

MOET NEWSLETTER



INTEREST RATES

Over the last 30 years, Lebanon has witnessed a wide range of interest rate variations across the choice of instruments they are applied to. It may not always be apparent, but these rates play an important role in everyday life since they can greatly affect purchasing power at the individual, institutional and national levels. The cost of borrowing money therefore plays an essential role in shaping a nation's economy.

This issue is dedicated to outlining the chronological evolution of the major interest rate changes in Lebanon along with their economic justifications. In particular, it will focus on the most popular instruments that they are applied to: 1) commercial bank loans and deposits, 2) Treasury Bills and Bonds and 3) foreign currency denominated government issues, otherwise known as Eurobonds.

Interest Rate Basics

Economists generally agree that the measurement criteria of the interest rates offered on a variety of investment instruments mainly take account of the following factors:

1. The interest rate on a risk free investment of a similar class.
2. The level of risk that the investment instrument chosen itself presents.
3. The economic environment such as inflation and inflationary expectations, economic growth, level of foreign reserves etc ..

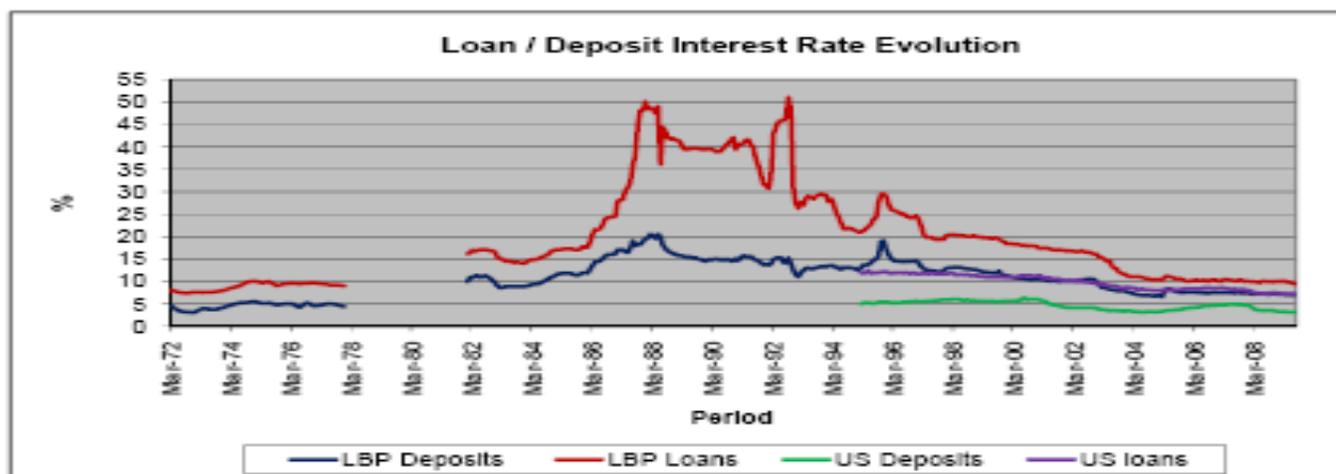
Although a truly risk-free asset exists only in theory, in practice most professionals and academics use short-dated government bonds of the currency in question. For instance, US Dollar investments usually use US Treasury bills as a risk-free benchmark. Such securities are considered to be risk-free because the likelihood of governments defaulting is extremely low, and because the short maturity of the bill protects the investor from interest-rate risk.

Most investment instruments however carry some level of risk, especially in a country similar to Lebanon, where elements such as political instability, high levels of public debt and systemic risks inherent from a monetary system

with a pegged exchange rate, highly dollarized banking system and potentially volatile non-resident deposits shape the determination of risk profiles and hence, interest rates. In Lebanon for instance, LBP instruments (such as LBP deposits, loans and government bonds) are mainly exposed to exchange rate risk- the danger that a currency faces of being overvalued or undervalued due to exchange rate fluctuations- that may arise from country specific economic or political factors as well as banking sector risk- the possibility of a financial institution being exposed to credit, liquidity or other banking problems. Foreign currency instruments on the other hand (such as US dollar deposits, loans or Eurobonds) may be exposed to similar shortcomings albeit international or to other risks such as sovereign risk- the risk that the nation cannot afford to repurchase the necessary foreign currency at the maturity of the bond. But on the whole, the riskier an investment instrument is, the higher its rate is likely to be.

