Lebanon: Staff Concluding Statement of the 2018 Article IV Mission

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A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The approaching elections are an opportunity to engage the public in a dialogue on how to support macroeconomic stability and implement structural reforms to raise inclusive growth and create jobs. Further, the upcoming Paris Conference is an opportunity to mobilize international support for these efforts. The authorities have some significant achievements in recent months, notably passing the first budget in over 12 years in October 2017. However, the overall economic situation remains fragile with prolonged low growth, public debt rapidly rising beyond 150 percent of GDP, and a persistent current account deficit of more than 20 percent of GDP. To preserve confidence in the system there is an urgent need to establish a policy framework that supports macroeconomic stability. This statement highlights key findings and recommendations of the recent Article IV Consultation mission to Lebanon (February 1-12, 2018), based on our discussions with a broad range of stakeholders. A more complete analysis of policy issues will be included in the forthcoming staff report. We thank the Lebanese authorities and other counterparts for their hospitality, and for a rich and fruitful set of discussions.

Key messages

The reform agenda needs to focus on three areas:

- First, fiscal policy needs to be immediately anchored in a consolidation plan that stabilizes debt as a share of GDP and then places it on a clear downward path. Any scaling up of public investment will need to be grounded in such an adjustment plan and must be preceded by strengthening the public investment management framework.
- Second, financial stability risks should be contained, including by incentivizing banks to gradually strengthen their buffers and by taking further actions designed to strengthen credit quality.
- Third, to promote sustainable growth and improve equity and competitiveness, the electricity

sector needs to be reformed and the anti-corruption regulatory framework should be enhanced and made effective.

Context

1. Lebanon has emerged from the political crisis of November 2017, but vulnerabilities are higher. Interest rates on new local-currency bank deposits are 2–3 percentage points higher than before the crisis, and the economic system's dependence on depositor confidence has deepened.

2. The authorities are planning to initiate a large capital investment program (CIP). Lebanon continues to host around 1 million registered Syrian refugees (equivalent to about a quarter of the population). The aims of the CIP are to raise Lebanon's growth and also alleviate the burden on both host communities and refugees. The authorities have indicated that they plan to raise up to $16 billion (32 percent of current GDP) over the next decade by tapping into the World Bank's Concessional Financing Facility, public-private partnerships, and other facilities that provide grants or long-term concessional lending. A conference in Paris to support investment in Lebanon is tentatively scheduled for April 2018.

3. The underlying economic situation has not changed and remains challenging, with high public debt, current account deficit, and funding needs. Public debt is estimated above 150 percent of GDP at end-2017, and is expected to rise rapidly with a budget deficit above 10 percent over the forecast horizon. The current account deficit is expected to remain above 20 percent. The funding environment has been affected by the political crisis of November 2017. Without a significant reduction in the economy's funding needs or an increase in deposit inflows (and given the global interest rate outlook), the Banque du Liban (BdL) will need to increase interest rates or use its sizable gross reserves to meet the funding needs of the economy. The budget of 2018 and preparation for the upcoming Paris conference could provide key platforms to initiate the much-needed economic reforms.

The Economic Backdrop

4. Growth remains low. We estimate growth to be at about 1–1.5 percent for 2017 and 2018. The traditional drivers of growth in Lebanon—tourism, real estate, and construction—remain slow and a strong rebound is unlikely soon. According to the BdL, real estate prices declined by over 10 percent over 2017, while the purchasing managers' index indicates that private sector confidence continues to be weighed down by political uncertainty. Inflation in 2017 reached 5 percent, likely due to a rise in the costs of imports, notably oil, and a weaker U.S. dollar.

5. The fiscal situation remains very difficult and poses significant risks. In July 2017, the Lebanese parliament approved an across-the-board increase in the salary scale of public sector employees and pensions of retired civil servants. A range of tax and fee increases was approved during the second half of the year. While the net fiscal impact is expected to be broadly neutral in 2018, higher personnel and interest costs will be main contributors to further deteriorating fiscal position over the projection horizon. The overall budget deficit in 2017 is expected at 7.3 percent of GDP, with a primary balance of 2.4 percent—in part due to one-off revenues from taxing higher bank profits due to BdL financial operations. In addition, subsidies to Electricité du Liban (EdL) are increasing, in part due to rising oil prices.

