Lebanon: If and When Financial Assistance is Received and Spent, Beware Accelerating Inflation!

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It is widely hoped that Lebanon will receive financial assistance on concessional terms for recovery and reconstruction purposes. Recent, perhaps conservative, estimates put the assistance at $12.5 billion[1]. These would come from multilateral financial institutions and official donors: $ 3 billion form the IMF, $3 billion from the World Bank, $4.5 billion from the GCC, and $2 billion from the EU; and they would be spent over 5 years, from end 2024 to end 2029.

In the meantime, despite the stability in the Lebanese exchange rate against the USD since July 2023, inflation in Lebanon hasn't subsided. In 2024, the annual inflation rate stood at 18%. If we consider that world 'imported' inflation was 6% in 2024, then the domestic component of inflation was 12%. But given that during that year the USD appreciated against the Euro by 6%, and given that a third of Lebanon's imports are from Europe then, assuming a prefect 'pass through', world 'imported inflation should fall by 2% to 4%. Hence, Lebanon's adjusted domestic inflation should be 14%. Of course, it is relatively high, and it was primarily caused by war and security issues, bottlenecks in air and land freight, and perhaps expectations of a weaker exchange rate, during that troubled year – in other words, it was mostly due to factors on the supply side.

But now, there could be potential concerns that inflation could be fueled by factors on the demand side, if and when assistance comes and is spent.

[1] IIF, "*New Era: The Urgency for Deep Reforms*", February 2025.

Why? The $12.5 billion in financial assistance implies on *average* spending of $2.5 billion a year for 5 years. Given an income multiplier of 1.3[2], then GDP should increase by about $3.3 billion in 2025. And since GDP in 2024 was estimated at $33 billion -- as recently there have been upward adjustments to Lebanese GDP during the crisis years[3] -- *then the growth rate in GDP from financial assistance spending should equal 10% in 2025. But isn't this too high, and wouldn't it ignite inflationary pressures?*

To answer the above valid question, we need to find out what is the potential real growth rate for the Lebanese economy. This is the growth rate consistent with steady growth and stable inflation. But since the Lebanese economy carries a lot of slack and unemployed resources because of the crisis (GDP has almost been halved!), then it can grow at a rate higher than the potential growth rate so as to catch up and until full employment is reached, **without accelerating inflation**. As such, we postulate the following regrading Lebanese GDP:

1) Potential growth rate = 4.6%
2) Catch up growth rate = 2%
3) Actual non-accelerating-inflation growth rate = 6.6%

The Appendix explains how the potential growth rate is derived. As to the catch up growth rate, it is referred to in the economic literature by Okun's law: a recessionary economy can grow by an *additional 2% annually, and that would reduce unemployment by 1% but keep inflation stable*. What level of spending from financial assistance would be consistent with an actual non-accelerating-inflation growth rate of 6.6% in 2025? At a level of GDP estimated at $33 billion in 2024, such a growth rate would imply an increase in GDP of $2.2 billion; and with an income multiplier of 1.3, the required spending from assistance that would generate that increase in GDP is $1.67 billion in 2025.

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[2] Mouradian, et.al. "Macroeconomic Effects of COLA and Salary Scale Adjustments for Lebanese Public Employees", *Association of Banks in Lebanon (ABL) Monthly Bulletin, No. 2/2016.*

[3] IIF, *ibid*

The above analysis has established three important conclusions. First, and most important, the desired real growth rate that will ensure price stability is 6.6% not 10%. Granted, the economy has plenty of un-utilized resources, but a real growth rate growth above 6.6% or thereabout would create excessive demand and absorption capacity problems that would cause inflation to shoot. Second, the desired average spending level should be around $1.7 billion, spread over 7.5 years annually, to exhaust the $12.5 billion at the end of that period. Third, at an annual real growth rate of 6.6% for 7.5 years, the unemployment rate – ala Okun' s law – should fall by 7.5%, implying a significant dent in the unemployment rate[4].

Of course, the real growth rate can exceed 6.6%, but that would come at the expense of higher inflation. This could arise because of the urge to spend more, especially initially to rebuild the damaged houses and infrastructure in the South and Dahia. In this case, policymakers would have to confront what is known in the literature as the 'Sacrifce or Tolerance Ratio' : the increase in inflation that should be sacrificed or tolerated to get additional real growth. No such ratio is estimated for Lebanon, but for typical lower-to--middle income countries – as is the case for Lebanon – it is estimated at 0.5[5]. This means that for every additional growth rate of 0.5%, a higher demand-driven inflation rate by 1% would be 'sacrificed' to accomplish that. In other words, for Lebanon, if the real growth rate rises to 10% (higher than the ideal by 3.4%), then the inflation rate would be expected to rise by about 7% more.

In closing, the aim of this note is not to discourage financial assistance – far from it, we badly if not desperately need it and we welcome it greatly. But what we propose here is that we have to be cautious in how we spend it if and when it arrives, not only because that will reduce any wasteful or corrupt expenditure but it will also evade harmful inflationary pressures.

[4] The latest World Bank estimate of the *formal* unemployment rate (for 2023) puts it at 12%, perhaps a bit underestimated.

[5] Dierks, L.H. "Inflation, Monetary Policy and the Sacrifice Ratio: The Case of Southeast Asia", *South East Asian Central Banks (SEACEN) Research and Training Centre, 2023.*

This is the more so since, most likely, financial assistance will not be the only additional spending in the economy, as FDI and domestic spending – intermediated by a recovering banking sector – will also be undertaken, putting more pressure on inflation from the demand side, in addition to any possible pressure from supply shocks like that we discussed at the outset of the note.!

Appendix

Using the growth accounting model, the growth rate of GDP is the sum of the following:

(1) $\Delta Y/Y = \Delta TFP/TFP + \alpha.\ \Delta L/L + \beta.\ \Delta K/K$

where Δ is change, Y is GDP or output, TFP is total factor productivity and measures output due to technology and governance, α is the share of labor L in output, β is the share of capita K in output. Equation (1) states that the growth of GDP is the sum of the growth in TFP i.e. technological and institutional development, the growth in Labor weighted by the share of labor L in output, and the growth in capital weighted by the share of capita K in output. In the post-civil-war period till 2019, $\beta.\ \Delta K/K$ averaged 2.2% (β= 0.45 and $\Delta K/K$=5%), $\alpha.\ \Delta L/L$ averaged 1.1% (α=0.55 and $\Delta L/L$=2%), and $\Delta TFP/TFP$ averaged 0.65%[6]. But $\Delta TFP/TFP$ at 0.65% is half the average for developing countries equal to 1.3%; hence, for any meaningful reform in Lebanon to justify assistance, improvements in governance and technology should be at least equal to the developing countries' average. As a result:

(2) $\Delta Y/Y = 1.3\% + 1.1\% + 2.2\% = 4.6\%$

which makes the potential real growth rate for Lebanon equal to 4.6%.

[6] For more on the model and the figures, see: Mouradian. et.al, "Potential Output and Unemployment in Lebanon", *Association of Banks in Lebanon (ABL) Monthly Bulletin, No. 4/2018.*

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