IMF Article IV Consultation for Lebanon 2016: Reform Agenda is Known but is now More Urgent

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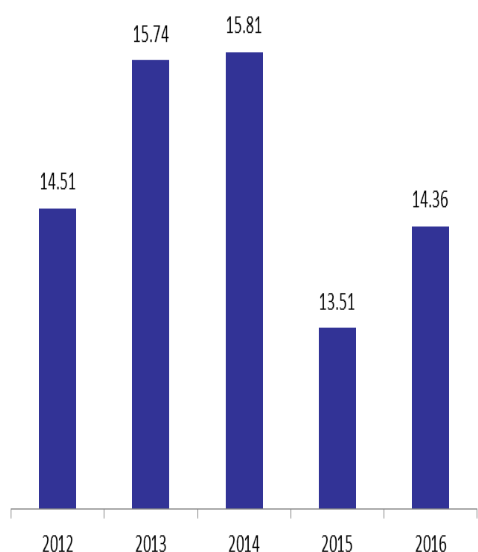
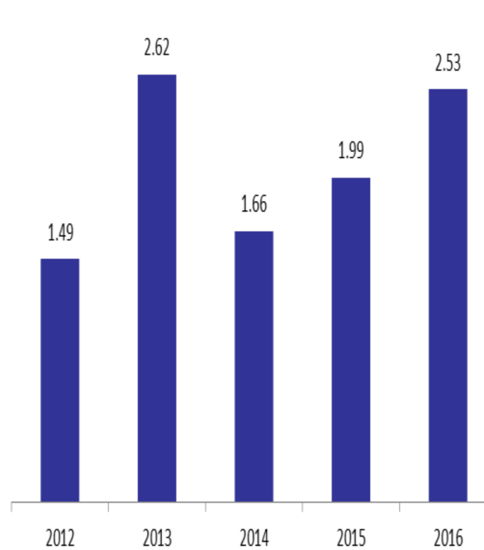
"The reform agenda is known, but is now more urgent" notes the IMF staff in their 2016 Article IV Consultation for Lebanon. Indeed, a lot of ink has been poured on the needed reforms in Lebanon: Fiscal imbalances must be repaired, public debt should be set on a downward path and the electricity sector needs to be more efficient. However, the novelty this time is the urgency with which these issues need to be addressed. The recent election of a president after two years and a half of deadlock is a positive and much-needed breakthrough in order for policy changes and structural reforms to be carried.

The longer the imbalances remain unrepaired, the deeper the damage they would inflict. According to the IMF report, the *"adjustment needed to stabilize Lebanon's debt dynamics has increased"* due to low growth and a heavier debt burden. The IMF estimates the real economic growth rate at 1% in 2015 and projects the same growth rate for 2016. The fund's figures indicate that real growth will remain below the 4% potential until at least 2018.

Trade Deficit by November ($B)

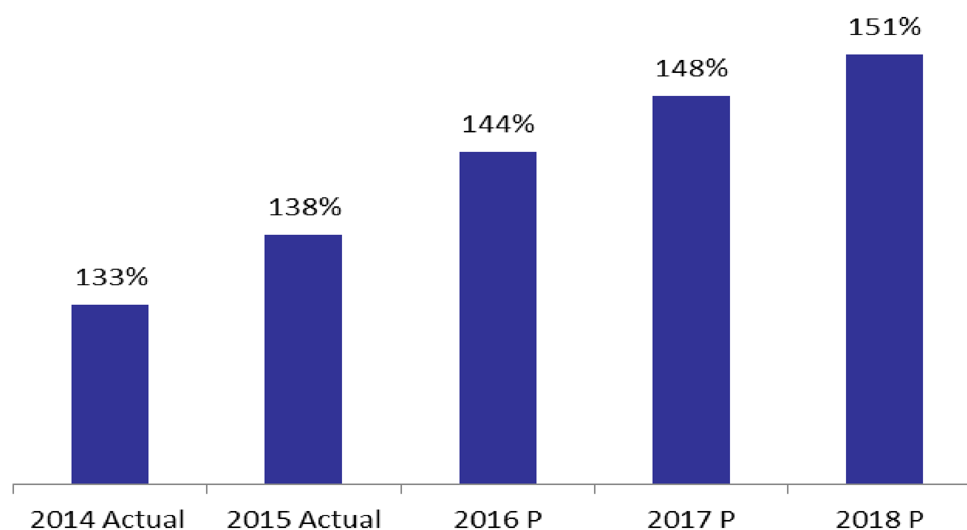


Fiscal Deficit by August ($B)



Source: Lebanese Customs, Ministry of Finance

Total Government Debt, In % of GDP



Source: IMF Article IV Consultation 2016

The Presence of Syrian Refugees is Extremely Costly for the Weak Lebanese Economy

The Syrian conflict, now in its sixth year, is still weighing on the Lebanese economy. The Syrian war has disrupted trade routes but it most importantly led to Lebanon hosting 1.5 million Syrian refugees, equivalent to a quarter of its population. The IMF acknowledged that Lebanon alone cannot bear the costs of the influx of Syrian refugees and that global aid is "needed and warranted". Lebanese authorities have estimated the total direct budget costs at $400 million per year while the World Bank puts indirect costs at 2 and a half billion dollars in terms of erosion of public services.

