LEBANON ECONOMIC MONITOR

In the Grip of A New Crisis

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In the Grip of A New Crisis

Fall 2023

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ACRONYMS

ABL	Association of Banks in Lebanon
AER	Average Exchange Rate
BdL	Banque du Liban
BNR	Banknote Rate
BTA	Beirut Traders Association
BoP	Balance of Payments
BPM	Balance of Payments Manual
CA	Current Account
CAS	Central Administration of Statistics
CIT	Corporate Income Tax
CPI	Consumer Price Index
EU	European Union
ERPT	Exchange Rate Pass Through
EdL	Electricité du Liban
FX	Foreign Exchange
GDP	Gross Domestic Product
GNDI	Gross National Disposable Income
IMF	International Monetary Fund
LBP	Lebanese Pound
LEM	Lebanon Economic Monitor
MIDAS	Mixed-Data Sampling
MoF	Ministry of Finance
NEER	Nominal Effective Exchange Rate
NPL(s)	Non-performing Loan(s)
PMI	Purchasing Manager's Index
pp	Percentage Points
SLA	Staff-Level Agreement
tb(s)	Treasury Bond(s)
UN	United Nations
US$	United States Dollar
VAT	Value Added Tax
XM-2022	First X months of the year
yoy	year over year

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. The *Monitor* places these developments, policies, and findings in a longer-term and global context and assesses their implications on the outlook for Lebanon. Its coverage ranges from the macro-economy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Lebanon.

The *Lebanon Economic Monitor* is a product of the World Bank's Lebanon Macroeconomics, Trade and Investment (MTI) team. It was led by Dima Krayem (Senior Economist), Ibrahim Jamali (Consultant), Naji Abou Hamde (Economic Analyst), with contributions from Nisreen Salti (Consultant). The Special Focus entitled *Impact of the Conflict in the Middle East on the Lebanese Economy* was prepared by Dima Krayem (Senior Economist), Ibrahim Jamali (Consultant), and Naji Abou Hamde (Economic Analyst). The *Lebanon Economic Monitor* has been completed under the guidance of Eric Le Borgne (Practice Manager), Norbert Fiess (Lead Economist), and Jean Christophe Carret (Country Director). Zeina El Khalil (Senior External Affairs Officer) is the lead on communications, outreach, and publishing.

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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EXECUTIVE SUMMARY

Recent Economic Developments

Lebanon is hit by yet another crisis: the spillover effects of the conflict in the Middle East. While the country remains mired in political and institutional vacuum, and a crippling socioeconomic crisis for over four years, it has now been hit by another large shock: fear that the current conflict centered in Gaza could escalate further into Lebanon.

By 2022 and early 2023, the economy was able to find a temporary bottom following years of sharp contraction, thanks to tourism and sizeable remittances (*Spring 2023 Lebanon Economic Monitor*). Lebanon's long economic contraction is estimated to have further narrowed in 2022, to 0.6 percent. The main drivers of the slowing contraction in economic activity are a growth in consumption coupled with signs of stabilization in private sector activity, both of which remain highly sensitive to exogenous shocks. The year-on-year (yoy) increase in tourist arrivals of 50.6 percent in 2022 also supported consumption growth. Nonetheless, a wide current account deficit, primarily driven by the increase in imports to pre-crisis levels, continued to constitute a drag on growth in 2022.

The temporary bottoming out helped the exchange rate to also stabilize temporarily. This stabilization reflects limited demand for dollars amid pervasive dollarization in the economy. The stoppage of the Sayrafa platform (the main platform used for foreign exchange interventions by the central bank) in July 2023, also contributed to a decrease in the demand for dollars. The exchange rate relative stabilization is also owed to foreign exchange interventions by the Banque du Liban (BdL) in the first half of 2023, along with an increase in foreign exchange inflows from tourism and remittances. However, depleted gross foreign currency reserves imply that the scope for further foreign exchange interventions by BdL is limited, while inflows from tourism receipts are susceptible to exogenous shocks.

Prior to October 2023, economic growth was projected—for the first time since 2018—to slightly expand in 2023 (by 0.2 percent). The projected positive growth rate in 2023 is ascribable to a favorable summer tourism season and remittances, both of which have underpinned consumption growth. An increasing dollarization of salaries coupled with signs of continuing stabilization in private sector activity have also supported economic activity. Whereas net exports' contribution to real GDP growth is expected to be positive and stand at 1.1 percent, investment and government consumption are expected to contribute negatively to real GDP growth by 0.9 and 0.2 percent, respectively.

The fiscal and primary deficits are projected to narrow to 1.3 and 0.3 percent of GDP in 2023, respectively. As planned revenue measures take hold, revenues to GDP are projected to rise to 8.8 percent of GDP. Nonetheless, increases in current expenditures, transfers to EdL, and the continuation of social assistance schemes to public servants are estimated to contribute to rising expenditures of 10.1 percent of GDP.

The current account deficit is projected to narrow to 12.8 percent of GDP in 2023, following a dramatic increase to 32.7 percent of GDP in 2022. The contraction in the current account deficit has been mainly driven by a narrowing trade-in-goods deficit following the revaluation of the exchange rate for custom duties that became effective in November 2022. A surplus in trade-in-services, following a vigorous summer tourism season during which many Lebanese expatriates flocked back to the country, will also likely contribute to narrowing the current account deficit.

Inflation is projected to accelerate to 231.3 percent in 2023, mainly a reflection of the continued deterioration of the underlying macroeconomic environment. The acceleration of inflation is primarily driven by exchange rate depreciation (in the first half of 2023) and the rapid dollarization of economic transactions and, in particular, the components of the consumer price index basket.

Even before the onset of the current conflict, the tepid growth that was projected for 2023 was unlikely to last as it was based on fragile drivers resting on a dysfunctional economic structure. The impaired macroeconomic framework is not only impoverishing a large share of the population and driving up inequality, but also preventing a sustainable development model from emerging. Without a crisis resolution plan, no long-term investment is feasible, which is eroding the country's physical, human, social, and natural capital stock as depreciation far exceeds investment. Lebanon's reliance on tourism and remittance inflows is neither a viable economic strategy nor an economic crisis resolution plan. Because tourism tends to be volatile and subject to external and internal shocks (the spillover of the current conflict, a case in point—see Special Focus), the sector cannot substitute for more sustainable and diverse drivers of growth. The stable inflow of remittances has supported consumption and acted as a de-facto economic and social safety net, but it also does not substitute for a sustainable growth model.

With the onset of the current conflict, Lebanon's economy is projected to be back in recession in 2023. The Special Focus assesses the impact of the current conflict and its spillovers on Lebanon's economy. Assuming that the current situation of containment of military confrontation to the southern borders persists, the economy is estimated to contract in 2023, primarily due to the shock to tourism spending. More specifically, real GDP growth declines to between −0.6 percent to −0.9 percent depending on the extent of the tourism shock.

ملخص تنفيذي

آخر التطورات الاقتصادية

يواجه لبنان أزمة جديدة جراء آثار وتداعيات الصراع في الشرق الأوسط. فيما لا تزال البلاد غارقة في فراغ سياسي ومؤسسي، وأزمة اجتماعية واقتصادية طاحنة منذ أكثر من 4 سنوات، تتعرض الآن لصدمة كبيرة أخرى بسبب احتمال تصاعد الصراع الحالي المتمركز في غزة أكثر إلى لبنان.

بحلول العام 2022 وأوائل العام 2023، وصل الاقتصاد إلى قعر مؤقت بعد سنوات من الانكماش الحاد، وذلك بفضل السياحة وتحويلات المغتربين (تقرير المرصد الاقتصادي للبنان لربيع 2023). وتشير التقديرات إلى أن الانكماش الاقتصادي الذي طال أمده في لبنان قد تقلص بشكل أكبر في عام 2022 إلى 0.6%. وتتمثل المحركات الرئيسية لتباطؤ انكماش النشاط الاقتصادي في نمو الاستهلاك واستقرار نسبي في نشاط القطاع الخاص، وكلاهما شديد التأثر بالصدمات الخارجية. كما أدت الزيادة السنوية في عدد السائحين الوافدين بنسبة 50.6% في عام 2022 إلى زيادة معدلات الاستهلاك. ومع ذلك، ظل العجز الواسع في الحساب الجاري، المدفوع في المقام الأول بزيادة الواردات إلى مستويات ما قبل الأزمة، يشكل عائقاً أمام النمو في عام 2022.

كما ساهم القعر المؤقت الذي بلغه الاقتصاد اللبناني في تحقيق استقرار مؤقت في سعر الصرف. ويعود هذا الاستقرار أيضاً إلى محدودية الطلب على الدولار في ظل انتشار الدولرة. وأدى إيقاف العمل بمنصة صيرفة (وهي المنصة الرئيسية التي يستخدمها مصرف لبنان لتحقيق استقرار سعر صرف الليرة) في تموز/يوليو 2023 إلى انخفاض الطلب على الدولار. ويعود الاستقرار النسبي لسعر الصرف أيضاً إلى تدخلات مصرف لبنان في سوق النقد الأجنبي في النصف الأول من عام 2023، إلى جانب زيادة تدفقات النقد الأجنبي من السياحة والتحويلات. إلّا أن استنفاد احتياطيات النقد الأجنبي يعني محدودية المجال أمام المزيد من الإجراءات التدخلية من جانب مصرف لبنان في سوق النقد الأجنبي، في حين أن التدفقات من عائدات السياحة معرضة لمخاطر الصدمات الخارجية.

وقبل أكتوبر/تشرين الأول 2023، كان من المتوقع أن يسجل الاقتصاد - لأول مرة منذ عام 2018 - نمواً طفيفاً في عام 2023 (بنسبة 0.2%). ويعود السبب في معدل النمو الإيجابي المتوقع في عام 2023 إلى الموسم السياحي الذي حقق عائدات كبيرة في الصيف، وتحويلات المغتربين، وكلاهما يدعم نمو الاستهلاك. كما أدت زيادة نسبة الأجور والرواتب المدولرة إلى تعزيز النشاط الاقتصادي، فضلاً عن استمرار الاستقرار النسبي في نشاط القطاع الخاص. وفي حين يتوقع أن يساهم صافي الصادرات في نمو إجمالي الناتج المحلي الحقيقي بنسبة 1.1%، من المتوقع أن يساهم الاستثمار والاستهلاك الحكومي مساهمة سلبية في نمو إجمالي الناتج المحلي الحقيقي بنسبة 0.9% و0.2% على التوالي.

ومن المتوقع أن ينخفض العجز في ميزان المالية العامة والميزان الأولي إلى 1.3% و0.3% من إجمالي الناتج المحلي في عام 2023 على التوالي. ومع دخول التدابير المتخذة لزيادة الإيرادات حيز التنفيذ، من المتوقع أن ترتفع نسبة الإيرادات إلى إجمالي الناتج المحلي إلى 8.8%. ومع ذلك، تشير التقديرات إلى أن الزيادات في النفقات الجارية، والتحويلات إلى مؤسسة كهرباء لبنان، واستمرار برامج المساعدات الاجتماعية لموظفي القطاع العام ستسهم في زيادة النفقات إلى 10.1% من إجمالي الناتج المحلي.

ومن المتوقع أن يتقلص عجز الحساب الجاري إلى 12.8% من إجمالي الناتج المحلي في عام 2023، بعدما سجل عجزاً كبيراً بلغ 32.7% في عام 2022. ويعود هذا التراجع في عجز الحساب الجاري بشكل رئيسي إلى تقلص العجز في رصيد تجارة السلع عقب إعادة تقييم سعر الصرف المعتمد للرسوم الجمركية والتي دخلت حيز التنفيذ في تشرين الثاني/نوفمبر 2022. ومن المرجح أن يسهم الفائض في رصيد تجارة الخدمات، بعد موسم سياحي قوي خلال فصل الصيف توافد خلاله العديد من اللبنانيين المغتربين، في تراجع عجز الحساب الجاري.

ومـن المتوقـع أن تتسـارع وتـيرة التضخـم ليبلـغ 231.3% في عـام 2023، نتيجـة التدهـور المسـتمر في بيئـة الاقتصـاد الـكلي الأساسـية. ويرجـع السـبب في تسـارع وتـيرة التضخـم في المقـام الأول إلى انخفـاض سـعر الـصرف (في النصـف الأول مـن عـام 2023) والدولـرة السريعـة للمعامـلات الاقتصاديـة، وعـلى وجـه الخصـوص، مكونـات سـلة مـؤشر أسـعار المسـتهلكين.

