Lebanon Debt Sustainability 2018-2022

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The issue of debt sustainability is now more relevant than ever. Here we explore two scenarios to assess Lebanon's debt sustainability.

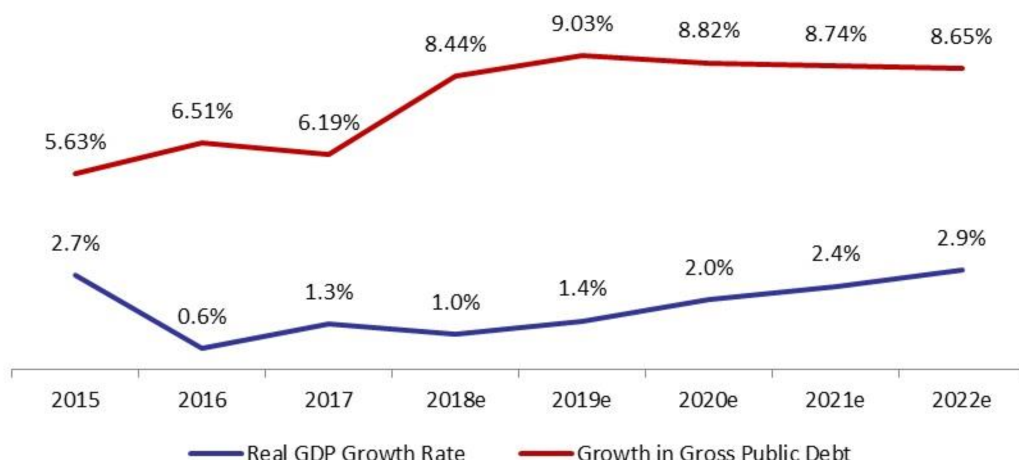
The first scenario is a baseline scenario in which we extend the current trajectory of key variables assuming no reforms are undertaken. In this case, the debt to GDP ratio is expected to swell to 175.6% in 2022. It is worth mentioning that our baseline scenario in this issue of the debt sustainability analysis worsened from our previous estimates as economic growth was revised downwards.

The second scenario is conservatively optimistic as it assumes sounder fiscal management and the implementation of reforms pledged during the CEDRE conference. In this scenario, we factor in the impact of the pledged funds on economic growth, government revenues and private sector deposits. In this scenario, the debt to GDP ratio would reach 139.7% in 2022.

The recent gridlock around the formation of a government is hurting confidence. According to the Central Bank of Lebanon, the growth in total private sector deposits slowed from 7.2% in 2016 to 3.8% in 2017 and 2.86% by September 2018. Meanwhile, on the lending side, loans to the resident private sector fell by 0.46% year-on-year to reach $52.18 billion by September 2018, hinting at a crowding-out effect of the private sector by the public sector due to higher interest rates. The crowding out of the private sector is likely to continue if confidence is not swiftly restored as the slim growth in deposits will be directed towards financing the sovereign.

Accordingly, questions about how much more strain the Lebanese economy can take have gained traction lately. With yet another prolonged political deadlock in Lebanon, we are still only talking about reforms rather than implementing them. The current context includes higher interest rates, recovering oil prices, $11 billion of loans and grants pledged for Lebanon by the international community during the CEDRE conference, higher inflation and weaker growth. This set of new givens compels us to take another look at the sustainability of Lebanon's debt, which earns it the third global spot in terms of debt to GDP ratio.

Annual Real GDP Growth versus Gross Public Debt Growth



Source: ABL, CAS, MOF, Blominvest Research Department

The recommendations for lowering our debt burden are now known to experts and non-experts alike. Fiscal consolidation is still the key to putting debt on a more sustainable path. Currently, the bulk of government spending does not generate any value-added to the Lebanese economy as it is centered on servicing our debt, paying the salaries and wages of public sector employees and covering the deficit of the national electricity company EDL. We must at least ease the spending on one of those three fronts in order to rein our debt levels back in.

Debt levels must always be looked at in relative terms and not absolute terms. Debt should be weighed against the economy's GDP and against the efficiencies of its allocation. It is only when debt levels are largely inflated relative to the economy's size and when they are accumulated towards no growth-boosting targets that they are frowned upon. This means that once Lebanon gains more fiscal space and reduces inefficiencies in fiscal spending, it will and should be able to borrow again, but this time, direct the borrowed funds to the long-neglected and much-needed capital expenditures.