The IMF sheds light on the controversial and particular impact of the Syrian refugees on the Lebanese labor market. According to the fund, and in simplified terms, theory states that an influx of labor initially competes with existing labor, lowers wages and might induce exits of existing labor from the market. Therefore, the first stage would actually lower the capital to labor ratio. However, the extra labor would make capital more productive and on the long run would compel higher investments and a higher capital stock. "Indeed, with constant returns to scale, the capital labor ratio will ultimately revert to the initial steady state; bringing back wages to their original level", explains the IMF.

Standard theory on the entrance of migrants to a country's labor market is not fully realizable in the case of Lebanon. First, the above-mentioned investments and increases in capital stock needed to accommodate the migrant's entry, suggest the need for a favorable investment climate. However, the IMF notes that the Lebanese investment climate suffers many drawbacks such as: poor infrastructure and low public investment. Second, the IMF states that in Lebanon around half of the workforce is employed in the informal sector where they are likely to compete directly with new Syrian refugees. According to the International Labor Organization (ILO, in 2014) and as quoted by the IMF, wages of unskilled workers in certain areas were slashed by as much as 50%.

The Economic Impact of Lower Oil Prices is Not Very Straightforward

Oil prices have dropped and at first sight this seems like a positive change for an oil importing country like Lebanon. The IMF nuances this notion by stating that the impact of lower oil prices on Lebanon has many facets and therefore paints a “mixed picture”. On the upside, in Lebanon, the sensitivity of oil prices at the pump to movements in global oil prices (what is called “the pass-through effect”) is the highest in the region. Accordingly, the IMF notes that gasoline prices at the pump have declined by 49% since their peak in April 2012. However, lower oil prices have also weakened the GCC economies which employ a large number of Lebanese expatriates sending remittances to Lebanon but which are also a source of funding (deposits), investments (particularly in real estate) and tourism revenues for the country.

The impact of lower oil prices on the fiscal sector is also mitigated. On the fiscal side, public revenue changes little following a change in oil prices. The IMF highlights that excises and VAT on gasoline are the only taxes directly related to oil while gasoil is not fully taxed. The main impact is therefore on the spending side: transfers to the electricity company EDL used to represent around 4% of GDP or $2B prior to oil prices plunge in mid-2014 but then dropped to 2.8% of GDP in 2015 and are projected at 1.5% of GDP in 2016.

Low oil prices also generate two different impacts on Lebanon’s current account balance and the outcome depends on which impact offsets the other. In terms of oil imports, they are certainly cheaper but the IMF staff believes that “the price elasticity of oil demand is relatively low” which means that consumption only increased marginally in response to the oil price drop. If Lebanese consumers use their savings from lower oil prices to consume more of other imported goods, then this could offset the positive impact of lower oil imports and keep the current account deficit high. The weakening of GCC economies could also negatively impact their demand for Lebanese goods; exports of goods to GCC economies along with Syria and Iraq account for more than 40% of Lebanon’s exports of goods. The IMF believes that “lower exports will partially offset lower oil imports”.

The Lebanese Economy Has High Foreign-Currency Financing Needs

Foreign deposit inflows, a long-time anchor of macro-economic sustainability in Lebanon, started to decelerate in mid-2015. The Lebanese banking sector has always relied on its loyal depositor base, mainly the Lebanese diaspora, to meet the economy’s financing needs. However, in mid-2015, the growth in deposits started to decelerate. The Balance of Payments (BoP) ended 2015 with a $3.35B deficit, the highest in 5 years.

According to the IMF, appetite for Lebanon’s external debt has weakened. Yields on the Lebanese Eurobonds rose by 70 basis points (bps) in the past year while other emerging markets have seen a decrease in yields of the same magnitude. Prices and yields have an inverse relationship so the rise in Lebanon’s Eurobonds yields indicates lower prices and lower demand. This, paired with weaker deposits inflows, adds more strain on Lebanon’s funding base.

