|
| Public revenues: | 1,144 | 1,021 | (10.8) |
| Tax revenues | 903 | 808 | (10.5) |
| Non-tax revenues | 180 | 144 | (19.9) |
| Public spending: | 1,217 | 1,691 | 39.0 |
| Fiscal balance | (73) | (670) | 820.4 |
| Primary deficit or surplus | 232 | (326) | |

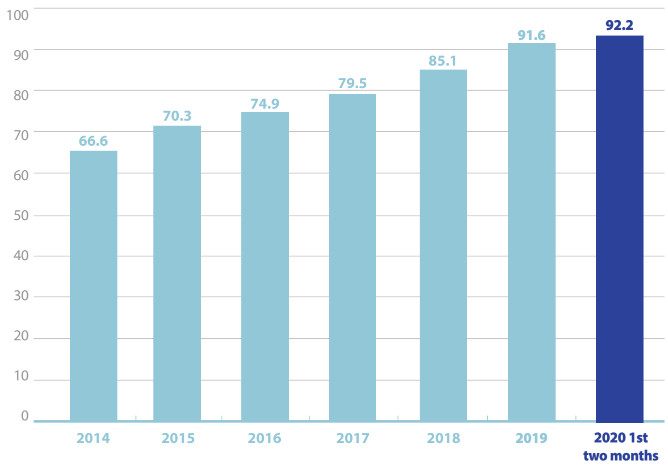
**Source:** Ministry of Finance

### B- Public Indebtedness

The State's public debt remains on growth trajectory, fueled by continued fiscal deficits and debt servicing. So far, the government did not implement any actions and measures to establish fiscal consolidation and debt control. The government seized the payment of any Eurobond issues to creditors, in light of the aggravating financial and economic conditions in recent months, and is currently undertaking debt-restructuring negotiations with international creditors.

Lebanon's gross public debt grew by an annual rate of 8.2% to reach USD 92.2 billion at the end of February 2020. If this debt increases by USD 5 billion this year, and with declining GDP, then the ratio of debt to GDP could reach a record level of 200% by the end of 2020, a very alarming figure.

• | **Evolution of the Gross Public Debt** (USD, billion)




• **Public Debt Indicators** (USD, billion)

| Indicators | 2019 1st two months | 2020 1st two months | % Change |
|---|---|---|---|
| Gross debt: | 85.2 | 92.2 | 8.2 |
| Domestic debt | 51.5 | 58.2 | 13.0 |
| Foreign debt | 33.8 | 34.1 | 0.9 |
| Net debt | 76.6 | 82.6 | 7.8 |

**Sources:** Ministry of Finance and Central Bank of Lebanon

## III. Financial Sector Conditions

The financial sector of Lebanon has experienced further pressures during the first quarter of 2020 due to the unfavorable socio-economic conditions and fiscal conditions prevailing in the country since 2019. The banking sector continues to witness a relative paralysis in its overall activity, coupled by declining banking indicators. The monetary situation continues to experience the pressures of exchange rate deterioration, and shrinking foreign-currency reserves of the Central Bank. The activity of both the capital market and financial institutions have worsened in the first quarter of 2020.

### A- Monetary Conditions

Regarding the Central Bank's situation, its balance sheet increased by 17.1% on annual basis to reach USD 146.3 billion at end-March 2020. The Bank's foreign-currency assets dropped by 8.6% on annual basis to reach USD 35.2 billion at end-March 2020. The latter assets reached USD 30.2 billion at end-March 2020, when excluding Lebanese Eurobonds. The value of the Bank's gold reserves rose by 24.5% on annual basis to reach USD 14.8 billion at end-March 2020. Deposits of the financial sector at the central Bank reached USD 113.1 billion at end-March 2020, up by USD 1.1 billion from end-2019.

