

MOET NEWSLETTER



Cartoon by Alex Hughes: <http://tribunecartoons.blogspot.com/>

THE FINANCIAL CRISIS:

International roots and local effects

Causation

Although the reasons for the financial crisis are no longer a mystery, the proposed grounds for the crisis remain varied and complex. It can be attributed to a number of factors pervasive in both the housing and the credit markets- factors which emerged over a number of years.

An article in the Time Magazine cites that the main causes of the crisis lie in the loose monetary policies and lax government and firm strategies, which encouraged higher risk lending practices such as leveraging of debt of households and financial institutions over the last couple of years. The actual crisis began with the burst of the housing bubble. Housing values began to fall as supply overwhelmed demand and many subprime borrowers found that their homes actually became worth less than their mortgages. As defaults rose, housing prices tumbled further. The next step in the lead up to the financial crisis then appeared. The current credit crisis was fuelled by excessive capital flows that were turbo-charged by "financial engineering" techniques used by banks. In clearer terms, investors had piled into Collateralized Debt Obligations (CDOs)- complicated securities based on pools of mortgages. With an increasing number of mortgage defaults taking place, the CDOs began to incur huge losses leading to banks needing to take write-downs and raise capital. As companies started to tumble, the stock market plummet followed and investors began to incur losses, leading to a drop in market confidence. As lending tightened, short term loans on which all kinds of businesses rely became less available. This, in turn, kick started the economic crisis that followed, because when the gears of commerce are jammed, growth slows down and lay-offs follow, as companies trim their costs.

Global Effects

Whether it is in the fields of finance, construction and real estate, tourism or retail, most sectors have been hit through the recording of huge losses and the lay off of workers. On many occasions, a number of firms have filed for bankruptcy. Even governments have done so, such as in Iceland late last year.

The international system, as a result, has been exposed to a global economic slowdown. According to the OECD's Economic Outlook Interim Report, economic activity is expected to plummet by an average 4.3 percent in the OECD area in 2009 while by the end of 2010 unemployment rates in many countries will reach double figures for the first time since the early 1990s. Recent data on consumer confidence also carried out by the OECD suggests that households are quite pessimistic on the severity of the current financial crisis, and its impact on the economy at large. Confidence indicators for OECD member countries in recent months have witnessed an almost unprecedented collapse, with some levels falling to the lowest on record.

Remedies adopted

Many plans were formulated by governments in order to deal with the financial crisis, and include the following:

- **Monetary expansion-** Since the onset of the credit crunch in August 2007, the Fed chairman Ben Bernanke has repeatedly cut the federal funds rate from 5.25% down to a low of between 0% and 0.25%. He has also poured money into the financial system through a variety of channels, which brings us to the second point.
- **Bailout plans-** The US government allocated \$700 Billion worth of funds towards covering the subsidized sale, nationalization and bailouts of many major insurance, finance and auto institutions: Bear Stearns to Morgan Stanley, the nationalization of mortgage Giants Fannie Mae and Freddie Mac and the sale of Washington Mutual

2008 2009 2010

	2008	2009	2010
Real GDP growth			
United States	1.1	-4.0	0.0
Japan	-0.6	-6.6	-0.5
Euro area	0.7	-4.1	-0.3
Other countries ¹	1.9	-3.9	0.3
Total OECD	0.9	-4.3	-0.1
Inflation² ye			
United States	3.8	-0.4	0.5
Japan	1.4	-1.2	-1.3
Euro area	3.3	0.6	0.7
Unemployment rate³			
United States	5.8	9.1	10.3
Japan	4.0	4.9	5.6
Euro area	7.5	10.1	11.7
Other countries ¹	5.6	7.8	9.4
Total OECD	6.0	8.4	9.9
World trade growth			
	2.5	-13.2	1.5
Fiscal balance⁴			
United States	-5.8	-10.2	-11.9
Japan	-2.6	-6.8	-8.4
Euro area	-1.8	-5.4	-7.0
Total OECD	-3.0	-7.2	-8.7
Short-term interest rate			
United States	3.2	1.2	0.7
Japan	0.7	0.6	0.3
Euro area	4.7	1.3	0.6

Source: OECD Economic Outlook

www.oecd.org/OECD/Economicoutlook

“According to Lebanon’s Ministry of Finance, 15,000 Lebanese expatriate workers have returned in recent weeks... (Lebanon’s) annual remittances represent 25% of GDP... A cut in the workforce would lead to a decline in remittances”.

to JP Morgan and Wachovia to Citigroup. This would prevent major companies from going bust, and hence, put a stop to large numbers of unemployment. The money was also used towards buying out toxic debts, which could set off additional problems within the economy.

