

LEBANON ECONOMIC MONITOR

So when Gravity Beckons, the Poor Don't Fall

Fall 2019



Global Practice for Macroeconomics, Trade & Investment
Middle East and North Africa Region

The World Bank

PREFACE

The *Lebanon Economic Monitor* provides an update on key economic developments and policies over the past six months. It also presents findings from recent World Bank work on Lebanon. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy on the outlook for Lebanon. Its coverage ranges from the macro-economy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Lebanon.

The *Lebanon Economic Monitor* is a product of the World Bank's Lebanon Macroeconomics, Trade and Investment (MTI) team. It was prepared by Wissam Harake (Country Economist) and Naji Abou Hamde (Economic Analyst), under the general guidance of Christos Kostopoulos (Lead Economist) and Eric Le Borgne (Practice Manager). Wissam Harake (Senior Economist), Lars Jessen (Lead Debt Specialist) and Patrick van der Wansem (Consultant) contributed the Special Focus. Zeina Khalil (Communications Officer) is the lead on communications, outreach and publishing.

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EXECUTIVE SUMMARY

I. **Lebanon is in Crisis.** While it is too early to gauge the economic impact of recent events, it is important to note that even prior to the eruption of the demonstrations, the World Bank projected a small recession in 2019; we now estimate that the recession will be deeper. There has been an unprecedented banking holiday, with banks closed over October 18-31 for retail and other transactions, reopening thereafter with informal capital controls and other uncoordinated measures, then closing again for 10 days on November 9. Critical short-term financing for businesses has been interrupted, leading to disruptions all along the supply chain and an ultimate impact on workers. Unemployment is expected to rise and poverty, already high, will follow. The emerging parallel exchange market is likely to trigger inflationary pressures, hurting the poor and middle class disproportionately. Shortages of imports are also expected to materialize.

II. **The crisis is a culmination of chronic conditions that have long impeded Lebanon's development process.** Lebanon's Systematic Country Diagnostic (SCD)¹ identified elite capture, hidden behind the veil of confessionalism and confessional governance, as one of two overarching constraints for the country's economic development (the other being conflict and violence, stemming, in part,

from the broader dynamics of conflict in the Middle East). Under the guise of preserving post-war confessional balances, a post-war elite emerged to command the main economic resources, both private and public, generating large rents and dividing the spoils of uncompetitive markets and a dysfunctional and hallowed state.

III. **Lebanon needs a credible crisis management strategy.** This strategy should involve short-term measures to contain the crisis, as well as medium- to long-term measures to address structural issues. Several packages of measures out to be analyzed in light of their impact on the short-, medium- and long-term development of Lebanon, and in particular, their distributional impacts. With this in mind, below is an illustrative example of what the contour of such a credible strategy could include:

- **Element 1: Addressing External Imbalances.** Lebanon runs a large structural trade imbalance which drives one of the largest current account deficit-to-GDP ratios globally (>20% of GDP), while maintaining a nominal dollar peg to the Lebanese Pound (LBP) set in 1997. This has resulted in a significant exchange rate overvaluation. The resulting large external financing needs exposes the country to a severe shortage of inflows should confidence were to falter.
- **Element 2: A Progressive Path to Fiscal Sustainability.** Lebanon has one of the

1 Le Borgne, Eric and Jacob, Thomas (2016), *Promoting Poverty Reduction and Shared Prosperity: A systematic Country Diagnostic*, World Bank Group, Report No. 103201, January 2016.

highest debt-to-GDP ratios globally, accumulated from persistent and large fiscal deficits since the end of the civil war. This imposes an elevated gross public financing need, a good part of which is in dollars, further aggravating the balance of payments. Lebanon would need to undertake a sustained fiscal adjustment process. **Equity considerations would warrant highly progressive measures that target key inefficiencies and realize resources from those who have disproportionately benefited from Lebanon's unequal growth model.** Measures include: *Addressing the cost of debt; Electricity reforms; A progressive global income tax.* In addition, we suggest the following financial management and State-Owned Enterprises (SOE) reforms: *Establishment of a Single Treasury Account; Elimination of unnecessary extra budgetary funds; Establishment of transparent accounting and reporting of revenues, costs, investments needs between: (i) OGERO, MoT and MoF, and for (ii) the Port of Beirut.*

- **Element 3: Regaining Efficacy of Banking Sector.** The reliance on continued deposit inflows to fund the large financing needs of both the public and private sectors while ensuring currency stability presents enormous challenges to the sovereign-commercial bank relationship. The banking sector balance sheet is among the largest globally, amounting to 437 percent of GDP by September 2019, 70 percent of which are lent to the sovereign (split between 58 percent to the central bank and 12 percent to the Government). Meanwhile, economic conditions are being reflected on banks' loan portfolio. To help address these vulnerabilities,

suggestions include: *Revise and update bank resolution framework; Recapitalization of the deposit insurance fund as needed, and aligning of the deposit insurance scheme with best practices; Conducting intensified supervision; Strengthening NPL resolution.*

- **Element 4: Strengthened Social Safety Nets.** Pre-existing inequities and social disenfranchisement will be further aggravated in the event of a crisis or a severe recession. In order to cushion these negative effects, Government could consider programs designed to respond to the short-term needs of the poor. These can include, for example, *scaling up the e-card food voucher of the National Poverty Targeting Program (NPTP); providing an education cash transfer for children from extreme poor households who are vulnerable to dropping out of schooling; increasing access to quality healthcare for poor Lebanese; and a wage subsidy scheme for youth.*
- **Element 5: Enhancing Growth and Forcefully Tackling Governance.** Illegal activities are not sanctioned by the state when they involve politically or confessionally connected or wealthy actors, exacerbating elite capture and the patronage system. This has been fertile grounds for corruption, nepotism and inequality; Transparency International's Corruption Perception Index 2019 ranked Lebanon 138 out of 180 countries worldwide in 2019, indicating endemic corruption and making Lebanon among the 50 most corrupt countries in the world. Suggested measures include: *Implement judiciary reforms; Annul the law on Exclusive Agencies and*

liberalization of the brand retail sector; Adopt a law on the recovery of Stolen Assets; Adopt a new Public Procurement Law that is aligned with international best practices; Passage and implementation of a new Competition Law that is aligned with international best practices; Adoption of a unified vision for the ICT sector and clear consensus on policy.

IV. Lebanon's challenge has been on the implementation side, especially, cross-entity coordination, sustaining momentum, and monitoring and evaluation. This can be addressed by establishing a reform secretariat that tracks the implementation of these reforms across Government. The reform secretariat should be staffed by top experts selected through a competitive process. It would report directly to Government and establish partnership with Civil Society Organizations and the private sector.

V. A new Government can gain credibility by quickly implementing a crisis management strategy and advancing strong governance reforms that help break the hold of the elite capture. Indeed, political discord has been a primary source of pressures. A new effective Government is a necessary, albeit insufficient, step toward crisis management.

ملخص تنفيذي

العنصر الأول: معالجة الاختلالات الخارجية. يشهد لبنان اختلالاً هيكلياً كبيراً في الميزان التجاري مما يؤدي إلى إحدى أكبر نسب العجز في الحساب الجاري إلى الناتج المحلي الإجمالي على مستوى العالم (أكثر من ٢٠٪ من الناتج المحلي الإجمالي)، مع الحفاظ على تثبيت إسمي لسعر صرف الدولار باليرة اللبنانية منذ ١٩٩٧. وقد أدى ذلك إلى سعر صرف مبالغ في قيمته. وقد نجم عن ذلك احتياجات تمويل خارجي كبيرة تُعزّض البلاد لسيناريو التوقف المفاجئ إذا ما تعثرت الثقة.

العنصر الثاني: المضي في سياسات تقديمية نحو الاستدامة المالية. يسجل لبنان إحدى أعلى نسب الدين إلى الناتج المحلي الإجمالي على مستوى العالم، وقد تراكمت هذه النسبة نتيجة عجوزات مالية كبيرة ومستمرة منذ نهاية الحرب الأهلية. ويفرض ذلك حاجة كبيرة إلى التمويل العام، جزء كبير منه بالدولار، مما يزيد من التأثير السلبي على ميزان المدفوعات. سيحتاج لبنان إلى إجراء عملية تكيف مالي مستدامة. كما تستدعي اعتبارات المساواة اتخاذ تدابير تقديمية تستهدف أوجه القصور الرئيسية وتأخذ الموارد من أولئك الذين استفادوا بشكل غير متناسب من نموذج النمو غير المتكافئ في لبنان. وتشمل التدابير ما يلي: معالجة كلفة الدين؛ إصلاحات قطاع الكهرباء؛ ضريبة تصاعديّة موحدة على الدخل. بالإضافة إلى ذلك، نقترح الإصلاحات التالية على مستوى الإدارة المالية والمؤسسات المملوكة من الدولة: إنشاء حساب خزانة واحد؛ إلغاء التمويل غير الضروري من خارج الميزانية؛ إنشاء نظام شفاف للمحاسبة والإبلاغ عن الإيرادات والتكاليف والاحتياجات الاستثمارية بين (i) أوجيهو ووزارة الاتصالات ووزارة المالية و(ii) لمرفاً بيروت.

العنصر الثالث: استعادة فعالية القطاع المصرفي. إنّ الاعتماد على استمرار تدفقات الودائع لتمويل الاحتياجات الضخمة للقطاع العام والخاص مع ضمان استقرار العملة يضع تحديات هائلة أمام العلاقة بين الدولة والمصارف التجارية. وتُعدّ الميزانية العمومية للقطاع المصرفي من بين الأكبر في العالم، حيث وصلت إلى ٤٣٧ في المائة من إجمالي الناتج المحلي بحلول سبتمبر/ أيلول ٢٠١٩، وتُقرّض ٧٠ في المائة منها كديون سيادية (٥٨٪ لمصرف لبنان و ١٢٪ للحكومة اللبنانية).

I. لبنان في أزمة. من السابق لأوانه قياس التأثير الاقتصادي للأحداث الأخيرة، لكن تجدر الإشارة إلى أنه حتى قبل اندلاع المظاهرات، كان البنك الدولي قد توقّع ركوداً خفيفاً في عام ٢٠١٩؛ ونقدّر الآن أن يكون الركود أعمق. فقد شهدت البلاد عطلة مصرفية غير مسبوقه، حيث أغلقت المصارف أبوابها في الفترة من ١٨ إلى ٣١ أكتوبر/ تشرين الأول أمام معاملات التجزئة وغيرها، لتعاود فتحها بعد ذلك مع ضوابط غير رسمية على رأس المال وغيرها من التدابير غير المنسقة، ثم أغلقت مرة أخرى لمدة عشرة أيام في ٩ نوفمبر/ تشرين الثاني. وتوقّف التمويل القصير الأمد الضروري للشركات، مما أدى إلى اضطرابات على طول سلسلة التوريد وأثر سلباً على العمال في المطاف الأخير. ومن المتوقع أن ترتفع البطالة ويتفاقم الفقر، المرتفع أصلاً. كما من المرجح أن يؤدي سوق الصرف الموازي الناشئ إلى ضغوط تضخمية، مما يضّر بالطبقة الفقيرة والمتوسطة بشكل غير متناسب. كما من المتوقع أن يحدث نقص في الواردات.

II. تمثّل الأزمة تنويجاً للظروف المزمنة التي أعاقّت عملية التنمية في لبنان لفترة طويلة. فقد حدّدت دراسة التشخيص المنهجي للبنان¹ سيطرة النخبة التي تتخفى وراء غطاء الطائفية والحكم الطائفي، كأحد العائقيين الرئيسيين للتنمية الاقتصادية في البلاد (والعائق الآخر هو الصراع والعنف، اللذان ينبعان جزئياً من الديناميات الأوسع نطاقاً للصراع في الشرق الأوسط). وتحت ستار الحفاظ على التوازنات الطائفية لفترة ما بعد الحرب، ظهرت نخبة ما بعد الحرب تتحكّم بالموارد الاقتصادية الرئيسية، سواء العامة أو الخاصة، وتولّد ريوماً ضخماً وتناقسم الغنائم الناتجة عن الأسواق غير التنافسية وعن الاختلال الوظيفي الذي شهدته الدولة.

III. يحتاج لبنان إلى استراتيجية لإدارة الأزمة ذات مصداقية. يجب أن تتضمن هذه الاستراتيجية تدابير قصيرة الأجل لاحتواء الأزمة، بالإضافة إلى تدابير متوسطة إلى طويلة الأجل لمعالجة القضايا الهيكلية. كما يتعيّن دراسة حزمة من التدابير نظراً لتأثيرها على التنمية القصيرة والمتوسطة والطويلة الأجل في لبنان، لا سيما من ناحية توزيعها الاجتماعي-الاقتصادي. ومن هذا المنطلق، نطرح في ما يلي مثلاً لما يمكن أن تتضمنه مثل هذه الاستراتيجية الموثوق بها:

1 إريك لو بورن وجاكوب توماس (٢٠١٦)، تعزيز الحد من الفقر والرفاه المشترك: دراسة التشخيص المنهجي للبلاد، مجموعة البنك الدولي، التقرير رقم ١٠٣٢٠١، كانون الثاني/يناير ٢٠١٦

تنافسية. على ان تقدّم الهيئة تقاريرها مباشرة إلى الحكومة وتقيم شراكة مع منظمات المجتمع المدني والقطاع الخاص.

V. بإمكان حكومة جديدة أن تكسب المصادقية من خلال الإسراع في تنفيذ استراتيجية لإدارة الأزمة والدفع بإصلاحات قوية على صعيد الحوكمة تساعد على كسر سيطرة النخبة. لطالما شكلت الخلافات السياسية مصدرًا رئيسيًا للضغط. إن تشكيل حكومة جديدة فعالة هي خطوة ضرورية، وإن كانت غير كافية، للمضي نحو إدارة الأزمة.

