

On hard road to reform, Lebanon may need old pals

[Tom Perry](#)[Tom Arnold](#) | Reuters

BEIRUT/LONDON: Heavily indebted Lebanon has passed a budget seen as a “first step” toward fixing its public finances, but still has much to do to steer the country away from crisis.

Investors are waiting to see if Gulf Arabs will offer a lifeline that may provide some breathing space.

Lebanon has one of the world’s heaviest public debt burdens, after years of big budget deficits rooted in waste, corruption and sectarian politics. The government is now trying to put the public finances on a more sustainable footing with a budget to cut the deficit and a plan to fix the state-run power sector, which bleeds funds while inflicting daily power cuts on Lebanese.

After years of backsliding, the impetus to reform has grown due to economic stagnation and a virtual halt in the flow of dollars into Lebanon’s banks from abroad.

Lebanon has depended on such flows from its diaspora to finance the current account and the state budget deficits.

The government hopes the state budget approved by Parliament last week will help confidence by slashing the deficit. An international support group for Lebanon, including donor states, welcomed it as “an urgently needed first step” and urged further reforms.

But many doubt the government can meet its goals. The International Monetary Fund says this year’s deficit is likely to be well-above a targeted 7.6 percent of national output - and donors are still waiting to see important parts of the power plan implemented.

Foreign reserves, while still large relative to the size of the economy, have been falling. This has led banks to launch a new bid to attract dollars by offering 14 percent a year to depositors willing to lock up large sums for three years - funds that the banks redeposit at the Central Bank for yet higher returns.

Lebanon’s risks are reflected in the cost of insuring its debt, which surged back to the highest of any government in the world after briefly easing in the wake of Parliament approving the budget Friday, signaling an elevated risk of default.

“We believe investor malaise towards Lebanon is unlikely to dissipate soon,” said Yacov Arnopolin, senior portfolio manager at Pimco, one of the world’s biggest asset managers. “While the significantly delayed budget passage is a step in the right direction, much remains to be done before the country is on a sustainable trajectory,” he said. “Foreign investors have been spooked by deposit flight.”

Bank deposits, which have grown consistently on annual basis since the end of the 1975-90 Civil War, have dipped by about 1.7 percent in the first five months of 2019. Such outflows are typically seen at times of major shocks, such as the 2005 assassination of former Prime Minister Rafik Hariri, economists say.

‘SMALL STEPS

FOR A BIG CRISIS’The budget included some politically tricky measures, such as a three-year freeze on state hiring. More difficult ideas were torpedoed, such as a public sector pay cut, and critics say the government also avoided the main problem: corruption.

The major deficit reduction measures include hiking tax on the interest paid on bank deposits and government bonds, a new import duty and a plan to cut debt servicing, though it is not yet clear how that will be achieved.

“It is small steps for a big crisis. We have a very difficult situation that needs drastic steps, drastic measures, and none of them are being taken,” said Sami Gemayel, head of the Kataeb Party, one of the few parties not represented in Prime Minister Saad Hariri’s unity government.

Deputy Prime Minister Ghassan Hasbani told Reuters the budget was a good step but fell short of what is needed.

“I expect the sense of urgency to rise over the next few months and trigger a series of major reform activities,” he said. The impact of these would be seen in the 2020 budget.

Hariri hopes that reforms will unlock about \$11 billion pledged at a Paris conference last year to finance investment.

“We think this budget is a decent start. The deficit will show a contraction,” a Western diplomat said, adding: “They need to crack on with implementation of reforms but also with the 2020 budget.”

A recent IMF mission said this was “an important moment for Lebanon” and the budget and power sector reform plan were “very welcome first steps on a long road.”

It also noted that deposit inflows had virtually stopped and the Central Bank’s foreign reserves had dropped by around \$6 billion since early 2018 despite continued Central Bank operations to support them.

‘DEEP-POCKETED SPONSORS’Investors now hope that Gulf Arab states, notably Saudi Arabia, may offer financial backing after a delegation of former Lebanese prime ministers met King Salman.

One of them, Najib Mikati, said Riyadh would “extend a hand of support.” The Saudi ambassador to Lebanon said the visit heralded a promising future for ties that have been strained with the growing power of the Iranian-backed Hezbollah. Saudi Arabia has yet to spell out what it might do.

Its rival, Qatar, has also signaled readiness to help, saying last month it had bought Lebanese bonds as part of a planned \$500 million investment to support Lebanon.

Farouk Soussa, senior Middle East and North Africa economist with Goldman Sachs, said Lebanon's deteriorating foreign exchange liquidity was "the real near-term pinch."

"The real challenge is to stimulate capital inflows, either from depositors or investors," he said.

Gulf support would "underpin investor confidence by sending a strong signal that Lebanon can rely on deep-pocketed sponsors," Soussa added.

Goldman Sachs remains bearish on Lebanon, said Sara Grut, emerging markets strategist with the bank.

'RED FLAGS' Alongside the fiscal crunch, the role of the Central Bank is also in focus. The IMF mission said the Central Bank had skillfully maintained financial stability in difficult circumstances for some years, but the challenges had grown. It called for action to increase the resilience of the financial sector through a stronger Central Bank balance sheet and increased bank capital buffers.

The Central Bank should gradually phase out its financial operations and step back from government bond purchases, it said.

Toufic Gaspard, an economist who has worked as an adviser to the IMF and to the Lebanese finance minister, said Lebanon was in "absolutely" its worst ever financial shape.

He said debate about fiscal problems had diverted attention from Central Bank "financial engineering" operations, which he called "the most important risk."

"The Central Bank has been buying dollars because of falling reserves. However this is not the problem per se, the problem is that for many years it has been paying very generous interest rates to banks," he said.

"These are red flags."

Gaspard wrote a paper in 2017 saying the policy was resulting in "mounting losses" for the Central Bank, which has not published a profit and loss account since 2002.

The Central Bank said at the time that its interest rate policies were in line with Lebanon's risk profile.

It said it was required annually to report its balance sheet and profit and loss accounts to the finance minister, and the Central Bank "continues to generate sustained and substantial profits."