6. External imbalances are large and persistent. The nominal effective exchange rate appreciated sharply in recent years, while the real effective exchange rate (REER) also strengthened in 2017 by 2.8 percent. The current account deficit is projected to have remained above 20 percent in 2017. Goods

exports as a share of GDP continue to decline, while imports remain strong, in part due to cheap credit made available by several BdL subsidy schemes and higher oil prices. The persistently large current account deficit and other imbalances are evidence of a significant REER overvaluation.

7. Sustaining deposit inflows is challenging. In the past, foreign-deposit inflows have been a key source of financing for the large current account- and budget deficits. However, deposit growth has eased in recent years. Private sector deposit growth was 3.8 percent in 2017—below the average growth in previous years.

8. In response, the BdL continues to expand its unconventional financial operations. The BdL has introduced several new financial operations since summer 2016 that offer large incentives to domestic commercial banks to invest in BdL's dollar-denominated term deposits. Consequently, the increase in bank exposure to the BdL has accelerated since summer 2016. While these operations have boosted the gross reserves of the BdL and the capital of banks, they have come at a cost to the BdL's balance sheet and net FX position, and have been regressive. In addition, the BdL introduced a new operation in December 2017 to incentivize banks to secure longer maturity local-currency deposits, by increasing the interest rate on existing BdL long-term instruments held by banks by 2–3 percentage points.

9. The sovereign credit ratings reflect the challenges faced by Lebanon. Moody's downgraded Lebanon from B2 to B3 in August 2017, while Fitch and S&P have maintained their ratings at B-/B3 equivalent. During the political crisis of November 2017, the spreads of Lebanese Eurobonds vis-à-vis other emerging market instruments spiked by 200-300 bps, but returned to pre-crisis levels by January 2018.

10. Lebanon's outlook remains uncertain. Under our baseline scenario, growth will gradually rise close to 3 percent as external demand picks up due to a global recovery. Inflation is expected to remain around its trend of 2.5 percent. Overall fiscal balances are expected to reach well above 10 percent of GDP and public debt close to 180 percent of GDP by 2023. The current account deficit will remain large. Under the baseline assumption of no reforms or increase in interest rates, Lebanon's reserve adequacy position is projected to deteriorate over the medium term. But the projection is subject to both upside and downside risks. On the upside, Lebanon's outlook is linked closely to developments in Syria. In the event of an early resolution, Lebanon would be well placed to benefit from the reconstruction effort, as well as from the reestablishment of trade and an improvement in regional investor confidence. This would have significant and positive implications for local incomes and growth, though not enough to restore debt sustainability without adjustment. On the downside, tensions in the region could lead to escalation of conflicts or trigger security incidents, higher oil prices could increase Lebanon's funding needs, or deposit inflows could decelerate putting pressure on foreign exchange reserves.

Policy Priorities

11. Lebanon needs urgent action to preserve confidence in the system and take advantage of international support. Over the past several years, Lebanon has maintained a policy mix of loose fiscal policy, and high real rates on bank deposits combined with cheap private sector credit through various quasi-fiscal subsidy schemes. However, given rising vulnerabilities, the need to establish a policy framework that places the economy and public debt on a more sustainable path has only increased. The increased engagement by some donor countries also offers an opportunity to secure their support for a reform and investment plan. The reform agenda needs to focus on three areas.

Critical Need for a Fiscal Consolidation Plan

12. Significant fiscal adjustment is inescapable if the current economic policy framework of a fixed exchange rate sustained by high deposit inflows is to be maintained. Lebanon's debt is unsustainable under the baseline scenario. In the context of Lebanon's low growth and rising global interest rates, debt dynamics will deteriorate further and public debt will increase rapidly to just below 180 percent of GDP by 2023 under the baseline and continue to rise thereafter. Similarly, without adjustment, government financing needs will continue to rise; the underlying codependence between banks and the sovereign will intensify; and Lebanon's growing reliance on deposit inflows will expose the economy even more to sudden swings in depositors' confidence.

