

LEBANON ECONOMIC MONITOR

نداؤنا لكم

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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 Macro-Fiscal Management (MFM) team. It was prepared by Wissam Harake (Country Economist), and Naji Abou Hamde (Economic Analyst) under the general guidance of Eric Le Borgne (Lead Economist and acting Global Practice Manager). A cross-sector team led by Wissam Harake (Country Economist) authored the Special Focus on priority reforms for the Government of Lebanon. Zeina El Khalil (Communications Officer) led on media outreach and print production, Naji Abou Hamde (Economic Analyst) provided Arabic translation and Nada Abou-Rizk (Program Assistant) assisted with French translation.

The findings, interpretations, and conclusions expressed in this *Monitor* are those of World Bank staff and do not necessarily reflect the views of the Executive Board of The World Bank or the governments they represent.

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LIST OF KEY ABBREVIATIONS USED

bps:	Basis points
H1, H2:	First half of the year, second half of the year.
3mma:	Three-months moving average
pp:	Percentage points
Q1 (Q2, Q3, Q4):	First (second, third, fourth) quarter of the year
qoq:	Quarter-on-quarter
sa:	Seasonally adjusted
saar:	Seasonally adjusted, annual rate
yoy:	Year-on-year
lhs, rhs:	Left hand side, right hand side (for axis of figures)

EXECUTIVE SUMMARY

I. The election of President Michel Aoun in October 2016 after almost two and a half years of a presidential vacancy, and the subsequent formation of a national unity government have generated hope for the resuscitation of the political process in Lebanon. Nonetheless, the protracted Syrian conflict is markedly worsening the country's vulnerabilities and remains an impediment to the return to potential growth. For the fifth year, Lebanon persists as the largest host (on a per capita basis) for displaced Syrians.

II. In 2016, real GDP growth underwent a slight acceleration to reach an estimated 1.8 percent, compared to 1.3 percent in 2015. This was driven by an improvement in the real estate sector, marking a low threshold-effect from a weak performance in 2015—cement deliveries expanded by 4.4 percent in 2016 compared to a contraction of 8.6 percent in 2015. Real GDP growth was also boosted by tourist arrivals, an indicator that registered an 11.2 percent growth in 2016. Nonetheless, economic activity persists below potential, inhibited by geopolitical and security conditions, which remain decidedly volatile.

III. The fiscal position of Lebanon became more tenuous as the overall fiscal deficit widened and the already elevated debt-to-GDP ratio surged. The overall fiscal deficit increased by an estimated 1.8 percentage points (pp) to reach 10 percent of GDP, hitting double digits for the first time since 2006. While both revenues and expenditures rose during 2016, the latter outpaced the former. Primary spending (excluding debt service) rose by 1.9 pp, cutting the primary surplus from 1.3 percent of GDP in 2015 to 0.1 percent in 2016. This combined with a limited increase in nominal GDP (driven by slow real GDP growth and a negative change in the GDP deflator) pushed the

debt-to-GDP ratio to an estimated 157.5 percent by end-2016, a rise of 8.1 pp from end-2015.

IV. A widening current account deficit along with declining capital inflows motivated the BdL financial swap. In 2016, a 3.5 percent growth in merchandise imports combined with a slowdown in remittances. The latter began decelerating in 2016 following a couple of years of being largely unaffected by lower oil prices. This led to an increase in the already sizable current account deficit to an estimated 21 percent of GDP, from 17 percent of GDP in 2015, which is among the largest in the world, exposing the country to significant refinancing risks. Faced with weaker capital inflows—a main resource for an economy with sizable fiscal and current account deficits—BdL financially engineered a swap that was able to boost its gross foreign exchange reserves by 11.1 percent in 2016 to reach US\$ 34 billion after registering a decline of 5.4 percent in 2015. Notwithstanding the short-term needs, given the current fundamentals and lack of structural reforms, such interventions can exacerbate macro-financial risks.

V. Assuming the political process does not revert back to a stalemate, improvements in the traditional economic drivers—tourism, real estate and construction—are likely to translate into a pick-up in real GDP growth in 2017, which we project at 2.5 percent. We forecast growth over the medium term to remain around 2.5 percent annually as potential growth is contingent on the resolution of the Syrian conflict.

VI. Following the resumption of the political process and in light of the urgent need for reforms, we present a menu of reforms that would enable the country to rapidly and significantly turn the page of inaction and

decline and return the country to a prosperous and inclusive development path (Special Focus).

To that end, reforms are prioritized over two time horizons—the short and medium terms. The first set of reforms suggested aim at establishing a record of achievements and government credibility that is currently sorely absent; without such a clear statement, policymaking effectiveness will be limited. They will also set the platform for the medium term that are more systemic.

الملخص التنفيذي

I. إن انتخاب الرئيس ميشال عون في تشرين الأول / أكتوبر ٢٠١٦ بعد نحو عامين ونصف من الشغور الرئاسي، وما تبع ذلك من تشكيل حكومة وحدة وطنية، قد ولد الأمل في إنعاش العملية السياسية في لبنان. ومع ذلك، فإن النزاع السوري الذي طال أمده يزيد بشكل ملحوظ من ضعف البلد ويظل عائقاً أمام العودة إلى النمو المحتمل. هذا ويبقى لبنان للسنة الخامسة أكبر مضيف للنازحين السوريين (نسبة إلى عدد السكان).

II. شهد العام ٢٠١٦ ارتفاعاً طفيفاً في نمو الناتج المحلي الإجمالي الحقيقي ليبلغ ١,٨ في المئة، مقارنة مع ١,٣ في المئة في العام ٢٠١٥. يعود هذا النمو إلى تحسن في القطاع العقاري، مع أخذ الأداء الضعيف في عام ٢٠١٥ بعين الاعتبار، حيث ارتفعت تسليمات الأسمنت بنسبة ٤,٤ في المئة في عام ٢٠١٦ مقارنة بانكماش بنسبة ٨,٦ في المئة في عام ٢٠١٥. كما تعزز نمو الناتج المحلي الإجمالي الحقيقي بارتفاع عدد السياح القادمين إلى لبنان وهو مؤشر سجل نمواً بنسبة ١١,٢ في المئة في عام ٢٠١٦. ومع ذلك، فإن النشاط الاقتصادي ما زال دون الإمكانيات بسبب المعوقات المتمثلة بالظروف الجيوسياسية والأمنية التي لا تزال متقلبة.

III. إزداد الوضع المالي للبنان هشاشة مع اتساع العجز المالي العام وتعاظم نسبة الدين إلى الناتج المحلي الإجمالي المرتفعة أصلاً. ارتفع العجز المالي العام بنحو ١,٨ نقطة مئوية ليصل إلى ١٠ في المائة من الناتج المحلي الإجمالي، في أعلى نسبة له منذ عام ٢٠٠٦. وفي حين ارتفعت الإيرادات والنفقات خلال عام ٢٠١٦، فاق الإرتفاع في النفقات مثيله في الإيرادات. وارتفع الإنفاق الأولي (باستثناء خدمة الدين) بمقدار ١,٩ نقطة مئوية، مما خفض الفائض الأولي من ٣,١ في المئة من الناتج المحلي الإجمالي في عام ٢٠١٥ إلى ٠,١ في المئة منه في عام ٢٠١٦. وترافق هذا مع زيادة محدودة في الناتج المحلي الإجمالي الاسمي (مدفوعاً ببطء نمو الناتج المحلي الإجمالي الحقيقي وتغير سلبي في مخفض الناتج المحلي الإجمالي) دفع نسبة الدين إلى الناتج المحلي الإجمالي إلى ما يقدر بنحو ١٥٧,٥ في المئة بحلول نهاية عام ٢٠١٦، بزيادة قدرها ٨,١ نقاط مئوية عن نهاية عام ٢٠١٥.

IV. شكلت زيادة العجز في الحساب الجاري والتي ترافقت مع انخفاض تدفقات رؤوس الأموال الداخلة حافزاً لمصرف لبنان للقيام بعمليات المبادلة المالية. جاء ارتفاع الواردات للسلع بنسبة ٣,٥ في المئة عام ٢٠١٦ مصحوباً بانخفاض التحويلات المالية

التي كان أثر انخفاض أسعار النفط عليها محدوداً لبضع سنوات. أدى ذلك إلى زيادة العجز المرتفع أصلاً في الحساب الجاري المقدرة نسبته بـ ٢١ في المئة من الناتج المحلي الإجمالي، بعد أن كانت هذه النسبة تمثل ١٧ في المئة من الناتج المحلي الإجمالي في العام ٢٠١٥، وهي من ضمن الأعلى في العالم مما يعرض البلد لمخاطر كبيرة في إعادة التمويل. لمواجهة ضعف تدفقات رؤوس الأموال الداخلة، والتي تعتبر مورد أساسي لاقتصاد يعاني من عجز بالغ في المالية العامة والحساب الجاري، قام المصرف المركزي بتصميم هندسة مالية استطاع بموجها رفع احتياطياته من النقد الأجنبي بنسبة ١١,١ في المئة في عام ٢٠١٦ لتبلغ ٣٤ مليار دولار أميركي وذلك بعدما سجلت انخفاضاً بنسبة ٥,٤ في المئة في عام ٢٠١٥. على الرغم من الإحتياجات على المدى القصير، نظراً للأساسيات الحالية ونقص الإصلاحات الهيكلية، يمكن لتدخلات كهذه أن تؤدي إلى تفاقم المخاطر المالية-الكلية.

V. على افتراض أن العملية السياسية لن تعود إلى حالة الجمود، فإن التحسن في المحركات التقليدية للعجلة الاقتصادية، المتمثلة بقطاعي السياحة والعقارات والبناء، من المرجح أن يظهر أثره بنمو في الناتج المحلي الإجمالي الحقيقي لعام ٢٠١٧، والذي نتوقع أن يكون ٢,٥ في المئة. إننا نتوقع أن يستمر النمو على المدى المتوسط في حدود ٢,٥ في المئة سنوياً نظراً إلى أن إدراك النمو المحتمل يتوقف على حل النزاع السوري.

VI. بعد استئناف العملية السياسية، وفي ضوء الحاجة الماسة إلى إجراء إصلاحات، نقدم قائمة بالإصلاحات التي من شأنها أن تمكن البلد من طي صفحة التقاعس والإنحدار بسرعة وبشكل ملحوظ والعودة إلى مسار الإزدهار والتنمية الشاملة (التركيز الخاص). تجاه هذه الغاية تم تحديد الأولويات الإصلاحية وفق إطارين زمنيين هما المدى القصير والمدى المتوسط. السلة الأولى من الإصلاحات المقترحة تهدف إلى إنشاء سجل للإنجازات وتأسيس مصداقية الحكومة الفأبة حالياً إذ إن الفعالية في صناعة السياسات ستمسي محدودة دون بيان واضح. كما أن هذه الإصلاحات ستحدد البرنامج على المدى المتوسط بشكل منهجي.

SOMMAIRE EXÉCUTIF

I. L'élection du Président Michel Aoun en octobre 2016 après quasiment deux ans et demi de vacance présidentielle et la formation conséquente d'un gouvernement d'unité nationale ont revigoré l'espoir dans la reprise du processus politique au Liban. Toutefois, le conflit syrien qui se prolonge aggrave d'une manière significative les vulnérabilités du pays et demeure un obstacle au retour d'une éventuelle croissance. Pour la cinquième année consécutive le Liban demeure le plus grand pays hôte (per capita) de déplacés syriens.

II. En 2016, la croissance réelle du PIB a connu une légère accélération pour atteindre un taux estimé de 1.8%, à comparer avec 1.3% en 2015, motivée par une amélioration dans le secteur foncier et marquant un bas effet de seuil à partir d'une faible performance en 2015 – les livraisons de ciment ont augmenté de 4.4% en 2016 à comparer avec une contraction de 8.6% en 2015. La croissance réelle du PIB a été également encouragée par le retour des touristes, un indicateur qui a enregistré une croissance de 11.2% en 2016. Toutefois, l'activité économique demeure en-deçà de son potentiel. Elle reste, inhibée ainsi par les conditions sécuritaires et géopolitiques, qui demeurent incontestablement volatiles.

III. La position fiscale du Liban devient plus précaire avec l'élargissement du déficit fiscal général et l'augmentation du ratio de la dette au PIB déjà élevé. Le déficit fiscal général a augmenté de 1.8 point de pourcentage (pp) pour atteindre 10% du PIB, enregistrant un niveau à deux chiffres pour la première fois depuis 2006. Alors que les revenus et les dépenses ont augmenté en 2016, les dépenses ont dépassé les revenus. Les dépenses primaires (excluant le service de la dette) ont augmenté de 1.9 pp, réduisant le surplus primaire de 1.3% du PIB en 2015 à 0.1% en 2016. Cela, associé à une

augmentation limitée du PIB nominal (motivée par une croissance lente du PIB réel et par un changement négatif du déflateur du PIB), a poussé le ratio de la dette au PIB à un taux estimé de 157.5% à la fin de 2016, soit une augmentation de 8.1 pp à partir de la fin de 2015.

IV. Un déficit du compte courant combiné à un déclin des flux des capitaux a motivé le swap financier de la BdL. En 2016, une croissance de 3.5% des importations de biens est venue s'ajouter à un ralentissement des remises de fonds. Ces dernières ont commencé à se ralentir en 2016 après des années pendant lesquelles elles demeuraient largement non affectées par des prix de pétrole plus bas. Ceci a abouti à une augmentation du déficit du compte courant déjà accru, estimé à environ 21% du PIB, à partir de 17% du PIB en 2015, soit l'un des PIB les plus élevés dans le monde, exposant ainsi le pays à des risques significatifs de refinancement. Face à des flux plus faibles de capitaux, constituant ainsi une principale ressource pour une économie présentant un déficit du compte courant et un déficit fiscal de taille significative – la Banque du Liban a mis en place, sur le plan financier, un swap qui était à même de promouvoir les réserves de change brutes de 11.1% en 2016 pour atteindre 34 milliards \$ après avoir enregistré une baisse de 5.4% en 2015. En dépit des besoins à court terme et vu les principes fondamentaux actuels et le manque de réformes structurelles, de telles interventions peuvent exacerber les risques macro-financiers.

V. A supposer que le processus politique ne se retrouvera pas de nouveau dans une impasse, les améliorations dans les moteurs économiques traditionnels – le tourisme, le secteur foncier et la construction – seront éventuellement traduites par une reprise de la croissance réelle du PIB en 2017, que nous estimons à 2.5%. Nous prévoyons

que la croissance à moyen terme demeure autour de 2.5% par an alors que la croissance potentielle est tributaire de la résolution du conflit syrien.

VI. Suite à la reprise du processus politique et à la lumière du besoin urgent de réformes, nous présentons un menu de réformes qui permettraient au pays de tourner, rapidement et radicalement, la page de l'inertie et du déclin et de s'orienter vers un développement prospère et inclusif (Centre d'intérêt spécial). A cette fin, les réformes sont proposées suivant un ordre de priorités qui sera exécuté en deux temps — à court et à moyen termes. Le premier ensemble des réformes en question vise à mettre en place un bilan des réalisations et à rétablir la crédibilité du gouvernement qui est actuellement particulièrement absent; sans un tel bilan clair, l'efficacité de l'élaboration de politiques sera limitée. Les réformes détermineront également la plateforme à moyen terme qui est plus systémique.

