The International Monetary Fund's Article IV Consultation for Lebanon – 2015

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In July 2015, the International Monetary Fund (IMF) released its Article IV consultation for Lebanon in which it discusses the current context, highlights challenges and priorities and, issues recommendations for the future. The following lines sum up the IMF's views.

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Contact Information

Research Assistant: Riwa Daou

riwa.daou@blominvestbank.com

Head of Research: Marwan Mikhael

marwan.mikhael@blominvestbank.com

Research Department

Tel: +961 1 991 784

Lebanon: Host to a Large Number of Refugees

For the fifth year now, the Syrian conflict is still playing a major part in determining the short-term and long-term outlook in Lebanon. The spillovers of the Syrian crisis are both substantial and multi-faceted. According to the United Nations High Commission for Refugees, the number of Syrian refugees surpassed 1.4 million in January 2015 and by adding the already-registered 0.4 million Palestinians in Lebanon, the total number of refugees would surpass one third of the Lebanese population.

Multi-Dimensional Syrian Spillovers

The Syrian spillovers have added pressure on several fronts in Lebanon. The World Bank estimates the direct fiscal impact of the crisis over the period 2012-2014 at $2.6B and estimates the cost of restoring public-service provision to pre-crisis levels at $2.5B. The inflow of Syrian refugees not only strained already-weak public finances but also added pressure on the country's infrastructure and social fabric. According to the IMF, the Syrian crisis caused the Lebanese poverty rate to rise by 4 percentage points to 32%, led to a 50% growth in the workforce compared to 2011 and widened the income gap as Syrian refugees accept lower wages than Lebanese workers.

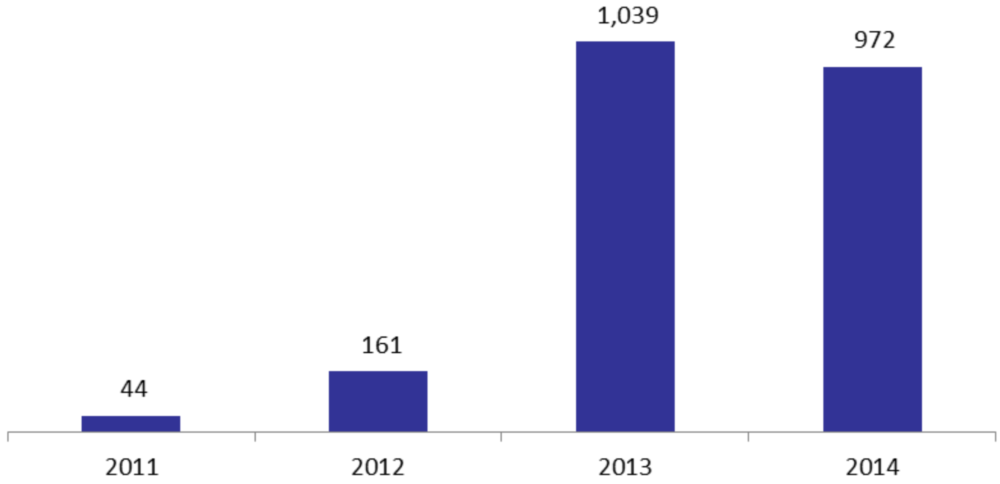
Humanitarian Support for Lebanon: Insufficient and Facing Shortfalls

$1B of humanitarian assistance1 were disbursed in each of the years 2013 and 2014, substantial but insufficient sums. The World Food Program's card voucher hands out a $30 voucher per month for 883,000 refugees and covered 40% of eligible refugees in 2014 compared to 28% in 2013. However, pressure is rising which led the WFP to temporarily suspend its program in December 2014 and to now often hand out assistance of less than $20 per month per refugee.

