Refocusing the message

14 January 2019

Coherent and unified communication to markets, finally

Economic and political policy-makers finally sent a unified and coherent message to markets yesterday, dispelling doubts about Lebanon's willingness to repay bondholders. We expect this communications strategy to persist, supporting a restoration of domestic confidence, as the economic administration reiterates reforms plans do not include external debt restructuring. This is in line with our view that a restructuring of Eurobonds that is not forced upon the sovereign is not in the best interests of Lebanon.

External debt restructuring not being considered

The communiqué from the meeting yesterday between President Aoun, PM Hariri, Minister of Finance Khalil, Minister of Economy and Trade Khoury, Chair of the Parliament Budget Committee MP Kanaan, BdL Governor Salame and Head of the Association of Banks (ABL) Torbay is consistent with our nuanced view of recent MoF comments. The cross-party nature of the meeting suggests no political manoeuvrings in MoF comments. The communiqué reiterates commitment to depositors and bond holders, and suggests that a proposed fiscal reform plan honours CEDRE conference obligations. We do not exclude domestic schemes to lower domestic public sector debt.

Refocusing the narrative

The market's shift from debating Lebanon's ability to repay to debating Lebanon's willingness to repay is misplaced, in our view. Eurobond restructuring would erode bank capital, endanger the USD peg and affect depositor confidence. Eurobonds are only a small part of external financing needs while Lebanon's ability to muddle through remains partly a function of depositor confidence, alongside reforms and donor support. Hence, we don't think restructuring can be a proposed government policy in the absence of a crisis.

In the absence of a shock to non-resident deposits, Lebanon could still muddle through near-term with BdL gross Fx reserves of US$47bn (including Eurobond holdings of US$4.7bn) and domestic banks US$12bn of currency and deposits with non-resident central banks. Gross external financing needs could stand at cUS$83bn (139% of GDP) for 2019. This would include a current account deficit of cUS$15bn (25.5% of GDP; IMF presentation), government medium-term external debt amortization of US$1.4bn (2.3% of GDP; adjusting US$2.6bn in Eurobond maturities for residency), and an assumed US$66bn of short-term non-resident deposits (111% of GDP). The latter would represent an assumed 35% of total banking sector deposits, versus the official share of non-resident deposits to total deposits of 25% as of end-2018.

The 2019 fiscal funding needs of US$16.1bn (27% of GDP), including a budget deficit of cUS$5.5bn (9% of GDP), domestic debt amortisations of US$7.7bn and external debt amortisations of US$2.9bn, are supported by the issuance in December of LL2.4trn (US$1.6bn) in 10- and 15-year T-bonds at 10.5%. The lengthening in average deposit maturity provides some breathing room but depositor confidence remains key. Note that the 2018 primary fiscal balance stood at an annualized deficit of US$0.8bn (1.5% of GDP) year-to-September. 2019 Eurobond coupon payments of US$2.1bn (3.5% of GDP) are lower than 2019 T-bill and T-bond coupon payments of US$2.7bn (4.6% of GDP).

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Lessons from Cyprus

The Cyprus crisis in 2012-13 could provide a template for implications of a hard landing, given some economic similarities. Cyprus had an oversized banking sector funded partly non-resident deposits, with high exposure to the domestic real estate sector and concentrated exposure to Greece. The latter incurred heavy losses due to the Greek restructuring, resulting in recapitalization needs. The government also had large fiscal deficits and high public sector debt (86% of GDP in 2012). The government lost market access since mid-2011.

The balance sheet of the sovereign and banks were highly intertwined. Full bank recapitalization with public funds would have exacerbated poor public debt dynamics. Broad burden sharing was thus necessary and achieved through a bail-in of uninsured depositors. Payment restrictions and capital controls were imposed to safeguard financial stability. The downsizing of the financial services sector resulted in a need to adapt the country's business model. Significant fiscal consolidation was implemented as part of an IMF EFF program combined with European Stability Mechanism (ESM) financing, targeting a medium-term government debt level of c100% of GDP.

What would a hard landing in Lebanon look like?

A muddle through scenario is our near-term base case scenario, under the assumption that depositor confidence remains stable. In the event where depositor confidence is sustainably impaired by recent market developments, higher domestic interest rates are likely to be a first line of defence on the monetary front. Imposition of capital controls is unlikely to be a sustainable policy given the need to attract non-resident deposits. Sustained deposit outflows would endanger the ability to maintain the USD peg and hence the ability to repay Eurobonds.

In a hypothetical external debt restructuring scenario, we doubt locals could be treated differently than foreign bond holders to minimize the impact on the domestic banking sector and maximize the potential haircut on foreign bond holders.

In this complex hypothetical external restructuring scenario, we would expect the large banking sector recapitalization requirements to have to be financed through external sources such as the IMF. The halt of non-resident deposit inflows could suggest a sharp real effective exchange rate adjustment would be necessary to narrow the large current account deficit.

We estimate the banking sector to hold a net long Fx position with net foreign currency asset position of cUS$34bn (60% of GDP), including its foreign currency deposits at the BdL. The counterpart is thus likely to be a large next Fx short position in the corporate sector, which could thus lead to large NPLs in the event of a hard landing and devaluation. The banking sector held US$16.3bn of Eurobonds, maintained capital of US$20.3bn and held US$189bn (333% of GDP) of deposits as of November.

Illustratively, assuming a 80% haircut on Eurobonds and a spike in NPLs to 20% on US$35bn on banking sector foreign-currency claims on residents would lead to losses of cUS$20bn (35% of GDP), erasing banking sector capital. In the event no external funding could be mobilized to keep banking sector adequacy ratio unchanged, this would require a bail-in of depositors of 10.6%. As the bulk of deposits is concentrated, with the IMF estimating that 1% of deposit accounts hold 50% of total deposits, deposit losses could be distributed unevenly. An external funding infusion would reduce this need.

Given large uncertainties and risks, we would expect exit yields to remain elevated.

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