## • Monetary Indictors

| Indicators | Q1 2019 | Q1 2020 | % Change |
|---|---|---|---|
| LBP/USD official exchange rate | 1,507.5 | 1,507.5 | - |
| Central Bank's total assets (USD, billion) | 124.9 | 146.3 | 17.1 |
| Assets in foreign currencies (USD, billion) | 38.6 | 35.2 | (8.6) |
| Assets in foreign currencies without Eurobonds (USD, billion) | 30.3 | 30.2 | (0.3) |
| Deposits of financial sector (USD, billion) at Central Bank | 112.0 | 113.1 | 0.98 |

**Source:** Central Bank of Lebanon

The unstable banking conditions prevailing in recent months can be traced through the development of the major indicators of the banking sector. The consolidated assets of commercial banks decreased by 17.5% on annual basis to reach USD 208.5 billion at end-March 2020. The loans extended to the private sector declined by 21.5% to reach USD 57.3 billion during this period. In addition, the loans extended to the public sector dropped by 24.6% on annual basis to reach USD 25.1 billion during this period. The private sector deposits declined by 13.3% on annual basis to reach USD 149.6 billion during the same period. The banks' aggregate capital accounts recorded an annual drop of 6.3% to reach USD 20.7 billion at end-March 2020.

On the dollarization of the economy front, the dollarization of private sector loans was 66.3% at end –March 2020, relative to 69.7% at end-March 2019. On the other hand, the dollarization of private sector deposits was 77.9% at end-March 2020, while it was 70.6% at end-March 2019. In this sense, the dollarization of the Lebanese economy, as proxied by the above two dollarizations, has increased during the period under consideration.

## • Banking Indicators

| Indicators | Q1 2019 | Q1 2020 | % Change |
|---|---|---|---|
| Total assets (USD, billion) | 252.8 | 208.5 | (17.5) |
| Loans to Private sector (USD, billion) | 57.3 | 45.0 | (21.5) |
| Loans to Public sector (USD, billion) | 33.3 | 25.1 | (24.6) |
| Deposits of Private sector (USD, billion) | 172.5 | 149.6 | (13.3) |
| Total capital (USD, billion) | 22.1 | 20.7 | (6.3) |
| Loan dollarization (%) | 69.7 | 66.3 | - |
| Deposit dollarization (%) | 70.6 | 77.9 | - |

**Sources:** Central Bank of Lebanon and Association of Banks in Lebanon

## B- Capital Market

The Beirut Stock Exchange (BSE) was negatively affected by the deteriorating economic and financial conditions during the first quarter of 2020. The total trading volume declined sharply by 95.5% on annual basis to reach 8,298,287 shares at end–March 2020. Aggregate turnover also fell by an annual rate of 94.4% to reach USD 43.3 million during the same period.

The BSE market capitalization shrank by 35.6% on annual basis to reach USD 6.2 billion at end–March 2020. The market liquidity ratio dropped from 8.1% in the first quarter of 2019 to 0.7% in the first quarter of 2020.

### • BSE Indicators

| Indicator | Q1 2019 | Q1 2020 | % Change |
|---|---|---|---|
| Total trading volume (shares) | 182,997,099 | 8,298,287 | (95.5) |
| Aggregate turnover (USD, million) | 777.3 | 43.3 | (94.4) |
| Market capitalization (USD, billion) | 9.6 | 6.2 | (35.6) |
| Market liquidity ratio (%) | 8.1 | 0.7 | - |

**Source:** BSE

## C- Financial Institutions

In the first quarter of 2020, the activity of financial institutions operating in Lebanon was inferior to that recorded during the same period of 2019.

The total assets of these financial institutions decreased by 9.1% on annual basis to reach USD 1,257 million at end–March 2020. In addition, the claims on resident customers fell by 7% on annual basis to reach USD 580.3 million during this period. Claims on the public sector declined by 6.4% to USD 4.8 million during the same period. On the other side, resident customer deposits dropped by 10.4% to USD 153.2 million during the same period. The capital accounts of these financial institutions shrank by 3.4% to USD 469.7 million during the same period.