وفي الوقت نفسه، تتعكس الظروف الاقتصادية على محافظة قروض المصارف. تتضمن الاقتراحات للمساعدة في معالجة مكامن الخطر هذه ما يلي: مراجعة وتحديث إطار تسوية وضع المصارف؛ إعادة رسملة صندوق التأمين على الودائع حسب الحاجة، ومواءمة خطة التأمين على الودائع مع أفضل الممارسات؛ إجراء رقابة مكثفة؛ وتعزيز إدارة الديون المتعثرة.

العنصر الرابع: تعزيز شبكات الأمان الاجتماعي. ستزداد حدة عدم المساواة والحرمان الاجتماعي في حال حدوث أزمة أو ركود حادّ. ومن أجل تخفيف وطأة هذه الآثار السلبية، بإمكان الحكومة النظر في برامج مصمّمة لتلبية احتياجات الفقراء القصيرة الأجل. وقد يشمل ذلك على سبيل المثال، توسيع نطاق القسيمة الإلكترونية لشراء الأغذية من البرنامج الوطني لدعم الأسر الأكثر فقرًا؛ توفير تحويلات نقدية تعليمية للأطفال من الأسر الأشد فقرًا المعرضين للتسرّب من المدرسة؛ زيادة فرص الحصول على الرعاية الصحية الجيدة للبنانيين الفقراء؛ ونظام دعم الأجور للشباب.

العنصر الخامس: تعزيز النمو ومعالجة الحوكمة بشكل حازم. لا تعاقب الدولة الأنشطة غير القانونية عندما تتورط فيها جهات فاعلة ثرية أو ذات روابط سياسية أو طائفية، مما يؤدي إلى تفاقم سيطرة النخبة ونظام المحسوبية. وقد شكل ذلك أرضية خصبة للفساد والمحسوبية وعدم المساواة. فقد صنّف مؤشر الفساد الصادر عن منظمة الشفافية الدولية لبنان في المرتبة ١٣٨ من بين ١٨٠ بلد في العالم في عام ٢٠١٩، مما يشير إلى فسادٍ مستشريّ ويجعل لبنان من بين البلدان الـ٥٠ الأكثر فسادًا في العالم. وتشمل التدابير المقترحة في هذا المجال: تنفيذ إصلاحات قضائية؛ إلغاء قانون الوكالات الحصرية وتحرير قطاع التجزئة التجاري؛ اعتماد قانون لاسترداد الأصول المسروقة؛ اعتماد قانون جديد للمشتريات العامة يتوافق مع أفضل الممارسات الدولية؛ إقرار وتنفيذ قانون منافسة جديد يتوافق مع أفضل الممارسات الدولية؛ اعتماد رؤية موحدة لقطاع تكنولوجيا المعلومات والاتصالات وإجماع واضح على السياسات.

IV. لقد تمثّل التحدي الذي يواجهه لبنان على مستوى التنفيذ، وخاصة التنسيق بين الإدارات، والحفاظ على الزخم، والرصد والتقييم. ويمكن معالجة ذلك عن طريق إنشاء هيئة إصلاح ترصد تنفيذ هذه الإصلاحات عبر المؤسسات الحكومية. وينبغي أن تضم هيئة الإصلاح كبار الخبراء الذين يتم اختيارهم بطريقة

I. THE PERFECT STORM?

1. **Lebanon is in a high-risk situation as it faces a combination of a balance of payments crisis, in parallel with a deep political crisis.** Hundreds of thousands of people poured onto the streets starting on October 17, marking a serious challenge to the ruling class. On October 29, PM Hariri resigned with little coordination with the other main political parties, leaving open the timeline and nature of a new Government. Even prior to these events, economic conditions, especially on the macro-financial front, have been acute; a shortage of dollars in the market resulted in parallel exchange rates, as well as informal restrictions and control mechanisms on dollar deposits and transfers out of the country—an unprecedented situation for Lebanon’s historically free capital account. The political crisis has aggravated these conditions as banks closed over October 18-31 for retail and other transactions, reopening briefly thereafter with informal capital controls, before being closed again for 10 more days. A new effective Government is a necessary, albeit insufficient, step toward crisis management.

2. **The shortage of dollars in the market has become palpable.** Recent on-the-ground manifestations of macro-financial stresses, which are unprecedented in Lebanon, include:

- Parallel exchange rates, especially in the more retail (and less voluminous) exchange bureaus market. BdL seems to be effectively backing bank exchanges only.
- Convertability of the Lira was interrupted and is currently supported by short-term lending from BdL at 20 percent interest rate.
- Severe limitations on dollar withdrawals from deposits.
- Severe limitations on transfers of money out of the country.
- BdL asked banks to increase equity capital by 20 percent, 10 percent of which should be provided by end-2019 and the rest by June 2020.
- Importers of goods, through their respective professional associations, are expressing social and political discontent via strikes and demonstrations. Importers need to settle dollar liabilities with receivables in Lebanese lira (LL). Previously, they were able to convert back to dollars via their banks. The limitations on bank exchanges have diverted them to exchange bureaus, which are charging more LL for the dollar than the official exchange rate.
- On October 1, BdL released a circular establishing a mechanism that guarantees dollar payments (and thus exchanges at the official rate) for critical imports: fuel, medicine and wheat.
- With a large part of the consumption basket imported (and, more generally, imports accounting for 60 percent of GDP), and thus susceptible to parallel pricing, the above cuts across the economy.
- Social tensions are spreading across the population as an expression of general discontent with economic conditions.

3. **A liquidity crunch in both foreign exchange (FX) and LL has ensued with ripple down effect on the supply chain of the real economy, leading businesses to inventory hoarding, shrinking operations, as well as demands for spot and cash-based payments.** FX shortages² are being reflected in a parallel exchange market that has discounted the LL by as much as 30 percent, although this rate has fluctuated heavily. In a highly dollarized economy, FX liquidity is a binding constraint on LL liquidity.³ Exchange market pressures and liquidity conditions are inducing a two-pronged effect on the real sector: (i) limitations on transfers out of the country imply that (capital/wholesale) imports for businesses are constrained; (ii) critical financing for current spending by businesses even in LL has been interrupted, leading to disruptions all along the supply chain.

4. **A main difference between current conditions and previous episodes of exchange market pressure is that it is starting from an elevated risk situation that is about two years old, with reduced buffer levels and negligible growth.** In addition, this time around, there is no single political or security act that will be seen as a reset to the deteriorating macro situation. *Macroeconomic forecasts in this issue have been completed on October 1, prior to latest events, and as such, we expect a significant downward bias on LEM projections.*

2 Banks have set withdrawal ceilings for deposits in FX and LL at around US\$1000 and LBP 2 million, per week per account (including businesses), with anecdotal evidence suggesting that many banks are working with lower ceilings on dollar.

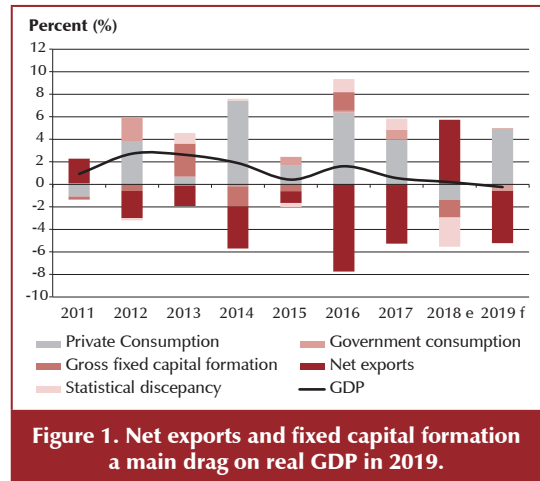
3 In addition to withdrawal ceilings on LL deposits, overdrafts have also been severely restricted and punitive interest rates charged. Overdrafts and other facilities are a main mechanism for short term financing for businesses.

II. MACRO-FINANCIAL CONDITIONS

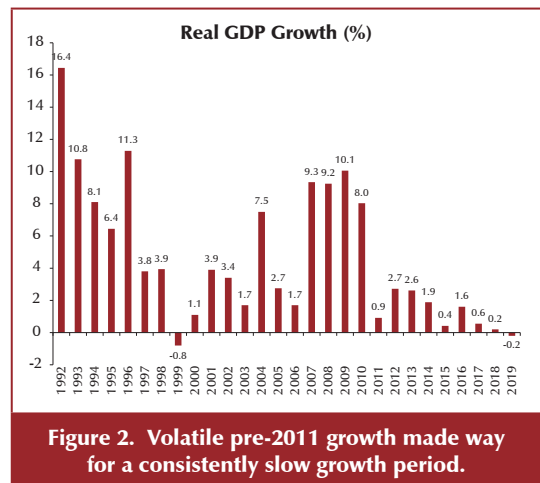
A. Output and Demand

5. **The economy stagnated in 2018 and is expected to contract in 2019.** While growth has been slow since 2011 at the outbreak of the war in Syria, the past couple of years have specifically witnessed a deceleration that is in part due to tightened monetary policy, used in defense of the exchange rate.

6. **High frequency indicators for Q1-Q3 2019 point to a broad-based slowdown, with tourism an exception**—tourist arrivals rose by 7.6 percent, year-on-year (yoy), in the first eight months of 2018 (8M-2019), compared to 4 percent over the same period in 2018. The real estate sector was a main drag on the economy as illustrated by a 29.8 percent and 28.1 percent yoy declines in cement deliveries and construction permits, respectively, over 8M-2019. This compares to respective 4.7 percent and 25.7 percent contractions for the same indicators over 8M-2018. Further, the BLOM-PMI Index, which captures private sector activity, averaged 46.8 in 9M-2019, indicating persistent contraction of activity (<50 represents a contraction of activity). On the demand side, private consumption, boosted by tourism, regains its traditional role of leading real GDP growth (Figure 1). Net exports, on the other hand, is a negative contributor to GDP, as the rise in exports is projected to be more than offset by import growth, with the latter driven by fuel imports; in fact, even as total imports



Sources: CAS and WB staff calculations.



Sources: CAS and WB staff calculations.

rose by 0.9 percent over 8M-2019, non-fuel imports decreased by 15.7 percent, in strong reflection of the sluggish economy.

7. **Post-civil war growth dynamics in Lebanon have undergone multiple structural changes** (Figure 2). Over the 1992-2010 period, growth was characterized by high volatility, resulting from frequent

negative political and security shocks, in sequence with periods of recovery, optimism, international bailouts (i.e. Paris 1, 2 and 3 etc.), and even positive shocks.⁴ Since 2011, however, real GDP growth rates have been persistently sluggish as traditional drivers—real estate, construction, finance and tourism—were greatly afflicted by the regional turmoil. Nonetheless, we can draw a distinction in growth dynamics between the 2011-2016 and the 2017-present periods. Over the former period, real GDP growth average 1.7 percent, as real economy factors were directly impacted by eruption of wars in the region, particularly in Syria. Since 2017, however, real GDP growth decelerated further to average 0.2 percent, as monetary and financial conditions became the main determinant. Specifically, the past couple of years have reflected decelerated growth that is linked to a policy of liquidity tightening meant to counter rising macro-financial risks. This includes a significant decrease in subsidized lending by the central bank, the Banque du Liban (BdL), that was being channeled via commercial banks to (mostly) the real estate sector, providing a rare source of growth impetus since 2012.

B. Fiscal Sector

8. **Following a sharp deterioration in the Government's fiscal position in 2018, a belatedly ratified Budget 2019 aimed for a reduction in the overall deficit via a number of revenue and expenditure measures.** On the revenue side, the 2019

budget included the following measures: (i) raising the tax rate on interest income from bank deposits from 7 percent to 10 percent; (ii) increasing income tax for high-earners from 20 percent to 25 percent; and (iii) raising import tariffs by 3 percent. In regard to expenditures, measures included (i) caps on wages and benefits for public sector employees; (ii) some pensions measures; and (iii) cuts in government purchases of goods and services. While the government aimed to reduce the overall deficit by 4 percentage points (pp) to 7.6 percent of GDP in 2019, its tardy ratification (July) and optimistic revenue projections make this target overly ambitious. Budget 2020 is currently under preparation.

9. **Partial-year fiscal data suggest that improvement in the fiscal position is driven by accumulation of arrears and tightened spending.** Despite an 8 percent decrease in VAT revenues in 7M-2019, reflecting the contraction in the economy, the overall deficit fell by 1.4 pp of GDP, driven by a 9.2 percent decline in expenditures. Similarly, the primary balance improved by 0.8 pp of GDP over the same period to maintain a surplus. Considering that 2019 budget measures were not yet in effect, the improving fiscal balance has been accomplished in part through low quality measures, including accumulation of arrears, cuts in unnecessary spending and the deferment of others. For the whole year, the overall fiscal balance is projected to register a deficit of 9 percent of GDP, with a small primary surplus, compared to overall and primary deficits of 10.7 percent and 1.1 percent, respectively, in 2018.

10. **The changing economic and financial conditions over the past couple of years along with policy changes have structurally weakened Lebanon's fiscal**

4 The global financial crisis of 2007-2008 reaped benefits for Lebanon as the country was perceived as a safe haven for regional capital that was exiting troubled western banks.

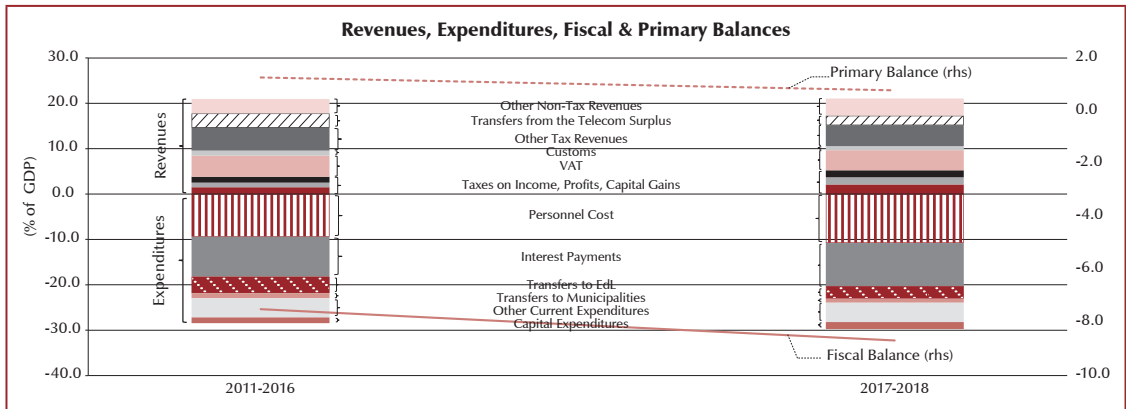


Figure 3. Changes in the fiscal balance have reflected structural changes in the economy as well as policy decisions.