The country's large foreign currency (FX) financing needs urged the Banque du Liban (Central Bank of Lebanon) to pre-emptively engage in a large swap operation. According to the IMF, as of May 2016, the Central Bank's gross reserves had declined by 10.1% year-on-year to $35.1B. In order to boost its reserves position, the Central Bank engaged in two swap operations:

- The first swap consisted of the Central Bank selling Lebanese treasury bills to the Ministry of Finance in exchange of $2B worth of new Eurobonds.
- The second swap consisted of the Central Bank selling the newly acquired Eurobonds along with Certificates of Deposits denominated in foreign currency and of long term nature to Lebanese commercial banks. ($13B)

Commercial banks were rewarded for providing dollars to the Central Bank. The Central Bank discounted the treasury bills or LBP Certificates of Deposits held by commercial banks at a premium with the income being split equally between the Central Bank and commercial banks.

The Central Bank's operation had many impacts that were highlighted in the IMF report.

1. The Central Bank's foreign reserves were boosted to $40.6B at the end of October 2016
2. The Balance of Payments turned positive to a cumulative $555M in September
3. Public debt service costs were reduced and the maturity of public debt structure was lengthened
4. An excess of Lebanese Pounds (LBP) liquidity was created, it is equivalent to a third of GDP as of mid-October according to the IMF. The report notes that part of this liquidity is already being channeled into newly-issued Treasury bills
5. The excess LBP was also used to strengthen the banks' capital buffers. This objective is due to the Central Bank's instruction that commercial banks are to retain all the swap-related income as provisions in Lebanese Pounds ahead of the upcoming IFRS 9 accounting regulation that should come into effect in 2018
6. The Central Bank also instructed Commercial Banks to give out loans denominated in Lebanese Pounds
7. Banks sold Eurobonds to clients at attractive rates by drawing down their foreign-currency liquidity mainly from correspondent banks
8. Annualized deposit growth rate increased from 3.5 percent at end-May to 4.7 percent by early-November, since banks offered attractive returns on large deposits from high-net worth depositors
9. The IMF notes that "the internal FX liquidity position of the banks weakened. Before the operation, banks' FX liquidity held abroad had declined from a peak of $18 billion in June 2011 to $10.4 billion by May 2016; by end-August, it was below $8.5 billion, increasing banks' reliance on the BdL for FX liquidity."

The financial engineering led by the Central Bank is not however a solution to the country's economic woes. The IMF concludes its report with three themes it believes are key: "(i) starting the process of fiscal adjustment immediately; (ii) standing ready to increase interest rates to support financial inflows, if needed; while safeguarding financial stability; and (iii) laying the ground for higher-quality and more inclusive growth."

The IMF clearly states that "there is no substitute to fiscal consolidation". The first step is to **pass a credible budget** after it has been absent for more than ten years in parallel with the ongoing work on the closing of accounts since 1993. The IMF suggests a series of measures that can boost fiscal revenues: an **increase in the corporate income tax** rate from 15% to 17%, the **introduction of a capital gains tax** on real estate, an **increase in the rate on interest income tax** from 5 to 7%, **an increase in the VAT rate** from 10 to at least 11%, an **increase in tobacco excises** and **new stamp duties and fees**.

Since we are in a low oil-price environment, the IMF believes this is an opportunity to be seized to increase fuel taxation. The VAT on diesel which was suspended in 2011 needs to be restored and gasoline excises which were alleviated in 2012 need to be restored to their previous levels.

Tax compliance needs to be rendered more comprehensive. According to the IMF, tax collection is only 50% of estimated capacity. The tax administration is short-staffed, despite the 120 staff increase in 2016, the IMF's estimates suggest the needs to be five times higher.

Average electricity tariffs need to be increased and eventually eliminated. The Ministry of Finance is burdened by transfers to the inefficient public electricity company and tariffs are unreflective of current costs.

The IMF recognizes the critical nature of the salary scale adjustment and the importance of safeguarding the social safety net. In regards to the salary scale, the IMF believes its budgetary costs need to be fully offset in order to remain on point in the proposed fiscal adjustments. The salary increases should be accompanied by measures to ensure higher productivity and make hiring in the public sector more efficient. The National Poverty Targeting Program (NPTP), funded partly by World Bank and UNDP grants needs to be strengthened in the IMF's view. Securing additional government funding is pending the Ministry of Finance's approval and should be "granted as a matter of priority" in the IMF's view.

On the long run, once the effects of reforms kick-in and growth bounces back, the IMF believes public investment and social spending must be increased. The growth that Lebanon should target is one that creates jobs, that is sustainable and that benefits all the population.

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