### • Indicators of Financial Institutions (USD, million)

| Indicators | Q1 2019 | Q1 2020 | % Change |
|---|---|---|---|
| Total assets | 1,383 | 1,257 | (9.1) |
| Claims on resident customers | 624.5 | 580.3 | (7.0) |
| Claims on public sector | 5.1 | 4.8 | (6.4) |
| Resident customer deposits | 171.0 | 153.2 | (10.4) |
| Capital accounts | 486.4 | 469.7 | (3.4) |

**Source:** Central Bank of Lebanon

# IV- Foreign Trade and Balance of Payments

The aggravating economic conditions during the first quarter of 2020, the weaker activity of the RHIA (foreign activity) and Beirut port, the weaker incomes of people and lower purchasing powers, the newly emerging controls on airports around the world, and domestic banking controls on certain types of imports, all were driving forces that led to weaker imports, exports, and foreign trade of Lebanon. However, a positive development was recorded during this period: declining imports and improvement of production in some domestic industries, especially those related to the sectors of food and beverages, medicines, medical equipment, and sanitization. This has led to a greater dependence on local production vis-a-vis foreign imports. On the other side of the foreign sector, the balance of payment continue to record further deficits, caused mainly by shrinking foreign capital inflows and lower remittances from the Lebanese expatriates.

## A- Trade Balance

The volume of foreign trade of Lebanon totaled USD 2.78 billion in the first two months of 2020, declining by an annual rate of 16.8%. This is caused by lower imports (24% to USD 2.1 billion), and higher exports (26.2% to USD 0.7 billion) during the same period.
Because of such trade exchanges, Lebanon's trade deficit shrank by 36% from the first two months of 2019 to USD 1.4 billion in the same period of 2020.
The export-to-import ratio was 32.2% at end-February 2020, relative to 19.1% at end-February 2019.

## B- Capital Balance

Lebanon continues to experience lower foreign capital inflows to its national economy, to its banking sector, capital market, real estate sector, and productive sectors. Several factors are behind this: economic contraction in many countries around the world, lower capital exchanges between international borders, and shrinking remittances from expatriates due to bad economic conditions in host countries and domestic capital controls.

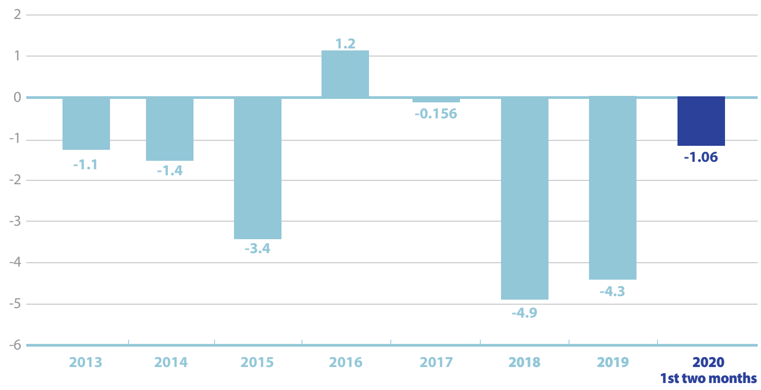
The level of foreign capital inflows to Lebanon reached USD 2.5 billion in the first two months of 2020, declining by an annual rate of 41.9%. At the same time, Lebanon has experienced an acute capital flight in billions of dollars over the past six months, leading to chronic shortage of foreign currencies (especially the US dollar) in the local market.

## C- Balance of Payments

The weaker inflows of capital and investments from abroad in the first two months of 2020, besides capital flight and weak export activity have all led to a further deficit in the country's balance of payments during this period.