Evolution of Lebanese Interest Rates

The figures on the following page show the paths followed by the most popular interest bearing instruments in the Lebanese economy.



Source: BdL

The overall pattern observed is that towards the end of the 1975-90 war, interest rates on all LBP denominated instruments began to rise significantly. This trend continued in the immediate aftermath of the war and reached, in some cases, record peaks. Towards the late 1990's however, they began to show a steady downward path. Over the last decade, the latter trend has continued, notwithstanding the accelerated progressions observed in 2002 and again in 2008-2009.

a) Effects of the war

Not surprisingly, the 1975-90 war had a profound effect on the Lebanese economy. However, there were two by-products that would be seen as directly compounding the observed rise in interest rates: a) the sharp devaluation of the Lebanese pound witnessed at the start of 1984 and its ensuing hyperinflation and b) the inflationary method encouraged by the central bank to help finance the growing budget deficit— money printing.

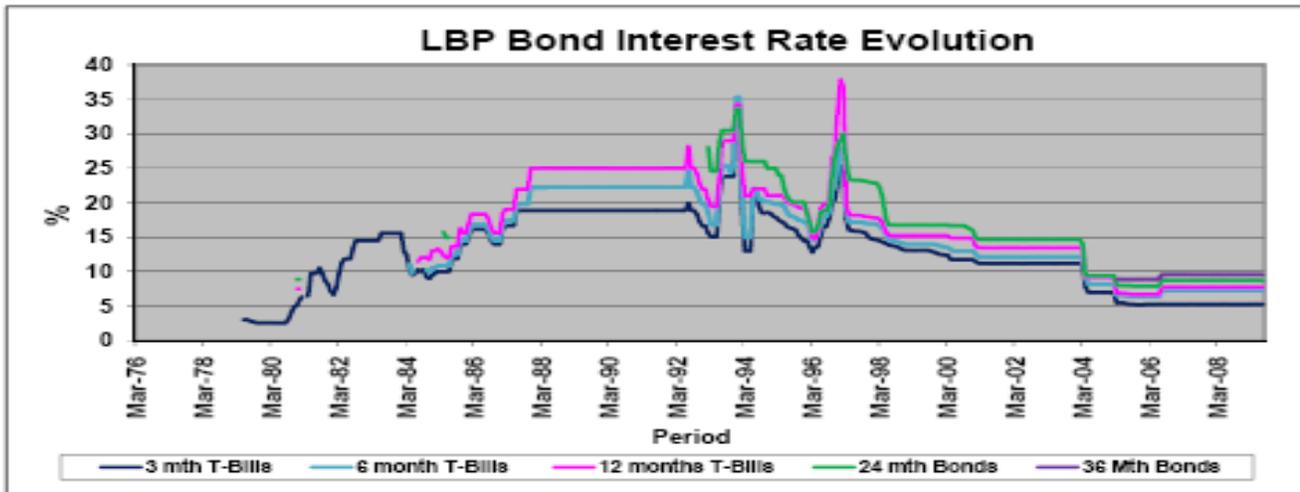
In detail, on the eve of the 1975-90 war, the Lebanese Pound was valued at approximately LBP 2.3 to the dollar. Although it devalued throughout the initial stages of the war, this wasn't enough to destroy the confidence in the pound, which was backed by substantial holdings of gold and foreign exchange accumulated during the dynamic years prior to the conflict. Thus, fluctuations in the LBP pound remained limited between 1975 and early 1984, ranging between LBP 2.3 and LBP 5.5 to the dollar.

However, the Lebanese pound began depreciating rapidly in the aftermath of several Beirut clashes, the withdrawal of the Multinational Force of Peacekeeping Troops from the capital and the abandonment of a number of western backed development projects. These features essentially led to a severe loss of confidence and resulted in the Lebanese pound losing half of its value against the US Dollar in 1984 and 60% of its value by 1985. This trend continued throughout the late 1980s, whereby the LBP peaked at around LBP 500 to the Dollar and dollarization levels rocketed from around 30% in 1984 to a high of 90% in 1987, before settling at the 60-70% mark thereafter.