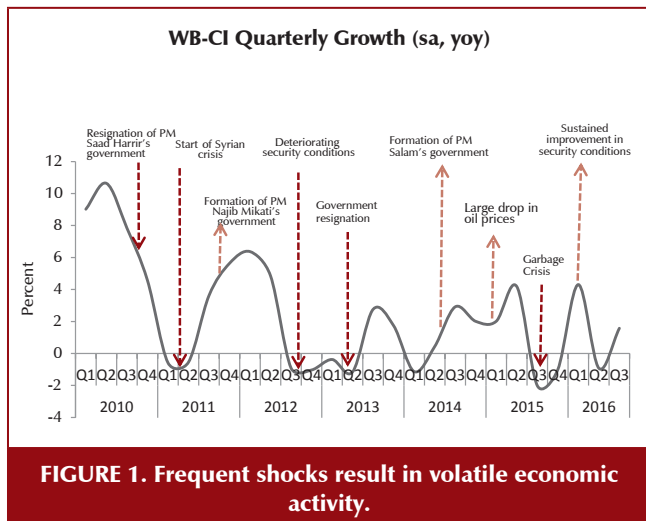
RECENT ECONOMIC AND POLICY DEVELOPMENTS

1. On 31 October 2016, Michel Aoun was elected President of the Republic putting to an end the longest presidential vacancy in Lebanon's modern history, which ran 29 months and 46 electoral sessions. This and the subsequent formation of a unity government under Prime Minister Saad Hariri raised hopes that the political process in Lebanon would be resuscitated, leading to a boost in confidence. However, the fate of parliamentary elections, the only national plebiscite, which are due in May 2017, is unclear as key political parties remain far apart on a new parliamentary electoral law. This law is considered crucial as it will help define the makeup of the new parliament, determining the extent of dominion by traditional parties over confessional representation. Failure to reach an agreement may regress the political environment to the pre-presidential election conditions of dysfunctionality and constitutional paralysis. A parliamentary vacuum is a notable risk.

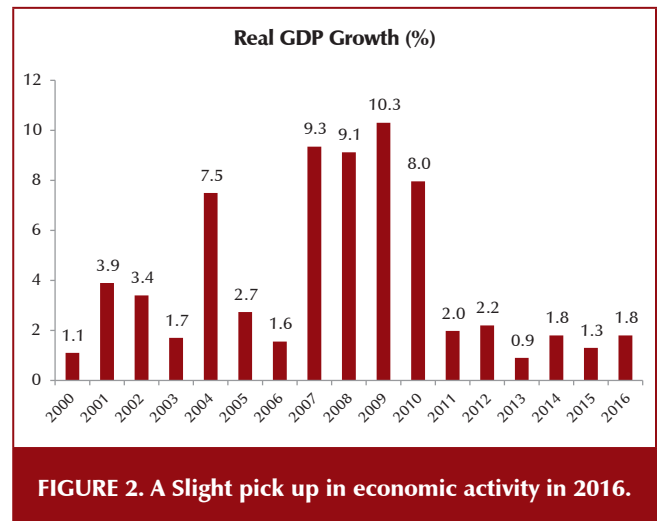
2. Council of Ministers (CoM) makes early headway with two essential achievements: passing two long-awaited decrees for the oil and gas sector and adopting the 2017 budget. In January 2017, the CoM finally approved two oil decrees that have been pending due to the political stalemate, paving the way for the first licensing round of offshore gas exploration in Lebanon's Exclusive Economic Zone (see Box 1). In March 2017, the government adopted the 2017 budget and sent it to parliament. If ratified by parliament, this would be the first formal budget for Lebanon since 2005. It remains unclear whether the previous discord between the political parties regarding accountability over previous fiscal accounts will re-emerge as a principal obstacle. Also unclear is the fate of the long-demanded salary scale adjustment, which has been included in the initial draft submitted to the CoM along with a set of associated fiscal measures consisting of hikes in tax

rates and fees intended to cover the additional cost. The salary scale, as included in the draft budget, is valued at LBP 1,200 billion (US\$ 800 million), equivalent to 1.7 percent of 2017 GDP.

3. The return of governing institutions after a long political stalemate offers Lebanon a unique window of opportunity to mitigate impending risks and tackle longstanding and, by now, pressing development challenges. Lebanon's high debt level, large twin deficits (fiscal and current account) and a highly dollarized pegged economy present significant macroeconomic vulnerabilities. These macroeconomic risks have been compounded by the Syrian war, which has taken a toll on the economy. Furthermore, the influx of displaced persons from Syria (estimated at over one million by UNHCR as of December 2016) has placed added strain on Lebanon's education, health, municipal and other sectors, while exacerbating already notable subnational inequalities. This sense of urgency is reinforced by a palpable deterioration in the quality of public services, institutions, governance and the business climate, to name a few. Critical reforms are needed to put the country on the right track.



Sources: Lebanese authorities and WB staff calculations.



Sources: Lebanese authorities and WB staff calculations.

Output and Demand

4. Spillover from the regional turmoil, in combination with a deteriorating domestic political process, have led to sluggish, below-potential real GDP growth since 2011.¹ While the economy since the early nineties has traditionally been susceptible to the frequent political and security shocks resulting in volatile growth rates (Figure 1), the post-2011 period has witnessed a shift in economic fundamentals. Traditional drivers—real estate, construction, finance and tourism—have suffered greatly from the regional turmoil. Instead, support for the economy has originated from other sources, including Syria-related economic activity in Lebanon.² For example, and despite lagging infrastructure due to deficiency by the government, information and communications technology (ICT) is one sector that benefitted from the surge

1 National accounts data since 2011 are World Bank staff estimates, guided by our coincident economic indicator (for details, see Matta, S. (2015) New Coincident and Leading Indexes for the Lebanese Economy, Review of Middle East Economics and Finance, 11 (3), 277–303), pending updates on GDP estimates from CAS for 2011 to 2015.

2 Positive economic contributions of Syrian nationals in consequence of the war in Syria has been discussed in the Spring 2015 issue of the Lebanon Economic Monitor. This contribution to overall economic activity from Syrian nationals living in Lebanon does not preclude negative impact on public finances (e.g. higher public spending on social services) or on overall economic activity due to the conflict in Syria. As the World Bank-United Nations Economic and Social Impact Assessment (ESIA) of the Syrian conflict details, both of these are large and negative for the country and its public finances.

in population as well as local human capital; the percentage of individuals using the internet jumped from 52 percent in 2011 to 74 percent in 2015, while fixed broadband subscriptions more than trebled to reach almost 1.3 million persons, and mobile-cellular telephone subscriptions expanded by 35 percent over the same period.³ Nonetheless, this has been insufficient to regain pre-crisis real GDP growth rates or even reach potential.

5. A marginal pickup in economic activity in 2016. Real GDP is estimated to have grown by 1.8 percent in 2016, compared to 1.3 percent in 2015 (Figure 2). This was led by a continued, albeit modest, revival in the tourism sector; tourist arrivals increased by 11.2 percent to reach 1.6 million arrivals in 2016, the most since the onset of the regional turmoil, while hotel occupancy rate jumped 3 percentage points (pp) to an average of 59 percent, surpassing the 2011 rate (Figure 3). Furthermore, after a weak performance in 2015, the real-estate sector experienced a slight rebound, largely reflecting a low-base effect; cement deliveries underwent a 4.4 percent expansion in 2016, compared to a contraction of 8.6 percent in 2015 (Figure 4). In this regard, the subsidized loan schemes by the central bank, Banque du Liban (BdL), continue to provide crucial support to the real estate and construction sectors.

6. From the demand side, private consumption continued to be a principal driver

3 Source: International Telecommunication Union (ITU).

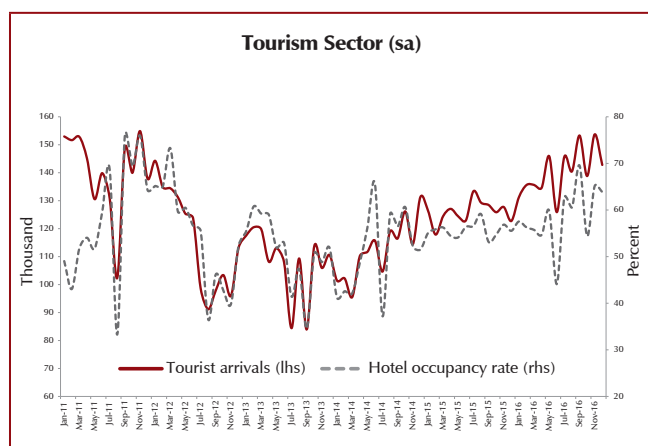


FIGURE 3. Recovery in tourism persisted in 2016.

Source: Lebanese authorities and WB staff calculations.

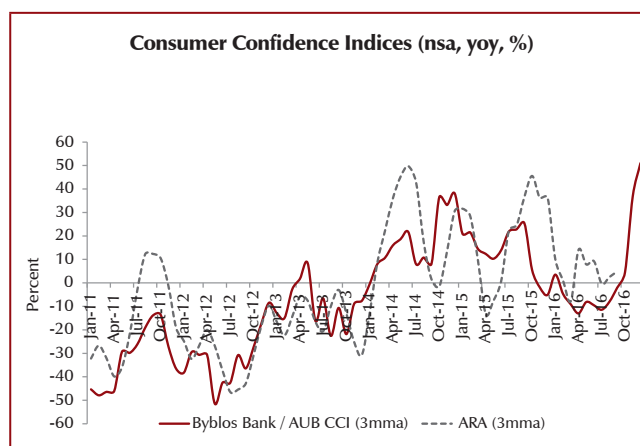


FIGURE 5. Consumer sentiment improving but volatile.

Sources: Byblos Bank, ARA Marketing Research and Consultancy and BdL.

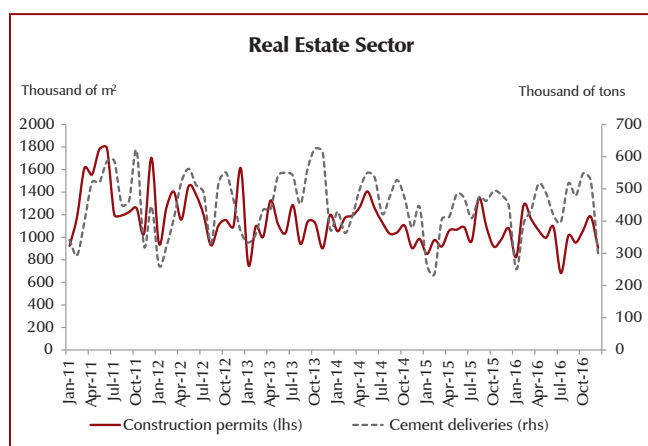


FIGURE 4. Slight pickup in real estate..

Source: Banque du Liban.

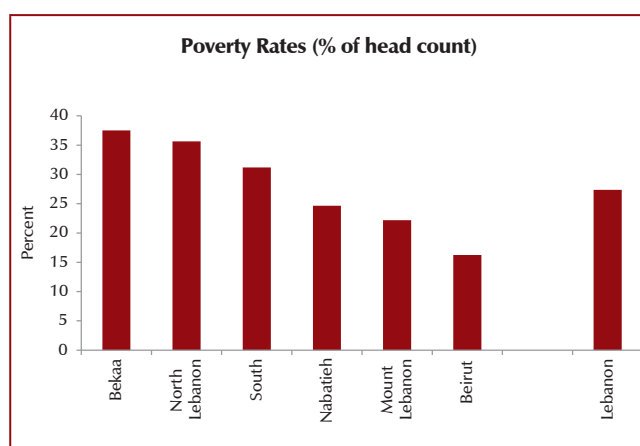


FIGURE 6. Poverty rate highest in the Bekaa and North 2011/12.

Sources: Lebanese authorities and WB staff calculations.

in 2016, while the external sector was a drag. Improved security conditions and low oil prices helped partially offset the negative impact on consumer sentiment caused by the deteriorating political climate last year. Both consumer confidence indices (CCIs) improved in 2016, with the Byblos/AUB CCI rising by 3.5 percent in 2016 and the ARA index doing so by 3.8 percent for the year to September, year-on-year (yoy) (Figure 5). While this marks a slowdown compared to 2015—where over corresponding periods, the Byblos/AUB and ARA CCIs rose by 12.4 percent and 12.9 percent, respectively—confidence has clearly improved since early 2014 as agents have adjusted to the long-term prospects of the Syrian conflict. Private lending toward consumption and real estate purchases continued to expand in 2016, in part thanks to continued BdL support in the

form of subsidized lending schemes; commercial banks' claims on resident private sector grew by 6.2 percent in 2016, compared to 5.9 percent in 2015. Anecdotal evidence suggests that private demand is also supported by Syrian investment and consumption, concentrated in the informal sector. The external sector, on the other hand, has contributed negatively to real GDP growth during 2016 as merchandise imports recovered from 2015 lows, when a sharp decline in oil prices combined with a euro depreciation provided temporary favorable conditions. Merchandise exports have also suffered from road closures through Syria that connected exporters to the lucrative GCC market. This led to a widening of the trade deficit in goods and services this year. Moreover, public investment continues to lag due to the political paralysis.

BOX 1. Oil and Gas Decrees.

In January 2017, the Cabinet of Ministers (CoM) passed two long-awaited oil decrees paving the way for the first licensing round of offshore gas exploration in Lebanon's Exclusive Economic Zone (EEZ). The first decree divides the EEZ into 10 blocks, only some of which would be open for bidding during the first licensing round. It also establishes a buffer zone spanning the coastline with a width of 3 nautical miles, within which no petroleum activities would be allowed. The second decree includes (i) the tender protocol; (ii) the exploration and production agreement; and (iii) annexes that detail the accounting and financial procedures and the joint operating agreement. According to the exploration and production agreement, royalties paid to the State on gas production is set at 4 percent, while royalties on oil production are progressive ranging from 5 percent to 12 percent. Once royalties are paid out, Right Holders are able to recover capital expenditure (CAPEX) costs, Cost Petroleum, which is a biddable component starting from a set ceiling of 65 percent of Disposable Petroleum.*

The remainder, Profit Petroleum, is then divided between the State and Right Holders according to the R-factor, defined as:

$$R = \frac{\text{Cumulative cash inflow}^{**}}{\text{Cumulative CAPEX}},$$

such that the State's share of Profit Petroleum, denoted by *SP* hereafter, is determined as follows:

- For $R \leq 1$; $SP = A$ percent, where A is a biddable component with the condition that $A \geq 30$ percent. That is, A is the minimum profit share for the State, which would be during the pre-breakeven point for the Right Holder.

As cumulative cash inflow increases with time, R rises, leading to an increasing SP , such that:

- For $1 < R < R_B$; $SP = A + \left[\frac{(B-A) \times (R-1)}{(R_B-1)} \right]$
- For $R \geq R_B$; $SP = B$ percent

where B and R_B are biddable items that determine the maximum share of Profit Petroleum that the State would earn beyond R_B under the condition that $R_B \geq 1$. To summarize A, B , and R_B are to be determined via a bidding process, such that $A \geq 30$ percent, $B > A$ percent and $R_B \geq 1$, thus constituting the commercial proposal of the competitive process. The Right Holders' portion will be $RHP = 100 - SP$, for every value of R .

Finally, petroleum activities will be subject to *Tax Payments*, including corporate and individual tax, tax on dividends, import tariffs etc. This would be specified by a new tax law currently under discussion by an inter-ministerial committee that has been formed to discuss a draft taxation law governing the oil and gas sector. Once the tax law passes cabinet, it would then need parliament ratification.

As such, Total State Income (TSI) from oil and gas activities will be:

$$TSI = \text{Royalties} + SP + \text{Tax Payments}$$

The commercial proposal, as summarized above, is given a 70 percent weight in the grading process, while the remaining 30 percent would be assigned to the technical proposal. In the technical proposal, the consortium bids for the minimum work commitment pertaining to the (i) geophysical survey given by the 3D seismic data carried out and processed, in square kilometers; (ii) other geological and geophysical activities given by line kilometers for airborne, gravity, aero-magnetics, and other means, and square kilometers for advanced technologies, such as electro-magnetics; (iii) the number and minimum depth of exploration wells.

* "Disposable Petroleum" means the balance of petroleum extracted which is not reinjected and thus remaining and set aside to determine the Right Holders entitlements to Cost Petroleum and Profit Petroleum after deduction of (i) petroleum allocated to satisfying the Right Holders obligations to pay the royalty or deliver it in kind to the State; and (ii) that portion of petroleum that has been consumed, burned or in any way released or lost between the point of extraction and the point where aforesaid portion of Cost Petroleum or Profit Petroleum may be taken.

** Cumulative cash inflow is cumulative profit plus cumulative Cost Petroleum since the beginning of the production phase minus operating expenses. Cumulative CAPEX is all capital expenditures recorded.

Poverty and Labor

7. **About 27 percent of the population in Lebanon were poor according to the most recent household budget survey in 2011/12.** The highest poverty rates were in North Lebanon and Bekaa regions, while the largest poverty count was observed in the most populous Mount Lebanon region (Figure 6). The unemployment rate was about 9 percent, based on the same household survey, which predates the impact of regional hostilities, including the influx of refugees. Poverty rates were significantly higher for workers employed in the agricultural and construction sectors who are paid on weekly or daily basis.

