Mapping Out the Path to Lebanese Economic Recovery

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The road to economic recovery in Lebanon will be difficult and tough. The government should take bold steps and implement a recovery plan that should tackle many important points. One of the most challenges subjects is the calculation of losses and how they should be distributed fairly in cooperation with the IMF. *We summarize below the excellent report "Mapping out the path to the Lebanese Economic Recovery" by "**Farouk Soussa" of Goldman Sachs International** published on 22/09/2021*. It presents important steps that the new government will need to take to put Lebanon on the path of economic stability and recovery.

No doubt, the formation of "Mikatti" Government is the first step of a long economic recovery road that will face major challenges. The first duty of this government is to produce a recovery plan supported by the IMF. This will give a green light for the government to reach an agreement with its creditors and to restructure the $31bn in Eurobonds that have been in default since March 2020.

This report divides the recovery in two phases. In first phase the government implements a recovery plan in consultation with the IMF. The second phase will unlock external support after the government signs a formal agreement with the creditors.

Phase 1- The Domestic Recovery Plan

The financial engineering adopted by BDL due the slowdown of in inflows has led to a giant increase in the FX liabilities and negative Net International Reserve (NIR). The negative NIR is around $57B (excluding gold and other FX holdings), that will require a write-down in the BDL's FX liabilities to the banking sector close to $60B. In all, the restructuring of the financial system would leave the banking sector facing likely losses of up to $65B. These losses may be absorbed (part of them) by depositors through a bail in.

The first phase should certainly include a strategy for dealing with embedded losses and a reform agenda that have a short and long term strategy. Of course, the IMF should be involved in this phase and help Lebanon to implement this strategy.

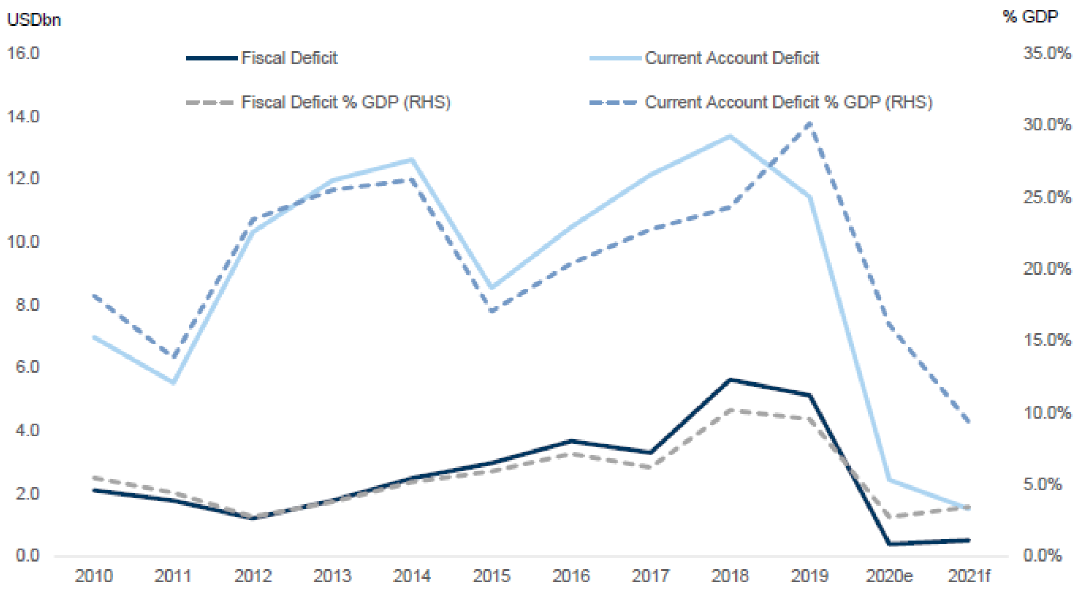
The second aspect in this phase should be a comprehensive reform program that should tackles major areas like fiscal reform, financial/monetary reform, economic reform and political reform.

- **Fiscal reform**: reform of the energy sector and the state-owned power company EDL.
- **Financial/monetary reform**: Review the role of the BDL, and unification of the exchange rate.
- **Economic reform**: Supporting the export sector in order to decrease the commercial deficit
- **Political reform**: Increase accountability and fighting corruption will help government to improve its credibility.