In 2014, the government cooperated with the UNDP in a plan targeting both refugees and vulnerable Lebanese. The project dubbed the Lebanon Crisis Response Plan (LCRP) is a 2 - year stabilization and development plan that targets 1.5M refugees and 1.9M vulnerable Lebanese, with one third of the project aimed at addressing Lebanese stabilization and development needs. Out of the $2.14B for the project, only $400M has been made available.

[1] Amount encompasses assistance given directly to refugees as well as to agencies working with refugees

Humanitarian Contributions for Lebanon, in millions of USD



Source: IMF, UNDP

Lebanon Lacks a Crisis-Response Strategy

So far Lebanon has not established a clear strategy to deal with the heavy influx of Syrian refugees. However, the IMF notes that the authorities adopted a policy paper in 2014 pledging to "reduce the number of individuals in Lebanon registered as displaced, to address local security concerns and to share the burden of the crisis by expanding the humanitarian response to include local communities and infrastructure."

In line with this policy paper, the number of Syrian refugees steadied in 2014 due, in part to tighter border control. The registration of new refugees is now down to around 10,000 per month compared to around 30,000 per month prior to October 2014.

Political Inertia is Crippling Decision Making

Lebanon has been unable to elect a President since May 2014. The Parliament can still legislate in the absence of a President if a unanimous agreement is reached. However, that agreement is tough to reach amidst the current political tensions. Even the legitimacy of the Parliament is under scrutiny after its term was extended for the second time to June 2017.

Economic Growth Witnessed a Significant Slump

Lebanon's GDP growth slumped from 2011 onwards and now falls short of its potential. GDP growth rate fell from a high of 8% in 2010 to less than 1% in 2011 and then eventually inched up to 2% in 2014 and is likely to remain at that level for 2015. Since core sectors of the Lebanese economy such as tourism, real estate and construction, have taken a hard hit and are unlikely to recover soon. Lebanon's GDP growth will probably not return to the potential 4% before 2019. Inflation also declined in 2014 as the prices of oil dropped but the IMF estimates inflation to return to about 3% by 2015.

Exceptional Factors Led to Short-Term Improvements on Several Fronts

Despite the morose economic background, incomes and consumption received a boost from lower oil prices. According to the IMF, the sensitivity of local fuel prices to global oil prices is relatively high in Lebanon[2] and that boosted incomes. Moreover, remittance inflows which mainly come from Gulf-Cooperation Countries remained and are likely to remain stable despite the volatility in oil prices, especially since GCC countries have large buffers against low energy prices.

One off measures also allowed Lebanon to have a better fiscal positioning in 2014. The treasury benefitted from exceptionally large telecom transfers, the non-implementation of the salary increase for public sector employees, the under spending on capital projects and the flat social and current spending. These factors allowed for an unexpected primary surplus representing 2½ % of GDP.

This exceptional, one-off set of circumstances cannot spare Lebanon the effort of fiscal reform. The IMF believes that if these one-off factors will not be repeated, the primary balance will deteriorate to record a deficit of 1¼ of GDP in 2015 and the debt burden will remain extremely high by international standards. The combination of slowing growth and the potential rise in global interest rates will put upward pressure on public debt. Without fiscal adjustment, interest payments will surge to 12% of GDP or around 40% of total spending and will therefore reduce much-needed spending on social and structural reforms.

Fiscal Adjustment through Fairer Fiscal Policies

According to the IMF, Lebanon's tax capacity remains under-utilized. Efforts to better oversee the collection of VAT refund claims was commended by the IMF but it believes that more can be done. The Fund called for an increase in the VAT rate by one percentage point to 11%.

The IMF believes that lower oil prices offer an opportunity for Lebanon to reform its fuel taxation. The IMF recommended the removal of the VAT exemption on diesel introduced in 2012 and an increase in gasoline excises which were significantly reduced in 2011. Not only will these measures increase government revenues but they will also promote a more conscious use of fuel products which would then reduce congestion and pollution.

