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Lebanon—Statement by IMF Staff for the April 6 CEDRE Conference

March 14, 2018

This statement reflects IMF staff's latest assessment of Lebanon's economic conditions and policies based on findings of the 2018 Article IV consultation visit. It supplements the end-of-mission concluding statement published on February 12, 2018. These statements do not reflect the views of the IMF Executive Board of Directors.

Recent Developments

Lebanon is facing low economic growth, twin deficits and high public and external debt. We estimate growth to be at 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. While the primary budget balance in 2017 was positive at 2.2 percent of GDP due to one-off factors, the overall budget deficit was 7.5 percent of GDP, reflecting interest payments on public debt, which stands at about 150 percent of GDP. The current account deficit was about 24 percent of GDP in 2017. Goods exports as a share of GDP continue to decline, partly reflecting the continuing conflict in Syria. Imports remain strong due to subsidized credit made available by several Banque du Liban (BdL) lending schemes, higher oil prices and significant overvaluation of the real effective exchange rate. Moreover, foreign-deposit inflows, which have been a key source of financing for the large current account- and budget deficits, have eased in recent years.

Recent policy actions resulted in important achievements but some have come at a cost. Lebanon's parliament passed the first budget in 12 years in October 2017, paving way for further improvements in public financial management. The parliament also passed a public-sector salary increase in the summer of 2017, which staff estimates is fully funded through additional revenue measures approved in the fall of 2017. The BdL has successfully maintained its nominal anchor, the peg of the Lebanese pound to the U.S. dollar, and quickly stabilized the financial sector following Prime Minister Hariri's temporary resignation in November 2017. The BdL used unconventional financial operations to boost its gross reserves and the capital of banks, while avoiding a general interest rate increase. However, these operations have come at a cost to the BdL's balance sheet and net foreign exchange position, and have been regressive.

Lebanon continues to host about 1 million registered Syrian refugees (equivalent to about a quarter of the population). It is providing an international public good in difficult circumstances where its economy is weakened by the Syrian crisis even apart from the impact of the refugees. International aid only covers part of the cost of hosting the refugees as the increased demand for government services raises fiscal expenditures. The refugees' presence also strains Lebanon's already-stretched public infrastructure, resulting in a lower service quality for existing Lebanese users, weighs on local communities, and fuels social tensions.

Outlook Under the Baseline Scenario and Risks

Economic performance and financial inflows are expected to remain weak under the baseline scenario of unchanged policies. Staff assumes that the impact of the Syria conflict on Lebanon will remain broadly unchanged over the five-year forecast horizon, though with some pickup in trade. Since growth has been low for the last seven consecutive years, structural factors are also likely to be a bottleneck for potential growth. Under the baseline, staff projects that growth will rise to close to 3 percent over the medium term as external demand picks up due to a global recovery. Inflation is projected to decline to about 2.5 percent by 2019. The current account deficit will remain large. Lebanon's foreign reserve adequacy is projected to deteriorate over the medium term.

The upside potential for growth is significant but downside risks remain. 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, the reestablishment of trade, and the improvement in regional investor confidence. This would have significant positive implications for local incomes, growth, and the current account balance, though not enough to restore debt sustainability. On the downside, tensions in the region could lead to escalation of conflicts or trigger security incidents, which would have a material impact on economic stability in Lebanon. Deposit inflows could also stall and dollarization could increase further. The willingness of depositors to fund Lebanon cannot be taken for granted, especially with the prospect of tighter regional and global financial conditions.

Policies to Support Macroeconomic Sustainability

Lebanon needs urgent action to preserve confidence and support macroeconomic stability. A reform agenda focusing on three areas can improve the country's economic outlook. First, fiscal policy needs to be immediately anchored in a consolidation plan that stabilizes and then reduces debt as a share of GDP. Second, risks to financial stability should be contained, including by gradually incentivizing banks to strengthen their buffers. Third, structural reforms, including reforming the electricity sector and addressing corruption and governance, could promote sustainable growth and improve equity and competitiveness.

Significant fiscal adjustment is inescapable. Lebanon's debt is unsustainable under the baseline scenario. A primary surplus of about 5 percent of GDP is needed over the medium and long term to stabilize public debt as a share of GDP and place it on a gradually declining path. Measures to achieve it could include: (i) increasing VAT rates, eliminating exemptions and refunds, and improving compliance, (ii) reinstating gasoline excise and fuel taxes to levels before 2012, and (iii) gradually eliminating the electricity subsidy. Sustained fiscal adjustment of such magnitude has been achieved in only a very few countries. Large current account deficits are expected to continue even after fiscal adjustment, in the absence of exchange rate adjustment or very favorable external developments.