Together with the severe devaluation in the LBP experienced over this period, the Central Bank also resorted to printing money towards the end of the war in order to help the government cope with the recurrent budget deficits stemming from the lack of revenues. Both brought about the ensuing hyperinflation and subsequent interest rate hikes.

b) Interest rates in the post war period

By 1992, the economic system was characterized by an inflation rate of 120%, a government budget deficit of 15% of GDP as well as the fear of facing a balance of payments crisis, since the surplus had only reached US\$54 Million during that year. Therefore, the Lebanese government at the time did not have to carry out postwar reconstruction activities only, but it also had to shift monetary policy towards targeting price and exchange rate stability. The nominal exchange rate consequently became the main anchor



Source: Bdl

in the government’s new stabilization program, otherwise known as the “Exchange Rate Based Stabilization”(ERBS) method. This technique aimed for an appreciation of the Lebanese pound by increasing the requirement of foreign reserves, rather than depending on the former inflationary finance method of money printing.

In order to encourage such an exchange rate and level of foreign reserves, high and flexible interest rates were adopted. The rationale was that higher interest rates on LBP denominated instruments would attract the necessary capital to allow the LBP to appreciate (and hence, fight inflation) as well as financing the growing fiscal deficit. Consequently, interest rates on government bonds, for instance, were inflated to highs of 36% whilst those on deposits and loans oscillated at their similar end of war highs.

In subsequent years, the high interest rates had managed to control the hyperinflation. According to Dr Dibeh, price increases in 1993, 1994, 1995 and 1996, averaged 24.7%, 8%, 10.6% and 8.9% respectively, falling from a high of 131% in 1992. In fact, by 1999, they reached 1.5%. Similarly, by July 2000, the Ministry of Finance stated that the Central Bank’s foreign reserves were at record level. Thus in this short period of time, Lebanon had man-

aged to curb inflation and increase its foreign reserves.

However, the high interest rates also had a devastating impact on economic growth and the emerging public debt. The high cost of borrowing funds for investment, such as those on bank loans, discouraged many productive projects from materializing. Similarly, the record profits incurred by commercial banks in the mid-1990s had not emanated from their traditional lending activities, but rather from the high returns they were receiving from the government bonds they had invested in. Moreover, the interest payments on those government bonds were becoming a drain on the public finances. Public debt soared from a rate of 59% of GDP in 1993 to over 140% of GDP in 2000. Economic growth consequently plummeted, reaching a level of -0.9% in 2000 (1% according to Makdisi) from a high of 8% in 1994.

In early 1997, the government declared that it was determined to boost economic growth while maintaining an annual inflation rate of less than 10% . In response to the growing recession and public debt, the early months of 1997 saw a simultaneous steady decline in interest rates on T-Bills as well as a rise in the share of long term maturity bills. It was argued

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Real GDP Growth	4.50%	7.00%	8.00%	6.50%	4.00%	3.50%-4.00%*	3.00%	1.00%*-4.00%	2.00%	1.40%	1.00%
Inflation rate	100%-131%	24.70%	8.00%	10.60%	8.90%	7.70%	1.60%-5.00%*	1.00%*-1.50%	-0.9%-1.00%*	1.00%*-2.90%	4.00%*-4.20%

Source: Dibeh(2007) and Makdisi (2004)*

that by focusing on T-Bills with longer term maturities, the government could ease the pressure on its debt repayments. Furthermore, the Lebanese Banks Association reduced the interest rate on LBP lending from 24% to 16% in the hope to encourage LBP lending, since most lending was being made in foreign currency.

This volatility in fluctuation however, is not apparent for interest rates on Dollar denominated deposits and loans. In fact, due to the limited availability of data, these rates are only recognized since 1995.

c) Interest rates since the turn of the century

One type of instrument whose interest rates strike out is Eurobonds. A list of the interest rates on all Eurobond issues is presented in the opposite table, along with their issuing amount and maturity.