13. The size of adjustment needed to halt the rise in public debt is still within reach, but it would require significant efforts, and would not by itself guarantee sustainability. A combination of increases in revenues and cuts in current spending amounting to about 5 percent of GDP is needed over the medium term to stabilize public debt as a share of GDP and place it on a gradually declining path. Such a large adjustment is undoubtedly costly, but in the case of Lebanon it needs to be viewed against mounting funding needs and high budget deficits reaching above 10 percent of GDP. A comprehensive fiscal adjustment and economic reform program would greatly improve economic conditions, including public debt ratios. However, it would not be without risks. The fiscal adjustment required has only been achieved in very few countries. There would also be continued large current account deficits even after fiscal adjustment, in the absence of exchange rate adjustment and/or significant structural reforms, which would leave sustainability in question.

14. The CIP could have positive effects on growth, but would need to be accompanied by strong fiscal adjustment and structural reforms. The CIP, if implemented with well selected projects, will likely boost economic growth in the short term, but at the same time will increase public debt, and possibly borrowing cost. Any scaling up of investment will need to be grounded in a comprehensive macroeconomic adjustment plan designed to stabilize public debt ratios and then put them on a gradually declining path, and preceded by improved public investment management.

15. A fiscal consolidation plan with front-loaded fiscal adjustment, embedded in a credible budget, is urgently needed. The proposed adjustment package combines revenue and spending measures. The measures include (i) increasing VAT rates, while limiting exemptions and refunds and improving compliance; (ii) reinstating gasoline excise and fuel taxes to levels that prevailed before 2012; and (iii) gradual elimination of the electricity subsidy. The adjustment proposal would significantly improve the trajectory of public debt. In addition, there is scope to contain personnel spending and undertake a civil service reform. This would reduce expenditure rigidity and create fiscal room to strengthen the social safety net to increase protection of the vulnerable.

16. The public investment management framework should be strengthened before undertaking large investment projects. Strengthening the institutional framework based on a formal assessment is crucial before undertaking large investments. Risks and fiscal costs arising from any PPPs needs to be contained. Furthermore, given capacity constraints, the authorities should consider a gradual scaling up of investment, to limit fiscal and implementation risks. Highly-concessional financing should be sought and domestic financing of public investment should be avoided.

Normalizing Monetary Framework and Preserving Financial Stability

17. The current policies of the BdL have helped preserve stability but also created market distortions. The BdL maintains the fixed exchange rate, helps finance the government by offering long-term instruments to banks, keeps interest rates steady at moderate levels by underwriting both the T-Bill and Eurobond primary markets, provides economic stimulus by a range of quasi-fiscal subsidy

schemes, addresses weak banks, and subsidizes deposit rates to lengthen their maturity. While the range of these operations has allowed the BdL to play a critical role in maintaining the current economic model and effectively manage crisis episodes, these policies are also associated with costs. They have resulted in the creation of new reserve money, weakened BdL's balance sheet, and created a different set of financial stability risks by exposing banks to significant sovereign exposure and maturity mismatches.

18. The materialization of various shocks could expose vulnerabilities in the banking system. The recent increase in bank capital levels is welcome. While regulatory capital requirements exceed the minimum levels set under the Third Basel Accord, banks' capital buffers are modest in light of their significant exposure to local-currency sovereign debt and foreign-currency BdL instruments—and sovereign risk weights are not in line with international standards. The rising interest rate environment also poses risks to banks profitability and capital positions. In addition, the slowdown in the economy and in the real estate sector, and rising interest rates, are likely to have affected credit quality and there are signs that nonperforming loans will increase. Lastly, foreign assets of commercial banks remain low, in part driven by banks transferring their FX placements from abroad to the BdL—motivated by BdL financial operations.