حتـى قبـل انـدلاع الـصراع الحـالي، لم يكـن مـن المرجـح أن يـدوم النمـو المتواضـع الـذي كان متوقعـاً لعـام 2023 لأنـه اسـتند إلى محـركات نمـو هشـة وهيـكل اقتصـادي مختـل. ولا يـؤدي ضعـف إطـار الاقتصـاد الـكلي إلى إفقـار نسـبة كبـيرة مـن السـكان وزيـادة عـدم المسـاواة فحسـب، بـل يحـول أيضـاً دون تبلـور نمـوذج للتنميـة المسـتدامة. فـما لم يتـم اعتـماد خطـة شـاملة لحـل الأزمـة، لا يمكـن القيـام باسـتثمارات طويلـة الأجـل، وهـذا يـؤدي إلى تـآكل رصيـد رأس المـال المـادي والبـشري والاجتماعـي والطبيعـي للبنـان حيـث يتجـاوز إهـلاك الأصـول قيمـة الاسـتثمارات بنسـبة كبـيرة للغايـة. إنّ اعتـماد لبنـان عـلى السـياحة وتدفقـات التحويـلات الماليـة لا يمثـل إسـتراتيجية اقتصاديـة سـليمة أوخطـة لحـل الأزمـة الاقتصاديـة. فنظـراً للتقلبـات في قطـاع السـياحة وتعرضـه لمخاطـر الصدمـات الخارجيـة والداخليـة (عـلى سـبيل المثـال تداعيـات الـصراع الحـالي، راجـع الفصـل الخـاص في هـذا التقريـر)، لا يمكـن لهـذا القطـاع أن يكـون بديـلاً عـن محـركات النمـو الأكـثر اسـتدامة وتنوعـاً. فقـد أدى اسـتقرار تدفقـات تحويـلات المغتربـين إلى دعـم الاسـتهلاك، وكان ذلـك بمثابـة شـبكة أمـان اقتصـادي واجتماعـي فعليـة، إلا أن هـذه التدفقـات ليسـت بديـلاً لنمـوذج النمـو المسـتدام.

ومـع انـدلاع الـصراع الحـالي، مـن المتوقـع أن يعـود الاقتصـاد اللبنـاني إلى حالـة الركـود في عـام 2023. ويقيّـم الفصـل الخـاص في التقريـر أثـر الـصراع الحـالي وتداعياتـه عـلى الاقتصـاد اللبنـاني. وبافتراض اسـتمرار الوضـع الحـالي المتمثـل باحتـواء المواجهـة العسـكرية عـلى الحـدود الجنوبيـة، تشـير التقديـرات إلى أن الاقتصـاد سـينكمش في عـام 2023، ويرجـع ذلـك في المقـام الأول إلى الصدمـة التـي أصابـت الإنفـاق السـياحي. وعـلى وجـه التحديـد، مـن المتوقـع أن يـتراوح إنكـماش إجـمالي الناتـج المحـلي الحقيقـي بـين 0.6%- و 0.9%- وفقـاً لحجـم الصدمـة التـي سيشـهدها القطـاع السـياحي.

RÉSUMÉ ANALYTIQUE

Évolution récente de l'économie

Le Liban est de nouveau frappé par une crise, due aux retombées du conflit au MoyenOrient. Alors qu'il continue de souffrir du vide politique et institutionnel et de la crise socioéconomique qui le paralyse depuis plus de quatre ans, le pays subit un autre choc majeur : la peur que le conflit au cœur duquel se trouve actuellement Gaza ne s'étende au Liban.

En 2022 et au début de 2023, l'économie était parvenue à sortir du creux de la vague après plusieurs années de fortes contractions, grâce aux recettes du tourisme et aux importants envois de fonds de l'étranger (*Bulletin de conjoncture du Liban, printemps 2023*) (a)**.** La contraction économique de longue durée enregistrée par le Liban s'est, selon les estimations, atténuée en 2022 pour s'établir à 0,6 %. Cette évolution a principalement tenu à l'augmentation de la consommation et à la stabilisation apparente de l'activité du secteur privé, deux facteurs qui demeurent extrêmement sensibles aux chocs exogènes. L'augmentation d'une année sur l'autre du nombre d'arrivées de touristes, qui a atteint 50,6 % en 2022, a également favorisé l'augmentation de la consommation. L'important déficit du compte courant, essentiellement dû au gonflement des importations qui ont retrouvé le niveau qu'ils avaient avant la crise, a néanmoins continué de freiner la croissance en 2022.

L'arrêt temporaire de la dégradation de la situation a également favorisé une stabilisation momentanée du taux de change. Cette dernière a également **été permise par la demande limitée de dollars dans un contexte de dollarisation généralisée de l'économie. L'arrêt des activités sur la plateforme** Sayrafa (la principale plateforme employée par la banque centrale pour procéder à des opérations en devises) en juillet 2023 a aussi contribué à réduire la demande en dollars. La stabilisation relative du taux de change tient enfin aux interventions en devises auxquelles la Banque du Liban a procédé au premier semestre de 2023, ainsi qu'à l'entrée de devises associées aux recettes du tourisme et aux envois de fonds de l'étranger. L'épuisement des réserves brutes en devises signifie toutefois que les possibilités qui s'offrent à la Banque du Liban de procéder à de nouvelles interventions en devises sont limitées, d'autant plus que les recettes du tourisme sont vulnérables à des chocs exogènes.

Les projections de la croissance économique effectuées avant octobre 2023 indiquaient — pour la première fois depuis 2018 — une légère expansion en 2023 (0,2 %). Le taux de croissance positif indiqué par les projections pour 2023 est imputable à la bonne saison touristique estivale ainsi qu'aux envois de fonds de l'étranger, qui ont tous deux favorisé la croissance de la consommation. La dollarisation grandissante des salaires ainsi que la stabilisation apparemment persistante de l'activité du secteur privé ont également stimulé l'économie. Si la croissance du PIB réel est censée bénéficier d'une contribution positive des exportations nettes (1,1 %), elle devrait en revanche être entravée par la contribution négative des investissements (0,9 %) et de la consommation publique (0,2 %).

Le déficit budgétaire et le déficit primaire devraient, selon les projections, être ramenés à respectivement 1.3 % et 0,3 % du PIB en 2023. Les mesures visant à accroître les recettes commençant à produire leurs effets, la proportion du PIB représentée par ces dernières devrait atteindre 8,8 %. Le gonflement des dépenses courantes, les fonds alloués à Électricité du Liban et la poursuite des régimes d'aide sociale dont bénéficient les fonctionnaires devraient, selon les estimations, porter les dépenses à 10,1 % du PIB.

Le déficit du compte courant, qui avait considérablement augmenté pour atteindre 32,7 % du PIB en 2022, ne devrait plus représenter que 12,8 % de cet agrégat en 2023. La contraction du déficit du compte courant tient essentiellement à la diminution du déficit des échanges de biens par suite de la réévaluation, en novembre 2022, du taux de change utilisé pour calculer les droits de douane. L'excédent du compte des échanges de services, après les solides résultats affichés durant l'été par le secteur du tourisme en raison du retour de nombreux expatriés libanais, contribuera aussi probablement à réduire le déficit du compte courant.

Le taux d'inflation devrait, selon les projections, encore augmenter pour atteindre 231,3 % en 2023, essentiellement *à cause* de la détérioration persistante de la situation macroéconomique *fondamentale*. L'accélération de l'inflation tient principalement à la dépréciation du taux de change (au premier semestre de 2023) et à la rapide dollarisation des transactions économiques, en particulier celles qui portent sur les articles du panier sur la base duquel l'indice des prix à la consommation est établi.

Avant même que n'éclate le conflit actuel, il n'était guère vraisemblable que la croissance morose indiquée par les projections pour 2023 perdure parce qu'elle tenait à des facteurs fragiles fondés sur une structure économique dysfonctionnelle. Le cadre macro-économique défaillant, d'une part, appauvrit une large proportion de la population et accroît les inégalités et, d'autre part, fait obstacle à l'établissement d'un modèle de développement durable. En l'absence d'un plan conçu pour résoudre la crise, aucun investissement à long terme ne peut être réalisé, ce qui a pour effet d'éroder le capital physique, humain, social et naturel du pays qui se déprécie à un rythme nettement supérieur à celui de l'investissement. La dépendance du Liban à l'égard du tourisme et des entrées de fonds des travailleurs à l'étranger n'est ni une stratégie économique viable ni un plan de r*ésolution* de la crise économique. Le tourisme est généralement volatil et tributaire de chocs extérieurs et intérieurs (comme les retombées du conflit actuel — voir le volet spécial), de sorte que le secteur ne peut pas s'appuyer sur des facteurs de croissance plus durables et diversifiés. Les entrées de fonds de l'étranger ont, grâce à leur stabilité, soutenu la consommation et constitué, en pratique, un filet de protection économique et sociale, mais elles ne peuvent pas non plus servir de base à un modèle de croissance stable.

Selon les projections économiques, le Liban devrait retomber dans une situation de récession économique en 2023 par suite du conflit actuel. Le volet spécial est consacré à l'évaluation des répercussions du conflit actuel et de ses retombées sur l'économie libanaise. Cette dernière devrait se contracter en 2023, essentiellement à cause du choc enregistré au niveau des dépenses de tourisme, à supposer qu'il soit possible de limiter les confrontations militaires aux frontières sud. Le taux de croissance réel du PIB devrait, plus précisément, tomber à un niveau compris entre –0,6 % et –0,9 %, selon l'ampleur du choc sur le secteur du tourisme.

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THE POLICY CONTEXT

Military confrontation at Lebanon's southern border with Israel is on the rise. Cross-border shelling and military operations have been intensifying and widening along the entire southern border since October 2023. This has resulted in loss of life, injuries, and destruction to infrastructure in these areas, and sparked an exodus of people from southern Lebanon.

With limited progress towards a comprehensive crisis resolution plan, Lebanon remains entrenched in a socioeconomic and financial crisis, further exacerbated by an institutional and political vacuum. A highly polarized political landscape, a Presidential vacuum, a caretaker government with restricted executive powers, an interim central bank governor, and limited legislative action by parliament have all markedly slowed the progress needed for a comprehensive crisis resolution plan. Progress on meeting the prior actions under the Staff-Level Agreement (SLA) concluded in April 2022 with the International Monetary Fund (IMF) is slow.

Legislation pertaining to restructuring the banking sector and the upfront allocation of the financial losses in the insolvent financial system remains elusive. Four years into the crisis, the banking sector, whose balance sheet continues to be severely impaired, is unable to perform its financial intermediation functions. The multiple exchange rate regime, engineered by Banque du Liban (BdL), persists in view of limited progress towards unifying exchange rates and transitioning to a new exchange rate regime. The economy is overwhelmingly dollarized, and the vast majority of transactions are settled in cash.

The central bank, under a new acting governor, has initiated limited but encouraging reforms. These include: (1) stopping the Sayrafa platform in July 2023 and reportedly preparing to transition towards a new, more transparent, platform, to be powered by Bloomberg; (2) ceasing to finance the fiscal and current account deficits; (3) publication of the central bank's liquid foreign exchange position and asset holdings;[1] and (4) publication of the special purpose audit of the BdL's foreign asset position, a

[1] The liquid foreign exchange holdings of BdL are published on the central bank's website. The latter practice has not occurred under the former governor's tenure.

prior action under the SLA with the IMF.[2] Beyond these, fundamental changes to bank supervision or the conduct of monetary and exchange rate policies have yet to be introduced as the multiple exchange rate regime persists, and regulatory forbearance continues to apply to the banking sector.

The (leaked) forensic audit of the BdL reveals systemic and large-scale governance weaknesses and abuses. These include the absence of an internal audit function, as well as the lack of an audit committee and independent board members. The forensic audit also uncovers functional deficiencies at the central bank such as the absence of a risk management framework. The findings of the forensic audit further point to unorthodox and questionable accounting practices such as recording massive losses on the BdL balance sheet under "other assets". It further underscores the unexercised scrutiny power by the Government Commissioner, members of the Central Council, external stakeholders, and commissions. The weak transparency and reporting standards at BdL constitute another main finding of the audit.