8. **In view of their protracted presence, Syrian nationals have de facto become part of the labor market.** With around half of the working age Syrian refugees economically active (ILO, 2014),⁴ by end-2014 the labor supply in Lebanon was estimated to have expanded by 50 percent (IMF, 2014⁵). The majority of Syrian refugees are low- to semi-skilled workers, engaged primarily in construction, agriculture, and personal and domestic services. The vast bulk of refugee employment, regardless of the level of education attained, focused on the informal sector (ILO, 2015).⁶ It is unclear to what extent low-skilled refugees have been competing with Lebanese nationals since, even prior to the crisis, the low-skilled labor market was dominated by foreigners (e.g. Syrians, Bangladeshi, Ethiopians, Filipinos). As such, it is more likely that low-skilled foreign labor in Lebanon, including other Syrians who were present before 2011, will bear the brunt of the competition from refugees. This can explain the lack of significant tensions between the refugees and host communities, considering the sheer number of refugees.

4 International Labor Organization (2014), Assessment of the Impact of Syrian Refugees in Lebanon and Their Employment Profile 2013. The study surveyed the employment profile of refugees and the impact of their economic participation on the host communities' livelihoods. Data was collected from 400 households, which included a total of 2,004 individuals.

5 IMF (2014), Article IV Consultation and Selected Issues, July, Washington DC.

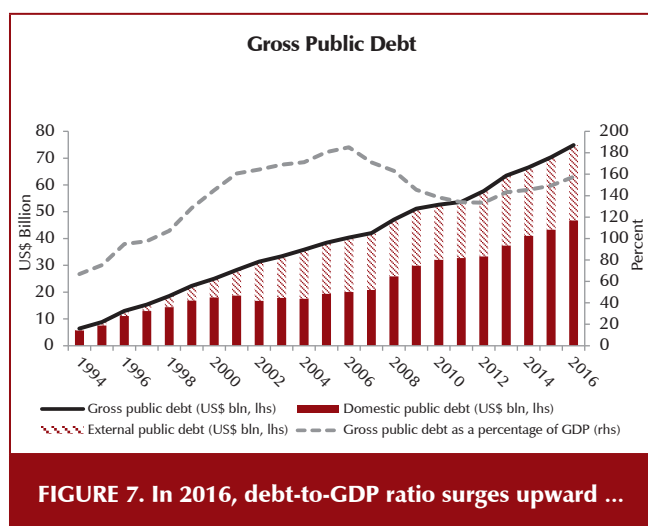
6 International Labor Organization (2015), Towards Decent Work in Lebanon: Issues and Challenges in Light of the Syrian Refugee Crisis, Beirut, Lebanon.

9. **Employment growth has been concentrated in low productivity activities as those involving higher productivity have not grown proportionally.** Over the past decade, trade accounted for about 47.3 percent of all new employment, public and private services for 34.7 percent and construction for nearly 10 percent (ILO, 2015). Thus, relatively low productivity activities dominated employment growth, while growth in productive activities such as communications, financial services, agriculture and manufacturing was marginal. Moreover, since foreign labor dominated low skilled (less productive) activities, high GDP growth rates have not translated into significant job creation for the Lebanese. In fact, the long-run employment-growth elasticity is estimated to be 0.2 (World Bank, 2012⁷), much lower than an estimated MENA average of 0.5 (IMF, 2014).

Fiscal Sector

10. **A surge in the already elevated debt-to-GDP ratio heightens macro-fiscal risks.** Gross public debt is estimated to have reached 157.5 percent of GDP by end-2016, a rise of 8.1 pp from end-2015 (Figure 7). The sharp rise is attributable to deteriorating fiscal accounts as the overall fiscal deficit widened and the primary surplus declined. This dynamic was further exacerbated by slow real GDP growth combined with a negative change in the GDP deflator, which together limited the increase in nominal GDP, enacting a denominator-led push on the debt-to-GDP ratio. As a result, almost half the progress achieved in the country's debt position over the latter half of last decade has been reversed; after peaking at 185 percent of GDP in 2006, robust real GDP growth drove the debt-to-GDP ratio down to 133.5 percent by 2012, at which point it started rising again. This should highlight the rising short-term risks associated with a lack of fiscal reforms in an environment where more brisk growth is contingent on either a resolution to the

7 World Bank (2012), "Republic of Lebanon—Good Jobs Needed: The Role of Macro, Investment, Education, Labor and Social Protection Policies", December, Washington DC.

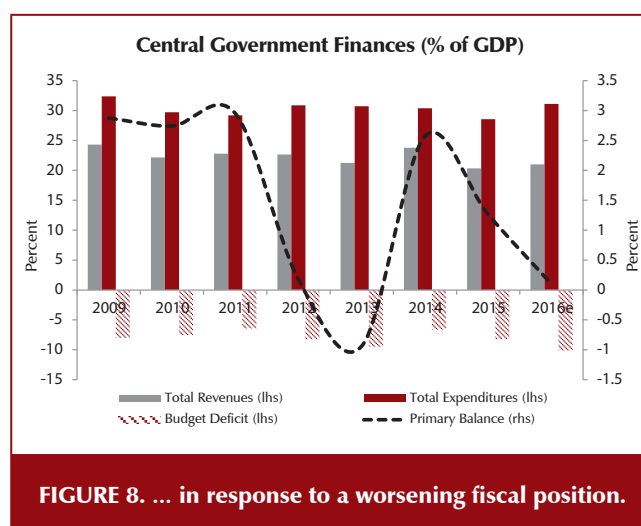


Sources: MoF and WB staff calculations.

Syrian conflict or structural reforms that can payoff but only over the medium and long terms.

11. The fiscal position of Lebanon became more tenuous as the overall fiscal deficit widened and the primary fiscal surplus almost disappeared. The overall fiscal deficit increased by an estimated 1.8 pp to reach 10 percent of GDP, hitting double digits for the first time since 2006 (Figure 8). While both revenues and expenditures rose during 2016, the latter outpaced the former. A marginally improving economy in 2016 helped push total revenues for government by an estimated 0.7 pp to reach 21 percent of GDP, driven by tax, non-tax and treasury revenues. However, this was more than offset by an estimated 2.5 pp rise in total expenditures to 31.1 percent of GDP, driven primarily by interest payments, payments of arrears and transfers to municipalities. Primary spending (excluding debt service) rose by 1.9 pp, which caused the primary surplus to decline from 1.3 percent of GDP in 2015 to 0.1 percent in 2016. Meanwhile, transfers to Électricité du Liban (EDL), the state-owned electricity company, continued benefitting from the fall in oil prices, regressing by an estimated 0.5 pp in 2016 to be around 1.9 percent of GDP, compared to an average of 4.3 percent of GDP during the previous decade.

12. The slowdown in economic activity since the onset of the regional turmoil has induced a general softening in total revenues, which has not been matched by a commensurate cut in



Sources: BdL, CAS and WB staff calculations.

expenditures. During the 2012-2016 period, total revenues averaged 21.8 percent of GDP, compared to 23.4 percent of GDP over the 2002-2011 period. On the other hand, primary spending has remained at the pre-crisis period average—21 percent of GDP for both the 2002-2011 and the 2012-2016 periods.

13. Sizable Eurobond issues by the Ministry of Finance highlight large financing needs. The government continues to primarily finance the fiscal deficit by issuing Treasury bills and Eurobonds. In April 2016, Lebanon successfully issued US\$ 1 billion in Eurobonds to replace maturing debt. The Eurobond issue was divided into two tranches: the first was for \$700 million, maturing in 2024 with a 6.65 percent interest rate, and the second was for \$300 million that matures in 2031 with an interest of 7 percent. This was followed by a sizable Eurobond issue in March 2017, in the amount of US\$ 3 billion divided between US\$ 1.25 billion, US\$ 1 billion and US\$ 750 million tranches at, respectively, 6.85 percent, 7 percent and 7.25 percent interest rate with a maturity of 10 years, 15 years and 20 years, respectively. For both Eurobond issues, the ministry announced that the bonds were oversubscribed. The stock of debt outstanding remains mostly in local currency; by end-2016, 62.5 percent of gross public debt was denominated in LBP, compared to 61.5 percent end-2015.

14. The passage of the 2017 budget by cabinet is a welcomed first step, which needs to be ensued by parliament ratification. The last official

budget for Lebanon was in 2005, at which point discord regarding accountability over previous fiscal accounts have prevented subsequent budgets from being ratified by parliament. Spending has since been conducted largely through treasury advances and ad-hoc measures in times of pressures. This left fiscal policy without an anchor. Even prior to 2005, fiscal policy has been missing a medium-term perspective. Moreover, none of the post-war budgets were voted within the constitutional period and the last officially closed fiscal accounts are those of 2003, although those from 1993 to 2003 need major adjustments. Such longstanding structural bottlenecks in public finance are important manifestations of the perceived endemic corruption⁸ and political malfunction, impeding the development of the country. There is a lack of proper oversight and accountability over public finance, including those over extra-budgetary entities that receive significant government funding, helping to entrench a perception of non-transparency and encouraging corruption in fiscal affairs.

External Sector

15. A pick up in imports of merchandize goods combined with deteriorating exports induced a widening in the already sizable trade deficit. After narrowing by 6.3 pp in 2015 to 23.2 percent of GDP as a result of import deflation (lower commodity prices, especially fuel products, and euro depreciation), the trade in goods and services deficit in 2016 reversed this progress by almost half to reach an estimated 26.5 percent of GDP. Despite continued favorable valuation effects due to low import inflation in 2016, a pickup in volumes imported, reflecting the slightly improving economic activity, helped boost nominal imports. As a result, merchandize imports increased by 1.8 pp to 38 percent of GDP, led by energy and pearls, precious stones and metal. Regarding exports, Lebanon

continued to be afflicted by the closure of the last remaining Syrian route in May 2015, through which exporters were able to access the GCC market, a factor that kept merchandize exports weak at 8.6 percent of GDP. Moreover, the increase in tourist arrivals signaling a mild revival in the tourism sector was more than offset by price deflation in 2016, leaving exports of services down by an estimated 1.9 pp to 31.7 percent of GDP. The regional turmoil has significantly worsened the trade balance, whose deficit in the pre-crisis period (2002-2010) averaged 19.9 percent of GDP, supported by stronger exports of goods and services that averaged 47.1 percent of GDP and 13 percent of GDP, respectively.

16. Following short- to medium- term resiliency to low oil prices, remittances inflows show evidence of a slowdown. Indeed, with oil prices declining sharply in 2014, balance of payments (BoP) data published by the central bank illustrate this resiliency as inflows of remittances actually rose by 0.4 pp to 14.1 percent of GDP in 2015, helping to push net remittances up by 1.5 pp to 7.6 percent of GDP. As expounded on in earlier issues of the *Lebanon Economic Monitor*, this resiliency stemmed from GCC fiscal buffers that mitigated the negative effects on remittances from the Gulf region in the short to medium term. The latest available BoP data, however, indicate that remittances inflows in H1 2016 are unvaried in levels (and lower as a ratio of GDP) compared to H1 2015, suggesting that medium term negative implications of low oil prices are materializing. This, along with increased outflows of remittances resulting from the slightly improved economy, reduced net remittances by an estimated 0.8 pp to 6.8 percent of GDP in 2016.

17. A widening trade in goods and services deficit along with decelerating inflows of net remittances effected a deterioration in the already sizable current account deficit. After narrowing by 8.4 pp in 2015 to 17 percent of GDP led by the improved trade balance, the current account deficit is estimated to have shot back up to 20.9 percent of GDP in 2016, exposing the country to significant refinancing risks.

8 World Economic Forum's Global Competitiveness Index for 2016-2017 ranks Lebanon very low in governance issues. For example, on the category of public trust in politicians, Lebanon ranked 125 out of 144 countries, while on transparency of government policy making and wastefulness of government spending the country ranked 126 and 135, respectively.

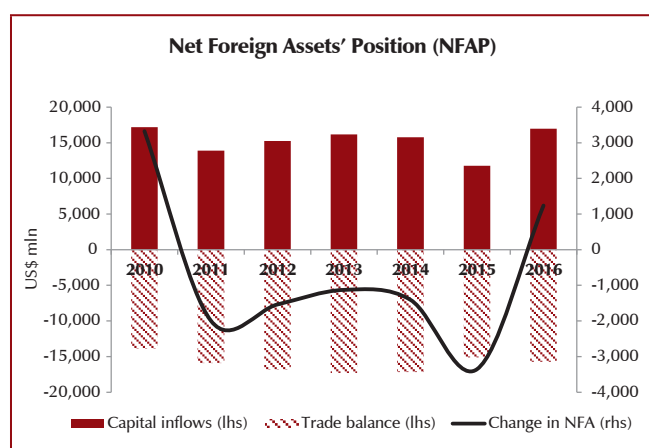


FIGURE 9. Regression in capital inflows reversed in 2016...

Source: BdL and WB staff calculations.

18. Financial engineering carried out by BdL in 2016 reversed the negative trend in the country's net foreign assets position (commercial banks plus central bank), which has been in effect every year since 2011. The annual cumulative change in net foreign assets (NFA) turns positive for the first time since 2010, resulting in a US\$ 1.2 billion increase in NFA in 2016, compared to a decline of US\$ 3.4 billion in 2015 (Figure 9). The BdL swap, whereby Eurobonds held on its balance sheet were exchanged for Treasury Bonds held by commercial banks, attracted higher capital inflows reinforcing the economy's NFA position.⁹ In fact, capital inflows increased by 44.2 percent in 2016, more than offsetting the widening trade deficit. The economy is structurally and heavily dependent on capital inflows to finance its current account deficit.¹⁰ Since 2012, leading sectors toward which the majority of foreign capital has traditionally gravitated have suffered a significant decline in activity, becoming a less attractive destination for FDI (e.g. real estate, tourism). While net FDI in 2015 (latest available data for a complete year) grew by 2.4 percent to US\$ 1.7 billion (3.6 percent of GDP), this is primarily due to a sharp 47 percent fall in outbound FDI. This compares poorly with the pre-crisis period, where between 2000 and 2010 net FDI averaged 9.5 percent of GDP. The presence of Syrian refugees

9 For a more in-depth analysis and presentation of the financial engineering mechanism, refer to the Lebanon Economic Monitor, Fall 2016 issue.

10 The current account deficit has averaged 18.5 percent of GDP during the past ten years.

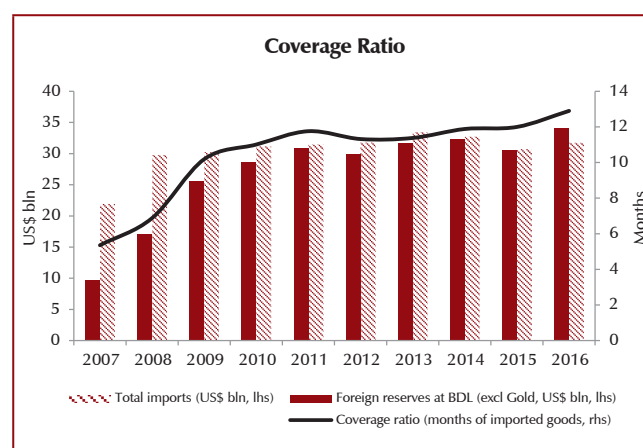


FIGURE 10. ... inducing an increase in gross foreign reserves at BdL.

Source: BdL, Lebanese Customs and WB staff calculations.

has partially compensated for the overall loss of inflows since 2010; international aid targeting Syrian refugees provides additional support to the balance of payments.¹¹ Support is also generated by the wide, albeit, slightly narrowing spread between domestic and international interest rates; by November 2016, this spread registered 353 basis points (bps), compared to 407 bps in November 2015.¹²

19. The BdL swap met a primary objective of replenishing central banks' stock of gross foreign reserves, following a contraction in 2015. As a result of the increase in capital inflows, the central bank's gross foreign reserves (excluding gold), reached US\$ 34 billion by end-2016, equivalent to 12.9 months of imports of goods and services and 11.1 percent higher than the end-2015 level (Figure 10). This compares to a decline of 5.4 percent in 2015, until when gross foreign exchange reserves seemed unaffected by the deteriorating balance of payments. In fact, from 2012 to 2014, the loss of foreign assets (see paragraph above) did not reflect on gross foreign exchange reserves at the central bank, which continued rising. A principal

11 Inflows to Lebanon have also included international aid targeting Syrian refugees, albeit via various international organizations and not through the government, which continues to appeal for assistance. A United Nations Development Program (UNDP) study assesses the impact on the Lebanese economy of international humanitarian aid delivered via UN agencies to the Syrian refugees in Lebanon. It estimates that this aid, estimated at over a billion dollars between 2012 and 2014, has a multiplier effect that added 1.3 pp to 2014 GDP growth.