The deficit recorded in the balance of payments in the first two months of 2020 totaled USD 1.06 billion, relative to a deficit of USD 2 billion for the same period of 2019. This deficit is based on the net foreign assets of both the Central Bank and commercial banks. The former declined by USD 2.1 billion, and the latter increased by USD 1.09 billion during the same period.

• | **Balance-of-Payments** (USD, billion)




• **Balance-of-Payments Components** (USD, billion)

| Components | 2019 1st two months | 2020 1st two months | % Change |
|---|---|---|---|
| Trade balance: | (2.3) | (1.4) | (36.0) |
| Imports | 2.8 | 2.1 | (24.0) |
| Exports | 0.536 | 0.676 | 26.2 |
| Capital balance | 4.3 | 2.5 | (41.9) |
| Balance-of-Payments | (2.0) | (1.06) | - |

**Sources:** Central Bank of Lebanon and Higher Customs Council

## V- Sovereign Ratings

The current adverse economic, financial, and social conditions prevailing in Lebanon have forced the international credit rating agencies to classify the level of political, financial, and economic risks in Lebanon as "high". The suspension of Eurobond settlement by the government of Lebanon, and its decision to restructure its public debt, have added further pressures on Lebanon's sovereign ratings.

According to the ratings of international agencies, Lebanon has fallen to a "Relative or Selected Default" grade on its short-term or long term foreign currency obligations, and to below "CCC" grade concerning its short-term or long-term local-currency obligations.

These rating agencies classify the "outlook" of Lebanon's sovereign ratings as "negative" or "stable".

• **Lebanon's Sovereign Rating, March 2020**

| | Foreign Currency | | | Local Currency | | |
|---|---|---|---|---|---|---|
| **Agencies** | LT | ST | Outlook | LT | ST | Outlook |
| Moody's | Ca | NP | Stable | Ca | - | Stable |
| Fitch | RD | C | - | CC | C | - |
| S&P | SD | SD | - | CC | C | Negative |
| CI | SD | SD | - | C- | C | Negative |

**LT: long term ST: short term**
**Sources:** Rating agencies

# Study | Lebanon: **Restructuring the Sovereign Debt**

## Introduction

This study defines sovereign insolvency and sovereign debt restructuring. It sheds light on the tools of this debt restructuring, the role of the IMF in case a national government decided to ask for its technical and financial assistance, and the risks and implications of debt restructuring on the State. The study also exhibits the overall situation in Lebanon and the possibility of sovereign debt default, indicators of sovereign debt and default, and the implications of such default on the financial, economic and banking sectors. The study presents the open alternatives for Lebanon as far as pre-emptive default or post-default restructuring are concerned.

## I. Financial Default and Sovereign Debt Restructuring Defined

"Sovereign Insolvency" can be defined as: the State's inability to pay its foreign debts to all creditors in full amount and according to the agreed-on timetable, due to the lack of sufficient financial resources.

This insolvency is correlated with the high and growing financial pressures on the State due to the rise in its overall indebtedness to "critical" levels, whereby the debt servicing constitutes a major drain on the State's revenues and GDP.

The major indicators of the sovereign insolvency problem are the following:

1- Unwillingness or inability to pay the sovereign debt issues in full amount according to the set timetable and/or breaking the commitment to pay the debts in the context of agreements with local or foreign banks.
2- Gradual downgrading of the country's sovereign credit ratings by international rating agencies.
3- Inability of the State to attract new financial resources and inject sufficient liquidity in the national economy.
4- The need to restructure the banks' capital bases and increase it in high ratios in order to support its financial liquidity and adequacy.

"Sovereign Debt Restructuring", on the other hand, can be defined as the agreement which can be concluded between the debt stakeholders, mainly the borrowing country and the creditor parties (governments, banks, companies and institutions), in order to reach a feasible financial arrangement whereby the borrowing country can settle its debts according to new financial conditions related to the value, interest rates, and timetables.

