Debt Sustainability Analysis for Lebanon 2017-2022

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Lebanon has been through many tough economic times, but none quite like current times. The novelty in the economic slowdown Lebanon has been witnessing since 2011 is most strikingly its prolonged nature. Structural weaknesses have been left unaddressed and political crises and inaction stretched from one year to the next. Therefore, absent significant growth and reform, the Lebanese economy's support system, the deposits from the large Lebanese diaspora, remittances (which were even negatively impacted by the slowdown in GCC economies), the Central Bank's role, has carried the entire load alone and for a long period of almost six years now.

Since 2011, the Lebanese economy has been chained by the vicious cycle of high fiscal deficit, high debt and low growth. Lebanon has been suffering from a chronic fiscal deficit, representing around 10% of GDP and compelling the Lebanese government to pile up debt. In turn, debt represented a growing share of GDP and the debt to GDP ratio has consistently grown from 131% in 2012 to 146% in 2016. In fact, the growth in debt has been outpacing the growth in GDP ever since 2011 as shown in the graph below. This vicious cycle has also negatively impacted Lebanon's sovereign rating by international rating agencies.

In order to break the cycle, changes must be brought about to the fiscal deficit, the gross public debt or economic growth. Acting on reducing the fiscal deficit must go through the reform of the deficient state-owned electricity company Electricite du Liban (EDL) to which the Ministry of Finance disburses over $1 billion per year (the value stood at $2 billion in the times of a $100 oil barrel). Reducing the debt however would have to go through lowering the interest payments which would imply a refinancing of our debt at a lower cost. Meanwhile, boosting growth would necessitate the revival of the country's main economic pillars: real estate, construction, tourism. However, a revival in those key sectors remains tightly bound to political developments in Lebanon and the region, both of which are currently in turmoil.

If the current backdrop is maintained in status-quo, Lebanon's debt will swell further. The debt burden will continue to rise unless action is taken to put debt on a sustainable path. Lebanon's debt figure is almost surely, one of the most renowned and debated economic indicator in Lebanon since it is almost 140% of the country's national output. By August of this year and according to the Association of Banks in Lebanon (ABL), Lebanon's gross public debt rose by an annual 4.36% to reach $77.27 billion. The majority of Lebanon's public debt (61.4% by August) is denominated in local currency (LBP) while the remaining 38.6% is denominated in foreign currency.

Ensuring debt sustainability should be a top priority for Lebanon. To begin, it is important to define what the sustainability of debt really means: A certain level of debt is deemed sustainable if its share in the country's GDP remains stable or declines. In other words, a country's debt is sustainable if it can be reimbursed and if no further accumulation takes place.

Achieving the goal of debt sustainability demands a forward-looking view which should be considered as the starting point of all policy actions and reforms. Below is a brief reminder of the parameters that come into play when the debt-discussion is on the table and the channels through which these parameters impact the level of debt.

The ratio of public debt to GDP depends on many factors:

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

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 virtuous 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.

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 several 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%. Only a part of these tax measures and a part of the higher salaries was disbursed in 2017 and that is reflected in the government's revenues and expenditures' projections below.

This scenario maintains a conservative outlook on growth and assumes that public finances will remain weak. It shows that the fiscal deficit will continue to widen until reaching $7.7 billion in 2022 and that the primary balance will continue to be too marginal to cover the country's debt service. Given this context, under the baseline scenario, the Debt to GDP ratio is expected to swell and reach 148.5% by 2022.

Baseline Scenario

	2016	2017	2018	2019-2022
Real GDP Growth Rate	1.0%	1.5%	2.0%	2.8%
Government Revenues	3.6%	5.0%	4.0%	5.0%
Government Expenses	9.9%	3.0%	7.0%	10.0%
Total Deposits	7.2%	5.0%	5.0%	5.0%

	2014	2015	2016	2017	2018	2019	2020	2021	2022
Real GDP Growth Rate (%)	2.0%	0.8%	**1.0%**	**1.5%**	**2.5%**	**2.5%**	**2.5%**	**3.0%**	**3.0%**
GDP Deflator	2.8%	2.0%	**2.0%**	**4.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**
Nominal GDP ($M)	47,833	49,459	50,953	53,786	56,784	59,950	63,292	67,147	71,236
Government Revenues ($M)	10,879	9,576	9,923	11,939	13,736	14,423	15,144	15,902	16,697
% of GDP	*22.7%*	*19.4%*	*19.5%*	*22.2%*	*24.2%*	*24.1%*	*23.9%*	*23.7%*	*23.4%*
% of Change		*-12.0%*	*3.6%*	*20.3%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Government Expenditures ($M)	13,952	13,527	14,867	14,623	16,647	18,311	20,143	22,157	24,373
% of Change		-3.0%	*9.9%*	*-1.6%*	*13.8%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*
Fiscal Balance ($M)	-3,073	-3,952	-4,944	-2,684	-2,910	-3,888	-4,998	-6,255	-7,676
Primary Balance ($M)	1,307	724	21	2,608	3,291	2,566	1,880	1,046	150
Surplus in Debt Issuance and Arrears ($M)	429	91	**500**	**300**	**300**	**300**	**300**	**300**	**300**
Effective Interest Rate on Debt (%)	6.58%	6.65%	6.9%	**7.90%**	**7.90%**	**8.00%**	**8.00%**	**8.00%**	**8.00%**
Gross Public Debt ($M)	66,564	70,311	74,886	78,494	81,704	85,974	91,272	97,828	105,804
Debt Service ($M)	2,488	4,459	4,766	4,507	6,201	6,455	6,878	7,302	7,826
Primary Balance (% GDP)	2.7%	1.5%	0.04%	4.8%	5.8%	4.3%	3.0%	1.6%	0.2%
Total Private Sector Deposits	144,425	151,585	162,495	170,620	179,151	188,108	197,514	207,389	217,759

The "Lower Debt Service scenario" is meant to show that putting debt on a sustainable path must go through servicing a chunk of our debt at a lower cost. On this note it is important to mention that Lebanon has never defaulted on its debt and has already befitted from debt at a preferential rate under the context of Paris II and Paris III conferences. According to the Ministry of Finance, the Paris II conference held in 2002 witnessed the international community providing $2.4 billion in financial support to Lebanon while during the Paris III conference a total of $7.6 billion were pledged.