12 This is the interest rate differential between the 3-month Lebanese T-bill and the 3-month LIBOR.

reason has been that commercial banks, faced with globally depressed interest rates, repatriated foreign assets in search of higher yields. Indeed, as illustrated in Figure 11, since 2010, and except for a brief interruption in 2012, commercial banks have increased their exposure to foreign currency-denominated sovereign debt;¹³ simultaneously, they have sharply decreased the share of total assets held as balances abroad, as proxied by balances held with Bank of International Settlements (BIS) reporting banks. In 2015, the combination of slowing capital inflows since 2010 and a growing need for government foreign currency financing, led to a 5.4 percent decline in central bank reserves to reach US\$ 30.6 billion. To re-incentivize commercial banks to hold domestic assets, BdL proceeded with the financial swap.

Monetary Sector

20. The deflationary trend in prices has reversed in 2016. After reaching a trough in Q3-2015, the 12-month headline inflation rate finally turned positive in September 2016, pushing the average for the year to -0.8 percent, compared to -3.7 percent in 2015. Higher inflation has been led by (i) real estate (rent and owner occupied), (ii) clothing and footwear and (iii) education (Figure 12). The contribution of the latter two categories has become increasingly palpable, reflecting the yoy change in rising energy prices since Q4-2015. Core inflation (excluding energy and food) turned positive earlier in April 2016 for the first time since August 2015. The deflationary trend over the past couple of years reflected (i) the decline in global prices for commodities, especially energy and food; (ii) an appreciating effective exchange rate given the country's peg to the dollar; and (iii) subdued economic activity (below potential output). Due to the provisional nature of this import deflation, we have been expecting this trend to be temporary,

13 This includes Eurobonds and World Bank staff estimates of commercial banks' foreign currency reserves held at the central bank (which we are assuming to include outstanding foreign-currency denominated Certificate of Deposits (CDs) issued by the central bank).

notwithstanding the persistent sluggish economic activity. Indeed, items (i) and (ii) ceased to be deflationary drivers in 2016.

21. Exchange rate stability, a negative output gap and price deflation constituted motivations for the central bank for continued expansionary monetary policy in 2016. The dollarization rate—a key gauge of confidence in Lebanon—has been largely unchanged since early 2015, registering 65.8 percent in July 2016. Simultaneously, real GDP growth continues to lag behind the 1993-2014 average rate of 4.4 percent, and well below potential, generating a negative output gap.¹⁴ These, along with price deflation, allowed BdL to extend its loan subsidy program in 2015 for the third year running,¹⁵ with an additional injection of US\$ one billion. The swap undertaken by BdL this year has also injected additional liquidity into the banking system.

22. To maintain the peg, BdL ensures banks offer attractive dollar spreads to finance the current account. Under sustained and large fiscal needs and a banking sector balance sheet that is over four times GDP, BdL ensures that banks keep attracting foreign deposits and that the public sector gross financing needs are met. For the former, BdL introduced various subsidized refinancing schemes as well as new certificate of deposits for the 15-year, 20-year and 30-year tenors, lengthening the maturity structure. As to public finance, BdL bids on the Treasury Bills and Bonds primary market and acts as a buyer on the secondary sovereign debt market. In the absence of a government, the central bank has aimed at sustaining or even boosting private demand (e.g., the stimulus packages) as well as the financial sector's stabilizer of last resort, multiplying the financial burdens on BdL. The resulting banking-sovereign feedback loop, however, is a source of

14 For a more in-depth analysis on the output gap, please refer to Box 1 in the Fall 2015 issue of the Lebanon Economic Monitor.

15 This program was launched by the BdL in 2013 and continued in 2014 in the amounts of US\$1.46 billion and US\$800 million, respectively. The real estate sector has been the principal beneficiary, boosting domestic demand after demand from Lebanese expatriates and foreign buyers dropped sharply. To a lesser extent, BdL's subsidized loans also targeted start-ups and venture capital (relatively nascent in Lebanon), with yet undetermined effect.

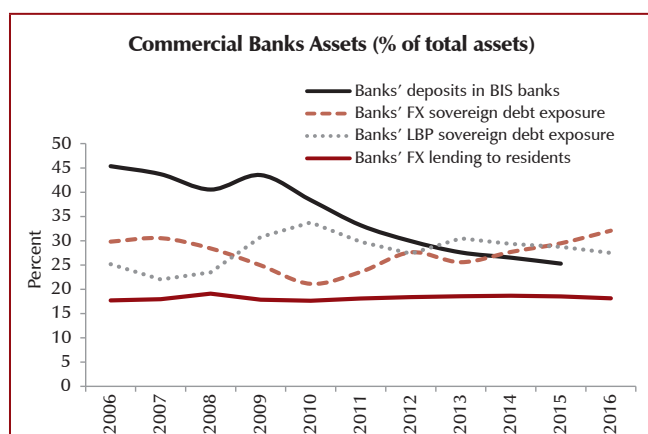


FIGURE 11. Banks increase their exposure to foreign currency-denominated sovereign debt.

Sources: BdL and WB staff calculations.

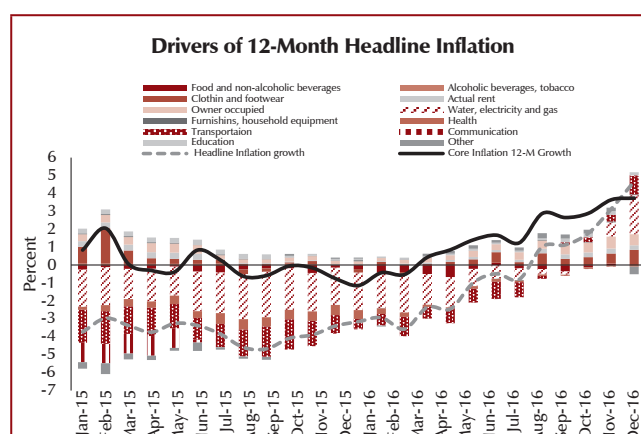


FIGURE 12. Deflationary trend reversed in 2016, as provisional import deflation abates.

Sources: CAS and WB staff calculations

significant macroeconomic risk (Le Borgne and Jacobs, 2016¹⁶).

23. Lending to the resident private sector continued to expand in 2016. Commercial banks' claims on resident private sector grew by 6.2 percent in 2016, compared to 5.9 percent in 2015. With a deflationary environment in 2016, the change in real private lending was larger. To a significant extent, this is supported by BdL's numerous subsidized lending schemes.¹⁷ Nonetheless, it is also a notable deceleration from an average growth of 9.4 percent and 9.7 percent in 2014 and 2013, respectively, possibly reflecting declining marginal returns to the lending schemes as the pool of viable borrowers shrinks. Going forward, authorities need to exert scrutiny and caution to risks associated with the over-leveraging of households, via possibly enhanced macro prudential measures such as those introduced by the BdL in 2014.¹⁸

16 *Lebanon: Promoting Poverty Reduction and Shared Prosperity*, Systematic Country Diagnostic, World Bank, Washington DC.

17 For an in-depth discussion of BdL-subsidized lending schemes, refer to the Special Focus in the Lebanon Economic Monitor, Fall 2016 issue.

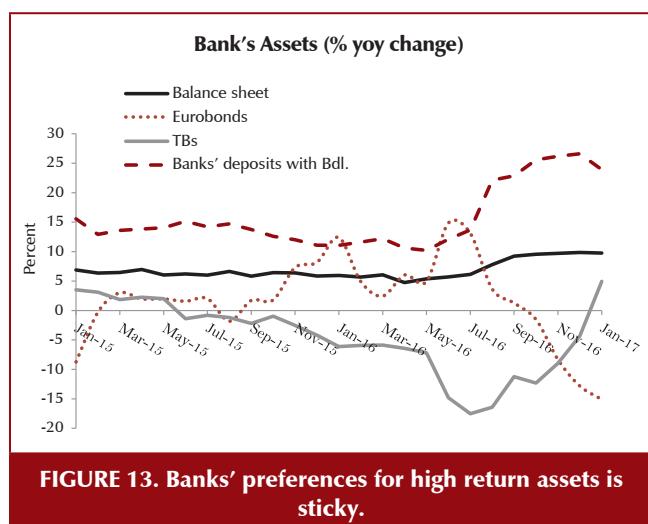
18 To limit leverage risks on the consumer side and the fallout impact on banks, in 2014, BdL instructed banks to require a minimum down-payment of 25 percent for any car or housing loan and to limit the value of the loan such that the monthly installment does not exceed 45 percent of family income (35 percent for a housing loan).

Financial Markets

24. The substantial size of the BdL swap¹⁹, both in scale and scope²⁰, has imposed short-term dynamics on the banking sector. Examining the evolution of commercial banks' balance sheet over the relevant time period can be illuminating. By end-January 2017, commercial banks' total balance sheet expanded by 9.8 percent (yoy), compared to an average of 6 percent over the previous 5 corresponding periods starting in January 2011. The scale becomes even more glaring if total balance sheet is considered as a percentage of GDP, rising from an already elevated 395 percent in January 2016 to 430 percent in January 2017. The monthly yoy growth in the total balance sheet began accelerating in spring 2016, picking up speed in Q3 2016 and then slowing down in Q4 2016 (Figure 13). The swap, which involved an exchange of LBP-denominated Treasury Bonds (TBs) held by banks with Eurobonds and foreign currency-denominated Certificate of Deposits (CDs) held by BdL, translated into increases and decreases in banks' holdings of Eurobonds and TBs, respectively, from spring until the summer. Interestingly, soon after, these trends were sharply reversed as banks' preferences to hold

19 For a more in-depth analysis on the implications of the financial engineering mechanism, refer to the Lebanon Economic Monitor, Fall 2016 issue.

20 IMF staff estimate BdL's sale of Eurobonds and other foreign exchange-denominated securities to commercial banks at US\$ 13 billion (Article IV, January 2017), equivalent to around 27 percent of 2016 GDP.



Source: BdL and WB staff calculations.

higher yielding instruments became evident with the surge of banks' deposits with BdL and even a re-accumulation of TBs.

25. The swap resulted in a surge in LBP liquidity presenting liquidity-management challenges.

Broad money measures, M3 and M4²¹, rose by 7.8 percent (yoy) and 7.1 percent (yoy), respectively, in January 2017, compared to 5.2 percent for both in January 2016, with M3 experiencing the fastest growth since June 2011. The liquid asset-to-total deposit ratio²², an indicator of short-term liquidity, stood at 74.5 percent by January 2017, compared to 70.4 percent end-2015. This increase in liquidity has translated into increased LBP lending to the private sector (Figure 14), as banks' LBP claims on resident private sector grew by 14.9 percent (yoy), its fastest pace since May 2014.

26. Over the past few years, there has been a discernable slowdown in deposit growth, which has constituted the principal funding source for commercial banks. The deposit-to-total liabilities ratio²³ stood at 81.5 percent by January 2017. Non-resident deposits, in particular, have been a vital factor in the stability of the banking sector, and in

21 M3 includes demand deposits at BdL, currency in circulation, deposits in LBP, deposits in foreign exchange and bonds, while M4 is M3 plus non-resident deposits.

22 Liquid assets consist of commercial banks' deposits with central bank, Treasury Bills and Bonds in LBP held by commercial banks and Eurobonds held by commercial banks.

23 This is the ratio of total private and public sector deposits at commercial banks to commercial banks' balance sheet.

fact the whole economy, constituting 21 percent of total private deposits (end-January 2017). Attracted by interest rate spreads, new private deposits at commercial banks have averaged a significant 13.4 percent of GDP annually since 1994, of which new non-resident deposits averaged 3.5 percent of GDP annually. These deposits are a principal resource for the economy, including crucial inflows used to meet external balances generated from a sizable and persistent current account deficit. In fact, between 2003 and 2010, total new private deposits (TD) averaged 19.4 percent of GDP, while new non-resident private deposits (NRD) averaged 4.4 percent. These ratios have declined sharply since, due primarily to the regional turmoil and secondarily to the unsustainability of such high levels. During the crisis period of 2011-2016, TD and NRD shares of GDP fell to 9.4 percent and 3.9 percent, respectively. Increasing deposit growth has been a main objective of the BdL swap.

27. Raising foreign exchange (FX) for the purpose of engaging in the swap operation has been a primary focus for banks in 2016. Figure 14 suggests three such sources of FX funding for banks, with non-resident deposits being an early source as the pickup in the trend is evident from the spring, while resident deposits growth began accelerating in Q3 2016. Resident and non-resident private sector deposits increased by 7.7 percent (yoy) and 6.2 percent (yoy), respectively, by January 2017, compared to a respective 5 percent and 5.3 percent in January 2016. Additionally, banks cut down FX lending to resident private sector allowing for savings.

28. The swap operation has also imposed short-term dynamics on the proportional allocations within the portfolio. As a percentage of total assets, Eurobond and TB bank holdings, once again increased and decreased, respectively, at the beginning, only to reverse trend later, with the former ending up at a lower ratio compared to the start of the operation (Figure 15). The proportion being deposited at BdL also increased, while that lent out to the resident private sector in FX declined.

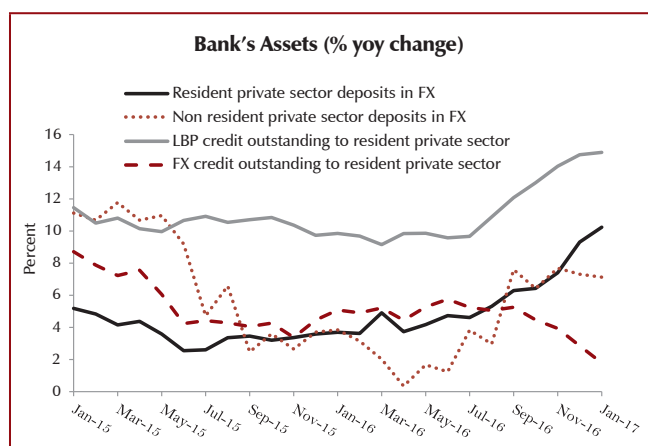


FIGURE 14. Funding sourced from resident and non-resident deposits.

Source: BdL and WB staff calculations.

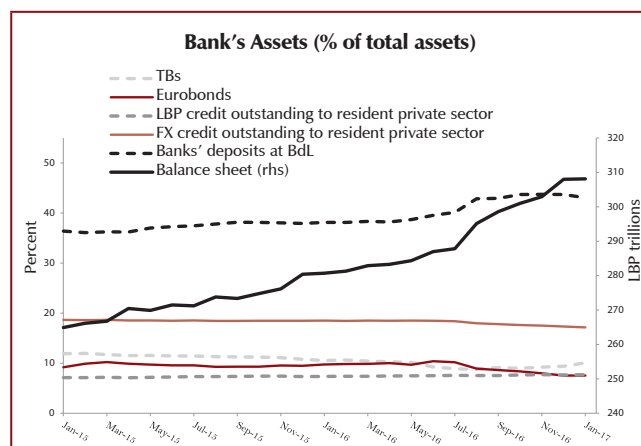


FIGURE 15. A discerned slowdown in both resident and non-resident deposit growth.

Source: BdL and WB staff calculations.

29. Commercial banks' already high exposure to sovereign credit risk, as they have long been large investors in public debt²⁴, has been further intensified, especially that denominated in FX. Hence, while Lebanese banks' sovereign debt exposure (FX plus LBP)²⁵ increased by only 2.2 pp (yoy) to 60.7 percent by January 2017, that denominated in FX rose by a much more substantial 15.5 pp over the same period, to reach 45.6 percent. The mild (substantial) increase in the former (latter) is due to the nature of the swap operation, where the face value of aggregate debt is minimally impacted, while that of the currency compositions are strongly affected. However, this renders banks highly exposed to FX sovereign debt.