Therefore, a sovereign debt restructuring process requires primary factors such as time, organization, efforts, coordination, negotiations, accountability, transparency, and agreement between all debt stakeholders – the borrowing country and creditors. This agreement is necessary and crucial for the borrowing country to avoid "hostile" measures and actions by creditors.

The sovereign debt restructuring process requires several objectives to ensure its success, of which the following are the basic ones:

1- Insolvency should be orderly and less messy, in order to avoid the hostile legal actions by creditors towards the borrowing country.
2- The borrowing country could be able to access the financial markets for further financing in the future. This requires an orderly, firm and early restructuring negotiations between the borrowing country and creditors.
3- Decreasing the potential costs of insolvency, and at the same time ensuring the government's willingness to settle its debt. This should be carried in an orderly, disciplined, and agreed-on restructuring process with creditors.

## II. Forms and Steps of Sovereign Debt Restructuring and the Role of IMF

There are two forms of sovereign debt restructuring a State can follow: pre-emptive restructuring and post-default restructuring.

The pre-emptive sovereign debt restructuring occurs under the following conditions:

1- The borrowing country is facing a major crisis and requires an early debt restructuring from creditors.
2- Approval of all or most creditors on restructuring the country's sovereign debt.
3- The borrowing country seeks to deal with a liquidity crisis in its economy.
4- A quick ability to access international capital markets to get additional financing for its local economic activity.

The post-default sovereign debt restructuring, on the other hand, occurs under the following conditions:

1- The borrowing country has defaulted in settling the maturing debts.
2- The borrowing country seeks to deal with a solvency crisis in its economy.
3- Usually a "haircut" policy (cutting a certain percentage of the money, savings and wealth of economic agents-individuals, institutions, companies and others) may be needed.
4- Loss of confidence in the borrowing country and its financial and economic future, besides the persistence of high debt levels due to high interest rates on the debt.

The orderly debt restructuring process can be implemented in several ways and alternatives:

The first alternative is to form a special committee from creditors, whereby an agreement could be reached concerning debt restructuring or messy default, or starting debt-restructuring negotiations and this requires the appointment of representatives and advisors to the borrowing country. This may also need the assistance of the IMF to play the role of an intermediator and information exchanger with creditors, which in turn needs an agreement on the terms, interval, and the country's willingness to settle its debts.

The second alternative is to appoint a legal advisor and also a financial advisor, whereby the former studies the legal frameworks related to the borrowing country's debt issues which are subscribed by international parties, or the legal frameworks of the creditors' countries. The latter advisor studies the potential options for debt restructuring with creditors and carries the necessary negotiations to reach an approved agreement between the borrowing country and creditors.

The third alternative is to resort to a third party like the IMF to intermediate in the debt restructuring process. Here, the IMF carries a "Debt Sustainability Analysis" which can indicate the ability to settle or unsettle the debt. This requires a negotiation with creditors, otherwise they will incur major financial losses. The IMF determines the country's ability ceiling to settle the debt, and hence starts the negotiation process with creditors. In this case, the borrowing country asks for a credit line from the IMF, and the latter may agree on this under certain credit conditions, including the implementation of economic, financial and structural reforms, besides a continuous and direct monitoring of the reforms progress according to the set plan. This usually results in calculated risks and international confidence in the borrowing country.

It is worth noting here that the IMF, in case of pre-emptive restructuring, leaves the details of negotiations to the borrowing and creditor parties. Its role becomes prominent in case of post-default restructuring, where it sets specific standards for negotiations with creditors according to its "Lending into Arrears Policy".

Once an agreement on restructuring is concluded, the borrowing and creditor parties agree on the form of debt relief, which ranges between a "haircut" policy (discounting all or part of the debt principal),"coupon adjustment" policy (discounting the debt interest rates", or "rescheduling" policy. The first two policies tend to lower the nominal value of the debt, while the third policy may deepens more the deterioration of financial conditions in the borrowing country and its ability to settle the future debt.