Sources

accounts. A comparison between the 2011-2016 and 2017-2018 period reveals the following (figure 3):

On the revenues side:

- a. Revenues from taxes on income, profits and capital gains have averaged 5.2 percent of GDP over the 2017-2018 period, increasing by 1.4 percentage points (pp) compared to the 2011-2016 period. The increase in this category has been driven equally by income taxes on profits and interest earned. The former benefitted from a surge in 2017, as banks paid taxes on a spike in profits in 2016 (from engaging in BdL’s financial operations), while the latter was a principal revenue measure that was introduced in Q3 2017 as part of the salary scale reforms.
- b. The worsening economy induced softer revenues associated with consumption, which is the largest expenditure component of GDP. Specifically, revenues from Value Added Taxes (VAT) declined from an average of 4.7 percent of GDP over the 2011-2016 period to 4.4 percent of GDP over the 2017-2018 period.

- c. The fall in imports (see Section C) are leading to softer custom revenues, which have fallen by 0.2 pp to average 0.9 percent of GDP in the latter period.
- d. Revenues from the telecom sector have regressed by 1.1 pp to average 2.1 percent of GDP in the latter period. This is a largely unexplained decline.

On the expenditures side:

- a. Personnel costs have risen from an average of 9.4 percent of GDP during 2011-2016, to 10.8 percent of GDP over 2017-2018, driven almost equally between (i) salaries and wages and (ii) retirement and end of service compensation. This is due to the surge in public sector hiring leading up to the 2018 parliamentary elections along with pension implications for the salary scale reforms introduced in 2017.
- b. Despite falling global interest rates, debt servicing has increased over the two periods from an average of 8.8 percent to 9.4 percent of GDP, on account of rising debt levels and higher Lebanese cost of borrowing.
- c. Capital expenditures have risen by 0.4 pp to average 1.6 percent of GDP during

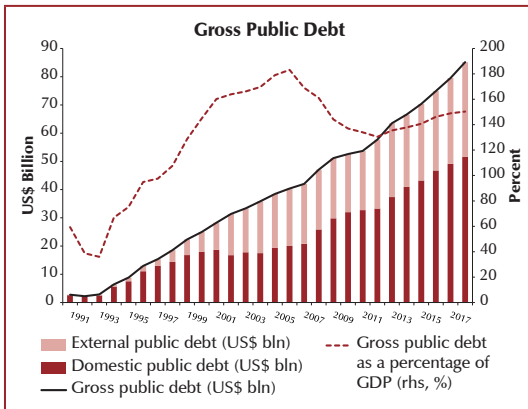


Figure 4: After 2010, the debt-to-GDP ratio regained an upward trajectory.

Sources: BdL and WB staff calculations.

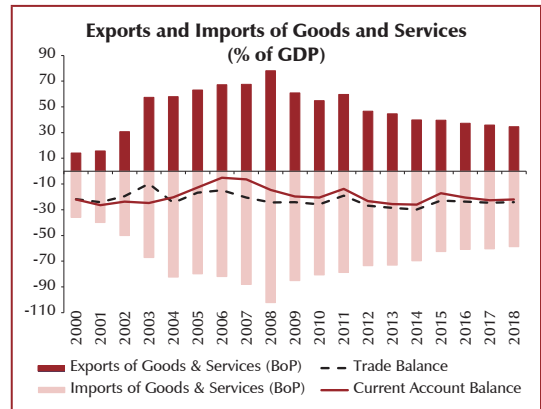


Figure 5: Exports of services have historically helped offset the large structural trade deficit.

Sources: BdL and WB staff calculations.

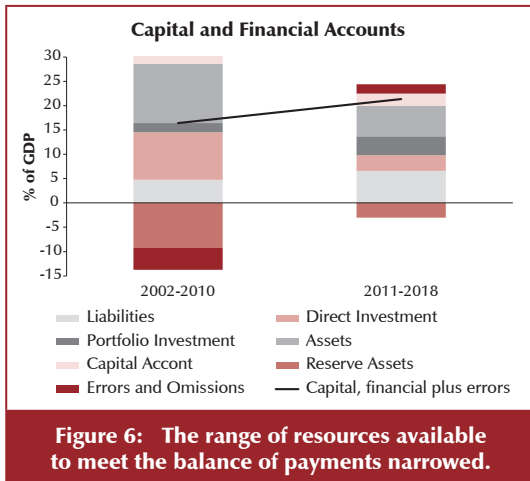
2017-2018. This coincides with the holding of parliamentary elections in 2018 and the resumption of executive and legislative work, following a long period of institutional paralysis.

- d. The increased spending detailed above from 2011-2016 to 2017-2018 has been partially offset by lower transfers to EdL, which decreased by 0.9 pp, constrained by power rationing and lower fuel prices. Savings were also sourced from a halt in payments to the National Social Security Fund (saving 0.2 pp), likely reflecting arrears, and a 0.2 pp cut in transfers to Municipalities due to lower telecom revenues, which constitute a main revenue source for local government.

Overall:

- a. The overall fiscal balance has deteriorated from an average deficit of 7.5 percent of GDP during 2011-2016, to a deficit of 8.4 percent of GDP for 2017-2018.
- b. The primary balance has also deteriorated from an average surplus of 1.3 percent of GDP during 2011-2016, to a surplus of 0.8 percent of GDP for 2017-2018.

11. **The Government has been unable to access the market at reasonable cost since Spring 2019, turning instead to BdL to meet Eurobond redemptions.** On several occasions, the Ministry of Finance (MoF) expressed an interest in accessing the market with new Eurobond issues. However, market appetite has been lacking in part due to: (i) the fact that returns earned by banks on financial engineering operations carried by the central bank were higher than those offered by MoF; (ii) a shortage of liquidity as banks' assets are mostly tied up with the central bank; and (iii) limited appetite from foreign investors given Lebanon's risk profile. As a result, in April and May 2019, BdL repaid, using its foreign exchange reserves, Eurobond maturities of \$500 million and \$650 million, respectively, through bridge financing to the MoF. Overall, the debt-to-GDP ratio is expected to persist in an unsustainable path, at 151 percent by end-2019, with over 60 percent denominated in local currency.



Sources: Bdl and WB staff calculations.

C. The External Sector

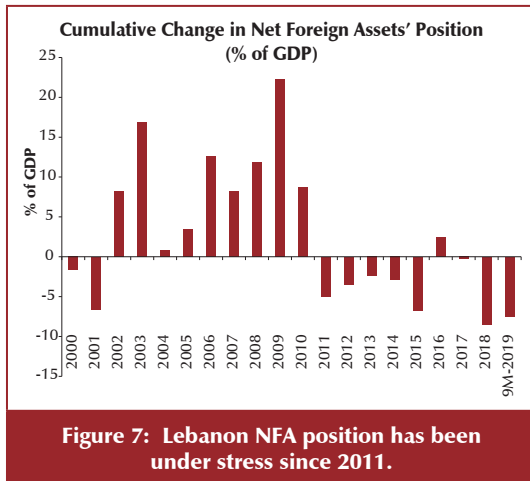
12. **Exports and imports underwent a marked decline over the past decade, reflecting both geopolitical, real economy and financial conditions.** Lebanon's exports (of goods and services) have been severely affected by the regional turmoil, although a decline in their share of GDP has been in effect since 2008, when they peaked at 78.1 percent of GDP (Figure 5).⁵ By 2018, exports had contracted to 34.6 percent of GDP, the lowest share since 2002, with both merchandize goods and services sharing this dynamic. Exports of merchandize goods have been particularly affected by the closure of Syrian routes, through which exporters traditionally accessed the GCC and Iraqi markets. Although some of these routes have since reopened, Lebanese exports have yet to recover substantially, due likely to a combination of informal barriers and lost markets. Exports of services have equally

⁵ While the drop in the GDP share of exports from 2008 to 2010 can be attributed to a denominator effect of exceptionally high GDP growth rates, the following years experienced a decline in the value of exports.

regressed since 2010, dragged by travel and financial services, with the former reflecting a contraction in the tourism sector and the latter a retreat in banks' strategy of regional expansion. Imports of goods and services underwent a similar dramatic shift, falling from a high of 102 percent of GDP in 2008 to a low of 58.8 percent in 2018. As much of the consumption basket is imported, and as consumption is by far the largest component of GDP, lower GDP growth rates will directly impact imports.

13. **The large trade imbalance drives one of the largest current account deficit-to-GDP ratios globally.** Deteriorating economic conditions constrain remittance outflows and can simultaneously incentivize remittance inflows, as expatriates boost assistance to their families at home, leaving net remittances improved. Remittance inflows, however, are also strongly determined by exogenous factors such as economic conditions in host countries and geopolitical tensions. Nonetheless, assuming unchanged conditions, the current account deficit is projected to be close to 21 percent of GDP in 2019, compared to 21.9 percent in 2018.

14. **The economy is structurally and heavily dependent on capital and financial inflows to finance its current account deficit.** This dependence has become more acute as the current account deficit expanded in recent years. In addition, there have been structural shifts in the capital and financial accounts since the period prior to the regional crisis, reflecting a diminished range of resources available for Lebanon (Figure 6). In the pre-Syria war period (2002-2010), the main inflows were sourced from net foreign direct investments (FDI) and net other investments (loans, currency and



Sources: BdL and WB staff calculations.

deposits), averaging 9.8 percent of GDP and 17 percent of GDP respectively, that partially offset an accumulation in reserves asset at an annual average of 9.3 percent of GDP. The war period (2011-present) witnessed a sharp decline in net FDI and other investments, averaging instead 3.2 percent of GDP and 12.9 percent of GDP, respectively.⁶ These, however, were mitigated by a slower accumulation of reserves assets, which fell to 3 percent of GDP.

15. Despite repeated financial operations by BdL over the past few years in support of Lebanon's Net Foreign Asset (NFA) position, the economy has been steadily draining US dollars since 2011—an unsustainable situation for a country with a large current account deficit and a fixed exchange rate. More recently, this hemorrhaging has intensified reflecting diminishing confidence and high-risk premia. The stock of private sector

⁶ Interestingly, an important resource in managing this transition has been a better identification of the balance of payments, as errors and omissions fell from an average outflow of 4.5 percent of GDP in the pre-crisis period to an inflow of 0.1 percent in the crisis period.

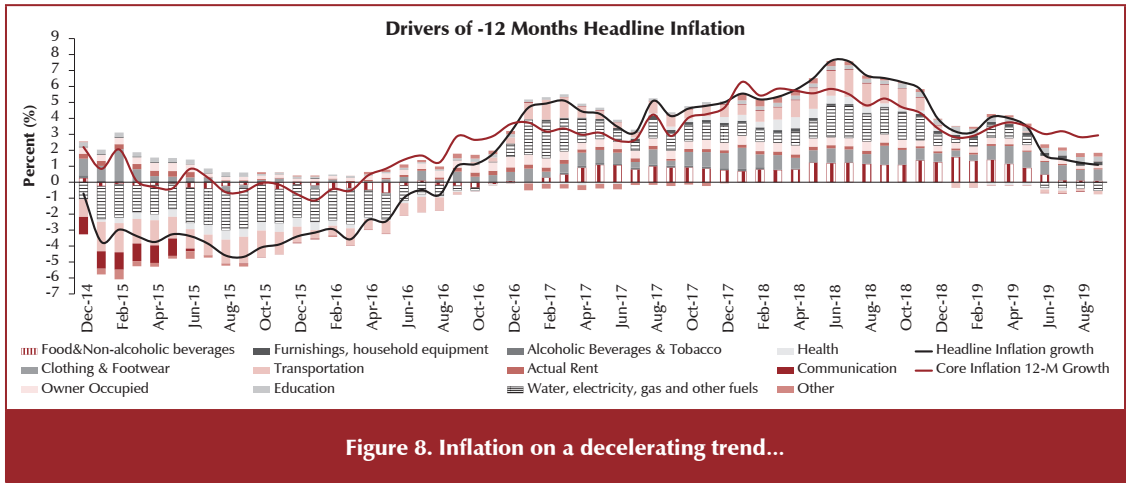
deposits at commercial banks has stagnated in 2019, which, once accrued interest are netted out, implies capital outflows.⁷ Mirroring diminished confidence, the deposit dollarization rate reached 74.4 percent by September 2019, up from 70.6 in September 2018. As a result, the country's NFA position declined by US\$ 4.5 billion over only the first 9 months of 2019 (approximately 7 percent of GDP) (Figure 7). This compares to NFA losses of US\$ 4.8 billion for all of 2018 and US\$ 156 million in 2017. This has reflected on BdL's gross foreign exchange reserves, which shrank by US\$ 5 billion, year-on-year (yoy), to US\$ 38.5 billion by end-July 2019, of which foreign currencies amounted to US\$ 29.3 billion.

D. Money and Banking

16. Following a spike in prices in 2018,⁸ itself a correction on the heels of a two-year deflationary period, the inflation rate is expected to ease in 2019. After reaching a peak in Q3-2018, the 12-month headline inflation rate commenced a marked deceleration (Figure 8). Over 9M-2019, headline inflation rate averaged 2.6 percent driven by average yoy increases of (i) 3.9 percent in the prices of food and non-alcoholic beverages; (ii) 14 percent in the prices of clothing and footwear; (iii) 2.4 percent in house rent prices; and (iv) 5.1 percent in the

⁷ This dynamic was further exacerbated by the closing of loans taken out on cash collateral.