Before exploring different scenarios for Lebanon's debt trajectory, here is a brief reminder of which variables are central in the debt sustainability discussion and how each one affects debt levels.

The level of debt is dependent on many factors:

Effective Interest Rate on Debt
Overall Fiscal Balance and Primary Balance
Real GDP Growth
GDP deflator

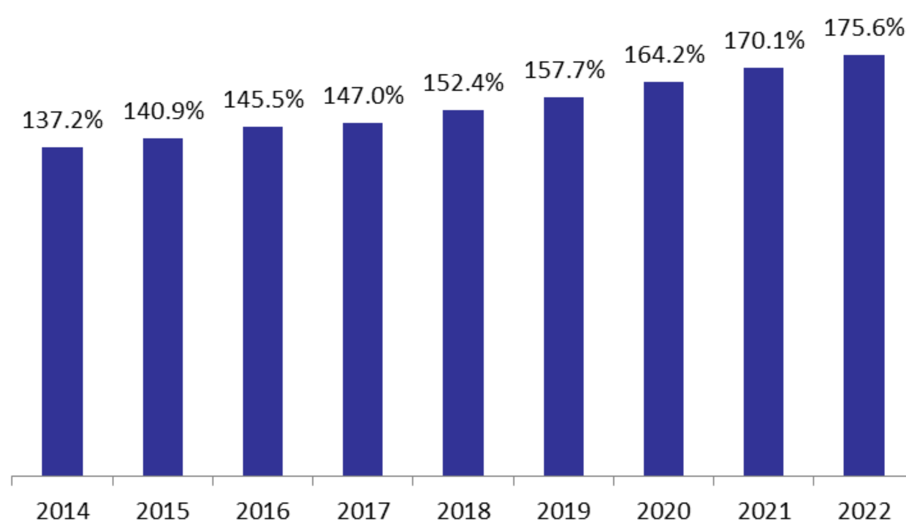
Effective interest rates on debt in Lebanon are dependent to a large extent on country risk and international interest rates. Intuitively, the higher the interest rates, the higher the due interest payments and the higher the debt burden.

The fiscal position of the country is inextricably linked to the level of debt. If the country is facing a fiscal deficit, it is bound to cover its shortage by resorting to more debt. If fiscal imbalances are not corrected, this vicious indebtedness cycle can be a major threat to the health of the economy.

Real GDP growth is linked to the level of debt through various channels. From a general standpoint, a robust GDP growth means that the country has created enough resources to finance its needs and pay back its dues. If debt levels are being accumulated to finance the fiscal deficit instead of financing capital expenditures, we will not be seeing any improvement in the country's potential GDP growth.

Below is a baseline scenario outlining the direction that public debt and other related economic indicators are likely to assume in the coming few years. This scenario takes into account the effect of the salary scale. The increase in the wages of public sector employees has passed and is estimated to cost around $1.2 billion which will be financed through a package of tax increases of which an increase in the VAT rate from 10% to 11%, an uptick in the tax on corporate profits from 15% to 17% and an increase in the tax on interest income from 5% to 7%.

Debt to GDP ratio under Baseline Scenario



	2016	2017	2018e	2019-2022e
Real GDP Growth Rate	1.74%	1.50%	1.00%	2.2%
Government Revenues	3.6%	17.0%	0.2%	3.0%
Government Expenses	9.9%	3.0%	20.0%	5.0%
Total Deposits	7.2%	3.8%	3.5%	5.0%

We have revised our baseline scenario to accommodate for new givens. GDP growth rates were revised downwards; in our previous set of assumptions, the real GDP growth rate for the year 2018 stood at 2% and that for the period 2019-2022 stood at 2.8% while in our new assumptions the rates now stand at 1.00% and 2.2%.

Exceptional factors led to a double-digit increase in government revenues in 2017. Government revenues exceptionally grew by 17% in 2017 to reach $11.63 billion as around $850 million in taxes were levied on banks' profits generated by the swap operation with the Central Bank of Lebanon and as the new package of taxes designed to finance the increase in the salaries and wages of public sector employees went into effect. VAT revenues increased in 2017 by 9.71% y-o-y in H1 2018 as the VAT rate was upped from 10% to 11%. However, a higher VAT rate paired with slow growth will not translate into a sustained increase in revenues for the full year 2018 and onwards.