G20 Summit- More recently, the G20 leaders gathered at a summit in London to discuss new methods of stimulating the world economy following the global financial crisis. The summit focused on 5 main topics for discussions, namely, fiscal stimuli; trade, financial regulation, IMF funding and the clamping down on tax havens. In the eyes of the G20 leaders, the summit was a success as it brought to the table a more modern world economic order, that is, new rules and guidelines regarding the international regulation of the financial system and an increase in IMF funding of up to US\$1.1 Trillion to help support countries who have been affected by the crisis. The rules and regulations touched on the clamping down on tax havens as well as the global regulation of hedge funds and executive pay - something that would have been unthinkable before the crisis broke.

In terms of the IMF funding, \$500bn will

be used to lend to struggling economies, \$250bn towards boosting world trade, \$250bn for a new IMF "overdraft facility" that countries can draw onto, \$100bn that international development banks can lend to poorest countries and \$6bn which the IMF will raise from selling gold reserves to increase lending for the poorest countries.

The Crisis at the local level

The crisis has already fuelled deliberations over its impact on the Lebanese economy. Prominent Lebanese bankers and politicians have suggested that the effects have been limited, as the conservative guidelines of the Central Bank provided a shield against the lax regulations and loose policies of the global financial system, as shown by the soaring deposit inflows in 2008.

However, the global recession and especially the weakened economic outlook in the Gulf are likely to have an indirect impact on the Lebanese economy. Lower global liquidity and a pronounced global downturn, including in the Gulf region- which was hard hit by the crisis- are likely to affect remittances, tourism, foreign direct investment (FDI) and deposit inflows. As a result, the IMF, for instance, expects economic growth to drop to 3-4% in 2009 relative to the 8% witnessed in 2008.

Overall, the implicit effects of the global financial crisis on Lebanon include the following:

1) A return of workers from the hard hit economies to the Lebanese Homeland. The crisis has led to vast unemployment abroad, especially in the Gulf, and the problem this constitutes is twofold:

First, the Lebanese economy is ill-equipped to provide employment to all the qualified workers who have lost their jobs. It neither has an adequate number of jobs on offer nor quality jobs with well paid salaries relative to those found abroad. Part of Lebanon’s economic outlook resides in how its neighboring GCC countries will be influenced by the crisis, as many key sectors of the economy depend on them, namely tourism, construction and remittances. Lebanon’s socio-economic structure is therefore heavily dependent

on its GCC expatriates, given that 30% of the Lebanese workforce resides in the Gulf. In fact, around 350,000 Lebanese work in the UAE, Saudi Arabia, Qatar, Kuwait, Oman and Bahrain.

Second, this impressive workforce sends over half of the \$5-6 billion in remittances each year. The annual remittances represent close to 25 percent of the country gross domestic product. Thus, a cut in this workforce would lead to a decline in remittances, a significant source of capital inflows to Lebanon. In fact, a recent article by Standard and Poor in an Audi Bank report indicates that Lebanon may be most at risk in the MENA region from a drop in remittances, as it would hurt the current account balance. A fall of 5-10% in the inflow of remittances in 2009 could result in a current account deficit of 10% of GDP for the year.

Currently, Gulf economies are foreseen to slowdown but not collapse as a result of the

crisis; in turn tourism, construction and remittances might decline in Lebanon in 2009, but not deteriorate. Minister of Finance, Mohammad Chatah, has already mentioned that Lebanon has begun to feel the negative effects of the crisis through these two methods. In this respect, the Lebanese government has begun to draft a Short/Medium term strategy plan in order to defy this issue, and it is now under discussion with private and public entities.

In addition, the global financial crisis is pushing governments to take measures and reform regulations that would be harmful to foreign workers- for instance by imposing taxes on foreigners in order to encourage the employment of nationals. This has been recently demonstrated in Bahrain, where hundreds of small businesses have voiced disapproval towards the Regulatory Authority of the labor market in Manama to denounce the inclusion of a tax on foreign workers.

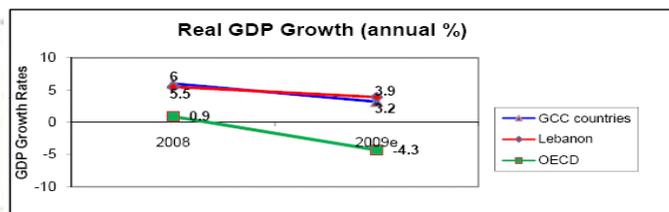
2) Negative impacts would result from the international contractions in consumption, investments and in the overall real sectors of economies. There is no doubt that the financial crisis has led to a shrinking in consumer and investor confidence, as job losses, credit tightening,

space of 3 months, transformed the financial crisis into an economic predicament for countries who rely on the oil rich Arab states for investments and funding. For instance, Lebanon depends a lot on Foreign Arab Credit in order to finance new projects and investments. In 2008, FDI reached 12% of GDP, the equivalent of US\$3.6 Billion. FDI flows could fall significantly in 2009 given the deteriorating global environment. In fact, an article by Osama Habib in the Daily Star has already described how the crisis put many schemes on hold, such as the privatization of the telecoms network and the airline industry, in part because they couldn't fetch a good price from the sale of under the current global credit crunch.