19. Going forward, the BdL should rely on conventional interest rate policy instead of financial operations. If deposit growth were to further soften, the BdL should maintain tight liquidity and raise interest rates to secure foreign exchange inflows—rather than relying on a repeat of financial operations. This will help the BdL to improve its FX position, and create incentives for banks to rebuild their liquidity buffers, while reducing the risk of a further rise in dollarization. It would also help to rein in the sizable private sector debt growth, contain inflationary pressures, and limit further deterioration of BdL's balance sheet. The recommended fiscal consolidation plan would mitigate the negative impact of higher interest rates on debt dynamics, since gross financing needs would decline. The BdL should also gradually withdraw from the T-Bill and Eurobond primary market and reduce reliance on quasi-fiscal schemes.

20. Buffers in the banking system should continue to be strengthened and steps should be taken to address rising credit risks. The sovereign risk weights should be aligned with the Basel Accord, and banks should engage in forward-looking capital planning in line with their risk profiles, and linked to multi-factor stress testing. In addition, the regulatory treatment of nonperforming/restructured loans should be aligned with international good practice, monitoring of loan-loss migrations at the bank level should be improved, and sustainable restructuring of nonperforming loans should be encouraged. Lastly, it will be important to enhance liquidity regulations to incentivize increase in deposit maturities and to ensure that banks do not weaken their short-term foreign currency liquidity buffers further.

21. The authorities should strengthen the crisis management framework and AML/CFT framework. In the past, weak small- and medium-sized institutions have been promptly handled, mainly through mergers, without jeopardizing financial stability. In line with the 2016 FSAP advice, the authorities should consider developing resolution options that enable the closures of failed banks, reform of the National Institute for the Guarantee of Deposits (NIGD) to become an operationally independent agency funded by premiums paid fully by banks, increase deposit insurance coverage levels, and ensure that the resolution regime awards preferential treatment to insured depositors and the NIGD. In addition, the AML/CFT framework should continue to be strengthened in line with the 2016 FSAP advice.

Promoting Structural Reforms

22. Given eroding competitiveness and low growth, structural reforms are essential . Even after accounting for the impact of the Syrian conflict, the external balance is weaker than suggested by fundamentals, pointing to an underlying problem with productivity and competitiveness. Lowering the cost of doing business, and improving services—in particular electricity provision—will promote jobs for both

Lebanese nationals and refugees, while also strengthening social safety nets. Structural reforms are essential to improving competitiveness and growth, and reducing external sector vulnerability.

23. Electricity reform and eradicating corruption are long-standing priorities . The electricity sector has not only been widely identified as Lebanon's most pressing bottleneck, but it also remains a significant drain on the budget. A more reliable service by EdL would reduce the need for expensive private generators, even after tariff increases, and contribute to more efficiency in the economy at large. In addition, the government acknowledges that corruption is widespread and is associated with large social and economic costs. Addressing corruption and improving governance should be an essential component of Lebanon's reform agenda.

24. Electricity reforms should focus on expanding capacity and eliminating subsidies. Still relatively low oil prices present an opportunity to begin to raising tariffs up to cost-recovery levels while simultaneously expanding capacity—though in a way that protects more vulnerable consumers. The benefits of reform would be sizable, in terms of significant budget savings including by eliminating the need for private generators, reduced business costs, and more efficient consumption. The authorities could combine the fiscal adjustment with expansion of social assistance programs to mitigate the impact on low-income households.

25. The anti-corruption regulatory framework should be made effective. The regulatory framework to fight corruption needs to be significantly enhanced and made operational. This should include passage of legislation to protect whistleblowers; making the illicit wealth law more effective by making the asset declaration system for senior public officials (and their family members and associates) public, with a system of audits, and combined with measures for banks to control and report suspicious activities related to politically exposed persons; establishing and adequately resourcing the planned anti-corruption body with sufficient enforcement powers; and enhancing fiscal transparency including by strengthening governance in the revenue and customs administrations, improving revenue compliance, making the procurement system transparent, and introducing an external audit agency.

26. Finally, there is a long-standing need to improve data quality. This could improve access to international investment, and enhance evidence-based policymaking. At a minimum, the quality, frequency, and timeliness of national accounts and balance of payment statistics needs to be improved; data on employment, unemployment and wages need to be frequently collected and published; trade in goods and services data needs to be enhanced; quality of indicators to monitor economic activity need to be improved; and inter-agency dialogue and sharing of information should be strengthened.

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