Normally, the interest rate spread between Lebanese Eurobonds and the relevant US or Euro treasury securities would reflect the level of sovereign risk among other factors, such as the issuing amount and time to maturity of the bond. Shocks that trigger a sustained deterioration (or improvement) in any of the elements that determine sovereign risk would most likely bring about negative (or positive) credit rating and a hence, a rise (or fall) in interest rates.

By the late 1990s, the Lebanese economy was continuing to suffer from the macroeconomic and stabilization policies it was caught up in. Economic growth and the public debt continued to fall and rise respectively. Given this macroeconomic climate, negative credit ratings should have adversely affected interest rates, but instead, Lebanon received generous support from the international community as a result of the Paris meetings. These meetings, known as Paris I and II respectively, sought to address the need for international donor support in order to protect Lebanon's economy from stagnating due to its ever growing fiscal and debt problems. Paris II, in particular, opened the path for reversing the high rates on Eurobonds. The government first negotiated

with international lenders to provide Lebanon with concessionary loans and grants, extend debt maturities, reduce interest rates on the public debt and in summary, change the overall structure of interest rates in the hope of avoiding a financial crisis and laying the foundations for economic recovery. The international community provided US\$2.4 billion in direct financial support at a maturity of 15 years, an interest of 5% and three quarters of the amount having a grace period of 5 years while the rest had a grace period of 3 years. Meanwhile, the local contribution from Lebanon's financial sector totaled US\$7.8 Billion, namely by BdL and commercial banks. BdL reduced the government's debt by US\$1.8 Billion while US\$2.3 Billion in debt was converted into a long term loan at concessional rates. The commercial banks pledged an amount of US\$3.6 Billion to a 24 month government bond at 0% interest. This fall in interest rates is clearly shown in the opposite table, as they shot down from an average of around 9% until 2002 the rates negotiated following Paris II.

The negotiations also had positive spillover effects on the entire economic system as similar downturns were extended to market interest rates on LBP and dollar denominated commercial loans as well as treasury bills. For instance, interest rates on two-year treasury bills fell from an effective 16.1 percent in May 2002 (which included a 2 percent premium then offered by the central bank in its swap operations) to 9.2 percent by late December 2002, while the yield on the three-month bill declined from 11.2 percent to 7.0 percent over a similar period. Interest rates on Treasury Bills again declined in 2004, as those coming to maturity were rolled-over, at longer maturities and lower interest rates.

d) Effects of the Financial Crisis

Another significant downturn in interest rates at the turn of the century can be observed in the months following the recent financial crisis. Thanks to BdL's conservative banking policies and the prudent strategies used by do-

