Report by Banque du Liban in reply to mistakes stated in a recently published document

In view of the damaging publicity and media coverage that has been created by a Policy Paper dated August 2017 entitled Financial Crisis in Lebanon, authored by Dr. Toufic Gaspard sponsored by Konrad Adenauer Stiftung and Maison du Futur, BDL would like to rectify a number of points falsely raised by it:

1- In the introductory statement of this Paper, the author disapproves of BDL's foreign exchange policy stating that "independently of the validity of the fixed exchange rate policy for a small and open economy…" and later states "the cost of that policy to the stability…remains immense". These statements are totally divergent and contrary to statements by the IMF, a reference the author often quotes. He ignores that, in concluding the 2016 Article IV consultations, the IMF's Executive Directors "agreed that monetary policy should remain geared to supporting the peg, and commended the BDL for maintaining adequate international reserves."
(http://www.imf.org/en/News/Articles/2017/01/24/PR1720-Lebanon-IMF-Executive-Board-Concludes-Article-IV-Consultation)

2- One of the reasons proposed by the author for Lebanon heading towards a serious financial crisis and the center point of the paper's argument is "the unnecessarily generous interest rates that BDL has been paying local banks for their $-deposits" and that interest rates are not market-determined in Lebanon.

Interest rates for any country have to reflect its sovereign credit risk rating. Money markets in Lebanon cannot trade at rates existing in AAA rated countries such as Germany or the US. These AAA rated countries were used by the author as reference to justify his conception of interest rates in countries such as Lebanon to be "generous". Lebanon's S&P current sovereign risk rating is B-. Table 1 below compares the local currency sovereign curve of Lebanon with similarly rated countries (B, B-) up to BBB+. Lebanon's rates range between 5.35% for 1-year and 7.46% for 10-years. They compare favorably with Egypt's 1 to 10 year rates ranging between 19% and 18.5%, Turkey's rates are between 11.66% and 10.43%. If we go up the scale to BBB rated countries such as Mexico and India, they are on par or better for some tenures.

As for foreign currency interest rates, these are determined by market forces which derive them from Lebanon's country risk profile captured by its Credit Default Swap rates and US Treasury Bill yields. With Lebanon's current Eurobonds trading close to the USD100 issue price, yields at which they are traded in the secondary market accurately reflect rates at which these securities were issued in the primary market.

The Central Bank of Lebanon, BDL, on its part receives foreign currency short term placements at rates quoted on Reuters and Bloomberg. All its rates up to 2-years are a notch below USD LIBOR rates. For example, USD placements are priced at 1.09375% to 1.18950% for 1-month depending on size. Moreover, Table 2 below clearly demonstrates that long-term BDL deposit rates in USD compare favorably with Eurobond and market sovereign risk-determined yields. For example, rates applied to 7 and 10 year placements are 6.0% and 6.5% respectively, against market sovereign risk-determined rates of 6.36% and 6.69%.

All these examples underscore the effectiveness of BDL's management of its deposit operations. It follows that BDL is not "generous" in its interest rate policies: they simply toe the country's risk profile. The IMF in its 2016 Article IV comments "The exchange rate peg is the appropriate nominal

anchor and the BDL needs to stand ready to increase interest rates if necessary." (IMF Country Report No. 17/19, January 2017,

http://www.imf.org/en/Publications/CR/Issues/2017/01/24/Lebanon-2016-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-44572, page 4).

Table 1: S & P and Fitch Credit Rating and Local Currency Interest Rates

Date	Lebanon (S&P/ Fitch)	Egypt (S&P/ Fitch)	Turkey (S&P/ Fitch)	Nigeria (S&P/ Fitch)	Mexico (S&P/Fitch)	Indonesia (S&P/Fitch)	India (S&P/Fitch)
End of 2012	B/N.A	B-/B+	BB/BBB-				
End of 2013	B-/N.A	B-/B-	BB+				
End of 2014	B-/N.A	CCC+/B	BB				
7-Sep-17	B-/B-	B-/B	BB/BB+	B+/B	BBB+/BBB+	BBB-/BBB-	BBB-/BBB-
Local Currency Sovereign Curve Rates							
	Lebanon (LBP)	**Egypt** (EGP)	**Turkey** (TL)	**Nigeria** (NGN)	**Mexico** (MXN)	**Indonesia** (IDR)	**India** (INR)
1Y Rate	5.35%	19.01%	11.66%	20.60%	7.00%	5.56%	6.07%
5Y Rate	6.74%	19.57%	10.63%	16.82%	6.76%	6.10%	6.50%
10Y Rate	7.46%	18.48%	10.43%	16.51%	6.85%	6.54%	6.51%

Table 2: Comparison between Lebanese sovereign securities, deposits at BDL and US treasury rates