The Government has recently set up dedicated reform committees to support reforms of public financial management in six priority areas. Reform committees bring together relevant central and line ministries, local and international experts, and private sector representatives. Committees have been tasked with the drafting of legislation and diagnostics in the following areas: (1) Law on a unified income tax system, (2) Civil service reform and SOE reform; (3) Modernizing the IT system in government, (4) Amending and updating the Public Accounting Law; (5) Customs reform; and (6) Tax on Luxury Goods. Reform committees are at different states of advancement, and momentum is expected to build in the new year. The reform committees are targeting much needed improvements in public financial management and government efficiency. If implemented effectively, resulting reform initiatives are expected to strengthen budget preparation and execution, increase domestic resource mobilization, and drive state modernization.

Following the demarcation of the maritime border, exploration for oil and gas has started, but concluding results have yet to materialize. Drilling took place in block 9 of South Lebanon's Exclusive Economic Zone during the summer and completed in October by the consortium consisting of TotalEnergies (France), Eni (Italy), and the state-owned QatarEnergy (Qatar). The Lebanese Petroleum Authority and the Ministry of Energy and Water issued a statement on October 19 qualifying the results of the exploratory drill as "promising" for the prospects of identifying a high-quality reservoir of hydrocarbon resources, despite the fact that no traces of oil or gas were discovered. The authorities are awaiting to be apprised of the official results of the exploratory drill by TotalEnergies. Prospective revenues from oil and gas, which if they materialize would in any case be years away, are expected to be dwarfed by the size of the losses in the financial sector (*Fall 2022 Lebanon Economic Monitor*). Hence, recourse should not be made to the rent from the nascent extractives industry to reduce the financial sector's losses or delay the much-needed equitable banking resolution.

[2] The vault audit confirmed that the physical gold holdings at BdL are in line with the published figures.

2

RECENT ECONOMIC DEVELOPMENTS

Output and Demand

The contraction in real GDP is estimated to have narrowed to 0.6 percent in 2022 (Figure 1).[3] The growth in consumption, coupled with signs of stabilization in private sector activity are the main drivers of the slowing contraction in economic activity. The BLOM-PMI index (capturing private sector activity), which inched up to 48.4 in 2022, up from an average of 46 percent in 2021, suggests a stabilization in private sector activity (a PMI reading of less than 50 is indicative of a contraction). A year-on-year (yoy) increase in tourist arrivals of 50.6 percent in 2022 has also supported consumption. In contrast, activity in the real estate sector, a traditional pillar of the economy, has decelerated. Construction permits have decreased by 1.2 percent (yoy) whereas cement deliveries declined by 8.1 percent (yoy) in 2022. Developers' inability to access credit coupled with subdued demand owing to falling real per capita incomes are contributing to the slowdown in the real estate sector. From the demand side, private consumption contributed positively to real GDP growth for the second consecutive year (Figure 2). Consumption growth in 2022 is underpinned by remittances, tourism, and an increasing dollarization of salaries. The increase in imports to pre-crisis levels constituted a drag on growth in 2022.

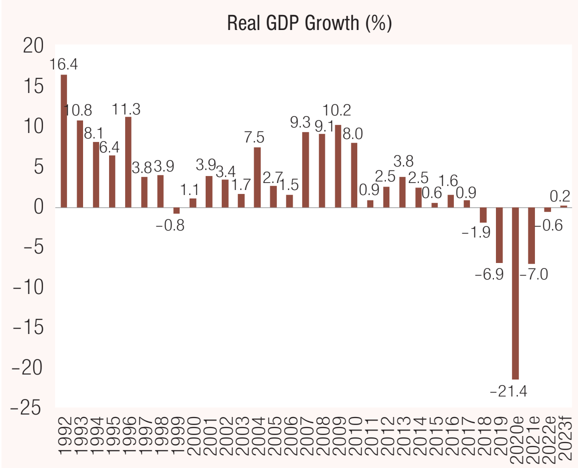
High frequency data, collected prior to the onset of the current conflict, suggest that private sector activity, tourism and remittance inflows will support additional growth in consumption in 2023. The BLOM-PMI index has for the first time in 4 years, with the exception of a brief uptick above 50 in August 2022, moved into an expansionary reading (albeit a very small one) in June and July 2023, standing at 50.2 and 50.3, respectively. The subcomponents of the BLOM-PMI—new orders, new exports orders, output and employment indexes—also indicate an expansion in 2023. Tourist arrivals and airport passengers have increased by 25.2 percent (yoy) and 19 percent (yoy) in 8M-2023.

Fiscal Developments

Following a modest improvement in the fiscal stance in 2021, the overall and primary balances

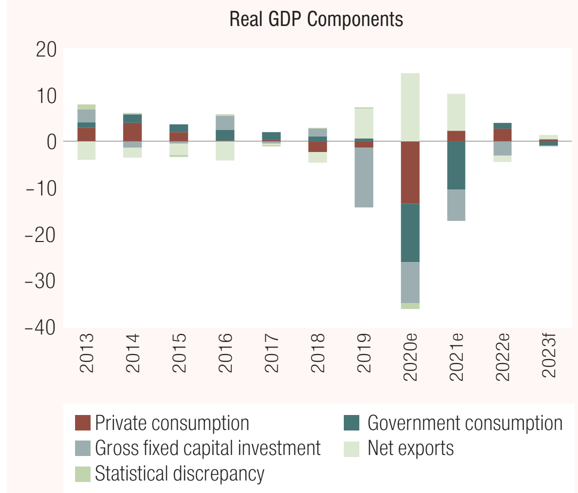
[3] This contraction is a revised estimate from a previous 2.6 percent contraction owing to better-than-expected high frequency indicators data.

FIGURE 1 • Prior to the current conflict, Lebanon's economy was projected to register a tepid growth for the first time since 2018



Source: CAS and WB Staff calculations.

FIGURE 2 • Consumption and net exports are positive contributors to real GDP growth in 2023



Source: CAS and WB Staff calculations.

are estimated to be in deficit in 2022 (Figure 4).[4] The fiscal and primary deficits are estimated to have recorded a deficit of 2.9 and 2.1 percent, respectively. Public finances deteriorated in 2022 as revenue mobilization efforts—correcting the mis-valuation in the exchange rate for customs and taxes—only came into force with the ratification of the budget in November 2022. Revenue mobilization measures have therefore not been sufficient to meet rising personnel costs and current expenditures. Revenues to GDP, which are estimated to have stood at 6.1 percent of GDP in 2022, are the second lowest ratio globally.[5]

Expenditures rose in 2022, both nominally and as a ratio to GDP, reaching 9 percent of GDP. In nominal terms, expenditures are estimated to have increased by US$ 391 million in 2022, compared to 2021. Despite that spending for most of 2022 followed the 1/12th rule of the last approved budget (2020),[6] and thus in nominal Lebanese Pounds given the triple digit inflation implies a sharp contraction in real terms, rising US$ expenditures were funded from budgetary allocations and using extra-budgetary spending (i.e., using Treasury advances and by tapping into the general Special Drawing Rights (SDR) allocation of the IMF). Rising expenditures are driven by (i) an increase in personnel costs owing to the social assistance schemes for public sector employees, (ii) transfers to Électricité du Liban (EdL),[7] and (iii) other current expenditures, current expenditures, which include transfers to the National Social Security Fund and other public entities, along with spending from the World Bank's Emergency Social Safety Net and Wheat Supply Emergency Response Projects. Estimates of the fiscal and primary balances are conservative given that they do not fully account for the quasi-fiscal operations of the BdL, which comprise the sale of foreign exchange to the government, public servants, businesses, and segments of society via its platform, Sayrafa, at favorable exchange rates in the first half of 2023.

Interest expenses are significantly lower after the sovereign default, but this has not led to debt-stabilizing fiscal dynamics. Interest expenditures have fallen from, on average, 6 percent of GDP

4 Fiscal data have not been published since 2021 due to inadequate human and technological resources within the Ministry of Finance.

5 Using the IMF WEO October 2023 data, only Venezuela has a lower revenue-to-GDP ratio, at 5.96 percent of GDP in 2022.

6 The 2022 budget only became effective upon its ratification in November 2022.

7 Transfers to EdL and the social assistance schemes for public sector employees were funded from Treasury advances and the SDR allocation.

BOX 1. GOVERNMENT BUDGET DRAFTS 2023 AND 2024

The 2023 and 2024 budget drafts were approved by the council of ministers (CoM), on August 16 and September 12, 2023, respectively, and sent to Parliament for ratification.[a] However, none of the budgets have been passed by parliament yet.[b] Given the delay in the ratification of the 2023 budget by parliament with only one month left in the year, the 2023 budget is expected to have very limited (if any) effect on public finances in 2023 if ratified by the end of the year. Because the budget draft was submitted to parliament within constitutional deadlines, it could, according to constitutional stipulations, come into effect by a decree issued by the CoM if parliament does not ratify it by January 2024. The budget drafts target deficits of 2.2 and 2.7[c] percent of GDP for 2023 and 2024,[d] respectively.

The 2023 Budget Draft

Revenues are projected to reach 9.5 percent of GDP, representing a 92 percent contraction in real terms compared to 2019. In line with pre-crisis budgets, the draft relies heavily on indirect taxes, constituting yet another missed opportunity for more progressive revenue measures. Tax revenues account for 76 percent of total revenues, which are mainly composed of indirect taxes, standing at 54.2 percent of total revenues. The most prominent change in the proposed revenues is the adjustment of tax brackets (for income and property taxes).

The 2023 budget draft maintains the top marginal income tax rate at 25 percent while it also keeps firms' profits taxable at a flat rate of 17 percent. The built property tax is capped at 14 percent. The highest rate for income tax applies to the annual income bracket exceeding LBP 2,440 million (around US$ 27,000 using the BNR), while the highest built property tax rate applies to annual revenues exceeding LBP 2,170 million (equivalent to US$ 24,382 using current BNR of 89,000 LBP/US$).

Table 1 presents a comparison between the old and the new brackets for income tax on profits for professionals and on salaries and wages, as per the 2023 budget draft.

The family abatement (exempted first income bracket), that is applicable for both the income tax on professionals and salaries and wages, was also increased from LBP 7.5 million to 37.5 million for the taxpayer, from LBP 2.5 million to 12.5 million for the unemployed spouse, and from LBP 500 thousand to 2.5 million for each child (up to the age of 25 if unemployed).

TABLE 1 • Tax Brackets for Income Tax on Profits for Professionals and on Salaries and Wages

Income tax on professionals	Tax rate	Old brackets (LBP million)	2022 budget (LBP million)	2023 budget draft (LBP million)
	4%	0–9	0–27	0–100
	7%	9–24	27–72	100–260
	12%	24–54	72–162	260–590
	16%	54–104	162–312	590–1,130
	21%	104–225	312–675	1,130–2,440
	25%	Above 225	Above 675	Above 2,440
Income tax on salaries and wages	**Tax rate**	**Old brackets (LL million)**	**2022 budget (LBP million)**	**2023 budget draft (LBP million)**
	2%	0–6	0–18	0–70
	4%	6–15	18–45	70–170
	7%	15–30	45–90	170–330
	11%	30–60	90–180	330–650
	15%	60–120	180–360	650–1,300
	20%	120–225	360–675	1,300–2,440
	25%	Above 225	Above 675	Above 2,440

(continued on next page)

BOX 1. GOVERNMENT BUDGET DRAFTS 2023 AND 2024 *(continued)*

Other changes in the proposed revenues of the state budget include:

- Increases in fees,[e] by a factor of 30 (from their August 2019 levels)
- Increases exit fees for airport and seaport passengers.
- Introduction of fees on trucks entering the country, requiring quarrying sector dues to be paid in US$
- Introduction of customs and fees exemptions as well as tax reductions for environment-friendly vehicles.

Expenditures are budgeted at 11.7 percent of GDP. Current expenditures represent the bulk of expenditures, with the social assistance scheme constituting the highest spending item. In lieu of wage corrections and comprehensive civil service reform, the 2023 budget draft proposes a social assistance scheme. The latter scheme does not constitute an increase in basic salaries of public servants and is not permanent. The social assistance scheme comprises a transportation allowance; four and three-fold increases in the wages of civil servants and military personnel; a three-fold increase in pensioners' wages; and adjustments to the hourly wages of contractual employees.

As such, salaries, wages, and social assistance (including pensions) are allocated 61.6 percent of expenditures. Interest payments stand at 7 percent of expenditure, while capital expenditures account for a mere 6.5 (0.8) percent of spending (GDP).

