Lebanon, a Commodity Producer: What Frameworks to Explore?

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With 25 trillion cubic feet (cf) of potential gas resources, Lebanon is set to become a commodity producer in the next decade. These reserves will reap substantial revenues starting from 2020 at the earliest but it is way before that authorities must review their fiscal assessment tools, decide what shares of these revenues to save or/and invest and to make sure that institutions will guarantee efficiency and transparency in the resource exploitation process.

The exploitation of Lebanon's resources raises multiple questions. Should Lebanon create a sovereign wealth fund (SWF) to handle its hydrocarbon resources? If the answer is yes, would it serve intergenerational equity, infrastructure projects, the government's pension liabilities or reducing public debt? How should Lebanon design its fiscal framework to absorb the stream of resource-revenues? Is it possible to reconcile intergenerational equity with fiscal stabilization and debt reduction? Based on World Bank and IMF reports, the first section of this report discusses the establishment, objectives, challenges and benefits of a SWF while the second part scrolls through several fiscal frameworks, each offering different specificities.

Establishing a Sovereign Wealth Fund

Various Types of Sovereign Wealth Funds (SWF)

	Stabilization Funds	Savings Funds	Development Funds	Pension Reserve Funds
Goal	Shielding the budget and the economy from the effects of commodity price volatility	Achieving Intergenerational equity	Allocating the funds to socio-economic projects such as infrastructure	Meeting the government's future liabilities related to pensions
How?	Implementing Counter-cyclical fiscal policy	Transforming non-renewable assets into diversified financial assets	Supporting local or national development through filling the gaps in private sector investment capacity	Aligning the fund's objective with the government's future liabilities
Where?	Chile, Russia, Timor-Leste, Iran	Abu Dhabi Investment Authority, Libya, Russia's National Wealth Fund	UAE, Iran	Chile, Australia, Ireland and New Zealand
Investment Horizon	Short Term , Invest in highly liquid portfolios so small return	Long Term, High risk return profile	Long Term	Long Term
Chosen By Lebanese Authorities	NO	YES	NO	NO

Source: World Bank, Lebanon Economic Monitor, "A Sluggish Economy in A Highly Volatile Environment

In 2010, the Offshore Petroleum Law was passed by Parliament. The law encompasses the establishment of the Lebanese Petroleum Administration (LPA), which went through in 2012, and the establishment of a SWF which still hasn't materialized.

In their report entitled "A Sluggish Economy in A Highly Volatile Environment", the World Bank draws pertinent conclusions regarding the purpose, the challenges, the benefits and the risks associated with a SWF for Lebanon's hydrocarbon resources.

What is a SWF? The World Bank defines a SWF as a pool of savings that could stem from balance of payments and fiscal surpluses, revenues from privatization and/or revenues from commodity exports. The fund is owned by the government and follows an investment strategy serving its main purpose and achieving a certain financial return.

The World Bank revisits the several types of SWFs identified by the International Monetary Fund. The Stabilization Fund's main goal is to protect the budget and the economy from the commodity's price volatility through implementing a counter-cyclical fiscal policy. The Stabilization Fund will therefore shield fiscal revenues from any exogenous shock related to volatile commodity prices. The Development Fund is oriented towards investments serving socio-economic projects such as infrastructure. As for the Pension Reserve Fund, it is designed to meet the government's future pension related liabilities. The Savings Fund, the type of SWF chosen by Lebanon in the 2010 Petroleum Law, seeks intergenerational equity. Since the gas reserves are finite and non-renewable, the fund ensures that this wealth is transformed into diversified financial assets benefitting the current generation and the ones to come. The risk associated with this kind of SWF is that inter-generational equity would not be guaranteed if the fund fails to meet its real return target.

Adapting the Savings Fund to the Lebanese context raises the critical issue of cohesion between the SWF vision and the fiscal policy. Lebanon suffers from a large fiscal deficit, which represented 10% of GDP in 2013, and from one of the largest debt to GDP ratios in the world. By opting for a Savings Fund, the World Bank warns that this SWF cannot be used for fiscal stabilization purposes as this would incur heavy financial losses for the country. The Savings Fund operates by investing in assets with high risk-return profiles and usually low liquidity. If during a recession, authorities tap into the Fund's resources to finance a fiscal stimulus program they would be selling their assets at very low prices and therefore record losses.