Currently, gasoline is subject to a 10% VAT tax and to low excises of less than 20 cents per liter. Green and red diesels for transportation and heating are tax free and have never been subject to excises.

Amongst regional peers, Lebanon showed the largest pass-through from falling oil prices. After the slump in global oil prices, retail fuel prices in Lebanon declined by about 30% in 2014. However, taxes on these now cheaper fuel products were not amended and that is a missed opportunity for Lebanon's treasury.

The low fuel taxes however generate revenues losses and are not fairly beneficial to all categories of the population. The cost of the VAT exemption on diesel exceeds ½ percent of GDP. As for the subsidy, the poorest 20% of the population only benefit from 6% while the richest 20% receive 55%.

[2] After the slump in global oil prices, retail fuel prices in Lebanon declined by about 30% in 2014. Amongst regional peers, Lebanon showed the largest pass-through from falling oil prices.

Minor Positive Steps but No Major Structural Reforms

Unfortunately, no advancement was made on structural reforms. The reforms of the electricity sector and of the Lebanese pension system have long been delayed. Moreover, Lebanon is also unable to make progress in terms of its oil and gas wealth as the bidding process for exploration has been constantly postponed and as the Petroleum Tax Law is still awaiting parliament approval.

On the upside, the IMF commended the Lebanese authorities for several undertaken steps. The first positive step is the Ministry of Finance's publication of a quarterly T-bill issuance calendar and of an updated public debt management strategy. The parliament was also commended for the passing a law allowing for new Eurobonds issuances.

Persistence of the Banking Sector's Resilience

Foreign exchange reserves and financial markets remained resilient. The IMF estimates Lebanon's current account deficit at a sizeable 25% of GDP in 2014. A large current account deficit might erode the country's foreign reserves, which is even more challenging given the Lebanese pound's peg to the US dollar. Luckily, foreign inflows are still growing which has allowed the central bank to stock up on an appropriate level of foreign reserves, which amounted to $38.86B at the end of June 2015.

The Lebanese banking sector is another source of resilience for Lebanon. The banking sector's aggregate assets exceed 350% of GDP, allowing it to be one of the largest in the world and in the MENA region in terms of share in GDP. Lebanese banks pull their strength from a loyal depositor base, residents and non-residents alike. In turn, banks have channeled these deposits back into the private sector and into the public sector. The conservative business model, the proper supervision and the significant buffers are also core pillars for the Lebanese banking sector.

The IMF however highlights that the tight link between the sovereign and the banks is a double-edged sword. Although the government is able to fund large budget and current account deficits due to Lebanese banks, this also means that a large part of the macroeconomic stability is dependent on the banks' ability to act as chief financiers for the government and therefore attract foreign deposits.
The growth in loans to the non-financial private sector has outpaced the growth in nominal output, but no risk to overall financial stability has been detected. The ratio of private sector to GDP grew from 86% to 91% over 2013-2014 partly on account of the central bank's stimulus packages of $3.4B. As a pre-emptive move, the Central Bank introduced new retail loans regulation by lowering the loan-to-value ratios and debt-service to income ratios.

Conclusion

Lebanon is facing a challenging regional and local context that needs to be addressed through an appropriate policy mix and structural reforms. Fiscal sustainability should be restored which would lighten the load placed on the Central Bank. In fact, the Central Bank's policy aims to build up foreign reserves to meet many targets since it has to maintain the peg of the Lebanese pound to the dollar, establish stimulus packages for the private sector and finance the government's needs. Structural reforms also need to be undertaken in order to promote inclusive growth, which is a growth that ensures rapid and sustained poverty reduction.

For your Queries:

BLOMINVEST BANK s.a.l.
Research Department
Bab Idriss, Downtown Beirut

Riwa Daou, Research Assistant
Riwa.daou@blominvestbank.com
+961 1 991 784

Marwan Mikhael, Head of Research
marwan.mikhael@blominvestbank.com
+961 1 991 782

research@blominvestbank.com