The major debt restructuring risks are the following:

1- **Reputational Risks:** This means that the borrowing country seeking a debt-restructuring process may face market exclusion, where creditors will not accept to buy its bonds. It may rather face higher credit costs, and in this case the creditors may demand higher interest rates on debt to compensate for the potential default or further restructuring(s) in the future.

2- **Market Risk:** This means that in case a country defaults to settle its debt, this will hardens the ability of its national economy and its financial sector to access international markets in pursuit of additional financing resources. Also, creditors may achieve certain gains in case the borrowing country agrees on a restructuring process and does not default, as creditors may demand higher returns.

3- **Legal Risk:** This means that creditors may resort to legal actions against the borrowing country in the case of default and improper restructuring. In this case, creditors may ask for seizure on the borrowing country's sovereign assets, or trade embargo, and both actions will add further pressures on the borrowing country's economy and financial sector.

## III. Overall Situation in Lebanon

Lebanon has been experiencing an aggravation in its overall conditions over the last years, which have produced economic, financial, monetary, and social crises, leading to an unprecedented, catastrophic position which is threatening the country with a global falldown on all levels.

These crises are induced by several local and foreign factors, as follows:

A. **Local Factors:** These include the continued political conflicts which have seized the work of preceding governments and the required reforms to halt the continued deterioration in the country. Also, there is the degradating authority of the government on all regions and public utilities, thereby encouraging tax evasion, customs smuggling, inability to control its maritime and river properties. In addition, there is the corruption and public-money waste whose annual costs exceed USD 5 billion. Furthermore, there is the substantial financial drain of several public utilities, mainly the electricity sector whose drain constitutes USD 40 billion out of a USD 92 billion public debt as of end-2019. This sector also causes an annual loss of USD 1.5-2 billion annually to the Treasury. The lack of sound governance and bad management of the country remains the prime source of financial and economic imbalances in the country.

B. **Foreign Factors:** These are the regional and international developments which exert pressures on Lebanon. These include the state of political instability in some countries of the region following the Arab upspring, besides the deteriorating economic conditions on the regional level due to the associated political instability and lower oil prices. In addition, there are the deteriorating relations between Lebanon and some Arab and foreign countries due to political reasons, a development that is haulting any financial support from some foreign and Arab countries.

These domestic and foreign factors have interacted to induce a global crisis in Lebanon, whose major indicators are the followings:

A. **A Critical Global Financial Crisis:** due to growing levels of fiscal deficits and public debt to unprecedented levels (10% and 150% of GDP respectively as of end-2019).

B. **A Wide Foreign-Sector Crisis:** due to growing trade and balance-of-payments deficits (in excess of USD 15 billion and USD 4.3 billion respectively as of end-2019).

C. **An Exceptional Economic Growth Crisis:** due to a major economic contraction, where growth rates were negative in 2019 (-3.8%) and 2018 (-1.9%), and is estimated to be deeper in 2020.

D. **A Deep Monetary and Banking Crisis:** due to the deterioration in the exchange rate of the Lebanese pound vis-à-vis the US dollar to more than LBP 2500 to one US dollar in the parallel market currently, against an official fixed rate of LBP 1507.5 for every US dollar. This exchange rate deterioration has induced lower purchasing power of the incomes and wealth of economic agents (individuals, families, institutions, companies and others). Also, there is the continued bankrun, where the banking sector is experiencing a huge demand for cash withdrawals both in foreign currencies (mainly the US dollar) and the Lebanese pound. The banking sector's total deposits has decreased by USD 15.4 billion in 2019, its credit declined by USD 9.6 billion, and its consolidated assets dropped by 32.7% from 2018. As a result, some capital controls are implemented to lessen the substantial demand for cash and the conversions from the Lebanese pound to the US dollar, safeguard depositors, and maintain stability of the financial sector. Also, the Central Bank imposed controls on the financing required for the imports of some basic goods.