²⁴ Interest income, as obtained from BilanBanques, amounted to 66.15 percent and 66.31 percent of total consolidated banks' income in 2013 and 2014, respectively.

²⁵ 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.

PROSPECTS

30. The regional turmoil, especially the war in Syria, continues to pose serious security threats in Lebanon and the recent relative calm is not a guarantee of stability. A key assumption underlying projections for the Lebanese economy regards the Syrian conflict and its spillovers. World Bank staff projections assume that current conditions hold, i.e., spillovers continue to be contained without precluding the occurrence of occasional serious security events. On those basis, real GDP growth for 2017 is projected to pick up somewhat to 2.5 percent, as a result of progress made in the domestic political process, continued revival of the tourism sector and a slight improvement in real estate and construction. This, however, is contingent on the political scene not reverting back to stalemate conditions. Removing the drag effected by the political stalemate will nonetheless not be sufficient for growth to return to potential as that critically hinges on a resolution of the conflict in Syria or on the introduction of a strong and credible reform program (see Special Focus). As such, we expect real GDP growth to continue to be around 2.5 percent over the medium term.

31. Large financing needs stemming from unsustainable debt ratios and persistent and sizable twin (fiscal and current account) deficits render the country exposed to significant refinancing risks. The overall fiscal deficit is projected to stay elevated over the medium term, remaining at around 10 percent of GDP in 2017 and 2018, and driving the debt-to-GDP ratio to a projected 166 percent of GDP and 170 percent of GDP, respectively. Similarly, a large trade-in-goods deficit will keep pressure on the current account balance, keeping it an expected deficit of 19 percent of GDP over the same period, a sizable and alarming level. As such, and in light of decelerating deposit inflows, pressure will be maintained on the authorities to identify refinancing sources, especially

that which is denominated in hard currency.

32. Absent significant structural reforms on either revenue or spending, Lebanon's public finances are projected to remain structurally weak. Debt servicing is expected to continue rising due to pass through from higher global interest rates, while rising oil prices will reflect on transfers to EdL. Meanwhile, government revenues are unlikely to improve significantly. As a result, and despite the return of positive inflation in 2017, the trend for the debt-to-GDP ratio based on current policies and real GDP growth rates remains unsustainable and is expected to notably worsen once global dollar interest rates start normalizing (a pace which is expected to pick up in 2017 due to a tightening of policy rates by the U.S. Federal Reserve Board).

33. Structural reforms are supplanted by an increasingly active central bank. Notwithstanding the short-term need, such interventions can exacerbate macro-financial risks other than the liquidity and balance-sheet challenges discussed above. First, the expected normalization of global interest rates will make it harder to attract hard currency deposits unless domestic interest rates rise in commensurate, which is inconsistent with the objectives of BdL's interventions. Second, the enthusiastic response to BdL initiatives (subsidized loans) has helped boost economic activity but after several years of such lending, more attention will need to be paid to the issue of household leveraging and repayment capacity. Third, it remains unclear the extent or duration of the swap operation, which reaped banks exceptional rates of return in a very unconventional way, and in their turn, banks extended seductive offerings to investors to transfer US\$ from abroad. These operations are disruptive to the market, creating massive liquidity that has a high long-term cost.

34. Lebanon is confronting a multitude of protracted shocks each of which can have the potential to alter the country in fundamental ways in the short to medium term. These include: security spillovers and economic challenges of the war in Syria; prolonged domestic political impasses and institutional paralysis; hosting the largest per capita refugee population in the world, most of whom made an influx over a period of only 2-3 years. The sense of urgency is reinforced by a palpable deterioration in the quality of public services, institutions, governance and the business climate. Moreover, a frail macro-fiscal framework, underpinned by unsustainable debt ratios and persistent and sizable fiscal and current account deficits, exposes the country to significant refinancing risks. As a result of these compounding risks, Lebanon can ill afford not to proceed with deep and expansive structural reforms (see Special Focus).

SPECIAL FOCUS

PRIORITY REFORMS FOR THE GOVERNMENT OF LEBANON²⁶

Abstract

The end to the long political stalemate offers Lebanon a unique window of opportunity to mitigate impending risks and tackle longstanding and, by now, pressing development challenges. The sense of urgency is reinforced by rising macroeconomic risks and a palpable deterioration in the quality of public services and institutional performances. This has been compounded by the Syrian war and the massive influx of refugees, taking a toll on the economy and placing added strain on Lebanon's education, health, municipal and other sectors. This Special Focus presents a menu of reforms that would enable the country to rapidly and significantly turn the page of inaction and decline and return the country to a prosperous and inclusive development path. To that end, reforms are prioritized over two time horizons—the short term, allowing for initiative by the present government to establish a record of achievements and government credibility that is currently sorely absent, and the medium term for more comprehensive and systemic reforms, which can alter Lebanon's fundamentals toward sustainable and inclusive development.

I. THE EXIGENCY: STATING THE CASE

35. Today Lebanon is confronting a multitude of protracted shocks each of which can have the potential to alter the country in fundamental ways in the short to medium term. These include significant internal and external security threats, extensive and systemic macroeconomic risks, and the arrival of an unprecedented number of refugees making Lebanon the largest per capita host of refugees in the world. Moreover, the protracted nature of these shocks is of particular concern as it is testing the limits of the country's well-renowned resiliency.

36. After a long political stalemate, reforms are urgently needed to return Lebanon to a sound development path. The election of President Michel Aoun in October 2016 after almost two and a half years of a presidential vacancy, and the subsequent formation of a unity government under Prime Minister Saad Hariri, have generated hope for the resuscitation of the political process in Lebanon. This constitutes a unique window of opportunity to mitigate impending risks and tackle longstanding and, by now, pressing development challenges. The country has been on a path of structural decline since the early 21st century—the quality of public services, institutions, governance and the business climate, to name a few, have all shrunk to poor levels, unbefitting the country's history of excellence (as detailed in the World Bank's 2016 *Systematic Country Diagnostic* on Lebanon). This new opening provides a renewed opportunity to address these challenges.

²⁶ This Special Focus was authored by a cross-sector team led by Wissam Harake (Country Economist).

37. A frail macro-fiscal framework, underpinned by unsustainable debt ratios and persistent and sizable fiscal and current account deficits, exposes the country to significant refinancing risks. Attracting sufficient capital, and in particular deposits, to finance significantly larger budgetary and current account deficits could prove challenging based on recent deposit growth data. This is especially so in light of rising U.S. interest rates and the persistence of sluggish growth prospects in oil-producing Gulf countries, knowing the strong correlation between inflows of capital to Lebanon and the dynamics of the economies of Gulf countries. Meanwhile, a near-complete void of Government initiative to address macroeconomic imbalances is best exemplified by an absence of an official budget since 2005. Instead, progressively potent interventions by the central bank, the Banque du Liban (BdL), to actively manage economic and financial challenges facing the country, even when successful, offer only temporary reprieve, and are not without additional macro-financial risks. Macroeconomic vulnerabilities are also a consequence of an unbalanced growth model that is heavily reliant on specific non-productive, non-tradable and rent-seeking sectors that benefit the select few and fail to deliver quality job opportunities to a large share of the population. Structural reforms emanating from a cohesive and integrated overall economic vision is the prerogative of the political authority, with the dual responsibility of the legislative and the executive branch.

38. The Syrian crisis has exacerbated already existing challenges and pressures compounding the need for reforms. The conflict in Syria is having a large and negative impact on Lebanon's economy and its social and infrastructure sectors.²⁷ Lebanon's macroeconomic framework has deteriorated markedly since the onset of the Syrian conflict; while the country is known for its resiliency and for seemingly defying gravity, its buffers now urgently need replenishing. Social cohesion has also been adversely affected partly due to the combination of rising poverty, unemployment and joblessness

particularly for the youth, and a (further) deterioration in core public services. The latter are under pressure given the sudden and large increase in demand arising from the Syrian refugee influx, which has incurred a sizable fiscal cost. Across all core public services, the surge in demand is currently being partly met through a decline in public service access and quality.

39. The following section identifies priority reforms that policymakers can adopt and implement on an urgent basis in order to mitigate sizable and impending risks and unlock principal constraints for Lebanon's development. These critical reforms are needed to put the country on the right track. Specifically, the Government can announce immediately a set of very specific reforms it intends to undertake with communication around the reforms the central message of the Government. Achieving a good mass of these reforms will bestow on the Government much needed credibility and generate essential momentum to launch and implement further key reforms over the medium term. Accordingly, the Special Focus is divided into short-term reforms, which are critically needed and are readily achievable, and medium term reforms. Below we summarize the top 10 priority measures that the new Government and the President, in collaboration with Parliament, can adopt and implement over the short term so as to send a strong signal to all stakeholders that the country is being governed again and that growth and development will resume.

²⁷ Lebanon - Economic and Social Impact Assessment of the Syrian Conflict, World Bank (2013), Report No. 81098-LB, September.

Priority Reform 1: RATIFICATION OF BUDGET 2017

Following the Council of Ministers (CoM) submission of a draft budget to Parliament, Parliament to pass a budget for 2017 in a manner that upholds constitutional edict and procedure, such that the budget generates a primary surplus.

Priority Reform 2: RATIFICATION OF PUBLIC PROCUREMENT LAW 2013

Parliament to ratify the revised Public Procurement Law of 2013.

Priority Reform 3: FISCAL REFORMS

CoM to pass a Decree stating that any increase in power supply from new power generation output would be matched by an automatic and commensurate rise in the average tariff leaving government transfers to EdL unaffected by the rise in output.

Priority Reform 4: PUBLIC PRIVATE PARTNERSHIP

CoM to pass an updated version of the existing draft PPP law.

Priority Reform 5: GAS-RUN POWER GENERATION

CoM to issue a tender package for a liquefied natural gas (LNG) terminal to supply fuel for power generation.

Priority Reform 6: INCREASING POWER GENERATION

CoM to support ongoing plans for development of power generation capacity through (a) resolving and providing the necessary public financing to complete ongoing generation projects; and (b) hiring a transaction advisor to initiate implementation of a program to develop new generation capacity by independent power projects (IPPs).

Priority Reform 7: ESTABLISHING PUBLIC TRANSPORT

CoM to authorize and mandate Council of Development and Reconstruction (CDR) as executing agency to prepare and negotiate the Greater Beirut Urban Transport Project.

Priority Reform 8: SOCIAL SAFETY NETS

CoM to scale up the National Poverty Targeting Program (NPTP) by approving the expansion of the electronic-card food voucher, and the necessary budgetary allocation, from the current 10,000 extreme poor households to 15-20,000 extreme poor households; and the Ministry of Social Affairs (MoSA) and the Presidency of the Council of Ministers (PCM) to finalize the updating and renewal of the NPTP database of poor households via a recertification of all beneficiaries currently in the database (110,000 households) and an assessment of new applicants based on the new targeting formula and agreed protocols of assessments and supervision.

Priority Reform 9: SOLID WASTE TREATMENT

Parliament to approve the Integrated Solid Waste Management Law.

Priority Reform 10: IMPROVED BUSINESS ENVIRONMENT

CoM to announce the launch of an accelerated program of business environment reforms through (i) the passage of a Secured Transaction and Collateral Registries law in close coordination with the central bank given its vital role over the banking sector; (ii) reform of the commercial registry and licensing procedures, in particular in the tourism sector; (iii) the passage of the e-signature law to enable dematerialization of regulatory processes; and (iv) the launch of a matching grant program designed to support job creating investments by Micro, Small and Medium Enterprises (MSMEs).

II. SHORT-TERM PRIORITIES

A. Passing a Credible Budget: the Litmus Test

40. Lebanon is unique in the world in that it has not had an official budget since 2005, leaving fiscal policy without an anchor, and development without a vision. This has prevented necessary reforms that address the country's structurally weak public finances with sizable and growing overall fiscal deficits. Moreover, current spending is projected to grow as a result of increased debt servicing and larger transfers to Electricité du Liban due to pass through effects from rising global interest rates and oil prices, respectively. As a result, the trend for the already sharply elevated debt-to-GDP ratio based on current policies and real GDP growth rates remains unsustainable and is expected to notably worsen. A budget is needed for fiscal policy decisions to be taken (on taxes, public spending, etc.) to restore the sustainability of public finances, to improve the progressivity of the tax system and to increase the efficiency of spending. A budget is also needed to enshrine fundamental development policy choices and charter a vision and a project through a well thought through medium term expenditures framework.

41. The budget process has been in disarray. Since 2005, budgets have not been ratified by parliament, while fiscal accounts have not been officially closed since 2003. Spending has been conducted largely through treasury advances and ad-hoc measures. Even prior to 2005, fiscal policy has been missing a medium-term perspective. Furthermore, there is a striking lack of adequate oversight and accountability, including over state-owned enterprises or extra-budgetary entities that receive significant government funding (most notably, the Electricity Company, the Council for

Development and Reconstruction, the Council for the South, and the Central Fund for the Displaced). This helps entrench a culture of non-transparency and capture of fiscal policy for geo-confessional and political purposes, creating room for fiscal leakages, inefficiencies and corruption.

Priority Reform 1: Ratification of Budget 2017

Following the Council of Ministers (CoM) submission of a draft budget to Parliament, Parliament to pass a budget for 2017 in a manner that upholds constitutional edict and procedure, such that the budget generates a primary surplus. The primary surplus will send a strong signal that the incoming government appreciates the gravity imposed by the macroeconomic risks. Passing a budget and institutionalizing best budgetary practices offer a high return-to-effort ratio, imparting a much-needed positive shock and allowing the Government to signal to its people and the world its resurrection

B. Building Trust

42. Poor governance and weak institutions are significant constraints that impede the economic and social development of Lebanon. Institutions are extremely weak, characterized by both inefficiency and corruption. The country suffers from a governance trap, whereby political stability is maintained through subordination of national prerogatives to consensus among sectarian leaders, at the cost of strong institutions focused on the common good. As a result, Lebanon scores poorly on many aggregate governance indicators. For instance, out of 144 countries, Lebanon ranks 118 in irregular payments and bribes, 125 in public trust in politicians and 135 in wasteful government spending.²⁸ Strengthening governance, institution-building, accountability procurement, and the rule of law can present key ingredients in achieving Lebanon's strategic objectives, from improved service delivery to growth and poverty reduction. Public procurement has received considerable

²⁸ Source: World Economic Forum, Global Competitiveness Index 2016-2017.

public attention recently, with controversies centered on large tenders related to main sectors (waste treatment, electricity). Moreover, weak public procurement procedures have enabled elite capture and prevented effective competition between bidders over a certain class of projects tendered out by the state.

Priority Reform 2: Ratification of Public Procurement law 2013

Parliament to ratify the Public Procurement Law of 2013. The law of 1963, which constitutes the legal foundation of Lebanon's current institutional framework for procurement, is excessively centralized, resulting in procurement and execution delays. A revised procurement law originally drafted in 1990, with the latest revisions introduced as recently as 2013, was submitted by the CoM to the Parliament. It was only put on the agenda of a "Combined Committee" for discussion on February 24, 2015. Due to lack of time, the review has been postponed, and the law remains unratified.

C. Securing a Soft Landing

43. Lebanon's high and rapidly growing debt level, large twin deficits (fiscal and current account) and a highly dollarized pegged economy present significant macroeconomic vulnerabilities. The country's substantial financing needs are primarily funded by a banking sector whose balance sheet is over four times GDP. Banque du Liban (BdL) ensures that banks keep attracting foreign deposits and that the public and private sectors gross financing needs are met, thereby financing the sizable current and fiscal account deficits. To attract foreign deposits, BdL has introduced certificate of deposits and various subsidized refinancing schemes. To meet the needs of government, BdL is the residual buyer of government debt in the primary and secondary markets. The result is a banking-sovereign feedback loop with an amplification effect on systematic macro-financial risks.

44. One potential risk with such a feedback loop can be a sudden stop scenario, whereby an abrupt confidence shock would lead to a short-fall in foreign capital inflows that would become insufficient to meet the country's sizable gross financing needs. Given Lebanon's large balance sheet vulnerabilities — starting with a banking system with a heavy balance sheet, primarily exposed to the Lebanese sovereign (directly or indirectly through the Central Bank) — said scenario will ripple extremely rapidly through the economy. First, through systemic banking sector bankruptcies (as all banks have broadly the same business model of holding large sovereign paper) and a currency collapse; and second, via a deep and prolonged recession in the real economy. People's deposits would likely be partially lost (given the limited assets of the deposit insurance fund), the exchange rate peg would break and economic activity would collapse. The banking-sovereign feedback loop should be gradually diluted; for that to occur, the fiscal deficit needs to shrink sufficiently. While this is a structural, medium-term effort, immediate signaling, in the form of balanced and effective fiscal measures on the revenue and expenditure sides, is critical.