The 2024 Budget Draft

Revenues are projected to reach 16.6 percent of GDP, 93.6 percent lower in real terms than in 2019.[f] Similar to the 2023 budget draft and pre-crisis budgets, the 2024 budget draft relies heavily on tax revenues, amounting to 80 percent of total revenues. Tax revenues are predominantly composed of indirect taxes, which stand at 53.6 percent of total revenues. The main adjustments to tax revenues and fees include:

- For the first time, the 2024 budget draft raises the Value Added Tax (VAT) rate from 11 to 12 percent.[g] The VAT constitutes a largely regressive indirect taxation scheme. In fact, over-reliance on consumption taxes is a highly regressive trend and key feature of the post-war economic model.
- Introduction of an ad-valorem tax on imports ranging from 0.1 percent to 0.4 percent
- Introduction of a fee to be paid for expedited administrative services and transactions.
- Adjustments to the payment method of taxes: income tax is to be paid in the same currency as that of income using a discounted Sayrafa rate (for salaries earned in foreign currency); payment of taxes is also allowed using pre-October 2019 bank deposits.
- The introduction of a US$ fee for the collection and treatment of solid waste.

On the other hand, expenditures are budgeted at 19.3 percent of GDP in the 2024 budget draft. With the BdL announcing that it will cease financing the deficit, a possible source of financing is to issue LBP denominated Treasury bills and bonds as provisioned for in article 5 of the 2024 budget draft. Nonetheless, demand for these debt instruments is likely to be non-existent amid a sovereign default and BdL may ultimately act as the financier of the deficit by purchasing these bonds. Similar to the 2023 budget draft, current expenditures represent the bulk of expenditures, with the social assistance scheme constituting the highest spending item, in the 2024 budget draft. Salaries, wages, and social assistance (including pensions) are allocated 58 percent of expenditures. Interest payments stand at 4.9 percent of expenditure, and capital expenditures account for 7 (1) percent of spending (GDP).

Expenditure Allocation to Ministries in both Budget Drafts

The biggest share of expenditures is allocated to the Ministry of Finance (MoF) in the 2023 budget draft, and to the budget reserve in the 2024 budget draft.[h] Moreover, the four sovereign ministries (Interior and Municipalities, Finance, Foreign Affairs, and Defense) are allocated 48.4 percent and 25.4 percent of total expenditure in 2023 and 2024 budget drafts, respectively. The MoF's share of total expenditures decreased by 26.6 percent in the 2023 draft budget to 1.6 percent in the 2024 budget. The latter decrease in the MoF's share of total expenditures is likely to entail persistent inadequacies in human and technological resources within the ministry and does not bode well for the prospects of revenue collection and fiscal management.

Five service ministries (Public Works and Transport, Education, Public Health, Telecom, and Energy and Water) account for 16.7 percent and 19.9 percent of expenditure in 2023 and 2024 budget drafts, respectively—with the Ministry of Energy and Water receiving just 0.6 percent and 0.3 percent of total expenditure. Consequently, the severe lack of public service provision, in the education, healthcare, transportation and energy sectors is expected to persist.

Despite the fact that conserving the environment was the alleged motivation behind imposing an "environment conservation consumption tax", the Ministry of Environment is allotted the lowest share of expenditure in both budget drafts at 0.04 percent in 2023 and 0.02 percent in 2024.

(continued on next page)

BOX 1. GOVERNMENT BUDGET DRAFTS 2023 AND 2024 *(continued)*

Regressive Fiscal and Tax Policies

The draft budgets of 2023 and 2024 represent missed opportunities for introducing much needed changes to fiscal and tax policies. The brunt of the fiscal adjustment is borne by wage earners despite the significant loss of purchasing power owing to the triple digit inflation and currency depreciation.

The two draft budgets do not entail changes to the tax system or fiscal policy. The tax system, in the two draft budgets, continues to overly favor the affluent and non-wage earners via the favorable treatment of wealth, capital gains and property taxation. In terms of policy recommendations, the fiscal authorities can mobilize revenues from wealth, income, and capital gains by, for example, obtaining and acting upon information on offshore holdings of Lebanese residents, taxing capital gains from the sale of shares in joint stock companies by individuals, taxing income from rent, and removing the exemption for dividend distributions to individuals from holding and offshore companies. The authorities can also consider abolishing the reduced Corporate Income Tax (CIT) rates for reinvested profits, subjecting corporate capital gains to the standard CIT rate, abolishing property tax exemptions for vacant properties and the preferential treatment for second properties as well as tightening the definition of residency for tax purposes (IMF, 2023).[i] Such measures are absent from both drafts. Moreover, taxing small to medium enterprises on a presumptive basis, subjecting professionals to the real profits regime, and taxing illegal maritime properties are additional revenue enhancing measures and policy recommendations that the fiscal authorities can pursue. The tax elasticity in Lebanon is likely to be high owing to significant declines in nominal and real incomes. Therefore, the scope for revenue mobilization from consumption taxes is likely to be limited.

Nonetheless, going forward, the government intends to enhance revenues by introducing new laws or putting into practice existing legislation. The measures that the authorities expect to embark on include (i) unifying the income tax and accounting for all sources of income, (ii) enhancing customs revenue by combating pervasive evasion, (iii) taxing illegal maritime properties, (iv) unifying and streamlining the property valuation system, with municipalities assuming a central role in the property valuation exercise, and (iv) modernizing the Public Accounting Law, which dates to 1963.

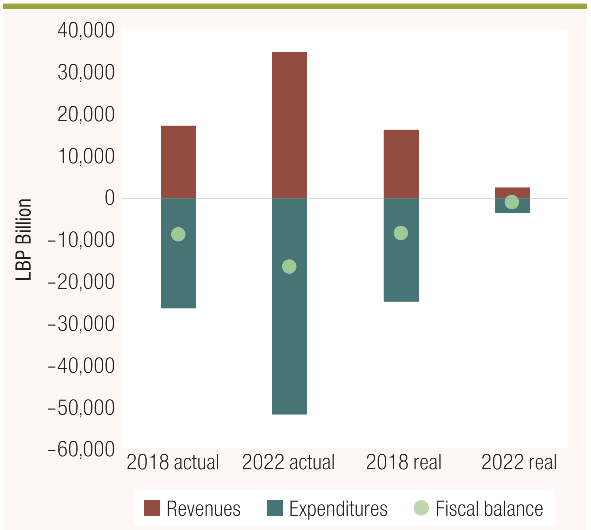
TABLE 2 • Fiscal Balance (2020–2022)

(LBP Billion)	Actual 2020	Actual 2021	Budget 2022	WB est. 2022	Budget draft 2023	WB proj. 2023	Budget draft 2024
Revenue	15,341	20,264	29,986	35,137	147,739	137,077	258,785
Expenditure	19,236	17,614	40,870	51,849	181,923	157,767	300,519
Fiscal balance	3,895	2,650	10,884	16,712	34,184	20,690	41,734
(% of GDP)	**Actual 2020**	**Actual 2021**	**Budget 2022**	**WB est. 2022**	**Budget draft 2023**	**WB proj. 2023**	**Budget draft 2024***
Revenue	13.1	7.5	5.2	6.1	9.5	8.8	16.6
Expenditure	16.4	6.5	7.1	9.0	11.7	10.1	19.3
Fiscal balance	−3.3	1.0	−1.9	−2.9	−2.2	−1.3	−2.7

* The 2024 ratios to GDP are calculated using the baseline GDP for 2023, which excludes the impact of the current conflict and its spillover into Lebanon. The World Bank staff are not producing a forecast for GDP in 2024 due to high uncertainty.

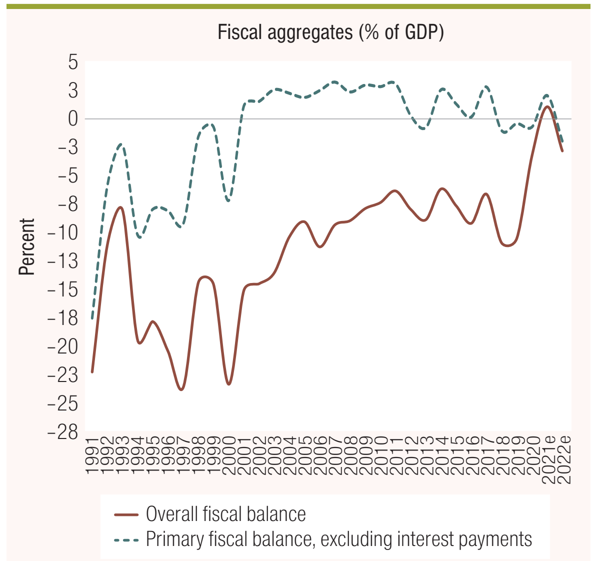
[a] The fiscal accounts have not been reconciled since 2003.
[b] The draft and final budgets may differ substantially as changes can be introduced to the draft budget by parliament and the Budget and Finance parliamentary committee.
[c] These numbers do not include extra-budgetary or quasi-fiscal spending, and therefore underestimate the fiscal deficits in both years.
[d] The 2023 nominal GDP is used to compute percentages to GDP.
[e] The thirty-fold increase applies to all fees that are not to be collected in US$. The nominal GDP for 2023 is used to compute the ratios to GDP in 2024 due to uncertainty regarding the GDP for 2024.
[f] The World Bank staff are not producing an inflation forecast for 2024 due to the high uncertainty. Therefore, the inflation forecast for 2023 is used to compute revenues in real terms for 2024.
[g] The VAT increase proposal has faced considerable push back in ongoing discussions in parliament.
[h] The budget reserve in the 2024 budget draft is large because it includes the three and four-fold (temporary) increases in the salaries of public sector employees and retirees.
[i] International Monetary Fund (2023). "Lebanon: Technical assistance report on putting tax policy back on track", Washington DC.

FIGURE 3 • Evolution of Public Finances in Nominal (LBP) and Real Terms, 2018 vs. 2022



Sources: Lebanese authorities and WB staff calculations.

FIGURE 4 • Overall and Primary Deficits Are Projected for 2023



Sources: Lebanese authorities and WB staff calculations.

during 2017–2019 to 1.3 percent of GDP over the period 2020 to 2022. Despite this significant decrease in debt-servicing costs, the primary balance has deteriorated, posting an average deficit of 0.3 percent over the 2020–2022 period compared to an average surplus of 0.3 percent between 2017 and 2019.

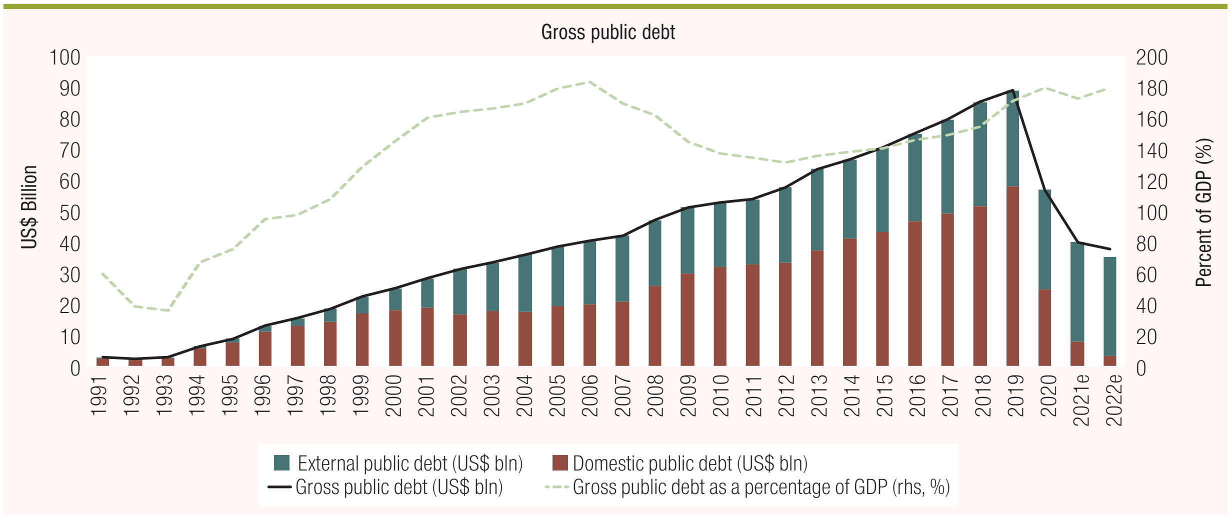
Sovereign debt, at 179.2 percent of GDP in 2022, remains unsustainable amid a sharp currency depreciation and economic contraction, and in the absence of comprehensive debt restructuring. The sharp depreciation in the local currency has eroded the domestic currency component of total debt (part of the numerator in the debt-to-GDP ratio). This, however, is more than offset by a lower denominator, GDP in US$, due also to currency depreciation and economic contraction, leaving a larger debt-to-GDP ratio in 2022 (Figure 5). Whereas the surge in inflation is rapidly eroding the real value of domestic debt, the sharp depreciation of the currency continues to make Lebanon's sovereign debt burden unsustainable. The World Bank debt model assumes a stable foreign-denominated debt stock and does not include accumulated arrears. As nominal GDP in US$ continues to decline in the absence of comprehensive reform and an economic stabilization plan, the debt-to-GDP ratio is projected to remain on its structurally unsustainable path, akin to the pre-crisis era (Figure 5).