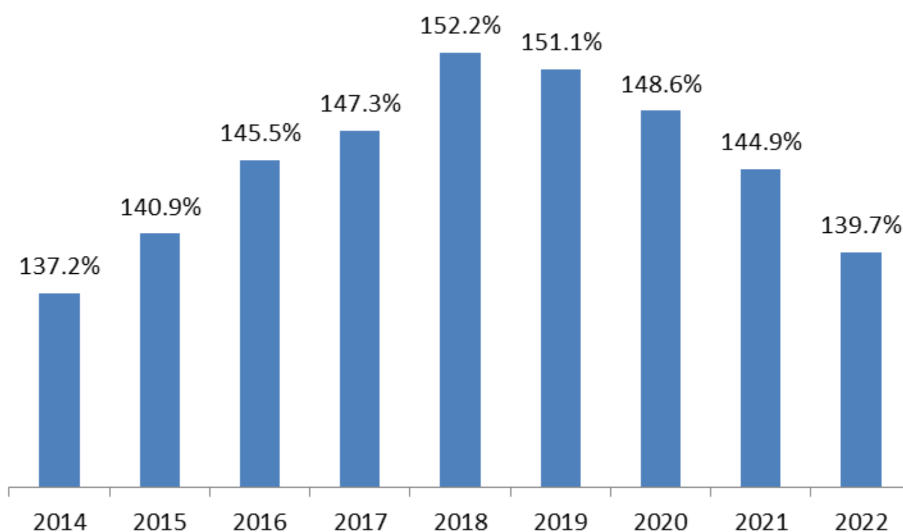
The primary surplus increased in 2017 but it is still not enough to finance Lebanon's debt service. Despite the fact that the primary surplus reached $1.43 billion in 2017, the highest level since at least 2010, it is still not enough to finance the debt service which reached $5.18 billion in 2017. In order to cover the debt service, the primary surplus would have to rise from the current 2% of GDP to 10% of GDP.

The debt to GDP ratio, is assuming an even more unsustainable trajectory in our current revision to debt sustainability. Under our previous assumptions, the debt to GDP ratio would have still been around the 160% of GDP by 2022 while in our new assumptions, the debt to GDP ratio is expected to swell to 175.6% of GDP by 2022. This is due to the downward revisions to GDP growth and to the expected worsening of fiscal conditions over the studied period.

The second scenario is an optimistic one whereby Lebanon benefits from CEDRE funds, enacts the pledged reforms and benefits from sounder fiscal management. Obviously, this scenario assumes higher GDP growth rates and a stronger fiscal position as CEDRE's capital expenditures begin to gradually add-value to the Lebanese economy as of 2019. Reforms will restore confidence and that will lead to a gradually recovering growth rate in private sector deposits. In our scenario, the growth in private sector deposits is restored to its "regular" level of 7% by the year 2022. Our debt service is similar to that of the baseline scenario as CEDRE funds will be accessed at 0% interest rate. Therefore, the debt-to GDP ratio in this second scenario would drop from 147.3% in 2017 to 139.7% in 2022.

	2016	2017	2018	2019-2022
Real GDP Growth Rate	1.7%	1.5%	1.0%	3.7%
Government Revenues	3.6%	17.0%	5.0%	6.0%
Government Expenses	9.9%	3.0%	20.0%	5.0%
Total Deposits	7.2%	3.8%	3.5%	5.0%

Debt to GDP Ratio under Optimistic Scenario



Finally, some caveats are important to nuance. There could be a better outcome for the variables we considered if Lebanon, along with CEDRE reforms, improves the ease of doing business. If we are to attract large multinational companies in our reform projects, procedures need to be less bureaucratic and need to be executed in a timelier manner. Finally, it is important to note, that CEDRE funds are not a magic potion which will make Lebanon's woes go away; first, improvements will be gradual and will take time to reveal themselves in the real economy. Second, the only path to a rosier economic picture would be through pairing CEDRE funds with fiscal and infrastructure reforms.

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