⁸ The inflation rate averaged a 6.1 percent in 2018, in good part due to the salary scale increases in 2017, a strong rebound in commodity prices, especially fuel products, and a low-threshold effect after 2 deflationary years.

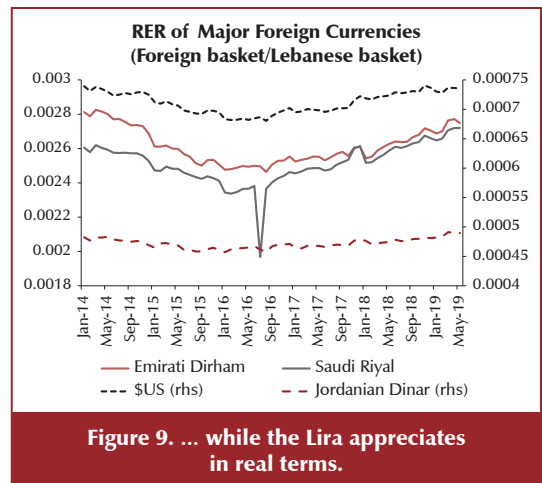


Sources: CAS and WB staff calculations.

cost of education. Similarly, core inflation (excluding food, water, electricity and gas and transportation) increased by an average of 3.2 percent (yoy) in 9M-2019.

17. Lebanon’s real exchange rate (RER) is overvalued and continues to appreciate vis-à-vis major trading partners. Following a steady and prolonged depreciation, the Lebanese pound gained real value with respect to the currencies of Jordan, United Arab Emirates, United States and Saudi Arabia⁹ (Figure 9). Since all aforementioned countries are linked to the dollar, this represents higher inflation rates for Lebanon compared to the others. The appreciation generally began in the second half of 2016, as prices recovered from a two-year deflationary streak. In addition, the pound also appreciated in real terms relative to the Turkish lira, Egyptian pound and Iran’s rial, all of which recently underwent large depreciations.

18. In response to a worsening NFA position, partially induced by domestic



Sources: CAS and WB staff calculations.

political discord, BdL initiated in July 2019 a new financial operation to encourage inflows of hard currency. This involved commercial banks soliciting dollar investors to place medium- (3 yrs) or long-term (10 yrs) deposits at elevated interest rates, which are then placed in term deposits (TDs) at BdL or invested in BdL Certificate of Deposits (CDs). While this operation partially offset outflows, the benefit was temporary and came at a high cost to BdL, with exchange market pressures resuming in September.

9 By May 2019, the Lebanese pound underwent a yoy real appreciation of 3.3, 1.7 and 5 percent for Jordan, USA and Saudi Arabia, respectively.

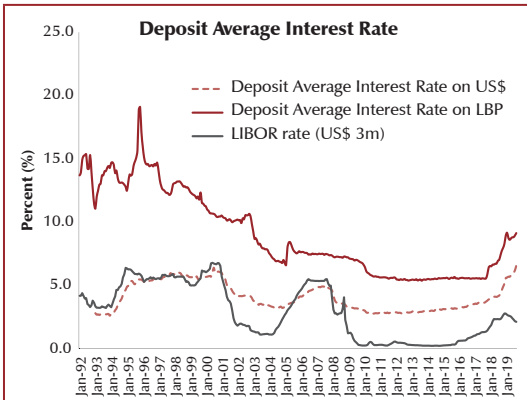


Figure 10. Despite banks offering higher deposits rates...

Sources: BdL and WB staff calculations.

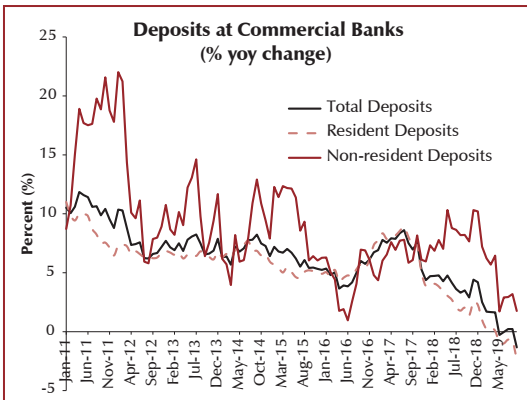


Figure 11. ... total deposits contract for the first time since the early 90s.

Sources: BdL and WB staff calculations.

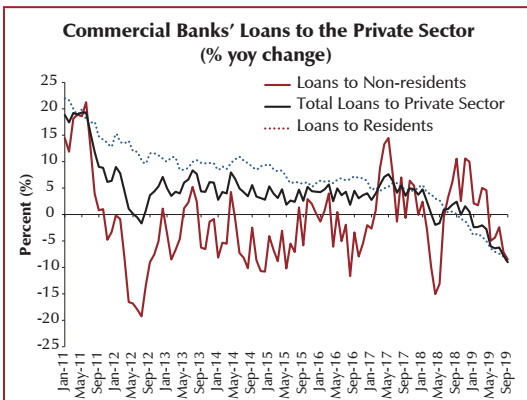


Figure 12. Banks are deleveraging from the private sector ...

Sources: BdL and WB staff calculations.

19. Following exchange market pressures and sovereign downgrades, BdL solicited a single large direct deposit from a foreign investor, signaling an adjustment in its strategy by bypassing commercial banks. In August 2019, BdL announced that it had secured up to US\$1.4 billion as a five-year deposit from a foreign private investor. This transaction is traded in the Euro market

20. In fact, Lebanon entered conditions of high-risk premia since the November 2017 crisis¹⁰, to which BdL responded by significantly tightening monetary conditions using direct, indirect, conventional and non-conventional tools. Subsidized loans backed by BdL to the real economy were curbed and interest rates raised; average interest rates on deposits in US\$ and LL increased by 285 and 357 basis point (bps), respectively, over the October 2017-September 2019 period (Figure 10). A principal objective for the policy-induced monetary tightening has been to boost BdL’s foreign exchange reserves and limit the LL resources in the market that can be used against the exchange rate. This is in a context of surging risk premia and rising dollarization. In August 2019, reflecting heightened macro-financial risk, Fitch Rating Agency downgraded Lebanon by two notches to CCC, followed by a downgrading to Caa2 by Moody’s and to CCC/C by Standard & Poor’s in November (see Box 1).

21. Amid falling confidence, tight monetary policy failed to prevent deposit outflows, while negatively impacting private sector lending. Total private sector

¹⁰ For in-depth analysis, see *De-Risking Lebanon*, the Lebanon Economic Monitor, Fall 2018 Issue. This is generally the period following the resignation episode of Prime Minister Hariri in Riyadh.

Box 1. Downgrading Lebanon

On November 15th, Standard & Poor's downgraded Lebanon's sovereign rating by two notches to CCC, from an earlier B-, with a negative outlook. Prior to that, on November 5th Moody's downgraded Lebanon's sovereign rating to Caa2 with under-review outlook. Fitch had already downgraded Lebanon's sovereign rating to CCC, from B-, on August 23rd. Table 1 below summarizes Lebanon credit ratings by the three main rating agencies: Moody's, Standard & Poor's, and Fitch.

Table 1. Lebanon credit rating by the three main rating agencies.

MOODY'S			STANDARD & POOR'S			FITCH		
Rating	Effective Date		Rating	Effective Date		Rating	Effective Date	
Long term	Caa2	5 Nov. 2019	Long term	CCC	16 Nov. 2019	Long term	CCC	23 Aug. 2019
Outlook	Under Review		Outlook	Negative				
Context			Context			Context		
<ul style="list-style-type: none"> » <i>Description of rating:</i> increased extremely speculative » 8 notches below investment grade (junk) » <i>Countries with the same rating:</i> Argentina, Cuba, Mozambique, 			<ul style="list-style-type: none"> » <i>Description of rating:</i> extremely speculative » 8 notches below investment grade (junk) » <i>Countries with the same rating:</i> Argentina (CCC-), Republic of Congo (CCC+), Zambia (CCC+) 			<ul style="list-style-type: none"> » <i>Description of rating:</i> substantial credit risk » 7 notches below investment grade (speculative) (Fitch has all 5 CCC categories that S&P uses combined into 1) » <i>Countries with the same rating:</i> Zambia, Republic of Congo 		

deposits in commercial banks shrank by 1.3 percent yoy in September 2019, dragged by a 2.4 percent outright contraction in resident private sector deposits, notwithstanding a 1.8 percent rise in non-resident private deposits (Figure 11). On the lending side, commercial banks' outstanding credit to the private sector declined by 9 percent by September 2019, compared to an increase of 2.4 percent in September 2018 (Figure 12). While this deleveraging is shared by both resident and non-resident private sectors, it is heavily weighed toward the former.

22. Banks' asset concentration with the sovereign is a systemic vulnerability. Commercial banks' have long been large

investors in sovereign debt,¹¹ and as a result, have a very high exposure to sovereign credit risk. This exposure continues to increase; Lebanese banks' sovereign debt exposure¹² rose by 514 bps (yoy) to 70.3 percent of banks' consolidated balance sheet by September 2019, of which exposure to the central bank alone constituted 58.2 percent

11 Interest income, as obtained from BilanBanques, amounted to 66 percent and 76 percent of total consolidated banks' income in 2017 and 2018, respectively.

12 The sovereign debt exposure is computed as a ratio of commercial banks' aggregate investment in Treasury Bills and Bonds, Eurobonds and deposits at BdL relative to total assets.

23. Banks pay lower deposit rates relative to comparator countries, a phenomenon largely explained by a captive/home-biased depositor base. In comparison with emerging market risk/return profile, Lebanon’s risk premium has been consistently higher, but interest rates are broadly around the average. As illustrated in Figure 14, risk premia paid on Lebanon’s Eurobonds have been significantly higher than that paid on emerging market debt. However, this has not been compensated for by relatively higher interest rates on deposits (Figure 15). This is explained by a depositor base that is relatively captured as both resident and non-resident depositors¹³ have historically exhibited strong resiliency toward political and security shocks in Lebanon. In addition, there has been strong confidence by depositors in the central bank, which has become renowned for its crisis management successes (2005 Hariri assassination, 2006 war etc.). More recently, the financial engineering operations have helped mitigate the drain from net foreign asset position of the economy, without having to increase interest rates at a time when the risk premium was surging and global interest rates rising. The question of whether there remains discretionary space in the form of interest rate increases, is not clear; while Figure 14 and Figure 15 might suggest so, the captured depositor base lowers the threshold interest rate above which a negative signaling effect might be triggered.

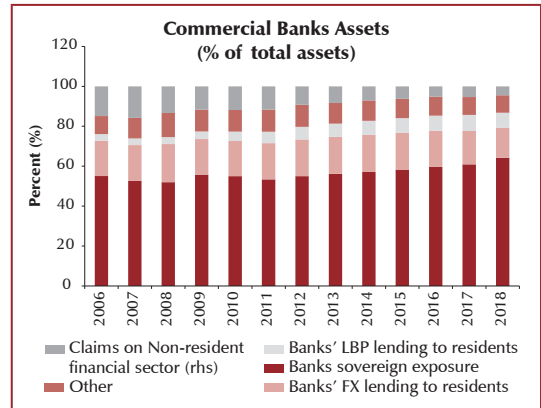


Figure 13. ... as they further concentrate their holdings with the central bank.

Sources: CAS and WB staff calculations.

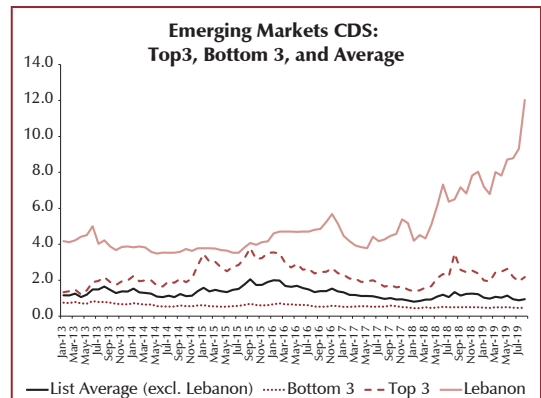


Figure 14. Lebanon’s risk premia have widened significantly compared to emerging markets ...

Sources: JP Morgan and WB staff calculations.

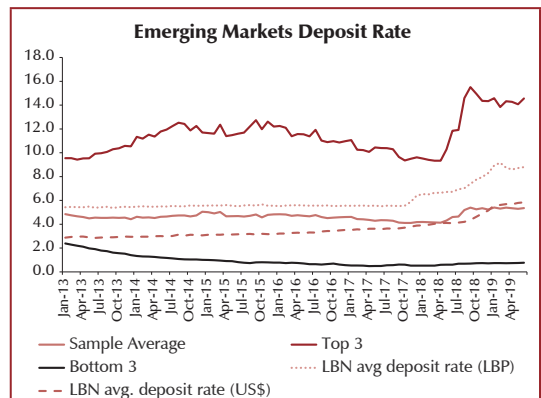


Figure 15. ... but deposit rates in Lebanon are broadly in line with those from emerging markets.

Sources: JP Morgan and WB staff calculations.

13 Lebanese expatriates are the main constituency for non-resident depositors.

III. LEBANON IN CRISIS: CRISIS MANAGEMENT STRATEGY

24. **The Spring 2016 issue of the Lebanon Economic Monitor (LEM) declared Lebanon's socio-economic model bankrupt.**¹⁴ The objective was to warn against the non-sustainable nature of Lebanon's economic model. It was presented as part of an analysis that suggested short-term and medium-term solutions, during a period when Lebanon had a margin of maneuverability in terms of time and resources.

25. **The SCD concludes that at the root of Lebanon's failure to generate inclusive growth and reduce widespread poverty is the presence of two mutually reinforcing and pervasive (overarching) constraints: (a) Elite Capture hidden behind the veil of confessionalism and confessional governance and (b) conflict and violence (stemming, in part, from the broader dynamics of conflict in the Middle East).** While the second constraint is exogenous, largely beyond the control of domestic policy makers, the former is endogenous and subject to the idiosyncrasies of the Lebanese system of governance, especially over the post-civil war period. Institutionalized confessionalism intended as protection for the mosaic of religious sects in a country that lacks a sectarian majority has developed into pervasive elite capture and patronage system. Other (more traditional) constraints are nested within

the two overarching constraints include macroeconomic instability, insufficient investment in infrastructure (especially in lagging regions), weak business environment, mismatch of skills with labor market needs and weak institutions and regulatory framework.