45. Electricité du Liban (EdL), the national utility company, imparts a staggering burden on Lebanon's public finances. Prior to the Syrian conflict, transfers to EdL amounted to an average of 55 percent of Lebanon's fiscal deficit. At their peak in 2012 and 2013, the government transferred around US\$2 billion per year to EdL. As the overall fiscal balance has been in deficit since 1992, EdL transfers have been effectively paid through borrowing. Based on annual budget documents, World Bank staff estimate that cumulative government transfers to EdL from 1992 to 2013 account for a staggering 55.4 percent of 2013 GDP, and almost 40 percent of Lebanon's total public debt. That is to say: Lebanon's debt-to-GDP ratio would have been 87.8 percent instead of 143.1 percent (in 2013) if EdL had not been loss making.

Priority Reform 3: Fiscal Reforms

CoM to pass a Decree stating that any increase in power supply from new power generation output would be matched by an automatic and commensurate rise in the average tariff leaving government transfers to EdL unaffected by the rise in output. This will mitigate the impact of the increase in capacity on government transfers to EdL, and importantly, establish a link between tariff increases and an expansion in power generation capacity. More than half of respondents to a World Bank's Social and Impact Assessment Survey said that they would be willing to pay double their current budget on EdL electricity in return for 24-hour service. The cost of EdL-supplied electricity would remain far lower than that of privately supplied generators. At the same time, the Government can protect the poor segments of the population from tariff increases through direct transfers via the National Poverty Targeting Program (NPTP – see below).

increased competitiveness, economic growth and job creation. Toward that end, the enactment of Public-Private Partnership (PPP) legislation is critical, helping to introduce best practices in the selection, preparation, negotiation, implementation and fiscal management of private participation for the delivery of public infrastructure and social services. Currently, PPP initiatives in Lebanon are undertaken on an ad hoc basis with mixed outcomes. A more coordinated approach will send an important signal to domestic and international investors to renew their engagement with the country and improve Value for Money outcomes.

Priority Reform 4: Public Private Partnership

CoM to pass an updated version of the existing draft PPP law. A proper PPP platform, with an effective and enforceable regulatory and accountability mechanism, and one that accounts for fiscal implications can re-invigorate and improve the investment climate and streamline Government-to-Business interactions. Hence, the positive externalities would extend to both the private and public sectors, with job creation and economic activity for the former and expanded and more efficient service delivery for the latter.

D. Delivering the Essentials

46. One of the most flagrant signs of failing governance and the weakening of the social contract between the state and its citizens is the breakdown in the delivery of basic public services. The key basic services that Lebanon lags behind in are electricity, safe water, sanitation, telecommunication and transportation. These services are not only essential for growth in productivity and aggregate income, but also for ensuring a basic level of living standard for people. When effectively provided, they can have a positive impact on income equality, allowing low income groups access to better and more productive opportunities. Their provision also enhances health and education outcomes, thus improving human capital—a critical driver of growth in high middle-income economies such as Lebanon.

47. In view of limited capacity and fiscal space for the Government, private sector participation is imperative in key infrastructure development and public service delivery, also helping to foster

48. Despite EdL's large and subsidized budget, power supply remains inconsistent for 92 percent of households, who need to be linked to private generators. EdL's production is both inefficient and insufficient, with a generating capacity of 2,019 MW, compared to a peak demand of 3,195 MW. This results in systematic and long daily blackouts, causing the extensive use of back-up private generators at a cost that is three times the level of EdL tariffs. Moreover, whereas only about half of total electricity production costs are recoverable, electricity tariffs have remained unchanged since 1996 (when the price of oil was US\$23 per barrel).

49. The poor quality of electricity supply is a primary impediment to economic activity. Development and cost-efficient investment in energy systems is correlated with GDP growth. When electricity supply is frequently interrupted or prohibitively expensive, economic growth slows down or even contracts. Electricity ranks as a key

binding constraint to doing business in Lebanon as the country ranks second worst in the quality of electricity supply in the world (2014–15 World Economic Forum’s Global Competitiveness Index).

50. The failures of the electricity sector also widen inequality in the country. Inequality is exacerbated as (a) consumers who are not billed are cross-subsidized by taxpayers and EdL customers who pay their bills; (b) consumers who suffer from electricity blackouts must use higher-cost alternatives (private generators for the rich, candles for the poor); and (c) electricity rationing favors the rich at the expense of the poor—poor regions go without public electricity for 12–13 hours every day, while richer ones such as Beirut are subject to 3 hours of daily blackouts.

Priority Reform 5: Gas-Run Power Generation

CoM to issue a tender package for a liquefied natural gas (LNG) terminal to supply fuel for power generation. Currently, most of the power generation capacity in Lebanon depends on expensive liquid fuels, whereas LNG imports provide a less expensive, more efficient and less polluting alternative. Moreover, gas infrastructure, which is currently completely lacking has strong implications on offshore gas extraction.

Priority Reform 6: Increasing Power Generation

CoM to support ongoing plans for development of power generation capacity through (a) resolving and providing the necessary public financing to complete ongoing generation projects; and (b) hiring a transaction advisor to initiate implementation of a program to develop new generation capacity by independent power projects (IPPs). It is imperative for EdL to increase its generation capacity to reduce rolling blackouts and increase energy supplies for residential, commercial and industrial customers, and with that it can justify tariff increases.

51. Lebanon’s endemic traffic congestion problem is estimated to cost the economy an estimated 8 percent of GDP annually. Road transport is by far the most dominant form of transport in Lebanon for passengers, freight and commerce, with

about 1.2 million vehicles in a country of only 4.5 million people. Its footprint is apparent on national energy consumption: road transport accounts for 25 percent of all energy consumption in the country. Compared to other countries, Lebanon’s supply of vehicles, defined as the number of vehicles per 1,000 people, is extraordinarily high. A primary and immediate step toward tackling Lebanon’s chaotic traffic is with the enforcement of already existing laws. This would have an instantaneously tangible positive effect on the citizen, reinforcing the role of the state in what is a very observable, low cost (in fact, revenue generating) measure.

52. Tackling Lebanon’s traffic logjam problem efficiently and structurally can only be with the introduction of a reliable, affordable and efficient public transport network. Traffic congestion and high transport costs are having huge detrimental effects on the development of lagging regions and are forcing the population to move closer to employment and services in Beirut. This dynamic has the dual effect of exacerbating congestion in Beirut and increasing poverty in the regions. While some highway expansions at key bottlenecks is needed, the past policies to continue highway and bridge expansions are financially and economically unsustainable, and will only provide temporary solutions at select areas since most of the road network is already saturated.

53. Given a near-complete absence of public transportation in Lebanon and the lack of fiscal space, an economically feasible starting point would be a public-private sector scheme for a Bus Rapid Transit (BRT) network. The concept involves allocating exclusive lanes on roads and highways for public buses bypassing typical traffic bottlenecks. These would be gradually rolled out from one region to another as additional resources materialize and as benefits become more tangibly perceived by the public. It would also heavily involve the private sector, especially in financing, construction and operation phases, helping to generate jobs.

Priority Reform 7: Establishing Public Transport

CoM to authorize and mandate Council of Development and Reconstruction (CDR) as executing agency to prepare and negotiate the Greater Beirut Urban Transport Project. This would establish a BRT within Beirut as well as between Beirut and Tabarja, with extension of services to Byblos and Tripoli. The operation of the BRT and feeder bus networks will involve the private sector boosting job creation. The project will also institute a feeder bus network in Greater Beirut.

E. Empowering the Poor

54. Even prior to the onset of the Syrian conflict and the inflow of large numbers of Syrian refugees, poverty in Lebanon was significant. The most recently completed Household Budget Survey (HBS 2011-12) shows that poverty in Lebanon was 27 percent (pre-Syrian crisis), which implies that about one million people had levels of consumption below the annual poverty line set at LBP4.7 million per capita per year (US\$3,150), the equivalent of approximately US\$8.5 per day. Similarly, it is estimated that extreme poor (i.e. below the food poverty line) Lebanese individuals live on LBP3.1 million per year (US\$2,078), the equivalent of approximately US\$5.7 per day. The Syrian conflict is estimated to have increased poverty among the Lebanese population.

55. Social safety nets (SSNs) can help reduce poverty when they are effectively targeted and adequately resourced. Currently, poor households rely primarily on assistance from private sources—welfare institutions, NGOs, remittances etc. The Government spending on non-subsidy SSNs does not exceed 1 percent of GDP and fails to target the poor effectively. If electricity subsidies and, in particular, transfers to EdL, are included as part of Lebanon's SSN for the Lebanese poor, then spending on SSNs increases dramatically to above 5.6 percent of GDP. However, EdL transfers are not targeted and subject to high leakages, and hence are not an efficient use of public funds.

56. The National Poverty Targeting Program (NPTP), launched in October 2011, is Lebanon's first poverty-targeted social assistance program. Its objective is to reach extreme poor households, defined as the 8 percent poorest segment of the population, which is approximately 42,000 Lebanese households. With significant progress and achievements accomplished since its establishment, the NPTP today nevertheless has reached a point where important reforms need to take place. These include: (i) a review of the social assistance provided with a view to transfer the hospitalization and basic education benefits to the Ministries of Public Health (MPH) and Ministry of Education and Higher Education (MEHE), respectively, and focus NPTP resources on expanding and enhancing the electronic-card food voucher program (and possibly a conditional education benefit for secondary and vocational education); (ii) renewal of the NPTP targeting database to reduce the leakages (i.e. number of in-eligible households from current 110,000 to 42,000); (iii) reduce inefficient program expenditure and adequately resource the program to finance the expanded e-card food voucher; and (iv) introduce a "graduation from poverty" component for beneficiaries via linkages to employment and skills upgrading opportunities.²⁹

Priority Reform 8: Social Safety Nets

CoM to scale up the NPTP by approving the expansion of the electronic-card food voucher, and the necessary budgetary allocation, from the current 10,000 extreme poor households to 15-20,000 extreme poor households; and the Ministry of Social Affairs (MoSA) and the Presidency of the Council of Ministers (PCM) to finalize the updating and renewal of the NPTP database of poor households via a recertification of all beneficiaries currently in the database (110,000 households) and an assessment of new applicants based on the new targeting formula and agreed protocols of assessments and supervision.

²⁹ Budgetary constraints limit the reach of the e-card food voucher today to only 10,000 households. Meanwhile, education and health benefits reach many more, a significant portion of whom are ineligible. We propose to recertify all beneficiaries aiming for at least 15,000-20,000 households, in the process reducing the number of education and health beneficiaries, but scaling up those for the e-card food voucher.

F. Shaping a Breathing Space

57. Environmental degradation incurs high economic and social costs in Lebanon as well as immeasurable health effects. The three most pressing issues are water pollution, inappropriate waste management and the destruction of natural resources. Water pollution threatens public health and agricultural productivity, while inappropriate management of waste impacts public health and damages the quality of life. Meanwhile, the progressive destruction of Lebanon's natural resources (its mountains, coastline, lakes, rivers and forests) poses irreversible damages. In fact, the World Bank estimates the environmental damage related to only five quarries at over \$90 million. There are more than 700 quarries scattered with little consideration to the environment.

Priority Reform 9: Solid Waste Treatment

Parliament to approve the Integrated Solid Waste Management Law. In April 2012, the Council of Ministers approved Decree 8003 on Integrated Municipal Solid Waste Management, which has been awaiting parliamentary approval since. The Draft Law promotes an integrated and proper management of municipal waste by encouraging waste minimization, source separation, recycling, energy recovery, effective treatment facilities, etc. An immediate approval by Parliament of the Draft Law is a first and essential step in setting the overall legal framework governing municipal waste management.

G. Working and Accessing Finance

58. In Lebanon, job creation has trailed labor force growth with employment opportunities concentrated in low productivity activities. Data analysis suggests that most job creation has been in low productivity sectors, especially trade, real estate and tourism, while only about one in three

labor force participants have a formal sector job. Moreover, since foreign labor dominated low skilled (less productive) activities, high GDP growth rates have not translated into significant job creation for the Lebanese. In fact, the long-run employment-growth elasticity is estimated to be 0.2, much lower than an estimated MENA average of 0.5. Thus, relatively low productivity activities dominated employment growth, while growth in productive activities such as communications, financial services, agriculture and manufacturing was marginal. Without more and better earning opportunities, households in Lebanon have difficulty in achieving substantial welfare improvements.

59. The business climate offers little support to private investment growth and competitiveness improvements. Both the Global Competitiveness (GC) and the Doing Business (DB) reports place Lebanon at low rankings – 101 out of 138 countries in the former and 126 out of 190 economies in the latter. In the GC report, only Egypt (115) and Yemen (138) ranked lower from the MENA region, with Lebanon's performance particularly weak in core components: institutions (including legal and administrative framework within which government and the private sector interact), infrastructure, macroeconomic environment and labor market efficiency. As for the DB report, the only MENA countries with a lower ranking than that of Lebanon are Algeria, Iraq, Libya, Syria and Yemen.

Priority Reform 10: Improved Business Environment

CoM to announce the launch of an accelerated program of business environment reforms through (i) the passage of a Secured Transaction and Collateral Registries law in close coordination with the central bank given its vital role over the banking sector; (ii) reform of the commercial registry and licensing procedures, in particular in the tourism sector; (iii) the passage of the e-signature law to enable dematerialization of regulatory processes; and (iv) the launch of a matching grant program designed to support job creating investments by Micro, Small and Medium Enterprises (MSMEs). These reforms aim to reduce the regulatory burden on businesses as well as improve access to credit for MSMEs, which dominate in the Lebanese economic landscape and are primary engines for job creation.

III. MEDIUM-TERM PRIORITIES

A. Making Government Work

60. Governance is at the root of Lebanon's failure to deliver basic services and generate inclusive growth and jobs. Internal failures stemming from corrupt and inefficient practices conflate with external security and political shocks to become mutually reinforcing and pervasive constraints on development, imposing a heavy burden on the economy. For example, the cost of confessional governance is estimated at 9 percent of GDP annually.³⁰ Influence of economic stakeholders and personal connections are likely to impact policy execution and enforcement of the rule of law. Thus, elite capture and corruption is endemic and undermine development objectives.³¹ Similarly, the cost of the conflict and violence is large and recurrent. These include the (i) 1975-1990 civil war that halved the country's economy; (ii) the 2006 conflict with Israel which resulted in estimated direct damages of US\$2.8 billion, and US\$700 million in indirect damages, and (iii) more recently the Syrian conflict which is estimated to have cost the Lebanese economy US\$7.5 billion in foregone output and widened the fiscal deficit by US\$2.6 billion through 2014. As such, a structural improvement in governance will not only provide typical returns reaped by other countries, but for the Lebanon-specific case, it will also reinforce resiliency to external shocks to which the country is frequently exposed. Toward that end, the following medium-term reforms are emphasized.

30 Chaaban, Jad (2014), The Costs of the Lebanese Sectarian System, mimeo, American University of Beirut.

31 Le Borgne, Eric and Thomas J. Jacobs (2016) Lebanon: Promoting Poverty Reduction and Shared Prosperity, Systematic Country Diagnostic, World Bank Group, Washington DC.

61. CoM to complete public consultations over the draft 2014 Decentralization Law and Parliament to pass it. Decentralization reform is essential to strengthen the delivery of sustainable services at the local level and encourage economic growth. In 2014, a Draft Decentralization Law was presented for public consultation, however, due to the political stalemate there has been no progress on its passage. The current unpredictable character of intergovernmental transfers makes it very difficult for municipalities to plan infrastructure and service improvements that encourage local economic development. Crucially, decentralization reform should include a restructuring of the fiscal transfer system, which will provide localities with sufficient resources and a clear delineation of roles between the central and local governments. As a result, investments will be more efficient and could be targeted towards promoting the healthy growth of businesses and increasing employment opportunities for communities.