By only taking into account financial considerations[1], the World Bank however notes that Lebanon can exploit its hydrocarbon resources to repay some of its public debt. Repaying sovereign debt will ease the elevated debt to GDP ratio and reduce Lebanon's risk premium and therefore the cost of its debt. According to the World Bank, if the debt to GDP ratio is reduced to 100% thus leading to a drop in interest cost and to a reduction in the risk premium by 100 basis points, the budget can save $4.4B every year based on 2014's GDP. Moreover, a higher sovereign rating might lower interest rates, allowing the private sector to borrow for less and paving the way for higher growth and competitiveness.

Based on the Lebanese context, establishing a SWF presents institutional and governance challenges. Lebanon is endowed with weak institutions, a poor regulatory framework and high corruption levels. In 2013, Lebanon was ranked 127th amongst 177 countries on the Corruption Perception Index issued by Transparency International, which raises concerns over governance of a potential SWF.

[1] The quick repaying of public debt is only based on the financial factor. The World Bank notes that once other elements are taken into account (economic, institutional and governance), this option might not be the most suited for Lebanon.

A Lebanese SWF also faces institutional risk factors. The SWF might be used for purposes different than the ones intended initially and would therefore be facing the risk of direct raiding. As for the risk of indirect raiding, it would present itself once excessive debt will accumulate on the back of the fund's resources. Inevitably, the high corruption levels might expose the SWF to poor and inefficient management as individuals are appointed on a basis other than meritocracy.

To address these risks and challenges, a Lebanese SWF must respect certain criteria. First, fiscal decision making must remain in the hands of the Ministry of Finance and SWF revenues must directly pour into the budget so as to maintain the alignment with the overall fiscal framework. Second, operational rules should have limited flexibility. Since Lebanon selected the type of SWF that seeks to save the resource-wealth for generations to come, withdrawals from the SWF should only be allowed in exceptional circumstances to avoid the risk of the fund's depletion. Third, the investment policies of the SWF and of Lebanon must be on the same wave length: A situation where the country is indebted at a cost higher than the financial returns of the SWF should be avoided.

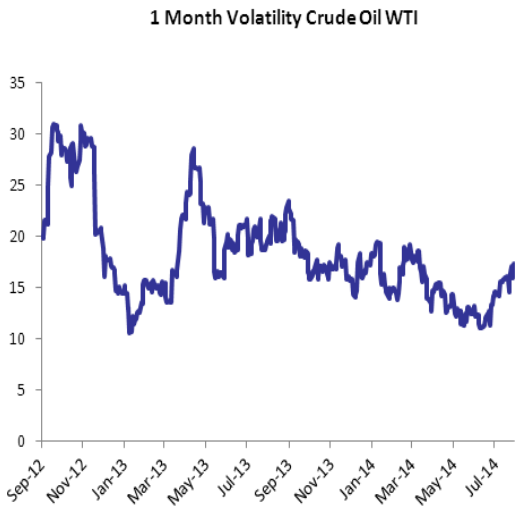
Aligning the SWF strategy and fiscal policy is crucial for Lebanon. The Ministry of Finance and the SWF management should remain independent as stated by the World Bank all while preserving a cooperative relationship. However, as Lebanon opted for a Savings Fund seeking intergenerational equity and at the same time has the need to reduce its fiscal deficit and its public debt, the challenge is to reconcile these two visions.

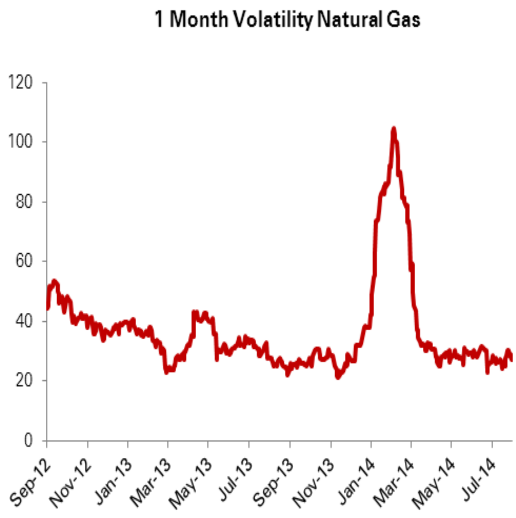
After having discussed the establishment of a SWF in the Lebanese context previously, we now delve into the various fiscal frameworks that Lebanon can adopt to manage its resource-wealth and that were presented in the IMF's selected issue entitled "Designing a Fiscal Framework for a Prospective Commodity Producer: Options for Lebanon". These fiscal frameworks provide an answer as to how the authorities can establish fiscal sustainability and intergenerational equity at the same time in a high fiscal deficit and public debt environment.