Phase 2- International Support& Debt Restructuring

The national currency has lost more than 90% of its value against the US dollar over the past two years. This is led to a huge increase in domestic prices as inflation reached 150% yoy in March 2020. One consequence of this has been reduction in Lebanon twin deficit. In details the current account deficit and the fiscal deficit have narrowed from $11.5B and $5B in 2019 to $1.5B and $0.5B, respectively this year. No doubt, this decrease can be considered as an economic adjustment that will decrease the burden of the crisis on the Lebanese economy.

Lebanon's Twin Deficits



Source: Haver Analytics, Goldman Sachs Global Investment Research

The decrease of the twins deficit is a good indicator, however Lebanon needs to establish a new economic policy that achieve a certain balance between imports and exports, but this path may take several years, leaving the international financial support inevitable for Lebanon.

Looking at embedded losses, the IMF will require that this issue should be resolved before any formal agreement. Furthermore, the unification of the national currency and a full lifting on all subsidies may be required before any official agreement between the government and the IMF.

CEDRE Financing in the Wings

The CEDRE financial support will also remain preconditioned on the implementation of IMF sponsored reforms. Cedre has committed to help Lebanon with approximately $11B. However, it’s not likely that those funds will have a direct impact at least in the near-term on the balance of payments or the public finances, because this financing will be on a project-by-projects basic, with no funds disbursed directly to the government. However, developing infrastructure as expected form these funds may provide stimulus to the economy and improve productivity that will lead to economic growth and an indirect support to the balance of payments and public finances.

Debt Restructuring

The big challenge here is to calculate the value of the current bonds. In details, the recovery value depends on three variables: the haircut applied to the nominal value, the terms of new debt (coupon), and the yield applied. The first two variables will depends on the negotiations between the government and creditors, as the government should aim to put the public debt and external balances on a sustainable path. For the exit yields, it can be low if the government shows some credibility and commitment to reform.

The objective of restructuring is to achieve a debt-to-GDP ratio between 70% and 80% by 2030. For this purpose we assume that the restructured coupon will be 3% annually, and it will have a tenor for an average of five years. Regarding the haircut it will be 75% on nominal value of the current Eurobonds.

The table below represents a base case scenario for some macro indicator from the constraint above.

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Government Debt	398	179	241	241	264	280	309	305	302	299	297
LBP	90	22	22	22	22	22	22	22	22	22	22
FX	309	157	175	165	174	177	190	187	183	181	178
Eurobonds	286	119	93	76	72	68	68	68	68	68	68
Other	23	38	82	88	101	109	122	119	115	113	110
Nominal GDP	127	226	246	262	275	297	319	338	355	373	392
FX Rate	8411	14000	11000	9000	8500	8000	8000	8000	8000	8000	8000
CPI (%yoy)		124.7%	10.0%	5.0%	4.0%	5.0%	4.0%	3.0%	2.0%	2.0%	2.0%
Deflator Growth (%yoy)		87.3%	7.0%	5.0%	4.0%	5.0%	4.0%	3.0%	2.0%	2.0%	2.0%
Real Growth (%yoy)		-5.2%	2.0%	2.5%	2.3%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Primary Balance (% GDP)		-1.1%	0.8%	1.3%	2.1%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Real Interest Rate (%)		-124.2%	-7.8%	-2.7%	-1.8%	-2.8%	-1.9%	-0.9%	0.8%	0.8%	0.9%
Debt/GDP (%)	**313%**	**79%**	**98%**	**92%**	**96%**	**94%**	**97%**	**90%**	**85%**	**80%**	**76%**

From an objective point view, the report can be considered as a roadmap to the government. The government should take into consideration several scenarios and benefit from all the information and expertise in order to save the Lebanese economy and put it on sustainable economic growth in the future. Lastly, the report is also very realistic, and as such has some concerns regarding the political obstacles - sectarianism, asked interests, the threat of violence, and external influence – that will pose challenges to the recovery plan. In this sense, the saving grace, according to the report, is that reform may become the best survival strategy for the current political class!

For your Queries:

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