In addition, the IMF's forecast does not appear to be too optimistic. IMF officials expect an almost inevitable drop in deposit inflows, remittances and direct investment from the region. The impact could also extend to a curb on the bank's profitability. On the other hand, some observers argue that Arab capital may attempt to invest in the Lebanese conservative banking system. However,

stock market crashes, bankruptcies and foreclosures become the norm on a day to day basis. The fall in international consumer and investor confidence has certainly had spillover effects on the real sectors of the local economy, namely in trade, retail, real estate/ construction and even in the banking sector. This is especially true when it comes to the Gulf economies, who rely greatly on oil revenues.

The initial feeling was that the crisis would not hit Lebanon region due to a lack of *financial* integration with the world economy. But the decline in oil prices, which constitutes the backbone of the economy of the Gulf and the main tributary of the economic and investment of the non-oil Arab countries, from \$150/barrel to less \$50 dollars/ barrel in the



Source: World Economic Situations and prospects 2009 & OECD Economic Outlook

what is certain – as highlighted by central bank governor Riad Salameh – is that deposits in Lebanese banks will not be invested in the domestic or regional market.

According to Lebanese economist Ghazi Wazneh, there are indications that Lebanon will not be spared by the financial crisis and this will translate into lower tax revenues- a drop in the value-added-tax receipts and in tariffs could be expected because of the overall drop in consumption activity. This comes despite the improvement in the public finances resulting from the dramatic fall in the price of oil. The Public Debt may also get worse as the tightening of world credit prevents the Lebanese government from obtaining new funds to cover the interest owed on the debt.

3) From a more social perspective, the global financial crisis may also delay the effectiveness of the major pillars of the poverty reduction strategy for Lebanon, as defined by the UNDP. These include:

“The first wave of the crisis brought a number of large banks and financial institutions to their knees. A prolonged and severe recession... Could likewise affect countries and regions with profound consequences for the security and stability of us all”

BAN KI-Moon -

Security General of The United Nations

Negative impacts (of the crisis) would result from an international contraction in consumption, investment and in the overall real sector.

- **Inclusive and Sustained Growth**, which involves the execution of an economic agenda that can lay the foundations for more sustainable growth in jobs, productivity and incomes.
- **Expand Educational Opportunities**, which entails investing in human capital by encouraging men and women to enroll in and stay in school, thus allowing them to have greater social and economic opportunities in the future as well as raising labor productivity and economic growth.

Since both of these pillars involve expanding public investment and encouraging greater private investment as a means to stimulate growth, one can only assume that the tightening of credit markets and the resulting reluctance of Banks and investors to support new projects may impose a restriction to the success of such an agenda.

In conclusion, there are no quick fixes to this crisis, but a system is being set up on a global scale to deal with its causes and repercussions. The aim is to do it in a manner where confidence, growth and jobs can be re-established; repair the financial system in order to restore lending and to reinstate a system that can be trusted. Although the expected negative repercussions of the crisis on Lebanon's economy have been widely discussed, the main indicators of economic growth have not yet shown the dangerous signs of an economic recession at the local level, and with the high influx of expatriates expected to flood the country as the elections and summer months approach, such a slowdown in economic growth may be eluded for the time being.

Viewpoints

- *"Now is the time for the international community to put its creativity and strength behind the development of a global monetary and financial system based on the maximization of human and environmental rights rather than alleged profit rights".*

Jubilee South http://www.socialwatch.org/en/noticias/noticia_285.htm

- *Social Watch, a network of citizen coalitions in over 70 countries monitoring the commitments of governments and international organizations to eradicate poverty and achieve gender equality, has submitted 10 measures to fight global recession and bail out the poor to the UN Commission on Reforms to the Global Economic and Financial System.*

Social Watch: 10 measures to fight global recession and bail out the poor

http://www.choike.org/nuevo_eng/informes/7360.html

- *"Lebanese expatriates are employed as professional and skilled labor and the Financial Crisis did not impact this type of employment. Therefore, the impact of the crisis may not be that bad on Lebanese expatriates employment.*

Fouad el Seniora- Prime minister of the Republic of Lebanon

- *"My view is that we probably need major bank cleanup and probably sustained fiscal stimulus until the private sector can repair balance sheets enough to start spending again".*

Krugman: FPC Briefing on the 'Return of Depression Economics'

- *"But it does not look as if developing countries are being hit that much worse. This is a crisis where the real epicenters are in the developed countries, and while – aside from emerging Europe, which is where you had really terrible things happening, it's not so severe elsewhere".*

Krugman: FPC Briefing on the 'Return of Depression Economics'



The MOET Newsletter hopes to keep its readers up-to-date on topics important to the Ministry as well as on the current economic climate.

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