The BdL should rely on a conventional interest rate policy instead of financial operations and encourage banks to gradually strengthen buffers. The BdL's past financial operations have accomplished important objectives, but they increased risks in the system (sovereign exposure, interest rate and liquidity risks, dollarization). The central bank should instead raise interest rates if it needs to secure higher foreign exchange inflows. Buffers in the banking system should continue to be increased by aligning sovereign risk weights with the Basel Accord, and encouraging banks to engage in forward-looking capital planning in line with their risk profiles. The authorities should also strengthen their crisis management and AML/CFT frameworks.

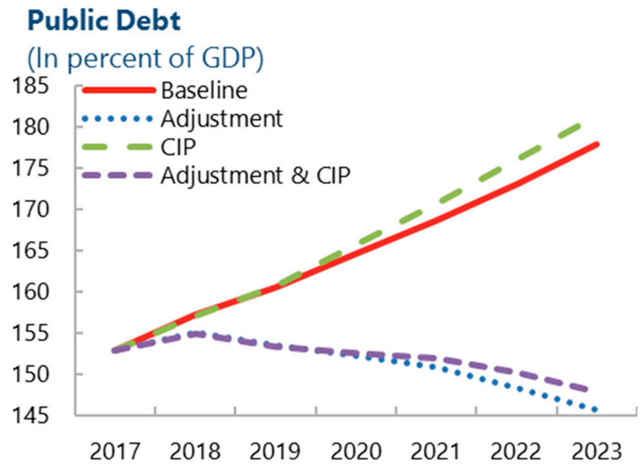
Structural reforms are essential given eroding competitiveness and low growth. In particular, the electricity sector has been widely identified as Lebanon's most pressing bottleneck and remains a significant drain on the budget. The government should step up investment in the electricity sector, which would increase electricity supply and reduce the need for consumers to rely on expensive private generators. The government should also gradually increase electricity tariffs to eliminate subsidies to the electricity company EdL. Separately, the government acknowledges that corruption is widespread, and in response is working on an anti-corruption strategy. Improving the business climate, strengthening governance in revenue administration, and significantly enhancing tax/customs compliance and transparency at public institutions, are likely to have a sizable impact on confidence and improve governance.

Capital Investment Program

The government is initiating a large capital investment program (CIP) to spur overall economic growth, benefitting both refugees and their host communities. The plan aims to raise $1.6 billion (3.2 percent of current GDP) annually over the next decade by tapping into the World Bank's Concessional Financing Facility, public-private partnerships (PPPs), and other facilities that provide grants or long-term concessional lending. The authorities hope that this will help address Lebanon's low growth problem, create jobs for both host communities and refugees, and alleviate longstanding infrastructure problems which have become more acute with the large refugee presence.

The CIP, if implemented under unchanged policies, would only provide a limited growth boost while worsening the public debt trajectory. Given Lebanon's current limited ability to manage large public investment projects, the CIP would yield a limited growth dividend beyond a temporary shift in output level due to the additional public spending. This would be due to both inefficiencies in the investment spending itself and the limited ability of the economy to translate the resulting higher capital endowment into additional output. The

CIP would slightly increase public debt as a share of GDP, compared to the baseline scenario (see chart and Table 2).



Source: IMF staff calculations.

If the CIP is embedded in a wider program of fiscal adjustment and structural reforms, it could generate better outcomes. A combination of policies including fiscal adjustment amounting to about 5 percent of GDP and structural reforms in electricity and governance together with the CIP would deliver higher growth and employment at the reasonable cost of a slightly higher debt level as a share of GDP relative to the adjustment scenario (see Table 2). The positive growth effects of the CIP in its initial years would partially offset the negative effects on growth arising from fiscal adjustment, while fiscal and structural adjustment would deliver a durable increase in potential growth. These policies would also first stabilize public debt as a share of GDP and then put it on a downward trajectory.

If implemented following improvements in public investment management the CIP would yield a higher growth dividend, which is reflected in the adjustment and CIP scenario. The quality of public investment management makes a significant difference to the growth impact of investment. Thus, an assessment and rapid reform of public investment management capacity ahead of initiation of a scaled up public investment program is critical if the full benefits of the CIP are to be realized. The authorities have recently requested a Public Investment Management Assessment (PIMA) and the Fund will undertake this in late spring or early summer 2018. The PIMA could then be the basis for reforms in public investment management ahead of a significant scaling up of public investment. The government should also be cautious and gradual in its use of PPPs to ensure that they attract private financing while minimizing fiscal risks stemming from contingent liabilities. Both the World Bank and the Fund stand ready to advise Lebanon on the framework for setting up PPPs.