Lebanon must confront its debt overhang with urgency. Since the sovereign debt default on March 9, 2020, little progress has been made on a debt restructuring strategy or in pursuing an agreement with foreign creditors.[8] Large-scale private investments, which are essential for an economic recovery, will not materialize without a restructuring of public debt. The World Bank's *2022 Lebanon Public Finance Review* underscores further that the restructuring of Lebanon's foreign-denominated debt is unlikely to be sufficient for debt sustainability. In fact, maintaining sustainable debt dynamics in the long run hinges on sustaining economic growth.[9] The sustainability of the foreign-currency component of the debt will also depend on positive net exports. It is essential for the country to resume negotiations with its creditors to assess the degree of the potential debt relief that it could receive. Existing research, based on

[8] The last conference call between the Lebanese authorities and the creditors took place on May 9, 2022.

[9] Should a successful debt restructuring be undertaken, maintaining debt on sustainable footing in the medium and long run hinges on the differential between GDP growth and the interest rate being positive.

FIGURE 5 • Sharp Decrease in Nominal GDP Prompts Erosion of Public Debt as a % of GDP to Pre Crisis Levels[a]



Sources: BdL and WB staff calculations.

[a] To convert domestic debt to US$, the World Bank Average Exchange Rate is used for 2020–2022, estimated at LBP 3,688, 11,755, 27,309 per US$, respectively.

a sample of 180 debt restructuring episodes over the period 1987 to 2010, points to an average haircut (i.e., face value reduction of debt outstanding) of 37 percent.[10,11] This number however is only indicative, as Lebanon would require a much larger debt write-off than the historical average to achieve debt sustainability. There is further evidence that larger haircuts tend to be associated with higher holdout rates, higher subsequent bond spreads and longer periods of exclusion from international capital markets.[12]

Lebanon's significant debt overhang relative to a shrinking GDP precludes a 'soft' debt restructuring. Significant face value reductions are necessary to reduce Lebanon's debt-to-GDP to sustainable levels and maturity extensions and interest rate reductions would not suffice to ensure debt sustainability.[13,14] Empirical evidence suggests that "hard" debt relief, which involves debt write-offs, is associated with stronger economic growth, debt sustainability and improved credit ratings; this is less evident for "soft" debt relief which consists of maturity extensions and interest rate reductions.[15] The

10 Ewards, S., (2015a). "Sovereign default, debt restructuring, and recovery rates: Was the Argentinean 'haircut' excessive?", Open Economies Review.
Edwards, S., (2015b). "Sovereign default and debt restructuring: Was Argentina's 'haircut' excessive?" Vox EU, Center for Economic Policy Research.

11 The haircut of roughly 75 percent for Argentina in 2005 can, therefore, be viewed as an outlier (Edwards, 2015b). According to Edwards (2015b), the haircut on Greek bonds, of roughly 64 percent, is more in line with international experience.

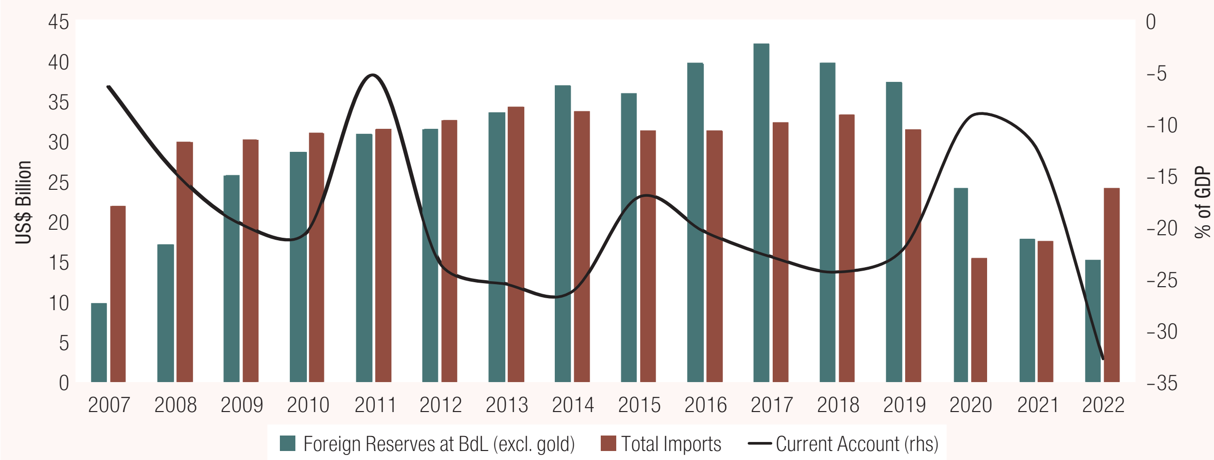
12 Cruces, J. J., & Trebesch, C., (2013). "Sovereign defaults: The price of haircuts", American Economic Journal: Macroeconomics 2013, 5, 85–117

13 Recent empirical research by the World Bank (2023) using a sample of 88 external debt restructurings since 1970 suggests that larger restructurings, which significantly lower debt-to-GDP ratios, entail a lower probability of relapsing into debt-related distress. For more information, please refer to World Bank (2023), Spotlight: An ounce of prevention, a pound of cure: Averting and dealing with sovereign debt default. South Asia Development Update, October 2023.

14 Morgan Stanley (2020). Lebanon sovereign debt restructuring awaits, March 24, 2020.
Goldman Sachs (2021). Mapping out the path to Lebanese economic recovery. CEEMEA Economic Analyst, September 22, 2021.

15 Reinhart, C. M., & Trebesch, C., (2016). "Sovereign debt relief and its aftermath", Journal of the European Economic Association, 14(1), 215–251.
Trebesch, C., & Zabel, M. (2017). "The output costs of hard and soft sovereign default", European Economic Review, 92, 416–432.

FIGURE 6 • Current Account Deficit Widens in 2022, Registering a Ratio to GDP Similar to Pre-Crisis Years



Sources: BdL, CAS and WB staff calculations.

absence of International Capital Market Association (ICMA)-recommended single limb Collective Action Clauses (CACs) for Lebanon's Eurobonds implies that the vote will have to occur on a bond-by-bond basis, which could entail low participation.[16,17]

External Sector

The current account (CA) deficit is projected to narrow to 12.8 percent of GDP in 2023, following a dramatic increase to 32.7 percent of GDP in 2022 (Figure 6). The contraction in the CA deficit, from US$ 6.9 billion in 2022, has been mainly driven by a narrowing trade-in-goods deficit following the revaluation of the exchange rate for custom duties that became effective in November 2022.[18] The gradual correction of the mis-valuation of the exchange rate for customs duties has reduced incentives for opportunistic purchases, hoarding, and possible over-invoicing. According to customs data, imports of goods have decreased by 9.4 percent (yoy) in 7M-2023. The compression in imports of goods is expected to persist for the remainder of 2023 and is projected to reach 23.1 percent by year-end, reducing imports of goods to an estimated US$13.9 billion or close to 2021 levels.

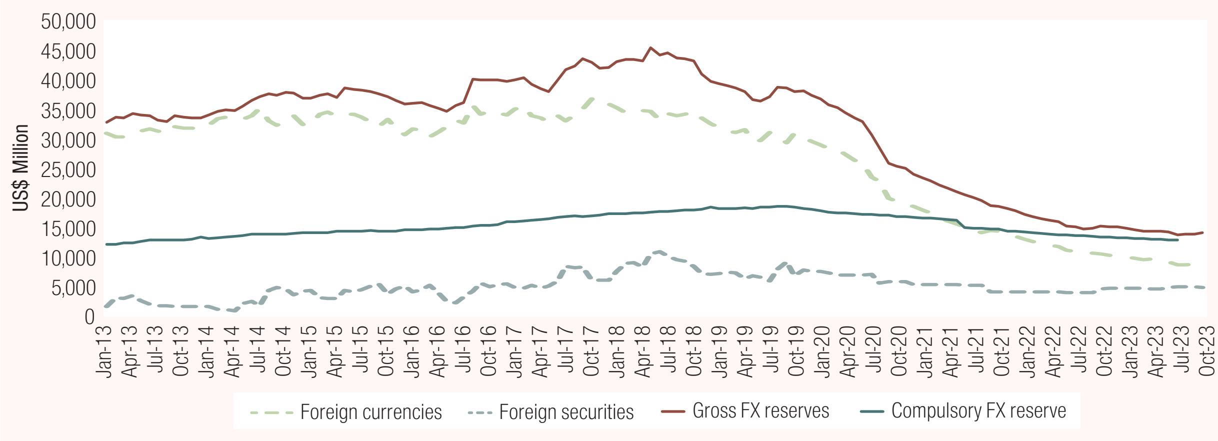
A surplus in trade-in-services will also contribute to a lower CA deficit. As many Lebanese expatriates flock back to the country following the end of COVID-19 related restrictions, hotel occupancy rates in Beirut averaged 42 percent and passenger arrivals via the Beirut international airport have increased by 23.3 percent (yoy) in H1–2023. This vigorous tourism activity is projected to spur tourism receipts and contribute to a record trade-in-services surplus of 10 and 17.7 percent of GDP in 2022 and 2023, respectively. The ongoing military operations in southern Lebanon are, however, already exerting a negative impact on passenger arrivals. Should these

16 Fang, C., Schumacher, J., & Trebesch, C., (2021). "Restructuring sovereign bonds: holdouts, haircuts and the effectiveness of CACs", IMF Economic Review, 69, 155–196.
Fang, Schumacher, and Trebesch (2021) offer a simulation that demonstrates that the holdout problem is minimized for the strongest form of CACs with single-limb aggregate voting. That is, classic CACs with bond-by-bond voting could also entail lower participation.

17 In Lebanon's case, the absence of formal CACs can be addressed by making a debt restructuring contingent on the vote for every bond reaching 75 percent as in Ukraine's debt restructuring of 2015 (Morgan Stanley, 2020). This could prove to be a significant hurdle for a debt restructuring.

18 The exchange rate used for customs duties has increased from LBP 15,000 per US$ in November 2022, to LBP 45,000 and 60,000 per US$ in March and April 2023. Since May 2023, the customs duties have been collected at the Sayrafa rate.

FIGURE 7 • A Steady Depletion in the Gross Foreign Exchange Position at BdL



Sources: BdL and WB staff calculations.

persist, expand geographically, or intensify, touristic activity in December is likely to be subdued, which will decrease the projected trade-in-services surplus in 2023. Tourism receipts, coupled with a compression in the imports of goods, are projected to lead to the narrowest post-crisis nominal CA deficit of US$ 2.3 billion in 2023.

