



Banque Du Liban's Financial Engineering: Background, Objectives, and Impact

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I. Background

The aftermath of the financial crisis is still bearing severe repercussions on the global economic landscape; developed, emerging, and developing economies alike. On the global level, the phenomenon of economic secular stagnation has damaged the real economy, exhausted quantitative easing leading to negative interest rates, and heightened uncertainties in the global political economy. All of these factors have exacerbated economic slowdown and socioeconomic inequities. Eventually, what once served as remedial cash flow reserves from emerging markets in the period of the financial crisis is now more or less paralyzed.

At the regional level, the political and security turmoil caused by various wars and conflicts, the humanitarian refugee crisis, and the drop in oil prices have led to severe macroeconomic and socioeconomic-developmental drawbacks. This has been mostly evident in the deteriorating aggregate demand and increasing deficits for many Arab countries, and in particular the austerity measures of oil-producing countries.

At the local level, the past few years have strained the Lebanese economy with political tensions, security challenges, and regional unrest, caused particularly by the spillover risks from the Syrian crisis and its consequential flow of over one million and a half refugees. The situation was also exacerbated by the political paralysis which kept the country without a president for more than two years. In effect, the main economic indicators, namely foreign trade, tourism, investment, and consumption, have been steadily decreasing since 2011. As a consequence, the debt-to-GDP ratio has risen to around 144 percent; fiscal deficit has reached 8 percent of GDP, aggravated by the absence of a public budget for a decade now; GDP growth has decreased from eight percent in 2010 to around 2 percent currently; the deficit in the balance of payments has reached USD 3.3 billion in the year 2015, mounting to USD 9 billion during the last four years; the country rating and outlook by relevant international agencies have been relatively unfavorable; the growth in bank deposits has been declining.

Despite all of these challenges, the Lebanese economy was able to achieve real annual growth of around one percent in 2015 with inflation rate close to 0%. Much of this resilience is rooted in a history of monetary and financial stability thanks to the prudent management by Banque du Liban (BDL). BDL policies, mainly its stimulus packages since 2013, have played a central role in fostering economic growth. Moreover, continuous increase in foreign assets and persisting decrease in dollarization ratios have been proof of confidence in the financial system and the Lebanese Pound.

II. BDL's Financial Engineering Mechanism

Based on the aforementioned, and in light of the persisting global economic stagnation and regional political-economic turmoil, BDL has resorted to

additional financial engineering policies as part of its monetary policy objectives.

The recent financial engineering mechanism was carried out on orders place between May and August 2016 as follows:

First, BDL swapped Lebanese Pound (LBP) treasury bills (TBs) held in its portfolio with equivalent Eurobonds issued by the Ministry of Finance, amounting to USD 2 billion.

Second, BDL sold the recently acquired Eurobonds and issued USD Certificates of Deposits (CDs) to commercial banks against fresh USD inflows provided by banks.

Third, BDL discounted at 0% an amount equivalent to the previous transaction (Eurobonds and USD CDs) of LBP denominated debt held by commercial banks in their portfolio. This transaction was subject to voluntary 50% haircut on interest in favor of BDL.

III. BDL's Financial Engineering Objectives & Impact

The objectives targeted by the financial engineering mechanism were achieved. This is evident through highlighting the following facts:

First, strengthening *BDL's foreign currency assets* from the standpoint that a strong balance sheet is essential to maintain exchange rate and interest rate stability, which is necessary to achieve sustainable economic development: After the financial engineering, *BDL foreign currency assets* have reached a historical record level of around USD 41 billion which confers stability to the Lebanese Pound and to interest rates.

Second, beefing up *the capital base of banks*: BDL instructed banks to book the proceeds from the financial mechanism in their Tier Two Capital, which would enable them to constitute additional general reserves ahead of the implementation of IFRS 9 in January 2018 (BDL is targeting a ratio of 2% of general reserves to risk weighted assets). Moreover, banks would be able to reach the BDL targeted capital adequacy ratio of 15% (end 2018), which is above the international capitalization requirements (Basel III).

Third, increasing *liquidity in local currency* as a form of improving the status of the Lebanese Pound and undertaking quantitative easing to secure the financing needs of the public and private sectors at optimal costs: This year and up to April 2016, deposits grew by 0.9%, compared with a growth of 2.5% after the financial engineering. On an annual basis, deposits grew by 5%, as compared to 2% annual growth before the financial engineering. With this fresh liquidity in LBP, banks would be able to keep expanding their credit portfolio, especially to SMEs, to back the economic activity, while complying with the new international capital and risk requirements.

Fourth, improving the *government debt profile* by reducing the cost of borrowing: BDL's financial engineering has led to a decrease in interest rates for the 5-year TBs from 6.74% to 5%. BDL has also lowered the interest rate on its long-term LBP denominated CDs and time deposits from 9% to 8.4%. Furthermore, and as a sign for *improving the government debt profile*, it was noted that international financial institutions have encouraged their customers (pension funds and asset managers) to invest in Lebanese Eurobonds.

Fifth, improving the *balance of payments* status through setting the means for increasing internal demand and productivity, hence bolstering growth and development: *The balance of payments* became positive after the financial engineering, turning a cumulative deficit of USD 1.7 billion in May 2016 into a cumulative surplus of USD 555 million in September 2016.

Sixth, targeting positive *inflation rate* below 4%: *Inflation rate* has risen to 2% in September 2016, which is in line with BDL's objectives.

Seventh, improving the *country's rating and outlook*: In September 2016 and despite the political deadlock in the country, Standard & Poor's revised *Lebanon's outlook*, from negative to stable.

IV. Conclusion

In conclusion, despite all downsides in the Lebanese scene, Lebanon is a country that has the ability to fund internally both its public and private sectors without resorting to any external funds or aid.

It is worth noting, this financial engineering was based on a win-win situation, whereby it didn't burden the Central Bank neither the Lebanese Government with any costs. On the contrary, it enhanced both BDL's balance sheet and Lebanon's credit profile.

Finally, amid these exceptionally harsh circumstances, the gains of this financial engineering scheme were not limited to financial ones; it also resulted in important social gains. The Lebanese society is the ultimate winner: it will benefit from more financial inclusion, better economic development, and a more stable social welfare.