26. **What followed was a series of publications/policy notes in which the World Bank (WB) identified specific structural and sectoral reforms that help mitigate risks and boost potential growth.** In December 2016, the WB published a White Paper which included World Bank staff assessment on needed reforms for a new Government to introduce and implement, following two and a half years of a Presidential vacancy and institutional paralysis. The White Paper¹⁵ presented a menu of priority reforms over two-time horizons—the first 100 days of the new Government, where 10 priority reforms were listed, and the medium term. This list was later developed and attuned in the WB Strategic Assessment of the Capital Investment Plan (CIP) for Lebanon¹⁶ that was presented in the CEDRE conference in Paris in April 2018. The Assessment listed specific structural and sectoral reforms that can enable the Government's CIP.

14 World Bank (2016), *A Geo-Economy of Risks and Rewards*, the Lebanon Economic Monitor, Spring 2016 Issue.

15 World Bank (2016), *Priority Reforms for the Government of Lebanon*, December 2016.

16 Harake, Wissam and Christos Kostopoulos (2018), *Strategic Assessment: A Capital Investment Plan for Lebanon*, World Bank Group, Washington DC.

27. **In the Fall 2018 issue of the LEM, the WB observed that risk premia for Lebanon had sharply increased, driven by a confluence of (local and global) factors and faced with inadequate policy responses.**¹⁷

Fiscal and electricity sector reforms and investments were highlighted as critical short-term initiatives for the Government.

28. **Lebanon is in Crisis.** While it is too early to gauge the economic impact of recent events, it is important to note that even prior to the eruption of the demonstrations, the World Bank projected a small recession in 2019; we now estimate that the recession will be deeper. There has been an unprecedented banking holiday, with banks closed over October 18-31 for retail and other transactions, reopening thereafter with informal capital controls and other uncoordinated measures, then closing again for 10 days on November 9. Critical short-term financing for businesses has been interrupted, leading to disruptions all along the supply chain and an ultimate impact on workers. Unemployment is expected to rise and poverty, already high, will follow. The emerging parallel exchange market is likely to trigger inflationary pressures, hurting the poor and middle class disproportionately. Shortages of imports are also expected to materialize.

29. **Lebanon needs a credible crisis management strategy.** This strategy should involve short-term measures to contain a potential crisis, as well as medium- to long-term measures to address structural issues. Several packages of measures out to be analyzed in light of their impact on the short-, medium- and long-term development of

Lebanon, and in particular, their distributional impacts. With this in mind, below is an illustrative example of what the contour of such a credible strategy could include:

Element 1: Addressing External Imbalances

30. **Lebanon runs a large structural trade imbalance which drives one of the largest current account deficit-to-GDP ratios globally (>20% of GDP), while maintaining a nominal dollar peg to the Lebanese Pound (LBP) set in 1997.** This has resulted in a significant exchange rate overvaluation. The resulting large external financing needs exposes the country to a severe shortage of inflows should confidence were to falter.

Immediate measures

» **Capital controls and other approaches to contain the exit of foreign exchange.**

Capital controls may serve a short-term purpose and need to be carefully designed.

» **Distributional impact considerations & equitable burden sharing.**

Crisis containment measures will have a distributional impact on households, enterprises, investors and banks. It is important to assess the impact of measures on economic agents and to ensure fair burden sharing. Government should set as a policy objective equitable or progressive burden sharing, where equity refers to the ability to contribute and the extent to which one has benefited from the unsustainable accumulation of vulnerabilities.

¹⁷ World Bank (2018), *De-Risking Lebanon, the Lebanon Economic Monitor*, Fall 2018 Issue.

Short-term measures

» **Clear and transparent assessment of fundamentals.**

Once a crisis has been contained, it is important to accurately assess where the economic fundamentals stand, including structural imbalances, risk premia, understand history (past drivers), and assess prospects to ensure that the selected policies are pragmatic and fair.

Element 2: A Progressive Path to Fiscal Sustainability

31. **Lebanon has one of the highest debt-to-GDP ratios globally, accumulated from the accrual of persistent and large fiscal deficits since the end of the civil war.** This imposes elevated gross public financing needs. Lebanon would need undertake a fiscal adjustment policy to rein in its fiscal deficit **using highly progressive measures** that target expensive inefficiencies and realize resources from those who have disproportionately benefited from Lebanon's unequal growth model. On the expenditure side, Lebanon's total expenditures amounted to 31.5 percent of GDP in 2018, of which 9.5 percent of GDP were interest payments and 3.4 of GDP were transfers to EdL¹⁸, leaving little discretionary space and even less capacity for much needed capital expenditures. Proposals include:

Immediate measures

» **Addressing cost of debt.**

The financial sector has been benefitting from an implicit subsidy (a positive 'cost of carry') from the BdL financial operations. One way

of demonstrating that the financial sector is sharing the cost of the crisis is to help reduce the interest burden on the short and medium term (See Special Focus).

» **Reduced pension payouts.**

Immediate measures to better align the public pension system include: to more correctly apply the multiplier rule' for the military to only include hazardous categories and service periods and recalculate accrual rates for all civil servants. Another measure is to limit survivor pensions to spouse and children.

Short-term measures

» **Electricity reforms.**

The loss-making, publicly owned *Electricité du Liban (EdL)* imparts a staggering burden on Lebanon's public finances as structural and large operating losses (dating back to the 80s) are covered by the central government. In fact, annual budgetary transfers to EdL averaged 3.8 percent of GDP over the last decade, amounting to close to half of the overall fiscal deficit. At peak in 2012, the government transferred US\$2.2 billion to EdL, equivalent to 5.1 percent of GDP.

As such, there is a need to: eliminate all HFO and diesel for EDL power generation by securing LNG supply and unbundle gas supply (FRSU) and temporary generation from IPPs; consider also progressive electricity tariff reforms; accelerated reduction of technical and non-technical losses; competitive bids for new IPP Capacity;

» **Unification of tax rates on income by sources.**

Lebanon's tax structure has large variations across income sources and distorts the flow of financial savings away from productive investment. Bank deposits earn relatively

18 In addition to payment of interest and principal on EdL debt.

high returns, which by policy is intended to support the exchange rate. Meanwhile, the government's tax rate on interest earned is 10 percent, compared to 17 and 15 percent on corporations and individuals, respectively. In addition, it is estimated that the largest 1 percent of deposit accounts hold 50 percent of total deposits, while the largest 0.1 percent of accounts hold 20 percent of total deposits (WB-IMF FSAP, 2017). Hence, the benefits of the lower financial income tax rate are highly skewed toward the very rich.

Short- to medium-term measures

» **Financial management and SOE reforms**

Establishment of a Single Treasury Account, eliminate unnecessary Extra Budgetary Funds; Establish transparent accounting and reporting of revenues, costs, investments needs between: (i) OGERO, MoT and MoF, and (ii) Port of Beirut.

Element 3: Regaining Efficacy of Banking Sector

32. **The reliance on continued deposit inflows to fund the large financing needs of both the public and private sectors while ensuring currency stability presents enormous challenges to the sovereign-commercial bank relationship.** The banking sector balance sheet is very large by global standards, at 437 percent of GDP by September 2019. Sovereign exposures amounted to 70 percent of total banking assets. Meanwhile, economic conditions are being reflected on banks' loan portfolio; gross non-performing loan (NPL) ratio (excluding accrued interests on NPLs) has more than doubled from below 5 percent at the end of 2016 to 10.3 percent as of February 2019.

To help address these vulnerabilities, considerations include:

Short-term measures

33. While necessary banking sector and client assessments are being undertaken, the authorities may consider actions on liquidity management and contingency planning, such as:

» **Revise and update bank resolution framework.**

The FSAP¹⁹ discussed the legal reforms needed to ensure that (i) insured deposits remain fully protected; (ii) losses are allocated to shareholders and, as needed, creditors (in accordance with the creditor hierarchy); and (iii) public support to failing banks, if warranted, is minimized.

» **Recapitalization of the deposit insurance fund as needed, and align deposit insurance scheme with best practices.**

The FSAP recommended that in the long-term the deposit insurance scheme "be reformed and made an operationally independent public sector agency, governed by a Board composed of public sector representatives and nonbank private experts, and fully funded on an ex ante basis via industry premiums", with increased coverage and options to finance asset and liability transfers, under the "least cost" criterion, to support resolution.

» **Conduct intensified supervision.**

Update early intervention/prompt corrective action regime for weak banks; and update/activate recovery plans.

19 World Bank-IMF Financial Stability Assessment Program (2016).

Short-term measures

» Strengthen NPL resolution.

The authorities could consider imposing regulatory requirements to promote timely NPL recognition and provisioning, providing supervisory guidance for banks to develop a credible NPL management and recovery strategy; Review existing out-of-court workout framework; Consider NPL resolution infrastructure options (AMC, decentralized bank-led strategy, immediate private/market solutions, depending on composition of NPLs and legal framework for insolvency and creditor rights).

Element 4: Strengthened Social Safety Nets

34. **Pre-existing inequities and social disenfranchisement will be further aggravated in the event of a crisis or a severe recession.** In order to cushion these negative effects, Government could consider programs designed to respond to the short-term needs of the poor. The measures could become part of Lebanon's long-term social protection and human capital development system. Four short- and medium-term mitigating measures could be considered:

- » (i) scaling up the e-card food voucher of the National Poverty Targeting Program (NPTP); (ii) providing an education cash transfer for children from extreme poor households who are vulnerable to dropping out of schooling; (iii) increasing access to quality healthcare for poor Lebanese; and (iv) a wage subsidy scheme for youth.

Element 5: Boost Growth and Forcibly Tackle Governance

35. **Illegal activities are not sanctioned by the state when they involve politically or confessionally connected or wealthy actors, exacerbating elite capture and the patronage system.** This has been fertile grounds for corruption, nepotism and inequality; Transparency International's Corruption Perception Index 2019 ranked Lebanon 138 out of 180 countries worldwide in 2019, indicating endemic corruption in and making Lebanon among the 50 most corrupt countries in the world. Suggested measures include

Short-term measures

- » **Annulment of Exclusive Agencies and liberalization of the brand retail sector.**

Lebanon's Legislative Decree No. 34 of 1967 grants exclusive agencies and sole distribution rights to importers of all products excepting foodstuffs, washing products. This undermines competition and efficiency and facilitate collusive behavior.

- » **Law on the recovery of Stolen Assets.**

A main impediment to fighting corruption is a lack of a well-articulated judicial process on how to recover assets that were obtained in illegitimate ways.

- » **Adopt a new Public Procurement Law that is aligned with international best practices.**

Corruption and clientelism are particularly pronounced in the public procurement market. Thirty percent of the 561 firms surveyed by the Enterprise Surveys state that they are expected to give gifts to secure government contracts. This should also

include limits on Ministers' ability to procure projects independently.

» **An independent and effective judiciary.**

The judiciary is the Government's main antibody against corruption. Currently, Lebanon's judiciary suffers from significant political and other (ie. financial) interferences and distortions. Progress on fighting corruptions cannot be realized if deficiencies within the judiciary are not addressed.

Medium-term measures

» **Passage and implementation of a new Competition Law that is aligned with international best practices.**

Unlike many of its peers, Lebanon lacks a competition law, which would establish an antitrust enforcement framework that prohibits anticompetitive agreements, abuse of a dominant position and anticompetitive concentrations (mergers).

» **Telecom reforms.**

The adoption of a unified vision for the ICT sector and clear consensus on policy; Standardization of the terms and conditions of all Data service providers licenses (among others revenue sharing, right to build infrastructure, spectrum usage); Standardization of the terms and conditions of all Data service providers licenses (among others revenue sharing, right to build infrastructure, spectrum usage); Drafting clear, transparent and non-discriminatory terms and conditions for access to MoT fiber infrastructure (prices, methods of allocations, SLA, etc...)

36. Lebanon's macro-financial stresses are dictating that resources and policy attention are directed towards meeting

the economy's short-term financing needs, especially those denominated in dollars.

This involves financing needs for both the public and private sectors, with the latter the larger of the two. For the public sector this is concentrated on meeting Eurobond coupon payments and maturing Eurobonds. Financing needs for the private sector is more complicated, generated from banks' deposit rates and imports that reflect and affect real economy conditions. Falling confidence works as a downward spiral that raises financing needs (higher Eurobond coupon and deposit rates), increasing expectations of a default, which further lowers confidence.

37. The Special Focus identifies credible financing and debt management strategies for the public sector in Lebanon.

These strategies aim to complement macroeconomic and structural reforms in order (1) for Lebanon to achieve sustainability in its public debt over the medium-term; and (2) to create necessary fiscal space in the short term for the Government to redirect scarce resources toward more productive sectors of the economy. A caveat is that financing strategies for the public sector, including in dollars, remain incomplete as the bulk of the economy's financing needs are in the private sector. Nonetheless, achieving debt sustainability and creating a fiscal space are important components of macro-financial stability, largely via the confidence channel in the short-term and enhancing potential growth in the medium to long term.

SPECIAL FOCUS

DEBT MANAGEMENT STRATEGY AND FINANCING OPTIONS FOR LEBANON²⁰

Summary

38. **In response to a request from the Ministry of Finance, the World Bank conducted an analytical exercise to identify a credible financing and debt management strategies for Lebanon.** These strategies aim to complement macroeconomic and structural reforms in order (1) for Lebanon to achieve sustainability in its public debt over the medium-term; and (2) to create necessary fiscal space in the short term for the Government to redirect scarce resources toward more productive sectors of the economy. Common to all of the options is that they are temporary and preconditioned on structural and macroeconomic reforms that achieve substantial cost savings.