62. The Government to see the implementation of the Public Procurement Law of 2013. Three interventions would be needed to implement the public procurement reform efficiently: (i) empowering the Central Tender Board (CTB) as an independent regulatory body; (ii) public procurement capacity building by the Institute of Finance; and (iii) moving towards e-procurement at CTB.

63. The Government to boost Public Financial Management (PFM) capacity in budget planning, preparation and execution to ensure efficient allocation of resources and improved service delivery. The PFM system suffers from several constraints that hinder its proper functioning, weaken its transparency and result in an inefficient use of public resources. As a result, unproductive spending and fiscal leakages are significant and widespread, and crowd out effective social safety net programs and improvements in living conditions for the population. Specific measures include:

- CoM to submit a credible, universal budget that incorporates extra budgetary entities (i.e. the Council for Development and Reconstruction,

Council for the South, and the Central Fund for the Displaced) to Parliament in a timely manner to ensure its approval before the end of the fiscal year;

- Ministry of Finance (MoF) to finalize the production and reconciliation of the government's financial statements for the years since the end of the war and submit them to the Court of Accounts for audit;
- Revamp and revitalize a national PFM steering committee to include MoF, BdL, line ministries and key oversight entities. The PFM steering committee would update the authorities' medium-term PFM reform strategy, endorse the output and oversee its implementation;
- Develop appropriate coordination mechanisms between the PFM steering committee and development partners;
- MoF to set up and empower critical functional PFM teams and units in the MoF (e.g. pilot internal audit, macro-fiscal department, public debt department, etc.).

B. Plugging the Information Gap

64. Adopting proactive disclosure measures can help mitigate corrupt practices by limiting discretionary opportunities for public officials and increasing accountability. In Lebanon, data availability and access to information appear as a cross-cutting constraint that impacts evidence-based policy making and impedes an informed population. Specific measures include:

- Make publicly available records on private and public land holdings through the MoF General Directorate on Land Registry and Cadastre. MoF could issue a communication announcing this policy;
- Publication of judicial decisions on the website of the Ministry of Justice;
- Create a single consolidated database of audited financial statements, to be accessed by financial

sector institutions and tax administration, in coordination with the Lebanese Association of Certified Public Accountants.

65. Major deficiencies exist in Lebanon's micro and macro data. The weakness of the statistical system is widespread and impedes economic analysis at the macroeconomic and sectoral levels. These deficiencies include: (i) the lack of regular information on the development of labor markets and living conditions of households—the latest household budget survey was conducted before the Syrian crisis and suffered from a large non-response rate; (ii) weak balance of payments (BoP) statistics issued with a long lag and subject to sizable revisions—for an economy that is heavily dependent on the external sector in general and capital inflows in particular, timely and accurate BoP data is essential for macroeconomic risk mitigation; (iii) weak inflation statistics; and (iv) long delays (up to three years) in the release of annual national accounts. Meanwhile, Lebanon frequently faces significant shocks, especially since 2011, and adequate policy measures require regular and high quality data.

66. The Government to enhance capacity of both the Central Administration of Statistics (CAS) and the Balance of Payments (BoP) unit at BdL to collect and disseminate regular high quality data by providing sufficient resources and securing their mandates.

C. Breaking the Debt Chain

67. Fiscal reforms need to be undertaken to reduce public debt ratios from being of the highest in the world to sustainable levels, thus generating widespread positive macroeconomic externalities. In such a case, the afore-mentioned risk-amplifying feedback loop (see paragraph 10) would be supplanted with a confidence-reinforcing one; as the country's risk premium decreases,

reflecting a reduced likelihood of default, the debt service would fall, which in turn further lowers sovereign risk. In addition, reduced financing needs in foreign currency will help boost confidence in the peg. Toward that end, tax reforms can be an effective tool. Currently, Lebanon's revenue generation is regressive in nature,³² while tax collection relative to GDP has been receding lately.³³

68. BdL to gradually streamline lending to real economy focusing more on monetary and financial stability. This would be in tandem with a gradual improvement in the country's fiscal position, allowing the government more responsibility over real economy issues. The process should also include a more market-based interest rate determination, by making commercial bank's bidding over central bank and government instruments a more competitive, more transparent process.

D. The Dream of 24/7

69. CoM to approve and implement a multi-year electricity tariff cost-recovery plan for EdL over a 3-year transition period. EdL's tariff has not been revised since 1996 and is thus far below cost-recovery levels, exacerbating the fiscal burden on government which covers the utility's revenue gap. Any tariff increases, however, need to be phased in to coincide with increases in hours of electricity supplied by EdL to show its customers tangible results commensurate with the larger bill. Importantly, tariff increases should also include an effective lifeline block helping to protect low income consumers and/or cash transfers. Taken together,

32 On average, since the start of the millennium, over half of budget revenues were generated from taxes on goods and services (largely consisting of the Value Added Tax) taxes on international trade (customs, as well as excises on gasoline, car and tobacco) and administrative fees and charges applied on various governmental services offered to the public. Meanwhile, direct taxation, property taxes and revenues from public institutions and government properties accounted for a bit over 40 percent of budget revenues.

33 In 2015, tax revenues amounted to only 14.7 percent of GDP, compared to an average over the previous decade of 16 percent.

this would improve sector financial conditions without increasing the fiscal burden on public finances, while also generating public support or at least minimizing public resentment.

70. CoM to approve the corporatization of EdL and create an inter-Ministerial committee to develop and implement a time-bound corporatization plan. Reforms of EdL's operation are a key aspect that have been outstanding for a long time, and the government has already completed multiple studies that form the basis of the identified corporatization plan. EdL's corporatization is expected to increase efficiency of sector operations and reduce its running costs. The governance framework should be designed carefully in order to maximize transparency and accountability avoiding the all too often Lebanese elite capture scenarios.

71. The Ministry of Energy to complete implementation of approved development plan for natural gas supply by developing new liquefied natural gas (LNG) supply and infrastructure facilities, LNG importing infrastructure and plan to explore and exploit off-shore domestic gas resources.

72. The Government to aim towards meeting and expanding the target in the 2010 energy plan for renewable energies and green growth. Evidence suggests that Lebanon is especially exposed to large vulnerabilities from climate change with the poor disproportionately affected. The estimated impact of climate change on Lebanon is encompassing and costly (estimated at US\$ 1.9 billion by 2020 in a first of its kind analysis for Lebanon released this year by Ministry of Environment/UNDP). A green growth and low carbon emissions development strategy for Lebanon could also be an opportunity for job creation.

73. Water storage capacity should expand in order to boost resilience to natural (i.e. drought) and man-made (i.e. refugees) shocks. Despite Lebanon's relatively high per capita water endowment,³⁴ inadequate management of and

34 Lebanon is the fourth best-endowed country in water resources in the MENA region.

investment in the sector are leading to chronic supply shortages. There is a seasonal mismatch between water supply (at its peak in the rainy winter) and demand (peaking in the hot, dry summer months). One of the principal factors that is exacerbating this seasonal water imbalance is the very low water storage capacity (6 percent of total resources, compared to the MENA average of 85 percent). As a result, water supply services are below the levels expected in a middle income country. If no action is taken, including in water governance to improve efficiency and manage demand, the country will continue to depend in the long-run on mined groundwater.

E. Toward a New Social Model...

74. A new social model needs to be developed and implemented between the Government and Lebanese citizens, particularly for the poor and low-middle income segments of the population. The main elements of such a model need to include: (i) a higher quality of public education; (ii) universal health coverage; (iii) a pension system for private workers (in lieu of current end-of-service indemnity system); (iv) an affordable, equitable and predictable public pension system; and (v) an effective and institutionalized social safety net system.

75. Education. Inefficiency and inequality characterize the education sector in Lebanon. Education is an investment with good returns in Lebanon as higher educational attainment corresponds to higher earnings in the labor market. Private spending on education is high and significantly exceeds public spending, which means that households carry the largest financial burden of education. In the public sector, teacher salaries represent 82 percent of the total public expenditure on education. Actual teacher workloads are low, resulting in additional spending and reduced productivity. In addition to these inefficiencies, there is inequality of opportunity in terms of access

to quality private and public schools; large amounts of money are spent on relatively low returns particularly in the public sector. Finally, the education information system is neither institutionalized nor integrated. This causes a lag in the collection of data from schools, resulting in a decreased ability to plan, specifically, to make data-based decisions and to measure the impact of policy initiatives.

76. A new teacher law is needed to end the two-tiered public teacher workforce and make the teaching profession more attractive to high-skilled individuals. There is need to create a smaller, higher-quality teacher workforce, including selecting among the most qualified of the contractual teachers. To advance the quality of public education, improving teacher quality through reforms in teacher recruitment and professional development is at the core. This can be done in part through reforming teacher recruitment processes and requirements and through continuous professional development and performance-based incentives for teachers. The law would also likely need to address teacher salary scale and working hours for civil servants at the same time. This could include the requirement to re-certify teacher accreditation every five years in order to remain in the system, as well as incentives for teaching high-need subjects or in high-need geographic areas. Furthermore, in order to reduce inefficiencies in teacher allocation, the Ministry of Education and Higher Education (MEHE) needs to re-allocate teachers away from low-student-population schools and toward higher-density schools in order to increase the efficiency of the teacher workforce.

77. There is a need for a new law to establish an internal audit department at MEHE to increase transparency and accountability for spending. Improving execution, efficiency and transparency of budget implementation in MEHE, as well as data collection and publication is imperative. This assumes a particular significance since MEHE has one of the largest budget allocations compared to other ministries and is the recipient of large amounts of donor funds to implement its Reaching All Children with Education (RACE) strategy. The law could be coupled with the publication of detailed budgets on MEHE's website and a revision of the

accounting department function and structure to create a properly staffed budget preparation unit.

78. Cabinet of Ministers to issue a decree requiring (i) that essential data on student enrollment be made publically available by March 1 of each school year; and (ii) that data on student pass rates and achievement be made publically available by August 31 for the school year ending in June. This will help improve access to reliable information for decision-making.

79. Health. Over reliance on direct payment for health services, at a time when people need care, is pushing many into poverty. Lebanese households share the burden of out-of-pocket expenditures disproportionately with some households being pushed into poverty as a result of paying for care. The obligation to pay directly for services is subjecting a large proportion of the Lebanese population to financial hardship, even impoverishment, especially among the poor. As such, financial protection is quite low, and there are inequities in the use of health services. Only 47 percent of Lebanese citizens are insured under three main insurance schemes: about 23 percent are covered by the National Social Security Fund (NSSF), 9 percent by military schemes, 7 percent by private insurance, 4 percent by the Civil Servants Cooperative (CSC) and 4 percent by other schemes. The remaining 53 percent lack any formal coverage, and are covered by the Ministry of Public Health (MoPH), which serves as an ‘insurer of last resort’. At the same time, Lebanon’s public expenditures on health have been decreasing as a share of GDP, falling from 3 percent in 1995 to 1.7 percent in 2011 (putting it well below the global and MENA averages). Meanwhile, private health spending, while regressing from 7.7 percent to 4.9 percent, is nonetheless significantly above the global average.

80. CoM to expand the current Universal Health Care (UHC) program to cover more Lebanese living under the poverty line. Currently, the MoPH is building the capacity of 75 out of the 208 Primary Health Centers (PHCs) and subsidizing the care for 150,000 Lebanese living below the extreme poverty line with a well-defined package of

health services. However, additional resources are needed to expand this program to cover all poor Lebanese identified as extreme poor through the National Poverty Targeting project (NPTP) and to expand the PHC Network beyond the 208 centers. The expansion of this program should also entail expanding the package of care to cover additional services for the treatment of other priority non-communicable diseases, as well as services that are targeting the health needs of the elderly. This requires an increase in budget allocation towards PHC services within an overall increase in the Government’s budgetary allocation for the health sector, and a fast track plan to build the capacity of services providers.

81. CoM to appoint a new Board of Directors of the National Social Security Fund (NSSF). The original mandate for the NSSF board has long expired and is instead being extended on a periodic basis. Simultaneously, the fund is facing significant budget deficits and has been accumulating large arrears with hospitals and individual subscribers. Ensuring adequate health provisions for retired workers and their families is vital and hence reform of the Sickness and Maternity Branch of the NSSF is needed. Sustainable health protection coverage can be achieved through the creation of broad risk pools. For this reason, the inclusion of retired workers into social health insurance for employees would be superior to creating a separate health insurance fund for retirees.

82. Private Sector Worker’s Pensions. A fresh review of already submitted proposals for the design of a new scheme for private sector employees is urgently needed followed by agreement and implementation of the most adequate proposal. Several reform suggestions have been prepared over the past 10 years and draft legislation is in Parliament. Currently, private sector employees are not covered by a pension scheme, but can only receive, if covered, a lump-sum payment (end-of-service-indemnity) which is not adequate and leaves them vulnerable at old age (especially that their health insurance also terminates at retirement).

83. Public Sector Worker's Pensions. Lebanon's public-service pension arrangements are a very large and growing financial burden on the national finances and on the country's taxpayers. Their cost amounted to LBP1.9 trillion in 2013, equivalent to 2.7 percent of GDP or 8 percent of total government expenditure, but reached only 9 percent of the labor force (military and civil servants). Yet, all workers pay into this mechanism through taxes on their incomes and consumption. The opportunity cost of this expenditure is readily apparent when compared to public spending on health and SSNs, which amount to only 1.7 percent of GDP and negligible, respectively.

84. A commission on pension reform to be constituted to review alternative scenarios of putting the public pension scheme on a sustainable path, considering 3 options:

- Smaller, slower reform: Gradual move from final to lifetime-average earnings measure to calculate pensions (year-by-year); phased reduction in benefit accruals from 1/40ths to 1/50ths of salary (2.1 percent to 1.7 percent); and gradual elimination of multiplier for military.
- Middle scenario: Reduction in lump-sum payments for more than 40 years of contributions (cutting spending from 14 percent to 9 percent of total); and reduction in allowances for military pensioners (from 40 percent to 20 percent of total pensions for new retirees).
- Larger, faster reform: Price indexation of pensions in payment; tighter conditions for survivors' benefits (single or divorced daughters); and reduction in survivors' payments from 100 percent to 80 percent of the deceased's benefits.

85. Social Safety Nets. Parliament to institutionalize the NPTP program as a permanent feature of Lebanon's social safety net system by passing the "Extreme Poverty Law - Afaal", which was presented to Parliament by MP Robert Fadel in February 2015. This would establish a program to provide conditional cash transfers to poor Lebanese building on and incorporating the NPTP. More broadly, it would constitute a significant step in the development of Lebanon's social safety net system,

providing a more sustainable solution to eliminating extreme poverty in Lebanon.

F. ...Growth for All...

86. Lebanon's growth model has been heavily dependent on non-productive, rent-seeking sectors that have exacerbated external imbalances without generating enough jobs. As highlighted earlier, a particular concern is macroeconomic risk emanating from the country's dependency on inflows to finance persistent and sizable twin (fiscal and current account) deficits. Lebanon possesses untapped possibilities using local resources and talents that will go some way in mitigating this dependency. Industry and Information and Communication Technology (ICT) are two sectors that have been long neglected and that can be important sources of job creation for skilled labor, an outcome that has evaded post-war Lebanese growth. They would also be a step toward sustainable growth since such sectors are less prone to external shocks compared to Lebanon's traditional drivers—tourism and real estate. Furthermore, human and financial capital can be tapped locally, while the export market is a realizable potential, enfeebling the dependence on capital inflows, attracting green field FDI and lessening balance of payments risks. Such a vision is necessary for Lebanon to exit a socially and economically unsustainable model, whereby human capital is exported in return for inflows that finance rent-seeking activities that aggravate imbalances. In this context, Lebanon needs to focus on its industrial and high-tech potential, providing solutions to the numerous constraints that are hindering the functioning of these sectors at their full capacity.

87. Spatial industrial policies, most notably, industrial parks and special economic zones (SEZs), can support increased investment and competitiveness in the industrial sector. Special care should be allotted to fiscal incentives which evidence suggest are ineffective as a source of differentiation, with the end result merely an increasing 'race to the bottom' and transfer of

rents from governments to private investors. Under suitable conditions, industrial zones have proven successful in various locations and industries across the world, which make them an attractive tool in Lebanon.