Gross foreign currency reserves have increased by US$ 425 million between end-July and mid-November 2023, reaching US$14,213 million, reflecting ad-hoc policy measures and not a sustainable improvement in the net foreign asset position. The two main factors that have led to a short-term increase in reserves are (i) halting the Sayrafa platform, the main monetary tool to supply foreign currency to shore up the LBP,[19] and (ii) BdL purchases of foreign exchange from the banknote market and exchange bureaus, absorbing the excess US$ supply accumulated following a buoyant summer season and substantive foreign currency inflows. Hence, the reserve accumulation does not stem from an intrinsic improvement in the financial sector's net foreign asset position and could be short-lived. Indeed, the volatile nature of tourism precludes predicating a long-term reserve accumulation strategy on tourism receipts. With the depletion of the SDR allocation, pressures to draw down BdL's reserves will mount. Prior to the accumulation of reserves in November, gross foreign currency reserves had declined by US$ 24,131 million between October 2019 and July 2023, reaching their lowest value of US$ 13,811 million in July 2023 (Figure 7). According to the central bank's official statements, net liquid assets stood at US$ 8,542 million as at end-August 2023 (Figure 8).[20,21]

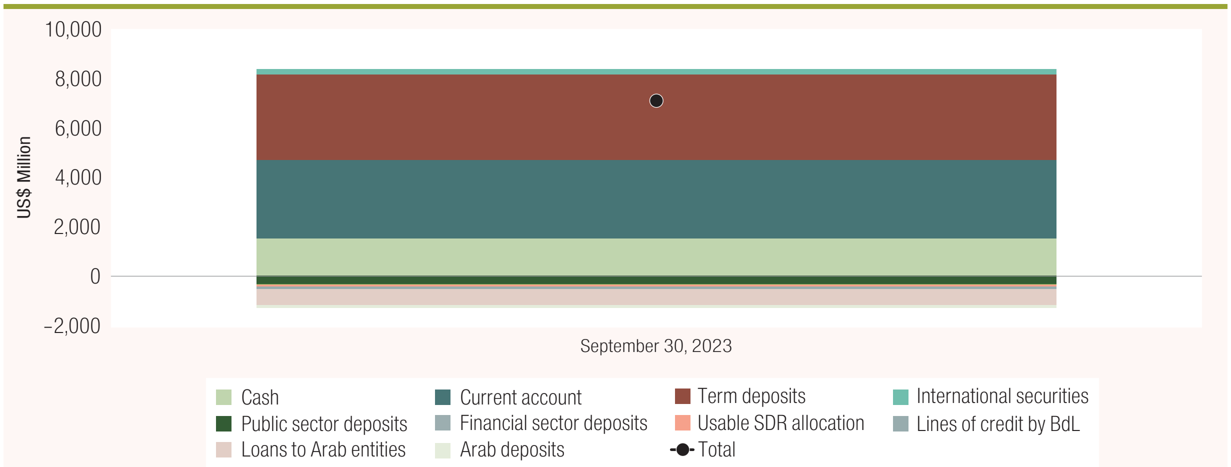
The sizeable inflow of remittances did not meet Lebanon's external financing needs. Remittances, which are proving to be resilient, continue to act as a de-facto social safety net and support a modest growth in domestic consumption. Remittances in 2023 are projected to remain near their 2022 levels, at US$ 6.4 billion. Net remittances to GDP are projected to stand at 23.4 percent whereas remittance inflows are projected to reach 35.2 percent of GDP; a record high since 2019, due to a

[19] Please refer to *Spring 2023 Lebanon Economic Monitor* for a discussion of Sayrafa platform's operations.

[20] The BdL began publishing its liquid foreign exchange position and asset holdings in August 2023. Liquid foreign currency assets comprise, (i) cash, (ii) current deposits at BdL, (iii) term deposits at BdL and (iv) international securities.

[21] The latter liquid reserve position differs from BdL's net reserve position—which accounts for BdL's liabilities to banks whereas the liquid reserves do not—and is estimated to be highly negative (several times current GDP). The net negative reserve position of BdL is estimated to exceed US$ 60 billion as discussed in the *Fall 2022 Lebanon Economic Monitor*. The bulk of the losses in the financial sector can be ascribed to the latter net negative reserve position.

FIGURE 8 • Breakdown of Liquid Reserves at BdL



Sources: BdL and WB staff calculations.

denominator effect (i.e., declining nominal US$ GDP). These figures only capture the inflows through official channels and may therefore underestimate the actual size of remittances.[22]

The current account deficit was, in the first half of 2023, predominantly financed from BdL's reserves. The rapid drawdown in foreign currency reserves coupled with limited net liquid reserves at BdL suggest that continued reliance on the central bank to finance the external deficit is becoming increasingly tenuous. The private sector has also resorted, in part, to financing imports via the full collateralization of credit lines and by leveraging funds from the sizeable cash economy.[23] Indeed, utilized credit from documentary lines of credit stood at US$ 80 million in 5M-2023 having registered US$ 223.2 million in 2022.

Consistent with mounting difficulties in financing the external deficit, Lebanon was forced to tap into its general Special Drawing Rights (SDR) allocation to finance critical imports. With BdL's waning ability to finance the current account deficit, Lebanon has increasingly relied on the 2021 general SDR allocation from the IMF as well as the World Bank's Wheat Supply Emergency Project to finance part of its US$ 420 million and US$ 228 million import bill for medicine and wheat. According to an official statement by BdL (dated August 31, 2023),[24] US$ 125 million of the US$ 1.139 billion general SDR allocation can be deployed, suggesting a rapid pace of utilization of the funds. The reliance on the SDR allocation has substituted for drawing down foreign currency reserves at BdL, but this strategy is untenable given the near complete depletion of the SDR allocation.

Money and Banking

The pace of the exchange rate depreciation has moderated, with the banknote market exchange rate stabilizing, albeit temporarily, at around 90,000 LBP/US$ since July 2023. Testament to the continued atrophy of the Lebanese economy, the Lebanese pound depreciated precipitously over

22 Lebanese expatriates could have brought in remittances in cash.

23 The cash economy is estimated in the *Spring 2023 Lebanon Economic Monitor* to stand at 45.7 percent of GDP. Some large importers are also reportedly relying on offshore bank accounts to finance their imports and partly circumvent the Lebanese banking sector. These importers use the Lebanese banking sector as a conduit for the remitting the cash revenues (from sales) to the offshore accounts.

24 BdL's statement on liquid foreign currency reserves is available here: Link

BOX 2. CIRCULAR 165: AN UNSUCCESSFUL ATTEMPT TO REBOOT THE BANKING SECTOR AND NATIONAL PAYMENT SYSTEM

Prior to his departure, the outgoing former BdL governor issued Circular 165 on April 19, 2023, to restart the settlement of transactions via the banking sector. The stated aim of the circular is to strengthen the economy and stimulate banking activity, by mandating commercial banks to extend basic banking services (the use of checks, electronic transfers, and payment by card) to all foreign or cash inflows into the banking system since November 2019. Since the onset of the crisis, the settlement of transactions, aside from deleveraging, has been predominantly carried out in cash, as detailed in the Spring 2023 Lebanon Economic Monitor. Circular 165 aims at resuming the use of the national payment system, which comprises the real-time gross settlement system (RTGS) and BdL-clear, to settle and clear transactions via the banking system and ultimately decrease the size of the cash economy. Nonetheless, this move carries important risks in that it effectively creates a parallel banking system for fresh dollar deposits that has been "reset" in November 2019, which ignores the pre-crisis encumbered foreign-currency deposits. Further, circular 165 poses financial integrity and anti-money laundering risks given that illicit funds may be channeled via the financial system. Despite the risks posed by a sizeable cash economy, Lebanon has avoided, until now, being placed on the Financial Action Task Force's grey list. Take up of the provisions of circular 165 is likely to be limited amid a complete loss of confidence in the impaired banking sector and the departure of the former BdL governor.

the period January to March 2023 and the Banknote Rate (BNR or parallel rate), at its weakest, stood at 134,900 LBP/US$ on March 21. In response, the BdL announced, on March 21, its readiness to sell dollars on the Sayrafa platform and raised the Sayrafa rate to 90,000 LBP/US$. BdL's foreign exchange rate interventions, coupled with an increase in foreign exchange inflows from tourism services and remittances, proved to be sufficient to stem the rapid depreciation. The exchange rate has now stabilized, albeit temporarily, at around 90,000 LBP/US$. However, the currency lost more than 98.3 percent of its pre-crisis value by July 2023.[25]

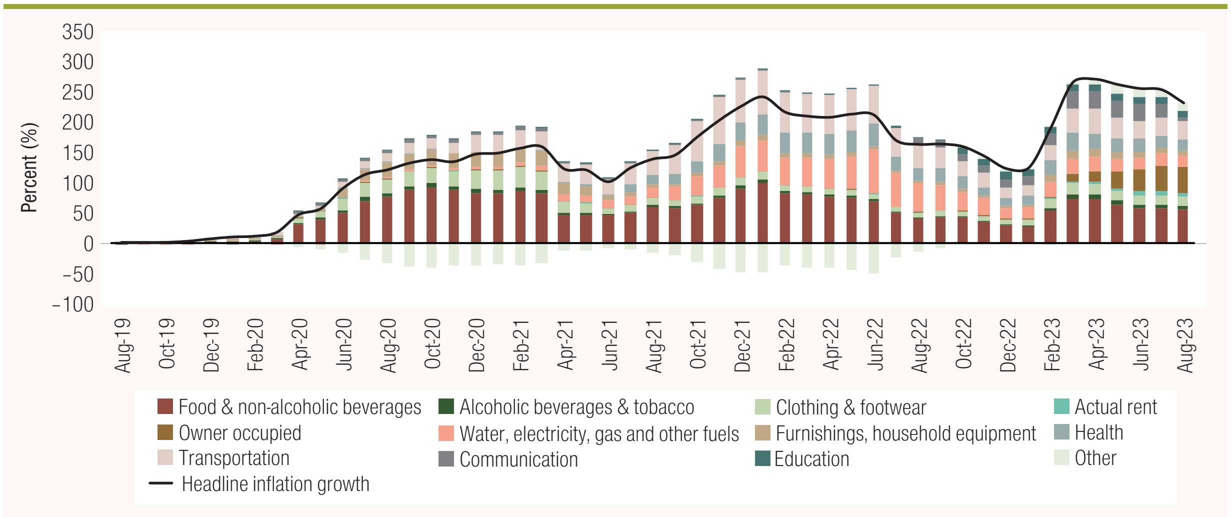
The BdL has stopped the Sayrafa platform in July 2023 and is reportedly transitioning towards a new platform, to be powered by Bloomberg. The new platform could permit larger transactions and offer more transparency than its predecessor in terms of order flow, leading to enhanced price discovery. Nonetheless, as expounded in the *Spring 2023 Lebanon Economic Monitor*, it is still not clear, should the exchange rate not be unified, who will assume the sell side of transactions on the platform in the absence of economic incentives to transact. Apart from discontinuing Sayrafa, the BdL, has not, to date, introduced fundamental changes to bank supervision or the conduct of monetary and exchange rate policies. The multiple exchange rate regime persists, and regulatory forbearance continues to apply to the banking sector.

Inflationary pressures have not abated, averaging 171.2 percent in 2022, one of the highest rates globally, primarily due to the depreciation of the LBP. Year on year inflation stood at 208.5 percent in September 2023, averaging 229.4 percent (yoy) in 9M-2023. As in 2022, food and non-alcoholic beverages are the largest contributor to headline inflation in 9M-2023. Of the other categories in the CPI basket, (i) transportation, (ii) owner occupied housing costs (i.e., equivalent rent), (iii) health, and (iv) water, electricity, gas, and other fuels are also substantial drivers of headline inflation with contributions standing at, respectively, 29.8, 25.1, 21.6, and 20.8 percent (Figure 9).[26] The latter inflationary dynamics can be ascribed to the increasing dollarization of prices across sectors,

25 The spread between the BNR, Sayrafa and World Bank Average Exchange rates, has narrowed to, respectively, 10.8 percent and 9.7 percent, on average, over the period March and July 2023. The *Spring 2023 Lebanon Economic Monitor* expounds that the removal of subsidies on critical imports by BdL is the main driver of convergence between the AER and parallel market rates.