39. **The Medium-Term Debt Management Strategy (MTDS) Analytical Tool, developed by the World Bank and the IMF, has been applied for the underlying analysis of the different options.** While the exercise is quantitative, analysis of

the various scenarios also contextualized political economy implications and financial market reactions. This technical exercise aims to inform political leadership, who will ultimately make final debt management decisions.

40. **Public debt in Lebanon is on an unsustainable path.** The debt-to-GDP ratio is at around 150 percent and almost half of government revenues are directed towards interest payments. Under current policies, debt-to-GDP will be increasing to 175 percent in five years, and well above 200 percent in ten years. For debt to stabilize relative to GDP under current macroeconomic policies and interest rates, real growth would have to be more than 4 percent or more annually, from current zero growth; for sustainability it is helpful that inflation remains above three percent. **Meanwhile, interest cost will consume most of the government revenues.** In 2019, interest payments on public debt consumed almost half of government revenues and that share is projected to increase to 65 percent in five years (14 percent of GDP) and more than 80 percent in ten years.

41. **Stabilization or structural improvement of the debt overhang can only be achieved with structural and macroeconomic reforms that can generate economic growth.** Simulations show that if structural and sectoral reforms are implemented, leading to restored confidence, lower market interest rates and a 'growth dividend' of 1.5 percentage points, debt-to-GDP could fall. Financing measures

20 The authors are Wissam Harake (Senior Economist), Lars Jessen (Lead Debt Specialist) and Patrick van der Wansem (Consultant).

can supplement that impact with a further 7-8 percentage point reduction in the Debt-to-GDP ratio.

42. **For financing measures to have an additional and sustainable impact, they would need to be conditional on decisions and implementation of the reforms.** Financing measures can generate meaningful fiscal space through lower cost of debt. Simulations show that (temporary) savings on interest can be 10-15 percentage points as a share of revenues.

43. **From a wide spectrum of options to reduce the debt cost for the government, the analysis focused on local, temporary, concessional new financing measures.** In principal, concessional financing can be backed up by international donors. However, the focus here is on domestic solutions as this is predicted by the fact that the bulk of Lebanon's creditors are residents. With this being a rare advantage, it is critical for this resource not to be wasted. As such, concessional financing provided by domestic investors in government bonds needs to be strictly aligned to a multi-year reform program. Moreover, alternatives are either not very likely, have limited impact or could be destabilizing. With concessional financing, several realistic variations have been simulated and reviewed. The most important impact is the creation of fiscal space for Government; concessional financing, in combination with structural and macroeconomic reforms, can bring down interest cost up 25 percent (amounting to more than LBP 2,500 billion) compared to the reform scenario without financing measures, thus reducing the ratio of debt interest payments-to-revenues, at least temporarily, to around 32 percent in 2023 (instead of 60 percent under unchanged policies).

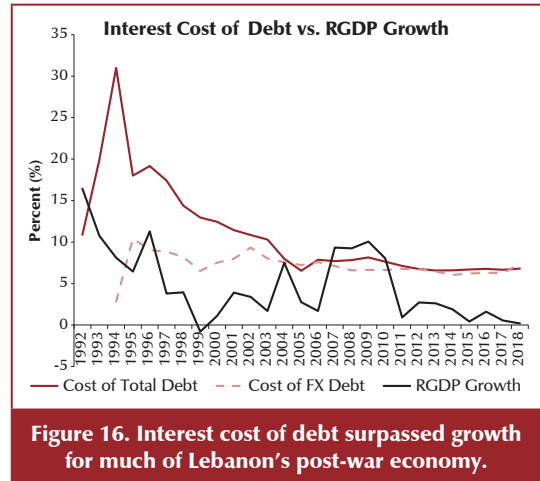


Figure 16. Interest cost of debt surpassed growth for much of Lebanon's post-war economy.

Sources: Lebanese authorities and WB staff calculations.

44. **A main driver of debt dynamics in Lebanon has also been elevated cost of debt.** Cost of debt has been traditionally high, with annual yields on the 2-year Treasury Bonds (TBs) averaging 27 percent between 1991-1993, the early years of reconstruction. While having declined appreciably since, the cost of debt²¹ has remained significantly higher than real GDP growth rates, driving a persistently higher debt-to-GDP ratio (Figure 16). The exception has been the period of above potential GDP growth rates between 2007-2010, which led to the afore-described decrease in the debt-to-GDP ratio.

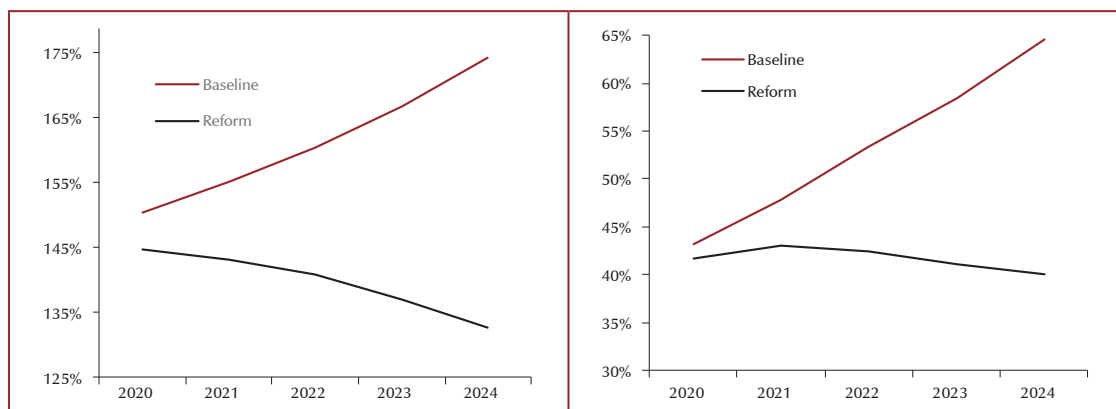
Reform Scenario

45. **The Government of Lebanon committed under CEDRE to an ambitious fiscal consolidation program.** The government presented at the CEDRE conference a Vision for Stabilization, Growth and Employment in which it pledged "a fiscal consolidation of 5 percentage points of GDP

21 Cost of debt in this case is proxied simply by calculating the interest payments at time t divided by stock of debt at time (t-1).

Table 2. Indication of size of assumed reforms, in percent of GDP and in currency amounts²²

Projected reforms		2020	2021	2022	2023	2024	Average
Primary balance	% GDP	0.5%	1.5%	2.5%	3.5%	4.5%	
Impact of reforms	LBP	254,162	1,071,987	1,216,055	1,395,696	1,572,662	1,102,112
	USD	169	711	807	926	1043	731

**Figure 17. Debt to GDP (left) and interest to revenue (right) under scenarios of unchanged policies and reforms**

Sources

over the next five years (i.e. one percentage point a year). This will be achieved through revenue measures, including improved collection and a reduction of loopholes, as well as a reduction in spending where possible, including through a reduction in the government's transfers to EdL which averages around 3.8 percent of GDP, as part of a broader effort to improve cost recovery in infrastructure services." Additionally, the Ministerial Statement for the new government states "Commit, as of the 2019 budget, to implement a financial correction by reducing the budget deficit by no less than 1 percentage point of GDP per year for five years, by increasing the revenues and reducing the spending, starting with reducing the annual deficit of *Electricité du Liban*, until ending it".

46. The reform commitments imply an improvement of the primary budget in the amount of about LBP 1,100 billion on average per year, moving the primary balance to a surplus of 3.5 percent of GDP by 2023. Figure 17 below compares the projected trajectory of debt to GDP under a scenario of unchanged policies and a reform scenario. Under current policies, economic growth and market prices are unlikely to improve, with debt and debt service persisting on an unsustainable path reaching, respectively, 175 and 65 percent of GDP in just the next five years.

²² This and all proceeding simulations in this note have used the year 2019 as base year and 2020-2024 as complete calendar years of simulations. Hence, 2020-2024 denote years 1-5 post reforms and/or measures taken.

47. **The reforms will have both direct and indirect impact on the debt overhang.** A sustained and ample primary surplus can break the deficit-debt spiral. While tight fiscal policy may initially suppress economic growth, this is expected to be outweighed by the restoration of confidence that is so vital to the Lebanese economy. This, in combination with effective implementation of a capital investment program, which prioritizes strategic infrastructural bottlenecks and allows for increased private sector participation, can generate a growth dividend, enabling interest rates to fall from the current high levels. These indirect effects have been incorporated in the quantitative model (see Annex I for macroeconomic assumptions on the different scenarios).

Options for Lowering Interest Cost

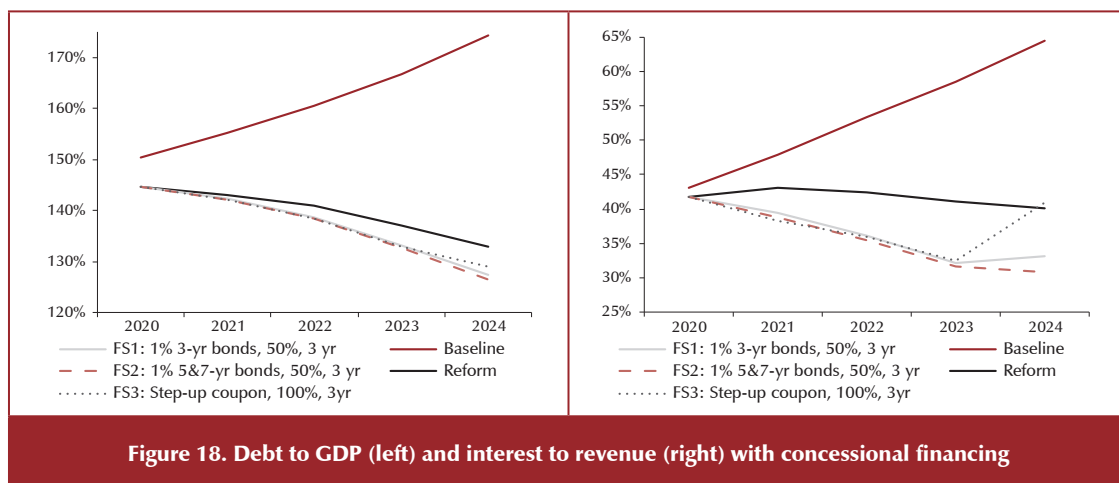
48. **As part of a structural and macroeconomic reform package, financing measures can reinforce the positive impact on Lebanon's fiscal position, especially with regard to the fiscal space.** While structural reforms are the main instrument to achieve debt stability or debt reduction, financing measures can reinforce the positive dynamics by generating necessary fiscal space for the government. It is also a tool that can facilitate the sharing of the reform burden among different sectors of the economy, including the financial sector. World Bank has considered a wide spectrum of financing options and financial operations that could lower interest cost and help restore fiscal space for more productive expenditures.

49. **After reviewing various strategies, the focus was narrowed to concessional**

financing measures. More than 10 different strategies were reviewed, some with several variations, to reduce the (cost of) debt with considerations for qualitative and quantitative merits and risks. In terms of the potential efficacy for reducing debt and cost, concessional financing concurrent with the reform program can be very effective, as is demonstrated below. It implies that the government will receive new financing, in Lebanese lira and in US dollars, well below market cost for some time during the reform period.

50. **There is an economic equity case for the burden of fiscal reforms to be shared across income strata.** Fiscal consolidation measures are generally socially painful. Commercial banks are viewed to have greatly benefited for many years from investing in government bonds. In fact, since the economic downturn in 2011, the banking sector has posted high profits as it benefited from financial engineering operations. It is important to stress that any option with implications for the banking system would need to be assessed within a more comprehensive macro-financial stability framework.

51. **The quantitative consequences of concessional financing for alternative options have been simulated.** The key indicators for measuring effectiveness of the various strategies are: (a) the ratio of debt to GDP, which is relevant for long-term debt sustainability; and (b) the ratio of interest cost to government revenues, reflecting the fiscal space available for Government. The average interest paid on the debt is included as an additional indicator. As described in the previous section, both are currently unsustainably high. The quantified impact of alternative financing operations has



Sources

been based on the MTDS Analytical Tool as developed by World Bank and IMF.

52. **Of the possible combinations of key terms in concessional financing, three possible strategies have been selected: Financing Strategy I (FSI), Financing Strategy II (FSII) and Financing Strategy III (FSIII).** Specific terms of these instruments are detailed in Annex II. The variations are merely an illustration. Ultimately, any strategy is an outcome of negotiations. With that in mind, we describe the main characteristics and variations for FSI, FSII and FSIII, namely:

i. **On concessional period:**²³

- FSI, FSII and FSIII offer concessional terms over 2020, 2021 and 2022;

ii. **On instrument/bond maturity:**

- FSI: three-year maturity for bonds denominated in both LBP and US\$;
- FSII: US\$-denominated bonds have a maturity of five years and LBP-bonds have a maturity of seven years;

- FSIII: a range of maturities that reflect the current portfolio—7 to 10 years for US\$-denominated bonds, and 3 to 10 years for LBP-denominated bonds;

iii. **On coupon rate:**

- FSI, FSII: a highly concessional rate of one percent;
- FSIII: a step structure, where bonds pay one percent over the concessional period (2020, 2021, 2022) automatically reverting to current market rates thereafter;

iv. **On volumes:**

- FSI, FSII: half of the Government's financing needs in LBP and US\$.
- FSIII: all of the Government's financing needs in LBP and US\$.

53. **The impact of all three strategies would be material, creating savings of up to LBP 2,800 billion (about US\$ 1.9 billion) in the budget by 2024.** The interest cost-to-revenues ratio would drop from the current 45 percent to about 32 percent by 2024, compared to strongly increasing

23 This is the period during which bonds with concessional terms are issued, after which Government returns to market terms.