Fiscal Anchors for Commodity Producers

A commodity producer uses particular tools to obtain a reliable assessment of fiscal stance. If the commodity-rich country has a high reliance on resource revenue, the overall fiscal balance and the primary balance are not reflective of the real fiscal position. If the authorities decide to increase spending as a result of increased revenues due to a surge in hydrocarbon prices while keeping the fiscal balance constant, the latter will show a neutral fiscal policy, while in fact there is an expansionary fiscal policy. This is due to the increase in revenue being generated by an external factor, which is the jump in hydrocarbon prices, rather than coming from the tax base. Therefore, excluding resource revenue and counting on the non-hydrocarbon primary balance is what delivers a proper view on where the country stands fiscally and separates fiscal policy from the volatility of commodity prices. The non-hydrocarbon primary balance will allow fiscal authorities to differentiate between spending that was financed by levied taxes and spending that was financed by exogenous revenue sources such as oil and gas.

Fiscal policy should be separated from the commodity's volatility in order to ensure stability too. The budget ought to be shielded from swings in the commodity's price and from the effects of procyclicality. Procyclicality exists when a surge in resource-revenues leads to a surge in government spending and vice-versa. If commodity producers mis-evaluate their resource wealth, they might over-spend, face sustainability issues and jeopardize intergenerational equity.





Source: Reuters

A way to avoid boom-bust cycles and ensure fiscal sustainability is to target a structural primary balance. The first step is to decompose the resource revenues into structural revenues and cyclical ones. The structural component is the chunk of revenues that is somewhat certain and likely to be there for a while and the cyclical chunk will be determined by using either backward-looking prices, future prices or a patchwork of the two. According to the IMF, "the Mongolia rule" which adopts 12 years of historical prices, a current year forecast and 3 years of futures prices, is the best price-based smoothing rule for Lebanon. This rule allows the highest level of savings and expenditure smoothing. Once this is done, the structural primary balance, equal to the non-hydrocarbon primary balance plus the structural component of resource revenues, can be calculated and can serve as anchor for fiscal policy.

Procyclicality can also be reduced by putting a cap on expenditure growth. Expenditure growth could be capped to 3-7% per year in real terms and would allow Lebanon to accumulate savings of around 70% of non-resource GDP by 2050.

Various Fiscal Frameworks

The following frameworks all prioritize long-term sustainability and intergenerational equity but allow the exploitation of hydrocarbon-related revenues to different extents.

The first proposed framework (Permanent Income Hypothesis) is designed to keep the resource wealth constant and never depleted. If the stock of oil and gas reserves lasts for 35 years, this scheme ensures that it won't be depleted before the full 35 years. To achieve this, fiscal authorities must exploit no more and no less than the annual return from resource revenues.

Unlike the conservative first scenario, the second scenario allows a looser spending path. The Modified Permanent Income Hypothesis (MPIH) allows authorities to exhaust more of the resource wealth for a few years only if they overcompensate later on with a longer period of fiscal adjustment. For example, if assets are drawn down for a period of five years, spending will have to be readjusted for a period of ten years.

The third scenario (fiscal sustainability approach FS) gives the most leeway to fiscal authorities in terms of exploiting hydrocarbon resources. Although this scheme reduces hydrocarbon related revenues, it states that the high front-loaded investments do not endanger fiscal sustainability since they will generate higher growth and will increase non-resource related revenues in the future.

So, which framework is the most viable option for Lebanon? The IMF concludes that the second and third scenarios (MPIH and FS) frameworks are the most relevant for Lebanon. The reason behind this selection is that they allow front-load spending into physical and human infrastructure, areas where efforts are needed. Moreover, these frameworks are optimal since they both ensure intergenerational equity and fiscal sustainability, therefore reconciling the SWF strategy and the fiscal needs of the country.

Regardless of the adopted fiscal approach, benefitting fully from our hydrocarbon wealth requires the establishment of strong fiscal institutions. Creating a public financial management system (PFM) should guarantee transparency for resource and non-resource revenues as well as sustainability of the fiscal strategy.

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