As at September 5, 2017	7Yrs	10Yrs	12Yrs	15Yrs	20Yrs	30Yrs
US Treasury	1.98%	2.18%	2.25%	2.36%	2.55%	2.79%
Lebanon Credit Default Swap	4.38%	4.51%	4.57%	4.65%	4.68%	4.74%
Lebanon Credit Default Swap + US Treasury	6.36%	6.69%	6.82%	7.01%	7.23%	7.53%
BDL's CertificateS of Deposit and Time Deposits In USD	6.00%	6.50%	6.70%	6.86%	7.00%	7.48%
Republic of Lebanon Eurobonds	6.57%	6.83%	6.97%	7.12%	7.24%	
BDL's Time Deposits in LBP	7.08%	7.46%	7.56%	7.70%	8.00%	8.40%

3- Estimates of BDL's foreign currency holdings mentioned in the "policy paper" are inaccurate. The policy paper's Table 1, entitled "Financial Crisis Indicators" presents BDL FX Reserves which are only its short-term liquid assets as identified in "note 1" namely, foreign currency deposits plus short term liquid investments such as those invested in US Treasury bills. However, BDL's balance sheet includes other foreign currency medium and long-term assets. The author chose to ignore these assets to advance a totally flawed and erroneous argument. By including these adjustments, BDL's net foreign currency reserves come to be markedly positive and provide sufficient cover to ensure the stability of the Lebanese Pound and financial stability in general.

4- On BDL's financial operation, which according to the author had "a most likely but un-announced objective…to strengthen the capital of at least two major banks…" For the record, this operation was conducted with 38 banks and financial institutions. It entailed a swap between banks' LBP held TB's and BDL's USD held Eurobonds without use of government funds. This operation supported the expansionary monetary policy and contributed to bolster prices and to improve expectations and thereby, the Consumer Price Index. The funding of the operation was conducted through the expansion of the balance sheet of the central bank, a common practice employed by other central banks. This is a point completely missed by the policy paper. The policy paper unprofessionally chooses to ignore BDL's intermediate circular number 440 dated 8 November 2016 that followed these operations requiring banks to retain and not to distribute as dividends the revenues generated by banks to implement the IFRS 9, the international capital solvency requirements. This operation had a multipurpose and multidimensional impact as emphasized in the following:

   (a) It strengthened BDL's foreign-currency assets which reached as a result a historical record high of around $43 billion following the operation.

   (b) It consolidated the capital base of banks, and allowed them to comply with international solvency requirements, and enabled them to build additional general provisions required to be implemented by the International Accounting Standards Board for the IFRS 9 (International Financial Reporting Standards) before the January 2018 deadline.

   (c) It increased liquidity in local currency to secure the financing needs of the private and public at optimal costs. As a consequence, deposits at banks grew in 2016 by around 7.2%, from $157.3 billion to $168.6 billion. Banks are better positioned now to expand their credit extension to support SMEs to stimulate national economic activity.

   (d) It improved the government's monetary situation and debt profile without any increase in interest rates, one of the proposals of an IMF mission to reinforce BDL's foreign currency assets. Had the latter prescription been adopted, it would have increased the debt servicing cost by around $1.3 billion annually for each interest rate increase of one percent.

   (e) The success in the latest issue reaffirmed the markets' confidence in the Republic of Lebanon Eurobonds, with subscription demand reaching around six-fold the issued amount ($17.8 billion against $3 billion issued). A measure taken by BDL during the financial operation to support this issue was to discount the certificates of deposit issued by BdL on condition the discounted amount is reinvested in the Republic of Lebanon Eurobonds.

   (f) The swaps attracted substantial capital inflows and turned Lebanon's balance of payments from $3.3 billion deficit in 2015 and a deficit of $1.76 billion in the first 5 months of 2016 into a surplus of $1.24 billion for 2016.

   (g) The average y-o-y inflation rate has risen from negative 3.75% in 2015 to negative 0.8% towards the end of 2016 (CAS official figures), in line with BDL's monetary policy objectives of enhancing prices. Shifting inflation from negative and zero rates to close or slightly greater than

real income growth rates alters future expectations from negative to positive and thereby stimulates investments in the real economy and raises the rate of growth further.

In its 2016 Article IV consultation, the IMF's Executive Directors commended Lebanon's authorities " for preserving macroeconomic stability and market confidence in very difficult circumstances", and also "commended the central bank for maintaining adequate international reserves." As for BDL's financial operation they recognized this "has successfully bolstered BDL's international reserves and banks' capital" (http://www.imf.org/en/News/Articles/2017/01/24/PR1720-Lebanon-IMF-Executive-Board-Concludes-Article-IV-Consultation).