EUROBONDS

*merged with previously issued bonds

Subscribing Institution	Date Issued	Issue Amount	Currency	Maturity	Years	Coupon Rate	Remaining Amount
	Oct-94	400,000,000	USD	Oct-97	3	10.125%	0
	Jul-95	400,000,000	USD	Jul-00	5	9.125%	0
	Jun-97	250,000,000	DM	Jun-02	5	6.500%	0
	Jul-97	100,000,000	USD	Jul-07	10	7.500%	0
	Oct-97	400,000,000	USD	Oct-07	10	8.625%	0
	Apr-98	500,000,000	USD	Apr-03	5	8.125%	0
	Apr-98	500,000,000	USD	Apr-03	5	8.625%	0
	Sep-98	450,000,000	USD	Sep-05	7	8.750%	0
	Mar-99	200,000,000	USD	Mar-04	5	8.500%	0
	Mar-99	550,000,000	EUR	Mar-04	5	7.250%	0
	Oct-99	300,000,000	EUR	Oct-06	7	8.875%	0
	Oct-99	650,000,000	USD	Oct-09	10	10.250%	150,010,000
	Sep-00	225,000,000	USD	Sep-03	3	9.125%	0
	Sep-00	225,000,000	USD	Sep-03	3	6 months US LIBOR +2%	0
	Jun-00	850,000,000	USD	Jun-05	5	9.375%	0
	Dec-00	850,000,000	USD	Dec-04	4	9.500%	0
	Feb 2001*	200,000,000	USD	Feb-04	3	9.500%	0
	Apr-01	1,150,000,000	USD	Apr-06	5	9.875%	0
	May-01	400,000,000	USD	May-16	15	11.625%	400,000,000
	Aug-01	750,000,000	USD	Aug-06	5	10.125%	0
	Sept 2001*	350,000,000	USD	Sep-05	4	9.375%	0
	Nov 2001*	250,000,000	USD	Nov-04	3	9.500%	0
BDL Contractors	Mar-02	1,000,000,000	USD	Mar-05	3	10.250%	0
BDL Contractors	May-02	350,000,000	USD	May-06	4	10.500%	0
BDL Contractors	Jun-02	500,000,000	USD	Jun-06	4	10.500%	0
Com. Banks	Aug-02	750,000,000	USD	Aug-06	4	10.500%	0
BDL	Oct-02	500,000,000	USD	Oct-07	5	10.500%	0
BDL (Paris II)	Dec-02	2,007,511,000	USD	Dec-17	15	4.000%	1,706,384,000
UAE-KUW-OM-MAL (Paris II)	Dec-02	950,000,000	USD	Dec-17	15	5.000%	552,500,000
KUW (Paris II)	Mar-03	700,000,000	USD	Mar-18	15	5.000%	630,000,000
Com. Banks (Paris II)	Apr-03	422,905,000	USD	Jan-May 2005	approx 2	0.000%	0
Com. Banks (Paris II)	May-03	236,250,000	EUR	Jan-May 2005	approx 2	0.000%	0
QATAR (Paris II)	May-03	200,000,000	USD	May-18	15	5.000%	180,000,000
	May-04	1,000,000,000	USD	May-11	7	7.875%	1,000,000,000
	May-04	225,000,000	EUR	May-09	5	7.250%	0
	Sep-04	1,265,000,000	USD	Mar-10	5.5	7.125%	1,065,000,000
	Sep-04	600,000,000	USD	Sep-12	8	7.750%	600,000,000
	Nov-04	625,000,000	USD	Nov-09	5	6 Months LIBOR + 3.25%	40,203,000
	Nov-04	700,000,000	USD	Mar-08	4	6.375%	0
	Nov-04	300,000,000	USD	Nov-10	6	6.875%	300,000,000
	Dec-04	425,000,000	USD	Dec-09	5	7.000%	103,661,000
	Feb-05	1,000,000,000	USD	Feb-07	2	6.500%	0
	May-05	250,000,000	USD	May-08	3	7.000%	0
	Jun-05	250,000,000	USD	Jun-08	3	7.375%	0
	Jun-05	250,000,000	USD	Jun-13	8	8.625%	650,000,000
	Oct-05	750,000,000	USD	Jan-16	10.5	8.500%	750,000,000
	Apr-06	676,902,000	USD	Apr-14	8	7.375%	676,902,000
	Apr-06	1,661,469,000	USD	Apr-21	15	8.250%	1,661,469,000
	Apr-06	324,542,000	EUR	Apr-12	6	5.880%	324,542,000
	Aug-06	450,000,000	USD	Aug-11	5	7.500%	450,000,000
	Aug-06	206,591,000	USD	Aug-09	3	7.500%	87,893,000
	Dec-06	145,000,000	USD	Aug-09	2.75	7.500%	0
BDL	Feb-07	569,000,000	USD	Mar-08	approx 1+	6.380%	0
BDL	Feb-07	431,000,000	USD	Apr-21	approx 14+	8.250%	431,000,000
BDL	May-07	400,000,000	USD	Jun-13	approx 6+	8.630%	400,000,000
BDL	Jul-07	137,511,000	USD	Dec-17	10.5	4.000%	0
Malaysia (Paris III)	Jul-07	300,000,000	USD	Jul-17	10	3.750%	300,000,000
Malaysia (Paris III)	Jul-07	200,000,000	USD	Jul-12	5	3.750%	200,000,000
BDL	Oct-07	400,000,000	USD	Nov-10	approx 3+	6.880%	400,000,000
BDL	Nov-07	300,000,000	USD	Aug-11	approx 4-	7.500%	300,000,000
	Mar-08	875,000,000	USD	Mar-13	5	9.250%	875,000,000
	May-08	881,612,000	USD	May-14	6	9.000%	881,612,000
	Aug-08	500,000,000	USD	Aug-15	7	8.500%	500,000,000
	Mar-09	268,937,000	USD	Mar-17	8	9.000%	268,937,000
	Mar-09	1,231,063,000	USD	Mar-17	8	9.000%	1,231,063,000
	Mar-09	175,739,000	USD	Mar-12	3	7.500%	175,739,000
	Mar-09	424,261,000	USD	Mar-12	3	7.500%	424,261,000
	Apr-09	211,097,000	EUR	Apr-12	3	7.750%	211,097,000