Table 3. Cost of debt in 2024 under different scenarios (2019: 6.7 percent)

Scenarios	2024
Baseline	9.1%
Reform	7.2%
FS1: 1% 3-yr bonds, 50%, 3 yr	6.6%
FS2: 1% 5&7-yr bonds, 50%, 3 yr	5.8%
FS3: Step-up coupon, 100%, 3yr	7.6%

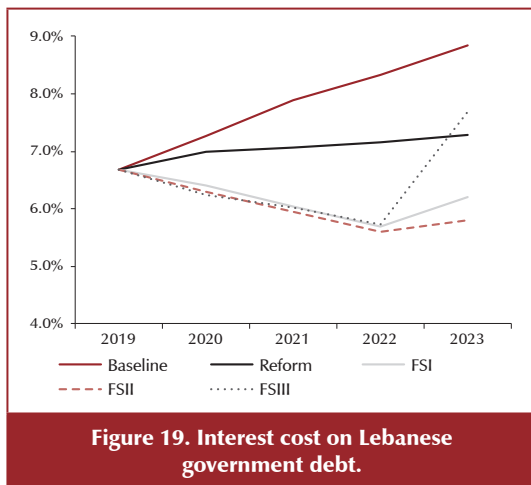


Figure 19. Interest cost on Lebanese government debt.

Sources

under current policies; or merely stabilizing under reforms without financing measures. Due to the step-up to current high interest rates, savings generated from FSIII are temporary and fade out in subsequent years. It is important to note that this would have significant fiscal implications and would need government to prepare in advance for mitigation measures, otherwise fiscal stresses can be sudden and sharp. To a lesser extent, this also applies to FSI. Additionally, the simulations also suggest that FSI, FSII and FSIII would contribute a reduction of around 7 percentage points in the debt-to-GDP ratio, on top of the reductions generated from reforms (Figure 18).

54. **Alternatively, the impact of the different strategies can be measured by the average interest cost of debt.** Whereas the indicators above are connected to the macro-fiscal context, the interest rate indicator is a more direct financial indicator. Those interest rates are averaging rates on old debt as well as on marginal new financing. Still, the current situation is grave enough that the impact of the different strategies clearly comes out (Table 3, Figure 19).

Burden Sharing

55. **The financial sector been benefitted from a positive ‘cost of carry’ on the difference between long-term government bonds and central bank bills on the one hand, and shorter deposits on the other.** Government financing in past years has followed a prudent approach of issuing longer-term maturities as much as the market would allow. This has reduced refinancing and interest rate risks and has allowed existing debt to carry a lower interest rate than current market yields. These policies were supported by BdL which transformed some of that debt using central bank CDs with even longer maturities. As a result, liquidity was locked in, strengthening financial stability. In return, banks were

Table 4. Cost of carry of concessional financing, in US\$ millions²⁶

Cost of carry impact	2020	2021	2022	2023	2024	2025	average
FS I	-518	-770	-1,100	-695	-330		-683
FS II	-518	-770	-1,100	-1,100	-1,100	-1,017	-934
FS III	-647	-842	-1,134	-	-		-875

protected against the transformation risk from short-term deposits into long bond investments.²⁴ This protection has come in the form of an implicit guarantee by the central bank to prevent individual bank failures – typically by arranging/subsidizing takeovers of vulnerable banks. As a result, the financial sector profited from the difference of high, long rates and the rates on (shorter) deposits, in what appeared to be a relatively safe manner.

56. More recently, successive financial engineering operations initiated by BdL and intended to reinforce the economy's net foreign assets (NFA) position and boost bank capital – in light of decelerating capital inflows – have provided additional profits to banks, with cost carried by BdL. Since 2011, the economy suffered 5 consecutive years of decline in its NFA position, a unique condition and an appreciable vulnerability for Lebanon. In response, BdL initiated its first large scale financial engineering operation in

2016 in the form of a SWAP, with the intention of attracting inflows into the country and boosting its own stock of foreign exchange reserves as well as banks' capital base.²⁵ This was followed by other SWAPs with differentiated terms but similar objectives of reinforcing the economy's NFA position, and more specifically, increasing BdL's stock of foreign exchange reserves. Common to all operations is a type of premium offered by BdL to incentivize banks to engage in these SWAP operations. The cost has been carried on BdL's balance sheet.

57. As far as burden sharing is concerned, the potential contribution from the banks should be defined by the negative cost-of-carry. Banks invest the deposits they receive in government bonds, but with concessional financing, the return rate is below the cost basis, the deposit rate. In the simulations, this negative carry would start at US\$ 500 million. As a reference for how much the banks could potentially contribute, the estimated total profits of the

24 Under the latest BIS Basel III prudential rules, which may not yet apply in Lebanon, two ratios regulate liquidity requirements of the banks: The Liquidity Coverage Ratio (LCR) for short liquidity and the Net Stable Funding Ratio (NSFR) for long-term liquidity. The LCR relates eligible high-quality liquid assets (HQLA) – consisting primarily of sovereign debt and reserves held at central banks – to theoretical net cash outflows over thirty days in the event of a severe liquidity shock. The NSFR requires that assets maturing in more than one year (weighted) and certain off-balance sheet items are 100 percent covered by available stable resources.

25 For more in-depth discussion of BdL's 2016 financial engineering operations, refer to: World Bank (2016), *The Big Swap: Dollars for Trust*, the Lebanon Economic Monitor, Fall 2016 Issue.

26 The assumption is that the fall in interest rates in the reform scenario applies also to deposit rates, i.e. US\$ deposit rates fall from the current level of 4.90 percent to 4 percent as of 2020; the LBP deposit rates fall from 8 to 6.5 percent. Coupons are paid in the following year (a simplification in case of semi-annual coupons).

Lebanese banks were around US\$ 2.5 billion in 2018. Thus, in the first year of concessional financing, the cost would be around 20 percent of 2018-profits; it should be noted that BdL expects bank profits to be lower in 2019. In following years, the cost would increase due to accumulation of concessional financing. Under FSIII, the strategy with step-up coupons, the burden would be confined to three years; with FS I and FS II, the burden is dependent on the maturities of the bonds, making FS II with the longer bonds clearly the costliest alternative for banks.

Alternative Financing Strategies

58. **The study considers a wide spectrum of alternative financing strategies that could lead to a reduction in the cost of debt.** Many strategies have been simulated and the quantitative and qualitative features have been reviewed. In addition to the option of concessional financing described above, alternative strategies and their impact are briefly outlined below.

Variations in concessional financing

59. **There are multiple strategies possible for concessional financing other than those discussed above.** The study examines concessional financing over shorter versus longer periods, i.e. one year and up to five years.²⁷ The impact of just one year of concessional financing has a limited impact. On the other hand, a more gradual but

extended support has ultimately a very similar impact to concentrating the concessional financing to three years. Concessional financing with longer maturities obviously has a stronger impact compared with a three-year intervention.

External donor support

60. **Substantial and credible economic reforms may entice external donors to provide budgetary support in the form of grants or guarantees.** External project financing, especially under the CEDRE commitments, are separate from general budget financing and are left out of the debt management challenges addressed in this report. However, in view of those commitments, it is considered less likely that donors will be prepared to provide budget support. Nevertheless, the impact of financial support in the form of grants or guarantees on international bonds has been analyzed. It is assumed that bond guarantees are provided without premium, as market-based premia would do little for a reduction of debt cost.²⁸ In other words, the donor-element is effectively the guarantee premium absorbed by the donor. The simulations assume either a one-off grant of US\$ 2 billion or guarantees for US\$ 5 billion Eurobonds; such contributions may not be very realistic, but even then, the impact on the debt indicators is limited. Quantitative analysis shows that bond guarantees tend to be more effective than grants with regard to interest cost, but grants are more effective in reducing debt to GDP.

27 For simulations of the latter, the share of concessional financing can be assumed constant or gradually regressing from 50 to 10 percent of the government's financing needs in each of US\$ and LBP.

28 Structures with market-based premia would only help to gain international market access when stand-alone access would not be possible, for example due to a rating's downgrade.

Taxation on banks

61. **Another option is to introduce a tax on banks as a measure to directly share the burden of the reforms.** In contrast to other financing options in this report, such a measure would be a matter of fiscal policy and the prerogative of Government and Parliament. These taxes should not replace other fundamental reforms that are required. From a quantitative perspective, the taxation on bank profits is assumed at US\$ 750 million, or 30 percent of estimated gross profits in 2018. This is equivalent to 1.3 percent of GDP per year and is in the order of the cost of the concessional financing above. The taxation leads to a cumulative improvement in the debt-to-GDP ratio by 4.5 percentage points over five years. There is a marginal improvement on the interest-to-revenue ratio, which can be explained by the relatively high cost of new financing compared to alternative financing strategies. Obviously, a change in taxation would require Parliamentary approval.

Shift towards variable and short-term debt

62. **The least effective option to reduce debt cost is to tap new financing using shorter maturity and variable rate bonds.** This is a completely market-based solution with no contributions from concessional instruments. Interest rates for shorter maturities are generally lower than those for long maturities, reflecting a positively sloped yield curve. For example, the difference between the 15-year bond and the 6-month treasury bill yields is currently about five percentage points. While this option does little for the debt-to-GDP ratio, it does gradually create additional fiscal space, running up to almost LBP 1 billion (US\$ 670 million) after five years; (shorter

maturities in US\$ have been ignored as the flat yield curve would barely produce a cost reduction). As a consequence of shorter-term issuance, the profitability of the banks would be affected. As far as the government is concerned, a strategy of issuing mainly short-term debt would reverse the policies of the past years, which centered around extending the average maturity. More short-term debt raises the refinancing risk, which might not suit the fragile Lebanese situation. In addition, more exposure to variable interest rates is riskier; while Lebanon's fiscal position can benefit from lower rates that might result from successful reforms, it can also be exposed to higher rates that can result from volatile security and geopolitical developments, as well as from global monetary conditions. The instrument, also known as a floating rate note (FRN), would be new and demand for the product would need to be tested. A challenge from a practical point of view would be identifying a proper and market-based reference rate.

Zero-coupon bonds

63. **In theory, debt cost on a cash basis could be reduced by issuing zero coupon bonds.** From a budget perspective, under cash accounting rules, long-term zero-coupon bonds can be attractive as they have no interest cost until repayment. However, there is a balloon-payment at maturity which increases refinancing risks. The advantages for the Government of Lebanon of issuing zero-coupon bonds would appear to be quite limited. While it is possible to reduce interest cost, this relief would be temporary, since the interest payments are pushed to the maturity date of the bond. Also, there may be negative signaling effects, since only countries under very substantial financial

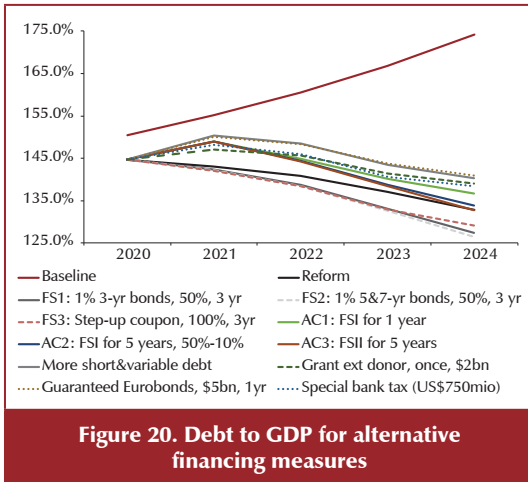


Figure 20. Debt to GDP for alternative financing measures

Sources

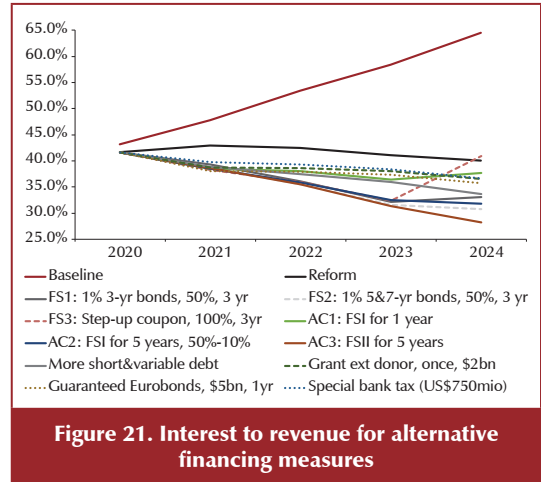


Figure 21. Interest to revenue for alternative financing measures

Sources

stress have been issuing zero-coupon bonds.

Summary of Strategies

64. **The simulations of the different measures illustrate the extent to which financing measures may contribute to Lebanon’s fiscal position.** Figure 20 and Figure 21 below compare the impacts of FSI, FSII and FSIII, as well as those for most of the alternative strategies discussed above. The thick (blue and black) lines are the same as those in Figure 17, showing paths for the baseline case (no reforms) and the case of reforms. We can also note that most strategies have an impact on debt to GDP. There is however larger dispersity on how the strategies affect the indicator of interest to revenues. For that indicator, concessional financing has the largest, albeit temporary impact. It should be stressed again that while the data presented in this report are mere simulations based on a set of assumptions and cannot be viewed as real projections, they are based on an internationally renowned and tested methodology and uses

the most updated information set available at the time.

65. **The duration of financing measures has a major influence on the results.** The study reviewed periods of one, three and five years. Structural reforms take several years to implement, justifying multi-year financing measures. Three years of financing measures have been the basis for most simulations.

66. **Support for a concessional financing strategy stems from a qualitative and quantitative assessment of feasibility and impact.** As can be seen from Figure 20, the impacts on the debt-to-GDP ratio goes in the same direction for most strategies, with concessional financing having the strongest effects. Regarding the interest cost-to-revenues ratio, while the results are more dispersed, concessional financing over at least 3 years offer the best results.

67. **More fundamentally, the results show that with realistic options, Lebanon’s fiscal position can be put back on a virtuous fiscal path.** The simulations demonstrate that a combination of structural

Table 5. Macro-fiscal assumptions – unchanged policies

Baseline	2019	2020	2021	2022	2023	2024
Real GDP growth (%)	-0.2	0.3	0.4	0.5	0.5	0.5
GDP deflator (%)	6.2	3.1	3.3	3.4	3.3	3.4
Nominal GDP growth (%)	6.0	3.4	3.7	3.9	3.9	3.9
Nominal GDP (LL bn)	90,495,672	93,578,142	97,073,705	100,875,157	104,807,571	108,908,772
Total govt revenue (% GDP)	20.5	21.8	22.0	22.0	22.0	22.0
Primary expenditures (% GDP)	20.3	21.8	21.6	21.5	21.5	21.5
Primary balance (% GDP)	0.3	0.0	0.4	0.5	0.5	0.5

and macroeconomic reforms and financing measures have the potential of bringing Lebanon back into a more sustainable macro-fiscal situation.