5. The author of this "paper" describes "the current economic situation in Lebanon as one with crisis conditions that can likely develop into a full crisis, with adverse developments affecting the value of the currency and the banking sector overall". The paper chooses to ignore that Lebanon is a country which hosts 1.5 million Syrian refugees and whose costs are estimated at over $14.5 billion since the outbreak of war according to IMF estimates, the impact of regional instability and the decline in oil prices and revenues on Lebanon, and the impact of devaluation in African currencies on the Lebanese working there. The paper continues to describe BDL's financial condition and "continuous losses are the reason for BDL's discontinuing the publication of its Annual Report

(a) Despite all these harsh circumstances, the economic indicators for Lebanon are stable by any norm as asserted by the following macro-economic figures:

- GDP growth is expected to reach 2.5% in 2017, outperforming the 2% real growth rate realized in 2016 as per BDL estimates

- the CPI in July 2017 y-on-y recorded 3.12%

- Money Supply (M3) y-on-y growth was 8.09% in April 2017, compared to 4.48% for the same period in 2016, i.e. before the financial operation;

- growth of deposits increased y-on-y by 8.3% in April 2017, compared to 3.8% in April 2016, including the deposits of non-residents which increased by 8.9% in April 2017 compared to 1.52% in April 2016;

-foreign currency reserves at BDL increased by 7.9% in April 2017, compared to a decline of 3.4% in April 2016;

- debt held by the market compared to GDP in July 2017 is equivalent to 93.7% (i.e. after excluding BDL's and public entities investment portfolios, Paris 2 foreign subscription and TBs held by BDL).

(b) BDL is required under Article 117 of the Code of Money and Credit (CMC) to annually report to the Minister of Finance its Balance Sheet, Profit and Loss Accounts, and report of activities and to publish B/S and the report on activities in the official Gazette. BDL's solid financial position is underlined by its Equity Capital Funds which increased from LBP113.9 billion (around $75 million) in 1993 to LBP5361.8 in 2016, equivalent to $3.5 billion. Under the dictates of the CMC it transferred to the Ministry of Finance between 1993 and 2016 LBP6778 billion, equivalent to $4.5 billion, which demonstrates BDL has been and continues to generate sustained and substantial profits and that these swap operations did not cause "a deterioration in [BDL's] financial condition".

6. The policy paper states that banks have enjoyed large profits, "which are directly due to BDL's generous interest rates". Profits of the banking sector were $1.727 billion in 2015 and $1.827 billion in 2016, clearly indicating there has been no large increase at all. The paper also suggests "these developments have weakened the condition of banks in Lebanon." Apart from maintaining their levels of profit, they also maintained similar levels of claims on non-resident banks, at $11.5 billion in 2015 and $11.2 billion in 2016.

7. On the issue of banks' balance sheet uses, whereas more than 55% of local market debt held by banks in 2008 was that of the public sector's and therefore public debt crowded out the private sector, this ratio is currently close to 39% with banks expanding their lending to the private sector benefiting from BDL's loan incentive schemes. These schemes have directed saving resources into productive investments which have had substantial measurable impact on national income growth since 2009.

8. Finally, the author states that in the 1980s, the exposure of banks to government debt was 17% of their total assets and concluded that it helped Lebanon weather its financial crisis. He disregards that the dollarization rate in the late 1980s was in excess of 80% for loans and in excess of 77% for deposits; and that almost all the LBP of banks was invested in TBs at a time Lebanon had not started issuing debt denominated in USD.

Furthermore, on banks' exposure to the public sector, the author does not dissociate between the risks associated with the exposure to Treasury instruments and to BDL. While the Central Bank is the issuer of the national currency, the proceeds of the placements received by BDL in foreign currencies are placed in investment-grade instruments. Pursuant to the spirit of the Code of Money and Credit, BDL follows a rigorous investment policy that takes into account, when formulating its investment choices, a wide range of exposure risks, namely market risk, credit risk, counterparty risk, liquidity risk, and operational risk. Moreover, in order to achieve an efficient risk management, BDL adopts a specific investment decision framework that establishes acceptable parameters (limits and controls) and asset allocation (benchmark portfolio).

Remark:

The reply published above by Banque du Liban has highlighted the main accounting, statistical, and economic mistakes that undermine the study of Dr. Toufic Gaspard. However, it has not tackled the legal gaps and loopholes in this study, which derive from the ignorance or the purported negligence of the following fundamental legal texts and principles:

1- The Central Bank's general mission is to safeguard the currency, in order to ensure the basis of a continuous economic and social growth, with the priority of maintaining the safety of the Lebanese currency and the soundness of the banking system. (Code of Money and Credit, Article 70).

2- Under Articles 110 and 111 of the same Code, Banque du Liban is prohibited from holding any kind of stake in any project, with the exception of Lebanese public utilities or national mixed corporations or for debt recovery. Consequently, any participation taken by Banque du Liban, for whatever reason, and beyond these exceptions, necessitates the existence of a relevant specific law (which is inconsistent with Dr. Toufic Gaspard's study which claims that BDL should have acquired shares in some banks, following its financial engineering…).

3- Pursuant to the applicable banking legislation, no bank can benefit from any form of assistance, except by virtue of specific decisions issued by the Central Council of Banque du Liban or by the Higher Banking Commission. Accordingly, this assistance is not a one-man decision (for instance, that of the Governor).