The scenario below assumes that Lebanon is refinancing $20 billion of its foreign currency debt at the same rates as those applied on the US treasuries and that in turn lowers the debt service (i.e. interest payments) and the effective interest rate on debt borne by Lebanon and drives the debt to GDP ratio down from 147% in 2016 to 101% in 2022.

Lower Debt Service

	2016	2017	2018	2019-2022
Real GDP Growth Rate	1.0%	1.5%	2.5%	2.8%
Government Revenues	3.6%	7.0%	4.0%	5.0%
Government Expenses	9.9%	3.0%	7.0%	10.0%
Total Deposits	7.2%	5.0%	5.0%	5.0%

	2014	2015	2016	2017	2018	2019	2020	2021	2022
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GDP Deflator	2.8%	2.0%	**2.0%**	**4.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**
Nominal GDP ($M)	47,833	49,459	50,953	53,786	56,784	59,950	63,292	67,147	71,236
Government Revenues ($M)	10,879	9,576	9,923	11,939	13,975	14,674	15,408	16,178	16,987
% of GDP	*22.7%*	*19.4%*	*19.5%*	*22.2%*	*24.6%*	*24.5%*	*24.3%*	*24.1%*	*23.8%*
% of Change		*-12.0%*	*3.6%*	*20.3%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Government Expenditures ($M)	13,952	13,527	14,867	14,623	11,401	12,541	13,795	15,174	16,692
% of Change		-3.0%	*9.9%*	*-1.6%*	*-22.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*
Fiscal Balance ($M)	-3,073	-3,952	-4,944	-2,684	2,574	2,133	1,613	1,004	295
Primary Balance ($M)	1,307	724	21	2,608	6,708	6,299	5,941	5,553	5,126
Surplus in Debt Issuance and Arrears ($M)	429	91	**500**	**300**	**300**	**300**	**300**	**300**	**300**
Effective Interest Rate on Debt (%)	6.58%	6.65%	6.9%	**7.90%**	**5.30%**	**5.49%**	**5.85%**	**6.25%**	**6.70%**
Gross Public Debt ($M)	66,564	70,311	74,886	78,495	78,041	75,850	74,043	72,781	72,134
Debt Service ($M)	4,380	4,677	4,965	9,380	4,134	4,166	4,328	4,550	4,831
					5,246				
Primary Balance (% GDP)	2.7%	1.5%	0.04%	4.8%	11.8%	10.5%	9.4%	8.3%	7.2%
Total Private Sector Deposits	144,425	151,585	162,495	170,620	179,151	188,108	197,514	207,389	217,759

However, a real best case scenario is one where Lebanon is refinancing its debt at a lower cost through a Paris IV agreement and where real GDP growth is higher. In the scenario below, where we assume real GDP growth would pick up from 2% in 2017 all the way to 4% in 2022, the drop in the debt to GDP ratio is much more pronounced and the ratio would eventually reach 97.4% by 2022.

Lower Debt Service + Higher Growth

	2016	2017	2018	2019-2022
Real GDP Growth Rate	1.0%	3.0%	4.0%	5.0%
Government Revenues	3.6%	7.0%	4.0%	5.0%
Government Expenses	9.9%	3.0%	7.0%	10.0%
Total Deposits	7.2%	5.0%	5.0%	5.0%

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GDP Deflator	2.8%	2.0%	**2.0%**	**4.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**
Nominal GDP ($M)	47,833	49,459	50,953	54,051	57,064	60,539	64,538	69,133	74,055
Government Revenues ($M)	10,879	9,576	9,923	11,939	13,975	14,674	15,408	16,178	16,987
% of GDP	*22.7%*	*19.4%*	*19.5%*	*22.1%*	*24.5%*	*24.2%*	*23.9%*	*23.4%*	*22.9%*
% of Change		*-12.0%*	*3.6%*	*20.3%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Government Expenditures ($M)	13,952	13,527	14,867	14,623	11,401	12,541	13,795	15,174	16,692
% of Change		-3.0%	*9.9%*	*-1.6%*	*-22.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*
Fiscal Balance ($M)	-3,073	-3,952	-4,944	-2,684	2,574	2,133	1,613	1,004	295
Primary Balance ($M)	1,307	724	21	2,608	6,708	6,299	5,941	5,553	5,126
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Effective Interest Rate on Debt (%)	6.58%	6.65%	6.9%	**7.90%**	**5.30%**	**5.49%**	**5.85%**	**6.25%**	**6.70%**
Gross Public Debt ($M)	66,564	70,311	74,886	78,495	78,041	75,850	74,043	72,781	72,134
Debt Service ($M)	4,380	4,677	4,965	9,380	4,134	4,166	4,328	4,550	4,831
					5,246				
Primary Balance (% GDP)	2.7%	1.5%	0.04%	4.8%	11.8%	10.4%	9.2%	8.0%	6.9%
Total Private Sector Deposits	144,425	151,585	162,495	170,620	179,151	188,108	197,514	207,389	217,759

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