88. Two such projects are being undertaken in Lebanon: the Tripoli Special Economic Zone (TSEZ) and a pilot project by the Ministry of Industry (MoI) for three locations (Baalbek and Terbol in Bekaa, and Jleileye in Shouf). The former is at a more advanced stage, while the MoI project is still at the feasibility stage. The TSEZ, however, includes an extremely generous set of fiscal incentives³⁵ in addition to labor regulatory incentives that can distort incentives toward the geographical relocation of business, rather than promoting the expansion or generation of new operations.

89. CoM to revise and update the Telecommunications law and the regulatory framework. The current law was passed in 2002 and is based on the 1995 European regulatory framework. Since then, market and technological developments incited most developed countries to revise, more than once, the telecom legislation. The government can initiate the revision of the Law, along with the related regulatory framework to account for convergence in infrastructure and services, the emergence of new services and business models and the overall changes in the global telecommunications market.

90. Restructuring of the Ministry of Telecommunications and Liban Telecom is essential toward a more dynamic ICT sector. A primary objection would be to achieve functional

separation between policy making and operation/ownership within the Ministry, thus enhancing the performance of the operation of the fixed network. Currently, while fiber optic infrastructure is available, it remains inoperative due to internal disputes and ad-hoc governance arrangements depriving the country of faster and more reliable services. Additionally, the development of the sector is hindered by a lack of functional separation involving ownership of infrastructure, regulations and policies, and decision making on investment and network planning. The separation between these functions would encourage private sector investment in the sector and provide more transparency and objectivity in policy-making.

G. ...And Jobs at Home

91. Job creation will be aided by reforms that improve the business climate. While there have been no substantial reforms across any of the key component measures that make up the Doing Business (DB) score since 2007, reform initiatives have been in the pipeline in key areas such as business regulation streamlining, extending credit to SMEs and insolvency resolution. These are reforms that can be implemented promptly given their current readiness which could, in turn, have a significant impact on SME start-up and growth and job creation. Limitations in these areas constrain the potential in areas where Lebanon does much better such as in business sophistication and innovation. Toward that end, the following have been identified as key reforms:

- CoM to pass the Insolvency and Insolvency Practitioners draft law that is currently pending.
- The Government to reduce the burden of customs procedures. Both, the GC and DB reports rank customs procedures in Lebanon below the country's aggregate score.
- CoM to pass the Judiciary Mediation Law currently pending. This would reduce the heavy burden on the court system, providing an alternate global best practice to resolving commercial disputes.

³⁵ This includes (i) 100 percent customs exemption on imported raw material; (ii) duty free export of finished goods; (iii) duty free import of construction material, equipment, office machinery and spare parts; (iv) 100 percent exemption on VAT and excise tax for goods and services destined for exports; (v) 100 percent exemption on corporate profit tax (provided that not less than 50 percent of the workforce is Lebanese and the value of fixed assets or capital is greater than USD 300,000); (vi) 100 percent exemption on withheld tax on salaries for employees of tenants and on social security contributions; (vii) 10 percent exemption on building permit fees and built property tax; and (viii) 100 percent exemptions on shares and bonds issued by companies within TSEZ.

- Parliament to pass a high quality competition law. The law should establish competent competition authorities; review the legal framework for public land allocation, customs operation and public procurement to increase transparency and reduce discretion; review the legal framework regarding conflict of interest. A draft competition law has been in existence since 2008.
- Extending the Prime Minister's decree #246 related to the establishment of the Commercial Registry committee to oversee the implementation of the commercial registry one stop shop for the coming two years. This will accelerate the process of the commercial registry one stop shop implementation and ensure that the reform is implemented in accordance with best international practices and addresses private sector needs by providing efficient government to business services.
- The Government to employ a two-pronged approach to increase job-creating investments which will create jobs for Lebanese as a priority and refugees from Syria in the sectors where labor regulations allow. The first prong to consist of a national level labor-intensive public infrastructure program that creates jobs for the large unskilled and semi-skilled labor force in Lebanon. The second prong is job creation through the private sector that can include matching grant programs conditional on job creation. It is also key to implement adequate active labor market policies to ensure vulnerable groups access those jobs.
- Taking advantage of concessional financing to effectively implement programs that address Lebanon's long-standing development needs, while at the same time, help mitigate the impact on the refugees.

H. The Refugee Crisis: Creating Opportunities

92. The Syrian conflict and the ensuing influx of an unprecedented number of displaced persons into Lebanon since 2011 has created tremendous pressure on the Lebanese economy, social sectors and infrastructure. In its sixth year, and with little short term prospects of an end to the conflict in Syria, the strain on Lebanon is clear. The international community's response has been significant but is not sufficient to match either the needs of the refugees nor those of the hosting communities. Going forward, the following suggestions are provided:

- The Government to continue to implement plans to provide access to schools, primary health care centers and hospitals, social development centers and other public services to refugees, while seeking and insisting on more international financing assistance to finance this increased demand.

DATA APPENDIX

TABLE 1. Lebanon Selected Economic Indicators, 2014-2019

	2014	2015	2016	2017	2018	2019
	Est.	Est.	Est.	Proj.		
<i>(annual percentage change, unless otherwise specified)</i>						
Real sector						
Real GDP	1.8	1.3	1.8	2.5	2.6	2.6
Real GDP per Capita ¹	-4.1	-2.8	-1.2	-0.5	-0.4	-0.3
Agriculture (share of GDP)	4.5	4.5	4.1	4.1	4.0	3.9
Industry (share of GDP)	15.5	15.4	14.5	14.6	14.6	14.6
Services (share of GDP)	80.0	80.1	81.4	81.3	81.4	81.5
Money and prices						
CPI Inflation (p.a)	1.2	-3.7	-0.8	3.8	2.7	2.0
Money (M3, including non-resident deposits)	6.0	5.1	7.0	7.0	8.0	8.0
<i>(percent of GDP, unless otherwise specified)</i>						
Investment & saving						
Gross Capital Formation	31.2	27.6	27.9	28.3	28.3	28.4
o/w private	29.6	26.1	26.2	26.8	26.8	26.8
Gross National Savings	5.8	10.5	6.9	8.1	9.1	9.2
o/w private	16.9	2.3	15.3	16.2	17.4	17.4
Central Government Finance						
Revenue (including grants)	23.8	20.3	21.0	21.5	21.6	21.5
o/w. tax revenues	15.1	14.6	14.9	15.0	15.0	15.0
Total expenditure and net lending	30.4	28.5	31.1	31.0	31.4	30.9
Current	28.8	27.1	29.4	29.5	29.9	29.3
o/w Interest Payment	9.2	9.5	10.1	10.5	11.0	10.8
Capital & Net Lending (excl. foreign financed)	1.6	1.5	1.7	1.5	1.5	1.6
Overall balance (deficit -)	-6.6	-8.2	-10.0	-9.5	-9.8	-9.4
Primary Balance (deficit -)	2.6	1.3	0.1	0.9	1.2	1.5
External sector						
Current Account Balance	-25.4	-17.0	-20.9	-20.2	-19.2	-19.2
Trade Balance	-29.4	-23.2	-26.5	-26.1	-25.6	-26.5
o/w Export (GNFS)	42.1	42.1	40.3	41.7	42.3	43.1
Exports of Goods	10.0	8.5	8.6	8.6	8.6	8.7
Exports of Services	32.2	33.6	31.7	33.2	33.8	34.4
o/w Import (GNFS)	71.5	65.3	66.8	67.8	67.9	69.6
Imports of Goods	42.8	36.3	38.0	38.9	38.7	40.3
Imports of Goods	28.7	29.0	28.7	28.9	29.2	29.3
Net Private Current transfers	5.2	7.2	6.6	5.9	5.4	5.5
Remittances	6.1	7.6	6.8	6.0	5.5	5.6
Net Income receipts	-1.1	-1.0	-1.0	0.0	0.9	1.8
Gross Reserves (months of imports GNFS) ^{2/3}	11.9	12.0	12.9	12.1	12.0	11.4
Total Public Debt						
Total Debt Stock (in million US\$)	66,564	70,325	74,886	79,650	84,529	89,371
Debt-to-GDP ratio (percent)	145.6	149.4	157.5	165.7	169.9	173.1
Memorandum Items:						
Nominal GDP (in billion LBP)	68,939	70,980	71,662	72,454	74,991	77,831
GDP (in million US\$)	45,731	47,085	47,537	48,063	49,745	51,629

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) = (Gross Res. excl. Gold / imports of goods & services) *12

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

SELECTED SPECIAL FOCUS FROM RECENT LEBANON ECONOMIC MONITORS

FALL 2016 LEM: THE BIG SWAP: DOLLARS FOR TRUST

Central Bank Intervention in the Lebanese Economy (Special Focus): Small and Medium Enterprises (SMEs) occupy a central role in the Lebanese economic landscape and are primary engines for job growth. To ensure adequate SME access to finance and stimulate economic activity, the Banque du Liban (BdL) has established a number of schemes. The Special Focus reviews SMEs' role in Lebanon's activities and outlines the various BdL policy interventions in the real economy. The preliminary findings suggest that the real estate sector was the largest recipient of subsidized lending by BdL and that the proportion of subsidized funds channeled to SMEs continues to be modest. Nonetheless, the preliminary evidence suggests that, with the existing political paralysis, a volatile security environment and spillovers from the Syrian conflict, economic activity in Lebanon would have been more sluggish in the absence of BdL's policy interventions. These interventions, however, come at a cost born by BdL, which are difficult to quantify but have possible implications on long-term monetary policy.

SPRING 2016 LEM: A GEO-ECONOMY OF RISKS AND REWARD

Industrial Parks and Special Economic Zones in

Lebanon (Special Focus 1): Lebanon's industrial sector in Lebanon has lagged, both on a regional and global comparative basis. Lebanon's macroeconomic structure, being heavily dependent on tourism and real estate at the expense of industry and agriculture, renders the economy vulnerable to political and economic shocks. In this context, Lebanon needs to focus on its industrial potential and provide solutions to the numerous constraints hindering its industrial establishments from functioning at their full capacity. One possibility to strengthen the industrial sector is via spatial industrial policies, most notably, industrial parks and special economic zones (SEZs), which support increased investment and competitiveness in the industrial sector. Special care should be allotted to fiscal incentives which evidence suggest are ineffective and might instead lead distortions such as the relocation of existing businesses to the zones rather than the establishment of new business. Under suitable conditions, industrial zones have proven successful in various locations and industries across the world which make them an attractive tool in Lebanon.

Tech Startup Ecosystem: The Case of Lebanon (Special Focus 2): A new wave of entrepreneurship driven by small digital businesses is sweeping both developed and emerging economies. Information and Communications Technology (ICT) has dramatically reduced the cost of innovation and market access, allowing small tech entrepreneurs to compete with established businesses. Today, a startup can be created with just a laptop and Internet connection. This has led to the surge of tech startup ecosystems worldwide, where communities of entrepreneurs interact. Lebanon in particular can benefit from this phenomenon, particularly for job creation. Tech startup founders are predominantly young and have a college degree, generating employment for educated youth. The innovation that

startups generate also helps make the tech sector more dynamic and sustainable. Lebanon's tech scene is becoming increasingly attractive driven by the example of successful startups that have tapped regional and global markets and the innovative initiative by the country's central bank in facilitating venture capital financing. The nation now needs to leverage these developments by finding solutions to constraints hindering the blossoming of its tech startup ecosystem.

FALL 2015 LEM: THE GREAT CAPTURE

Elite Capture and the Hollowing of the State: an Overarching Constraint to Lebanon's Development (Special Focus 1): Lebanon's post-war governance endures systemic failures. Institutionalized confessionalism intended as protection for the mosaic of communities in a country that lacks a demographic majority has developed into pervasive elite capture and patronage system. This elite commands the main economic resources, generating large rents and dividing the spoils of a dysfunctional state. In the process, the public sector has become increasingly governed by bribery and nepotism practices, failing to deliver basic public services and incapable of resolving the most urgent needs. This has culminated in the comprehensive breakdown in the political process, with the three branches of government either vacant or effectively idle, and the only national plebiscite abrogated. This has triggered a series of protests and civil disobedience measures targeting the ruling political class with emphasis on corruption and incompetence. Current conditions are unsustainable, and without significant political and economic reforms, a widening and worsening of socio-economic unrest is not unfathomable.

Lebanon's Health Sector: Modest Reforms despite the Challenges (Special Focus 2): This special focus provides an overview of the health sector in Lebanon and highlights both successes and challenges facing the system. Lebanon's trends in health outcomes,

inputs and spending are analyzed over time and compared to a number of countries with similar levels of income and health spending, as well as to the averages for the Middle East and North Africa (MENA) region. Global comparisons are presented for each of these measures based on the latest available year of data (generally 2011). Key challenges are highlighted; (i) low public spending on health which hinders the Ministry of Public Health's (MoPH) ability to adequately respond to the health needs of low income groups; (ii) high household out-of-pocket spending on health subjecting low income groups to financial hardship; (iii) disproportionate allocation of resources on expensive curative care; and (iv) emerging epidemiologic and population trends associated with unprecedented influx of refugees having significant implications on the delivery and financing of the health sector. Despite the challenges and prolonged periods of instability, the MoPH embarked on several successful reforms that contributed to the resilience of the system in the face of the crisis.

SPRING 2015 LEM: THE ECONOMY OF NEW DRIVERS AND OLD DRAGS

The Trade Impact of the Syrian conflict on Lebanon (Special Focus 1): We explore the trade effect of the Syrian war on Lebanon up until the second half of 2014. A dissection of the data reveals that, so far, the war seems to have affected neither merchandise nor services exports at the aggregate level. At the same time the relative stability of merchandise imports is likely a result of increased demand due to refugee inflow being offset by higher transit costs through Syria as well as depressed Syrian production. A gravity-type trade model confirms these findings, suggesting also that Lebanese trade seems to have been less negatively affected by the Syrian war than other Syria's neighbors. An empirical analysis using

micro level exporter data substantiates this finding. While Lebanese exporters to Syria have suffered from a drop in demand in the Syrian market (but less so than their Jordanian counterparts), other Lebanese exporters have started to export to Syria to fill the gap in Syrian production. Further econometric analysis suggests that Syrian refugees in Lebanon provide important impetus to Lebanese services exports.

agency coordination and weak central government oversight. Moving forward, the Government must urgently address priorities within the sector.

Challenges in the Lebanese energy sector (Special Focus 2): The Lebanese electricity sector has been underperforming and in crisis for several decades, requiring urgent action to avoid further deterioration of the quality of electricity delivery. The macroeconomic impact has been massive; accruing debt on investments in and transfers to Electricité du Liban's (EdL) amounts to 40 percent of Lebanon's gross public debt and is escalating rapidly as transfers now account for over half of the fiscal deficit. Some of the measures needed to improve EdL's financial situation are well known, such as increased investment, tariff reforms and corporatization of EdL. Political and confessional obstacles, however, have so far hindered any progress.

Water in Lebanon – Coupling Infrastructure with Institutional Reform (Special Focus 3): Despite the relative availability of water resources, the Lebanese water sector has not achieved suitable levels of service provision and is not in line with the level of economic development reached by the country. The cost of inaction in the water sector is estimated at about 1.8 percent of GDP, or 2.8 percent of GDP if the cost of environmental degradation is included. Several factors have led to this situation and require sustained attention. These include: (i) low continuity of water supply due to small storage capacity, large amount of water lost to the sea, growing demand for water and deficiency of the existing water networks; (ii) unfinished reform agenda that contributed to institutional uncertainty and fragmentation of functions particularly relating to wastewater and irrigation; (iii) an irrigation sector that is characterized by inadequate water storage capacity, lack of proper maintenance and a heavy reliance on subsidies; and (iv) regional water establishments (RWE) that severely lack management and financial autonomy and are impeded by limited inter-

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Lebanon Economic Monitor, Spring 2016: A geo-economy of risks and reward	2016/06/02	Working Paper
Lebanon - Promoting poverty reduction and shared prosperity: systematic country diagnostic (English)	2016/01/01	Publication
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Snapshot of poverty and labor market outcomes in Lebanon household budget survey 2011-2012: central administration for statistics and World Bank	2015/12/08	Working Paper
Lebanon economic monitor, April 2015: the economy of new drivers and old drags	2015/04/27	Working Paper
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