ANNEX I:

MACRO-ECONOMIC ASSUMPTIONS OF QUANTITATIVE ANALYSIS

68. **The financing strategies in this report have been analyzed in the context of two scenarios for macro-economic and interest rate projections: a baseline scenario and a reform scenario.** This helps segregate the impact of these strategies from that of the reforms.

69. **The baseline scenario is the current outlook that reflects the status quo and precludes reforms and the capital investment program (CIP).** WB outlook have been used for these projections.

70. **The key characteristics of the baseline scenario are:**

- **Sluggish economic activity** with almost no real economic growth;
- **A primary balance** trajectory which starts from a deficit under current fiscal conditions but that converges to balance. The downside risk is that the low economic growth leads to a worsening of the fiscal situation;
- **Sizable financing needs** driven by the large twin deficits, unsustainable public debt and volatile market sentiment;
- **Elevated risk premia** reflected by the persistence of relatively high interest rates, in light of the large financing needs. Both Eurobonds and TBs with longer maturities are assumed to remain above

10 percent reflecting current valuation of risks, especially credit risk, and by extension, credit spreads for Lebanon. While international investors have limited holding of Lebanese Eurobonds (estimates range between 20 and 30 percent), they are able to influence marginal pricing.

While a downside scenario is that interest rates rise further, we have assumed that they remain steady at current levels for the purpose of the simulation of the baseline scenario.

71. **In the more optimistic reform scenario, the growth and fiscal outlook are improving through a combination of tangible reforms and the CIP implementation.** In this case, market and popular confidence are expected to be reinforced. Clearly, this scenario does not materialize by itself, but only if the authorities take decisive action on reforms. While the optimistic projections vary more among sources, we have adopted the following reasonable assumptions:

- The **primary balance improves** annually by one percentage point of GDP. This size of budget adjustment has already been agreed in the context of CEDRE. The reform measures themselves are not specifically addressed in this report.

Table 6. Macro-fiscal assumptions - reform scenario

Reforms	2019	2020	2021	2022	2023	2024
Real GDP growth (%)	-0.2	3.25	3.4	3.5	4.0	4.0
GDP deflator (%)	6.2	3.8	3.5	3.25	3.25	3.0
Nominal GDP growth (%)	6.0	7.2	7.0	6.9	7.4	7.1
Nominal GDP (LL bn)	90,495,672	96,987,379	103,794,923	110,919,147	119,104,980	127,585,255
Total govt revenue (% GDP)	20.5	21.8	22.0	22.3	22.8	22.8
Primary expenditures (% GDP)	20.3	21.3	20.5	19.8	19.3	19.3
Primary balance (% GDP)	0.3	0.5	1.5	2.5	3.5	4.5

- Growth** will be the result of opposing impacts: on one hand, fiscal reforms are initially contractionary, while the CIP implementation will take time.²⁹ On the other hand, renewed confidence, which would be impactful in the short term, will combine with a gradually increasing growth dividend generated from CIP implementation. The net result is a projected positive growth dividend that starts at of a percentage point, accelerating to 3.5 to 4 percent. As a result of higher growth, inflation will also be somewhat higher, which is in fact beneficial for debt.
- Interest rates:** as confidence is reinforced by reforms, credit spreads can fall back to historical levels of relatively low risk periods in Lebanon (from about 700 to 450 basis points). Domestic interest rates are anticipated to drop by about two percentage points to 8 percent at long maturities, and up to 1 percentage point (to 5 percent) for T-bills. This is a market-induced drop and not an exogenous monetary policy measure. The inverted yield curve on Lebanese USD-denominated bonds will normalize and their interest rates will end up about half a percentage point lower than those for LBP bonds. The lower rates are assumed as of 2020, remaining constant thereafter. The fiscal effect materializes the year following the decline in interest rates; in reality with semi-annual coupons, it would show a bit faster.
- The gap between the two scenarios provides an indication of the needed fiscal adjustment, amounting to more than LBP 1,100 billion (US\$ 750 million) per year during the next five years.** See Table 1 in the main text. With risks to the downside increasing (high macro-financial risks, geopolitical tensions.), the reform quantifications should probably be seen as a minimum requirement.

29 Government expenditures preclude CEDRE and CIP related spending. Only the growth dividend is taken into account in the projections.

ANNEX II: CONCESSIONALITY TERMS FOR FSI, FSII AND FSIII

72. **Of the possible combinations of key terms in concessional financing, three possible strategies have been selected.** Steering variables can be (a) the concessional interest rate, (b) the duration of the concessional period, (c) the range of the concessional instruments and (d) the finance volume applied to concessional financing. The variations are merely an illustration. Ultimately, any strategy is an outcome of negotiations.

i. **Financing Strategy I (FSI) offers concessional bonds in two currencies, LBP and US\$.** In view of the dollarization on the balance sheet of domestic banks, it would be evident to have concessional bonds in both currencies.

- Bond **maturity** is assumed three years for both currencies.³⁰
- The **coupon rate** is set at a highly concessional level of one percent.
- The concessional **period** of the combined package of reforms and financing measures covers three year, i.e. concessional bonds would be issued for three consecutive years, 2020 to 2022 (the alternative

of just one year has been included in the next section).³¹

- Advantages of this option include the simplicity of the instrument and the gradual fading out of its impact on interest cost in years four to six, with the last concessional bonds maturing in 2025.
- An important disadvantage is the short maturity of the bond, elevating liquidity and refinancing risks during a phase of recuperation.
- As these concessional bonds would be issued alongside more market-oriented bonds, decision-makers can negotiate the **share of total financing** that would be concessional; in the simulations, half of gross annual financing needs are covered by the concessional bonds during each of three years.

ii. **Financing Strategy II (FSII) is similar to FSI except for diverging and longer bond maturities.** In FSII, US\$-denominated bonds have a maturity of five years and LBP-bonds have a maturity of seven years. Challenging redemptions during the reforms period are avoided in

30 Maturity would be more or less aligned to the duration of the concessional period but long enough to have impact. Moreover, the redemption concentration could be avoided by assuming slightly diverging maturities in the US dollar bonds and the Lira bonds (see also the next two strategies below).

31 An extension could always be negotiated in due course for remaining reform years.

this strategy. An important consequence is that the reduction of interest cost is extended over a longer period. The issuance of the concessional bonds occurs again over a period of three years, from 2020 to 2022, and covers half of the gross financing needs.

iii. **Financing Strategy III (FSIII) applies a step-up coupon, decoupling the period of concessionality from the maturity of the bonds.** Compared to the first strategy, this mitigates a concentration of redemptions.

- The **coupon rate** would be concessional during the period of 2020 to 2022 and subsequently restored (stepped up) to the current market rate for the remaining maturity of the bond. As yields differ per maturity, the concessionality would be expressed as a discount to prevailing rates; in the simulations, a reduction of five percentage points has been applied. For example, a five-year bond would initially have a coupon of 3 percent instead of 8 percent until 2023 and subsequently a market-conform coupon.³² Likewise, a ten-year bond would start with a coupon of 5 instead of 10 percent, stepping up to 10 percent as of 2023.
- Bonds are issued over three years, such that bonds issued in 2020 would offer concessionary rates for 2020, 2021 and 2022, thereafter reverting

back to market rates at the time of issuance. Bonds issued in 2021 would offer concessionary rates in 2021 and 2022, and bonds issued in 2022 would offer concessionary rates in 2022, all reverting to market rates at issuance starting in 2023.

- It is assumed that all gross financing needs are covered by step-up bonds, both in LBP and USD.
- The drawback of this strategy is that interest cost will jump back up in 2022. However, parties could always negotiate a more gradual step-up structure, like a step-up of one percent point per year as of the fourth year.

73. **For practical purposes, it is recommended to keep all the concessional bonds, both those denominated in USD and LBP, strictly under Lebanese documentation and law.** First, these bonds are targeted toward domestic banks and investors, while minimizing market segmentation. While they could be tradeable instruments, they are not intended to trade internationally, avoiding any unwanted arbitrage (in that sense, even a loan format could be considered). Secondly, Lebanese documentation and law would keep issuance costs down and make issuance much more flexible. Overall, it is important that there is a clear distinction between concessionary bonds and standard Eurobonds, with the latter also held by non-residents.

³² Meanwhile, in the reform scenario, and precluding financing measures, it is anticipated that the success of reforms will drive market rates down by ¾ percent in short bills to 2 percent in ten-year bonds. The step-up coupon increases to the current market rate and would not follow the fall in market rates; however, the concessional and the step-up rate are ultimately a matter of negotiation.

TABLE 7. Lebanon Selected Economic Indicators, 2013-2020

	2014	2015	2016	2017	2018	2019	2020	2021
	Est.	Est.	Est.	Est.	Est.	Proj.		
	(annual percentage change, unless otherwise specified)							
Real sector								
Real GDP	1.9	0.4	1.6	0.6	0.2	-0.2	0.3	0.4
Real GDP per Capita /1	-3.8	-3.7	-1.1	-0.9	-0.3	-0.7	-0.2	-0.1
Agriculture (share of GDP)	4.2	3.6	3.8	4.2	4.2	4.0	4.1	4.1
Industry (share of GDP)	13.6	12.8	12.7	12.1	12.6	12.5	12.5	12.8
Services (share of GDP)	72.3	73.3	72.6	72.7	73.9	75.3	74.8	74.7
Net indirect taxes (share of GDP)	9.8	10.3	10.9	11.0	9.4	8.2	8.6	8.5
	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Money and prices								
CPI Inflation (p.a)	1.2	-3.7	-0.8	4.5	6.1	1.6	1.5	2.3
GDP Deflator	1.1	3.0	0.9	3.6	2.5	6.2	3.1	3.3
Money (M3, including non-resident deposits)	6.0	5.1	7.3	4.2	3.0	-1.0	3.0	3.0
Investment & saving								
Gross Capital Formation	24.0	21.1	20.9	19.8	19.5	19.4	19.9	21.5
o/w private	19.8	22.4	19.5	18.3	17.9	17.8	17.2	18.5
Gross National Savings	-2.2	4.1	0.5	-2.9	-2.5	-1.5	-1.5	0.2
o/w private	-4.6	0.1	-3.1	-6.1	2.9	5.9	5.5	7.0
	0	-0	0	0	-0	0	0	0
Central Government Finance								
Revenue (including grants)	22.5	19.2	19.4	21.8	20.4	20.5	21.8	22.0
o/w. tax revenues	14.3	13.7	13.7	15.4	15.0	15.2	16.0	16.0
Total expenditure and net lending	28.8	26.9	28.6	28.4	31.1	29.5	31.6	31.8
Current	27.2	25.5	27.2	27.0	29.5	27.9	28.8	28.8
o/w Interest Payment	8.7	8.9	9.3	9.3	9.6	9.2	9.8	10.2
Capital & Net Lending (excluding foreign financed)	1.5	1.4	1.4	1.5	1.6	1.6	2.8	3.0
Overall balance (deficit -)	-6.2	-7.7	-9.3	-6.7	-10.7	-9.0	-9.8	-9.8
Primary Balance (deficit -)	2.4	1.2	0.0	2.7	-1.1	0.3	0.0	0.4
External sector								
Current Account Balance	-26.1	-16.9	-20.5	-22.8	-21.9	-20.8	-21.4	-21.3
Trade Balance	-29.8	-22.9	-23.6	-24.6	-24.2	-23.9	-24.1	-24.5
o/w Export (GNFS)	39.9	39.7	37.3	35.9	34.6	34.4	34.3	34.5
Exports of Goods	9.4	8.0	7.7	7.6	6.8	7.0	7.0	7.0
Exports of Services	30.4	31.7	29.6	28.3	27.8	27.4	27.3	27.5
o/w Import (GNFS)	69.7	62.5	60.9	60.5	58.8	58.3	58.4	59.0
Imports of Goods	42.3	35.2	35.0	34.5	33.5	33.3	33.9	34.2
Imports of Services	27.3	27.4	25.9	25.9	25.3	25.0	24.6	24.8
Net private current transfers:	4.9	6.8	4.8	2.3	2.8	3.5	3.4	3.7
Remittances	5.8	7.2	6.6	5.1	4.3	5.1	4.9	5.0
Net Income receipts	-1.2	-0.9	-1.6	-0.5	-0.5	-0.5	-0.7	-0.5
Capital Accounts	0	0	0	0	0	0	0	0
Gross Reserves (months of imports GNFS) /2 /3	13.1	13.8	15.2	15.6	14.3	12.8	12.0	11.2
Total Public Debt								
Total Debt Stock (in million US\$)	66,564	70,325	74,900	79,530	85,139	90,512	96,579	102,863
Debt-to-GDP ratio (percent)	137.8	140.7	146.2	149.0	150.3	150.8	155.6	159.7
Memorandum Items:								
Nominal GDP (in billion LBP)	72,806	75,336	77,243	80,491	85,384	90,496	93,578	97,074
Exchange Rate, Average (LBP/US\$)	1,507.5	1,507.5	1,507.5	1,507.5	1,507.5	1,507.5	1,507.5	1,507.5
GDP (in million US\$)	48,296	49,974	51,239	53,394	56,639	60,030	62,075	64,394

Source: Government data, and World Bank staff estimates and projections.

/1 Population figures, which include Syrian refugees registered with the UNHCR, are taken from the United Nations Population Division

/2 Gross Reserves (months of imports GNFS) = (Imports of Goods & Services / Gross Res. excl. Gold)*12

/3 Total Imports using the BOP data from the Quarterly Bulletin of BDL

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Shedding Light on Female Talent in Lebanon's Energy Sector	2019/04/01	ESMAP Paper
Behavioral Strategies to Support Social Stability in Lebanon	2019/03/28	Working Paper
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