Relations with the Fund

The 2016 Article IV consultation was concluded by the IMF Executive Board on December 12, 2016. Staff visited Lebanon for the 2018 Article IV consultation on February 1–12, 2018 and the staff report is scheduled for discussion by the IMF Executive Board on May 9, 2018. The Fund has also been providing technical assistance to Lebanon in a broad range of areas.

Table 1. Lebanon: Selected Economic Indicators, 2016–23

(Population: est. 4.5 million; 2014)
(Per capita GDP: est. US$11,112; 2014)
(Quota: SDR 266 million, 0.11 percent of total)
(Poverty rate: 28 percent; 2004-05)
(Unemployment: 11.0 percent; 2011) 1/
(Main products and exports: services, jewelry)
(Key export markets: UAE, Saudi Arabia, Switzerland)

	2016	Proj.						
	Act.	2017	2018	2019	2020	2021	2022	2023
Output and prices	(Annual percentage change)							
Real GDP (market prices)	1.0	1.2	1.5	1.8	2.2	2.6	2.9	2.9
GDP deflator	-0.7	2.5	2.7	3.3	2.4	2.3	2.1	2.1
Consumer prices (end-of-period)	3.1	5.0	3.5	2.5	2.5	2.5	2.5	2.5
Consumer prices (period average)	-0.8	4.5	4.3	3.0	2.5	2.5	2.5	2.5
Investment and saving	(In percent of GDP)							
Gross capital formation	20.4	22.7	21.4	20.4	19.4	18.4	18.4	17.8
Government	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Nongovernment	19.0	21.3	20.0	18.9	18.0	17.0	17.0	16.4
Gross national savings	-2.1	-2.2	-4.3	-4.8	-5.2	-5.8	-5.3	-5.5
Government	-7.7	-5.9	-9.1	-9.6	-9.9	-10.3	-11.0	-11.6
Nongovernment	5.6	3.6	4.8	4.8	4.6	4.5	5.7	6.1
Central government finances (cash basis)	(In percent of GDP)							
Revenue (including grants)	20.0	22.1	23.0	23.2	23.3	23.1	23.0	23.0
Expenditure	29.2	29.4	33.6	34.2	34.6	34.9	35.4	36.0
Budget balance (including grants)	-9.2	-7.3	-10.6	-11.0	-11.3	-11.7	-12.4	-13.0
Primary balance (including grants)	0.1	2.5	0.2	0.3	0.5	0.4	0.3	0.3
Total government debt	151	153	157	161	165	169	173	178
Monetary sector	(Annual percentage change, unless otherwise indicated)							
Credit to the private sector	6.1	6.1	4.2	5.1	4.7	4.9	5.0	5.0
Reserve money	27.7	32.0	-11.5	2.2	2.2	2.2	2.1	2.0
Broad money 2/	7.6	4.1	5.0	5.0	5.0	5.0	5.0	5.0
Deposit dollarization (level)	65.9	68.8	69.0	69.0	69.0	69.0	69.0	69.0
Interest rates (period average, in percent)								
Three-month treasury bill yield	4.4	5.1	5.8	6.1	6.2	6.3	6.4	6.4
Five-year treasury bill yield	6.8	7.9	8.2	8.4	8.5	8.6	8.7	n.a.
External sector	(In percent of GDP, unless otherwise indicated)							
Exports of goods and services (in US$, percentage change)	-4.5	2.6	6.0	5.2	5.3	5.2	5.5	5.6
Imports of goods and services (in US$, percentage change)	0.4	6.9	7.0	3.0	3.1	4.0	4.3	4.4
Balance of goods and services	-24.0	-26.3	-27.4	-26.1	-24.9	-24.2	-23.6	-23.0
Current account	-22.5	-25.0	-25.8	-25.2	-24.7	-24.2	-23.7	-23.3
Foreign direct investment	4.0	4.6	4.0	4.0	4.0	4.0	4.0	4.0
Total external debt 3/	190	198	202	205	208	211	213	216
Gross reserves (in billions of U.S. dollars) 4/	40.2	40.6	37.5	33.7	29.9	26.1	22.4	18.6
In months of next year imports of goods and services	14.7	13.9	12.4	10.8	9.2	7.7	6.3	5.1
In percent of short-term external debt 5/	48.0	44.8	38.8	32.7	27.3	22.4	18.1	14.1
In percent of banking system foreign currency deposits	37.6	35.1	30.7	26.2	22.2	18.4	15.0	11.9
In percent of total banking system deposits	24.8	24.1	21.2	18.1	15.3	12.7	10.4	8.2
Memorandum items:								
Nominal GDP (in billions of U.S. dollars)	49.6	51.5	53.6	56.4	59.0	61.9	65.0	68.3
Non-resident deposits (staff estimate, percent change)	11.7	3.8	5.0	5.0	5.0	5.0	5.0	5.0
Commercial bank total assets (percent of GDP)	394	396	394	394	392	389	385	n.a.
Imports of petroleum products (in millions of U.S. dollars)	-4,107	-4,760	-5,700	-5,424	-5,287	-5,281	-5,378	-5,535
Local currency per U.S. dollar (period average)	1,508	1,508	...	...	...	...	...	...
Real effective exchange rate (annual average, percent change)	-0.4	3.0	...	...	...	...	...	...