E. **Deep Social Crisis:** due to the bankruptcy and closure of several private enterprises and the discharge of many workers besides major wage drops. This has led to an increase in general unemployment in the country to nearly 30% in general and to 40% among the youth. Today, almost one-third of the Lebanese people are below the poverty line, and more than 66,000 persons have emigrated from Lebanon in 2019.

F. **Confidence Crisis:** This crisis is the result of all the preceding crises, and the seizure of paying sovereign Eurobond issues. Lebanon seized the settlement of a USD 1.9 billion Eurobond issue due 9 March 2020, which is a part of a total Eurobonds amount of USD 30 billion due in 2037. Lebanon decided to restructure its sovereign debt potentially with the IMF, as it requested recently a technical assistance from the IMF, and appointed a legal advisor and a financial advisor to help the government in the process of debt restructuring.

## IV. Lebanon's Position with Respect to Sovereign Debt and Insolvency

Lebanon's gross public debt stood at USD 92 billion as of end-2019. Some domestic and foreign sources estimate the real debt value at nearly USD 120 billion. This gross debt is composed of an internal debt of USD 58 billion, and a foreign debt of USD 34 billion. The net public debt stood at USD 81.2 billion at the end of 2019.

This level of public indebtedness is considered high by international standards, especially if we deflate it by the country's GDP of nearly USD 53 billion for 2019, thus we have a debt-to-GDP ratio of 173.6%. The debt service constitutes nearly 46% of total revenues and 32% of total spending. The debt service also constitutes 107.5% of total fiscal deficit and 8.1% of GDP. The foreign debt constitutes nearly 64% of GDP as of end-2019.

The ratios of sovereign debt for Lebanon as indicated above constitute a general indicator of potential insolvency. This is because indebtedness has become untolerable in the short, medium and long runs, especially with the substantial imbalances in public finances and continued growth of fiscal deficits.

There are other indicators that reflect the possibility of sovereign insolvency in Lebanon, as indicated earlier. On 9 March 2019, a USD 1.2 billion Eurobond was due, besides upcoming due Eurobonds of USD 700 million in April, and USD 600 million in June. In April 2021, USD 2.1 billion Eurobonds are due. In May 2022, USD 1.54 billion are due, and in October, USD 1.54 billion are due.

The government of Lebanon has appointed a legal advisor and a financial advisor to provide a legal and technical assistance concerning the settlement of USD 1.2 billion Eurobond issue due on March 2020 and debt restructuring. It also requested a technical assistance from the IMF concerning the Eurobond issues and the solutions for the global current economic and financial crisis. It is obvious that the government should have started early negotiations with creditors concerning an orderly restructuring of sovereign debt in order to avoid its negative consequences. In fact, the government has resorted to an un-orderly, late restructuring, and a post-default restructuring.

The government of Lebanon has decided the freezing of payment of its sovereign debt on Saturday, March, 7, 2020, which will definitely has a negative impact on Lebanon's confidence in international markets.

Another indicator of the potential sovereign insolvency is the continued pressures on the Central Bank's foreign-currency denominated assets which stand currently at USD 30 billion, besides the allocation of the Central Bank of certain financing for the imports of basic commodities such as oil, medicines, medical equipment and flour. This is a major reason for some domestic calls not to settle the March 2020 Eurobond issue, claiming that the public interest of the Lebanese is ensured by the provision of basic commodities and not settling accumulated debt over the past years.

There is also another indicator of the potential sovereign insolvency which is the request of the Central Bank that commercial banks have to enhance their capital bases by 20% till June 2020, in order to increase total capitalization of the sector by nearly USD 4 billion, raising its private funds from nearly USD 20.7 billion as of end-2019.