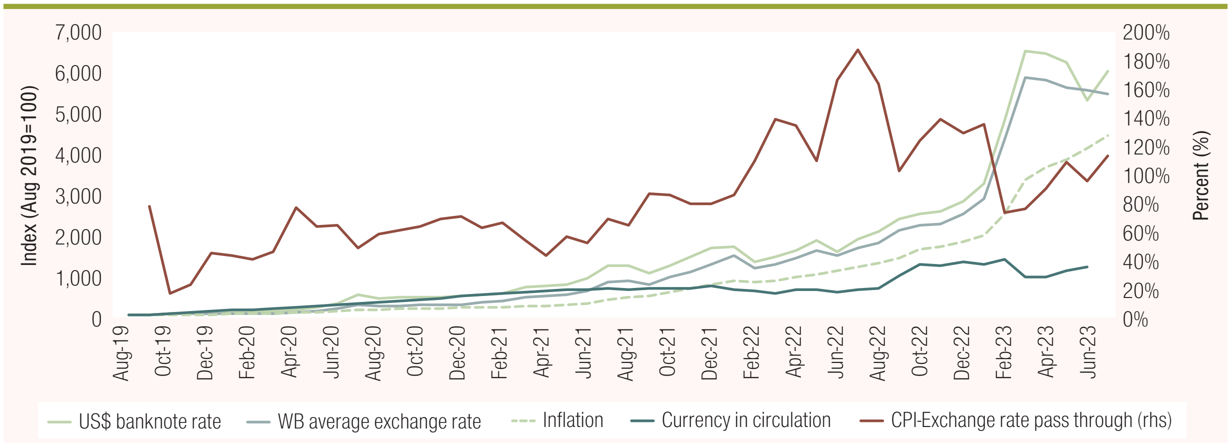
26 The year-on-year increases in the price food and non-alcoholic beverages, owner occupied equivalent rent, health, and transportation stood at, respectively, by 239, 324, 215.8, and 176 percent. The price of the communication component of the CPI basket grew by a staggering 337.6 percent (yoy) in 9M-2023. The

FIGURE 9 • CPI Subcategories' Monthly Contribution to Headline Inflation (Aug 2019–Aug 2023)



Sources: CAS and WB staff calculations.

FIGURE 10 • Exchange Rate Depreciation Drives the Surge in Inflation



Sources: BdL, CAS and WB staff calculations.

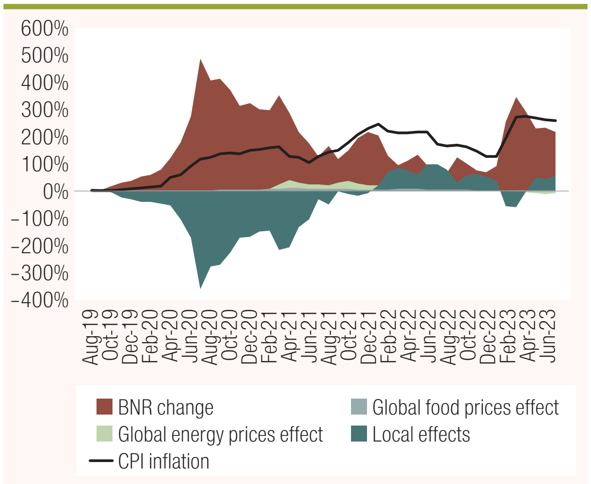
which drives domestic-currency inflation (Figure 10). Social tensions could rise as the poorest and most vulnerable segments of society struggle to afford shelter and access to services.[27] World Bank staff analysis reveals that local factors and dollarization remain important drivers of inflationary pressures (Figure 11) (*Spring 2023 Lebanon Economic Monitor*).

Lebanon topped the list of countries that are hardest hit by nominal food price inflation in the first quarter of 2023. Nominal food price inflation stood at 350 percent (yoy) in April 2023 (Figure 12). On a global level from March to July 2023, Lebanon was also the second hardest hit country by nominal food price inflation, which stood at 280 percent, second only to Venezuela. Soaring food prices following the Russian invasion of Ukraine are forcing

latter increase predates the seven-fold increase in telecom tariffs that was enacted by the Ministry of Telecommunications and approved by the caretaker government. The increase in tariffs will be effective on September 1.

27 Rent prices have also increased by 204.9 percent (yoy) in September 2023. The inability to afford shelter and access to basic services may potentially lead to social unrest.

FIGURE 11 • Currency Depreciation and Local Factors are Main Drivers of Inflation



Sources: CAS and WB staff calculations.

households to adopt extreme livelihood coping measures and exacerbating the precarity of the conditions of the poorest and most vulnerable segments of the host and refugee communities.[28]

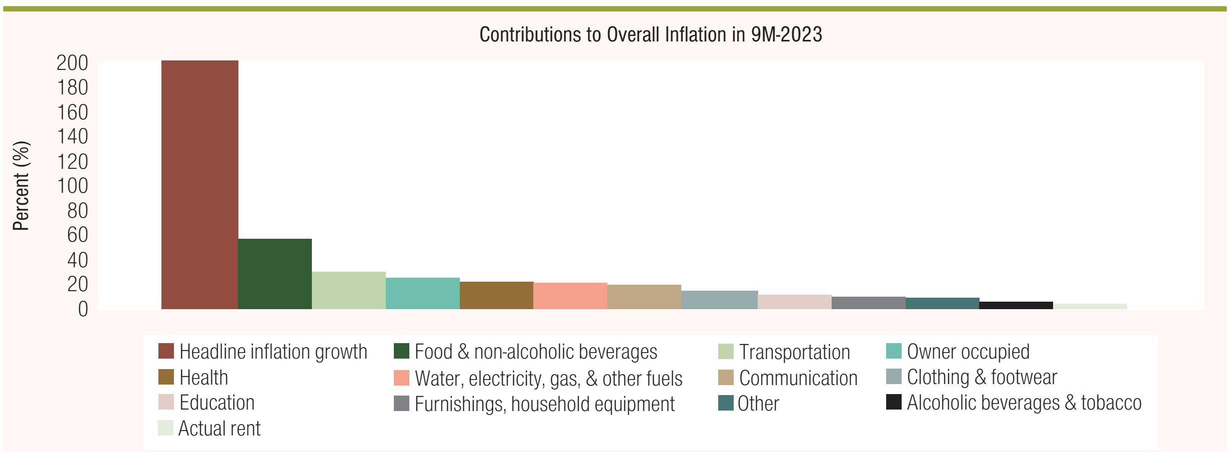
Currency in circulation contracted by 26.8 percent in Q1-2023 amid limited demand for LBP (Figure 10). The downward trend has reversed in Q2-2023 leading to a cumulative contraction in currency in circulation of 10.2 percent in H1-2023. The deleveraging in the banking sector continues. Resident foreign currency deposits decreased by 6.8 percent (yoy) and stood at US$ 71 billion whereas non-resident foreign currency deposits decreased by 6.7 percent (yoy) and stood at US$ 24.3 billion in August 2023. The commercial banking sector's deposits at BdL declined by 22.5 percent (yoy) in August 2023.

The banking sector remains insolvent, with a severely impaired balance sheet. With losses exceeding three times GDP and standing at US$ 72 billion, the banking sector's losses as a share of GDP are among the largest, if not the largest, in the world. A comparison with global banking crisis episodes suggests that the losses of the Lebanese banking sector are orders of magnitude larger than for any of the comparators and are indeed unprecedented.[29] The quality of the private sector lending

[28] The soaring food inflation and adverse economic conditions have led more than 10 percent of Lebanese households to send their children to work to access food and pay for essentials (World Bank, 2023a). Further, more than 90 percent of households are lacking funds to meet payments on essentials and make ends meet (World Bank, 2023a).

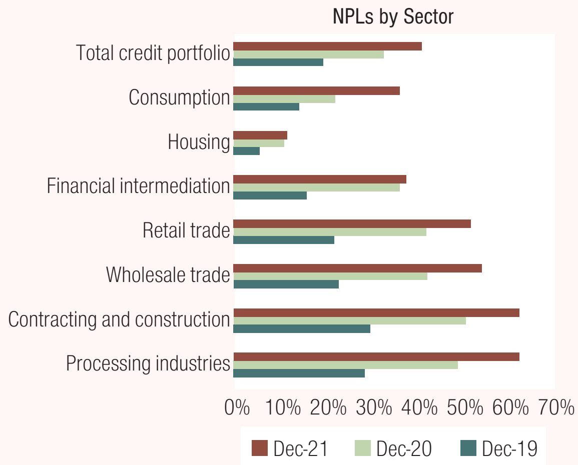
[29] Caprio Jr., G., & Klingebiel, D. (1996), "Bank insolvencies: Cross-country experiences", Policy Research Working Paper 1620, World Bank, Washington DC.
Goldstein, M., & Turner, P. (1996). "Banking crises in emerging economies: Origins and policy options", Trade Currencies and Finance, 301–363.

FIGURE 12 • Inflation in Basic Items Has Been a Key Driver of Overall Inflation, Hurting the Poor and the Middle Class



Sources: CAS and WB staff calculations.

FIGURE 13 • A Steady and Sharp Deterioration in Credit Performance as Measured by NPL Ratio for Banks



Sources: Lebanese authorities and WB staff calculations.

portfolio shows no signs of improvement and the banking sector's balance sheet remains impaired (Figure 13). The inability of the banking sector to intermediate funds and perform its delegated monitoring and maturity transformation functions will prove to be an obstacle to the much-needed domestic and Foreign Direct Investment (FDI), large sized and long-term capital and financial inflows, which will obfuscate an economic recovery. An economic recovery plan which does not place an equitable banking resolution—that comprises an upfront allocation of losses, bail-ins and restructuring—at the forefront is unlikely to yield high and sustained economic growth rates that are required for keeping debt on a sustainable footing (assuming a successful debt restructuring process) and restoring economic activity to its pre-crisis levels.

BOX 3. REMITTANCES: LEBANON'S LIFELINE

Lebanon has experienced several waves of out-migration due to political instability, internal strife, civil unrest, and regional conflict. The postwar economy's structural inability to produce high-quality jobs has also prompted a brain drain of highly skilled workers seeking employment opportunities in the region and globally. As a result, Lebanon boasts a large and highly educated diaspora, and its economic model has become highly dependent on the inflows of remittances. Remittances have also been essential in partially financing the persistent and structural current account deficit. In fact, remittances have exceeded Lebanon's exports of goods since 2002, underscoring their importance in meeting the country's external financing needs.

Remittances have served as a de facto social safety net in the absence of adequate social spending and have permitted the Lebanese to achieve a higher standard of living. Indeed, Gross National Disposable Income (GNDI) has, over the period 2004 to 2020, consistently exceeded GDP. Since the onset of the crisis in 2019, remittances have proven to be resilient and provided many Lebanese with a lifeline in terms of supporting basic needs. The sizeable inflow of remittances has also facilitated access to healthcare and education. Further, remittances have played a critical role in partially remedying the severe loss of purchasing power owing to the massive depreciation of the LBP in the ongoing crisis.

However, despite their stable nature, remittances are prone to slowing down due to external shocks, such as a decline in the price of oil, a decrease in real incomes in the remitting countries, pandemics, or conflicts and wars.[a] Moreover, remittances have not, according to a survey conducted by the UNDP in Lebanon, reached the most vulnerable segments of society.[b] According to the Mercy Corps (2022), the disbursement of remittances that are channeled via Lebanese municipalities may have been subject to political considerations and patronage. The empirical evidence on the effect of remittances on growth is mixed and, therefore, remittances cannot be considered a sustainable pillar for growth.[c]

Remittances have averaged US$ 6,450 million (14.2 percent of GDP) between 2009 and 2018, and US$ 6,346 million (22.3 percent of GDP) over the period 2019 to 2022. While remittances displayed remarkable resilience in level terms (i.e., in nominal US$ terms) in the post-crisis period (Figure 14), remittances to GDP have exhibited a discernable increase, largely due to a denominator effect (i.e., the decline in US$ nominal GDP) (Figure 15). Lebanon received remittances equivalent to 29.9 percent of GDP in 2022 making it the 3rd largest recipient globally, as a percentage of GDP, trailing only Tajikistan, and Samoa. In comparison, remittances to GDP stood at

[a] According to the IMF (2017), both oil supply and demand shocks lead to a decrease in remittances to Lebanon. However, the increase in real GDP and household incomes stemming from a supply shock can counterbalance the drop in remittances. Details are provided in IMF (2017), "Lebanon: Selected Issues, Oil-price spillovers in Lebanon: The role of remittances", IMF Country Report No. 17/20, Washington DC.

[b] Mercy Corps (2022), "Thematic report: Understanding remittances as a coping strategy amidst Lebanon's crises: Opportunities and challenges for aid actors".

[c] Please see Yang (2011), D., "Migrant remittances", Journal of Economic Perspectives, 25, 129–152 and the references therein.