Source: MoF

mestic banks, the Lebanese banking system was regarded as a safe haven among regional and international neighbors. Together with worldwide benchmark interest rates falling following the global financial crisis, this status allowed the interest rate spread between LBP deposits and Foreign Currency deposits to initially grow and consequently, attract large amounts of capital into the economy's banking system. Growth in LBP deposits rose by 55.2% in 2008 compared to 5.6% and -5.7% in 2007 and 2006 respectively. A wave of de-dollarization also followed: the percentage of dollar accounts dropped from 77% in March 2008 to 67.7% by March 2009 and 65.31% by August 2009. Salim Chahine, associate professor at the American University of Beirut (AUB) also stated that this phenomenon would reduce the pressure on the Central Bank to keep a large amount of low yielding reserves in foreign currency and reduce the cost of managing the foreign exchange rate, which would hence lower interest rates.

Furthermore, attempts have been made to lower interest rates on LBP loans while ensuring that those on deposits remain the same. For instance, a temporary solution by the central bank has been to subsidize the lending rate on LBP loans by exempting them from reserve requirements and lira-denominated loans used to finance first home purchases or capital investments. The deposit reserve of 15% required by the Central Bank was a significant contributor to the costs to the lending bank and therefore, overall interest rates.

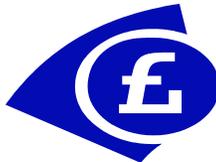
The most recent interest rates on interest rates on Eurobonds have also shown signs of progress as they follow a downhill trajectory. For instance, in March 2009, the interest rate on Eurobonds with a 3 year maturity was 7.5%. In the latest November Issue of Eurobonds, interest rates on Eurobonds with a maturity of 5 years reached 5.875% against 7% for the bond with a 15 year maturity. This decline on the most recent Eurobond issue, as stressed by the minister of Finance Raya el Hassan, reflects an improvement in confidence in Lebanon's economic and security situation, since the decline in interest

rates is the result of the high demand for the Eurobond. For the minister, the success of the program is the result of several factors, namely political stability, the decline in the ratio of public debt to GDP, the success of various economic indicators in recent months and the resilience of Lebanon's banking sector to the global financial crisis and most recently, to the severe downturn witnessed in Dubai.

Conclusion

Interest rates are one of many tools available to authorities that can influence the economy. In particular, they act as a vital tool for monetary policy and aim to manipulate economic variables such as investment, inflation, and growth by directly influencing the cost of borrowing money. In Lebanon, a number of factors appear to have played a role in determining interest rate levels. The volatility in the level of interest rates has heavily depended on the risk profile of the currency they denominate as well as on the economic situation of the nation, as interest rates on LBP instruments have fluctuated heavily in comparison with Dollar denominated ones and since they have played a prime role in reversing the sharp depreciation of the LBP pound and the hyperinflation that ensued following the 15 year war.

The main objective of the central bank at this moment in time is to take advantage of the excess liquidity, that has been fuelling commercial bank deposits since the onset of the global financial crisis, by channeling it towards productive investments. The anticipated downturn in interest rates on LBP loans would also improve the competitiveness of the Lebanese Lira against the Dollar. Together, both circumstances would result in the strengthening of the economy.



The MOET Annual Bulletin hopes to keep its readers up-to-date on Lebanon's economic climate.

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