In addition, there are the deteriorating sovereign ratings of Lebanon, where the international credit rating agencies downgraded the country's ratings to "CC" or even lower recently. S&P also downgraded the ratings of three major Lebanese banks to a "selected default" level. The agency also asserted that individuals, companies and institutions are unable to access their bank deposits in full amount due to the current capital controls, besides controls on foreign transfers, a development that may reflect a potential insolvency on the part of banks towards their customers.

## V. Orderly or Un-orderly Restructuring

Obviously, Lebanon has asked a legal and financial assistance from a legal advisor and a financial advisor, besides a technical advice from the IMF, just before a short time of the March Eurobond issue. Given Lebanon's shortage in financing, the country will be unable to carry an orderly or pre-emptive debt restructuring whether with or without the IMF. The experiences of countries around the world similar to the case of Lebanon show that the restructuring process usually requires a long period.

Since Lebanon did not settle the March, 2020 Eurobond issue, in amount and interest, it may be destined to ask for a financial assistance from the IMF that will take the form of a structural reform program in order to access its "Lending into Arrears Policy".

In the context of this IMF Program, Lebanon has to commit to implementing a global economic plan in order to deal with the chronic deficit in the balance of payments, inability to settle debt service, inability to access international capital markets, debt relief needs, sovereign debt restructuring, fostering internal financial stability, strengthening crisis management potentials, growth stimulation, and other national objectives which support national economic and financial security.

## VI. Liquidity Crisis or Insolvency Crisis

According to modern literature, a liquidity crisis takes place when the short-term debt due on a country exceeds 130% of official reserves in foreign currencies; while an insolvency crisis occurs when the foreign debt exceeds 50% of GDP.

Concerning Lebanon, the short-term debts, i.e. due within one year (between March 2020 and April 2021) are nearly USD 4.6 billion, while the official reserves in foreign currency are nearly USD 30 billion, then the country is not facing a liquidity problem because the ratio is nearly 15%, well below the 130% ratio mentioned above.

But it is obvious that Lebanon is facing a potential insolvency crisis, since the value of foreign debt which stands at nearly USD 34 billion as of end-2019 which represents 64.2% of GDP (USD 53 billion for 2019). This ratio is higher than the 30% ratio mentioned above.

Since Lebanon has adopted the alternative of post-default restructuring of sovereign debt, it is possible that it may face the following major negative consequences at least in the first two years following insolvency:

- Higher borrowing costs.
- Exclusion from international capital markets.
- Lower economic growth.
- Decline in total foreign trade.
- Shrinking foreign capital inflows to the national economy.
- Drop in the stock prices of companies listed on the local stock exchange.
- Decline in credits to the private sector.
- Additional loss of confidence in Lebanon.

Restructuring of the public debt may be repeated several times in the coming years in Lebanon. This is the experience of some countries around the world over the past years. This experience, in case it happens in Lebanon, will have several negative consequences on the national economy and its financial, banking and business sectors.

It is worth noting here that economic agents in Lebanon (individuals, households, companies and institutions) are facing, since the eruption of the current socio-economic crisis, a comprehensive "haircut". This is reflected in higher prices of goods and services by nearly 50-100% which means "price haircut", substantial differential between the official exchange rate (LBP 1507.5 per US dollar) and the parallel exchange rate (nearly LBP 2500 per US dollar) which means "exchange-rate haircut", and lower interest rates by nearly 40-50% which means "interest-rate haircut". It is very risky to implement a "deposit haircut" because this will have very negative implications for the Lebanese economy and banking sector and the related confidence.

### What Does All This Necessitate?

In fact, given the current crises on the economic, monetary, and financial levels in Lebanon, and given the shortage in domestic and foreign financing, it is preferable that Lebanon requests a financial assistance from the IMF. This is crucial for dealing with the structural imbalances in public finances, balance of payments, economic sectors, and capital and monetary markets. It is very crucial that the government seizes the transformation of the sovereign debt crisis into a banking crisis, owing to the fact that the banking sector holds a large proportion of the public debt. This consideration should be taken into account in any debt restructuring process.

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