Sources: Lebanese authorities; and IMF staff estimates.

1/ According to a labor force survey conducted by the World Bank in April 2011. The latest official unemployment rate is 9.7 percent in 2007.

2/ Defined as currency in circulation plus resident and nonresident deposits.

3/ Includes nonresident deposits.

4/ Excluding gold and encumbered assets.

5/ Short-term debt on a remaining maturity basis, including short-term nonresident deposits.

Table 2. Lebanon: Alternative Scenarios, 2016–23

	2016	2017 Est.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.
	(In percent of GDP, unless otherwise noted)							
Baseline								
Real GDP growth (percent)	1.0	1.2	1.5	1.8	2.2	2.6	2.9	2.9
Non-resident deposit growth (staff estimate, percen	11.7	3.8	5.0	5.0	5.0	5.0	5.0	5.0
Primary balance	0.1	2.5	0.2	0.3	0.5	0.4	0.3	0.3
Budget balance	-9.2	-7.3	-10.6	-11.0	-11.3	-11.7	-12.4	-13.0
Total government debt	150.9	152.8	157.3	160.6	164.7	168.6	173.0	177.8
Current account	-22.5	-25.0	-25.8	-25.2	-24.7	-24.2	-23.7	-23.3
Total external debt	189.5	198.4	202.3	204.8	208.1	210.8	213.4	215.8
Gross reserves (billions of US dollars)	40.2	40.6	37.5	33.7	29.9	26.1	22.4	18.6
Adjustment								
Real GDP growth (percent)	1.0	1.2	0.8	0.7	1.6	2.4	3.1	3.4
Non-resident deposit growth (staff estimate, percen	11.7	3.8	6.9	7.5	7.4	7.4	7.4	7.3
Primary balance	0.1	2.5	1.7	4.2	5.7	5.9	5.8	5.7
Budget balance	-9.2	-7.3	-8.9	-6.7	-5.3	-5.0	-5.1	-5.2
Total government debt	150.9	152.8	155.2	153.5	152.3	150.8	148.4	145.8
Current account	-22.5	-25.0	-25.2	-23.7	-22.3	-21.0	-19.9	-18.9
Total external debt	189.5	198.4	205.6	212.1	221.1	229.9	237.1	243.4
Gross reserves (billions of US dollars)	40.2	40.6	39.7	39.7	40.9	43.3	47.1	51.9
CIP								
Real GDP growth (percent)	1.0	1.2	2.3	2.9	2.7	2.9	3.1	3.2
Non-resident deposit growth (staff estimate, percen	11.7	3.8	5.6	5.6	5.6	5.6	5.6	5.6
Primary balance	0.1	2.5	-0.9	-1.7	-1.4	-1.3	-1.3	-1.3
Budget balance	-9.2	-7.3	-11.6	-12.8	-12.9	-13.2	-13.8	-14.2
Total government debt	150.9	152.8	157.1	160.7	165.7	170.7	176.0	181.4
Current account	-22.5	-25.0	-26.8	-27.0	-26.4	-25.7	-25.0	-24.5
Total external debt	189.5	198.4	202.6	205.8	210.6	214.9	219.0	222.7
Gross reserves (billions of US dollars)	40.2	40.6	38.0	34.7	31.5	28.3	25.2	22.1
Adjustment & CIP								
Real GDP growth (percent)	1.0	1.2	1.6	2.0	2.4	2.9	3.6	4.0
Non-resident deposit growth (staff estimate, percen	11.7	3.8	6.9	8.0	8.0	7.9	7.9	7.8
Primary balance	0.1	2.5	0.7	2.2	3.8	4.1	4.1	4.1
Budget balance	-9.2	-7.3	-9.9	-8.5	-6.9	-6.5	-6.5	-6.4
Total government debt	150.9	152.8	155.0	153.3	152.7	152.0	150.3	148.0
Current account	-22.5	-25.0	-26.3	-25.6	-24.2	-22.8	-21.7	-20.7
Total external debt	189.5	198.4	205.0	211.6	221.2	230.8	238.3	244.3
Gross reserves (billions of US dollars)	40.2	40.6	39.7	40.2	41.8	44.4	48.2	53.0