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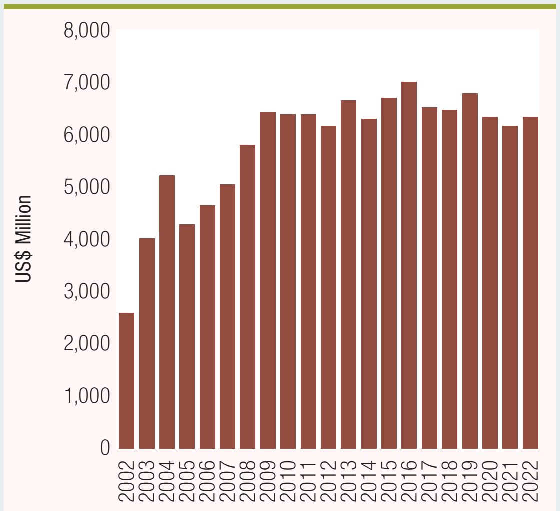
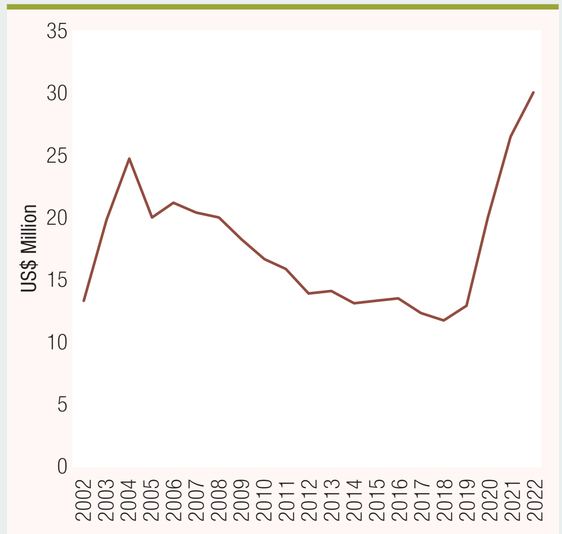
BOX 3. REMITTANCES: LEBANON'S LIFELINE *(continued)*

FIGURE 14 • Remittance Inflows to Lebanon Remained Resilient Throughout the Crisis…



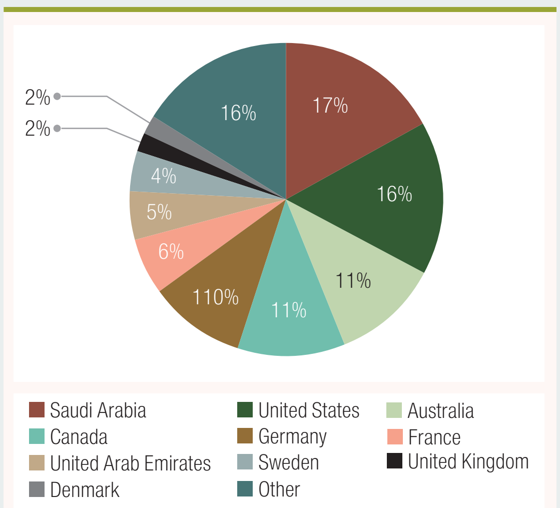
Sources: BdL and WB staff calculations.

FIGURE 15 • …and have Increased Significantly as a Percentage of GDP



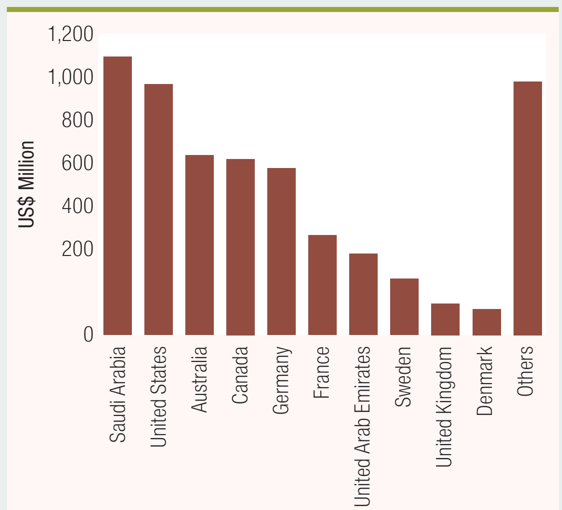
Sources: BdL and WB staff calculations.

FIGURE 16 • Sources of Remittance Inflows to Lebanon in 2021 (percentage)



Sources: Knomad and WB staff calculations.

FIGURE 17 • Sources of Remittance Inflows to Lebanon in 2021 (nominal US$)



Sources: BdL and WB staff calculations.

4.6 percent for lower middle-income countries, 4.4 percent for MENA countries (excluding high income countries), and 4.2 percent of GDP for Fragility, Conflict and Violence (FCV) countries.[d]

The Kingdom of Saudi Arabia was the largest source of remittances to Lebanon in 2021, with US$1,114 million, followed by USA with US$1,002 million, and Australia with US$719 million (Figures 16 and 17). The inflows of remittances originating from Canada, Germany, France, the United Arab Emirates have also been sizeable.[e]

[d] This comparative assessment is based on data for remittances to GDP in 2022 for 179 countries that are comprised in the World Development Indicators database.
[e] Knomad bilateral remittance matrix with data for 2021 (Link).

3

OUTLOOK AND RISKS

The spillovers from the current conflict will dent the export of tourism services and tip Lebanon's fragile economy back into a contraction. The pre-conflict baseline projection of tepid growth of 0.2 percent in 2023 is attributable to a growth in consumption stemming from a strong tourism season, stable inflow of remittances, increasing dollarization of salaries, and stabilization in private sector activity. The escalation of the military operations along Lebanon's southern border will break these trends and weigh on consumption. Moreover, net exports' contribution to real GDP growth is likely to be smaller than the anticipated 1.1 percentage point (pp) due to a drop in the exports of goods and services. The contraction in investment is also likely to be larger than anticipated due to the uncertainty created by the military escalation along the southern border.

Lebanon's macroeconomic framework, however, remains severely impaired. Four years into the crisis, and despite a favorable tourism season until Q3-2023, the current account deficit is projected to continue to be in a deficit of 12.8 percent of GDP in 2023. Public finances have also not yet been fixed, and the government remains in deficit. As planned revenue mobilization measures take hold, revenues to GDP are projected to rise to 8.8 percent of GDP. Nonetheless, increases in current expenditures, transfers to EdL and the continuation of social assistance to public servants will contribute to rising expenditures of 10.1 percent of GDP. Owing to higher revenues, the overall and primary deficits will narrow relative to 2022 to 1.3 and 0.3 percent of GDP in 2023, respectively. The deficit is likely to require central bank financing as the government has no alternative sources and debt issuance by the government is likely to be held by BdL due to lack of appetite by other investors. Additional money creation to finance the fiscal deficit will in turn perpetuate large scale inflation: the inflation rate has been in triple digit since 2021 and is projected to accelerate to 231.3 percent in 2023.

The halt of monetization of the fiscal deficit, as announced by the new BdL leadership, may lead to lower overall and primary deficits if implemented. Whereas the implementation of planned revenue mobilization measures is projected to narrow the fiscal and primary deficits in 2023, BdL's intention to refrain from financing the government will lead to an additional reduction in the deficits. In the absence of monetary financing of the deficit, the fiscal authorities will have to mobilize additional revenues to balance the budget, which could decrease disposable income. Given Lebanon's significant reliance on imports for consumption, the lack of financing of the external deficit would lead to an import compression and a decrease in private consumption. Import substitution will not be readily possible to meet domestic demand in view of capacity constraints (i.e., limited production capacity) and infrastructure bottlenecks facing domestic producers.

Inflationary pressures are also fueled by an increase in the exchange rate pass-through and the dollarization of components in the CPI basket. A higher price of oil, following supply cuts by Saudi Arabia and Russia and/or a significant escalation of the conflict, could contribute to a broad-based increase in inflation. The expiration of the Ukrainian grain export agreement between Russia and Ukraine could also increase the prices of wheat and marginally stoke inflationary pressures.

The current conflict and its spillovers into Lebanon are expected to quickly reverse the tepid growth projected for 2023, as the economy returns to a recession. The tense and volatile security environment is already undermining tourism, the main engine of growth to date. Insurance premia soared and some insurers have canceled coverage for flights to Lebanon after clashes erupted along the southern border. Lebanon's national carrier resorted to modifying its schedule and halved its incoming flights. Other airliners have halted their trips to Beirut. A palpable pickup in departures is unfolding, while over 50 percent of the travel reservations to Lebanon have been canceled. Depending on their intensity and duration, the ongoing military operations, even if they remain confined to the southern border, are all but certain to dampen the tourism season in December. Should the ongoing military operations significantly escalate, the human, economic, and social tolls will be severe.

Tourism cannot, on its own, serve as the basis for an economic recovery, nor be the single pillar of sustainable economic growth. Because tourism tends to be volatile and subject to external and internal shocks, the sector cannot substitute for more sustainable and diverse drivers of growth. The ongoing military confrontation along the southern border, which is already affecting touristic activity, is a case in point of the precarity of a growth model that is highly reliant on the tourism sector. The accelerating triple-digit inflation will affect the poorest and most vulnerable segments of society the most and could stir social discontent. The twin—current account and fiscal—require financing, which, absent other financing sources, may lead to a draw down in the central bank's foreign currency reserves.

TABLE 3 • Selected Economic Indicators (2015–2023)

	2015	2016	2017	2018	2019	2020 Est.	2021	2022	2023 pre-conflict; Proj.[a]
	(annual percentage change, unless otherwise specified)								
Real sector									
Real GDP	0.5	1.6	0.9	−1.9	−6.9	−21.4	−7.0	−0.6	0.2
Real GDP per capita[b]	−1.7	3.8	3.4	0.7	−4.2	−19.7	−5.8	1.2	0.7
	(Share of Real GDP)								
Agriculture	3.7	3.8	4.3	4.4	4.7	6.0	6.0	6.0	6.0
Industry	12.7	12.8	12.3	12.0	10.7	12.8	12.8	12.8	12.8
Services	72.0	71.7	71.8	72.2	73.9	76.9	78.6	78.6	78.6
Net indirect taxes	11.6	11.7	11.6	11.4	10.6	4.3	2.6	2.6	2.6

(continued on next page)

TABLE 3 • Selected Economic Indicators (2015-2023) *(continued)*

	2015	2016	2017	2018	2019	2020 Est.	2021	2022	2023 pre-conflict; Proj.[a]
	(annual percentage change, unless otherwise specified)								
Inflation (Consumer Price Index)	−3.7	−0.9	4.5	6.1	2.9	84.3	154.8	171.2	231.3
Public finance	(percent of GDP, unless otherwise specified)								
Revenue	19.2	19.4	21.9	21.0	20.8	13.1	7.5	6.1	8.8
o/w tax revenue	13.7	13.7	15.5	7.7	15.6	9.0	5.6	4.9	7.5
Expenditure	26.9	28.7	28.6	32.0	31.4	16.4	6.5	9.0	10.1
Current expenditure	21.7	23.2	23.6	26.0	26.1	14.3	5.8	8.2	9.2
o/w interest payment	8.9	9.3	9.4	9.9	10.1	2.5	1.0	0.8	1.0
Capital expenditure	1.4	1.4	1.5	1.7	1.3	0.4	0.1	0.2	0.2
Overall fiscal balance	−7.7	−9.3	−6.7	−11.0	−10.6	−3.3	1.0	−2.9	−1.3
Primary balance	1.2	0.0	2.7	−1.2	−0.5	−0.8	1.9	−2.1	−0.3
External sector	(percent of GDP, unless otherwise specified)								
Current account balance	−17.1	−20.5	−22.9	−24.3	−22.0	−9.3	−12.5	−32.7	−12.8
Trade balance	−22.9	−23.7	−24.8	−24.8	−25.1	−20.3	−31.0	−55.0	−32.7
o/w export (GNFS)	39.7	37.3	36.1	35.7	35.7	28.2	44.9	60.1	76.4
Exports of goods	8.0	7.7	7.6	7.0	9.4	12.9	20.1	21.0	24.7
Exports of services	31.7	29.6	28.5	28.7	26.3	15.3	24.7	39.1	51.7
o/w import (GNFS)	62.6	61.0	60.9	60.5	60.8	48.5	75.9	115.1	109.1
Imports of goods	35.2	35.1	34.8	34.4	35.3	33.4	55.4	86.0	75.2
Imports of services	27.4	25.9	26.1	26.1	25.5	15.1	20.5	29.1	34.0
Factor services and transfers	5.8	3.2	1.9	0.5	3.0	11.0	18.5	22.3	19.9
o/w net remittance inflows	7.2	6.7	5.2	4.2	6.1	11.9	17.8	21.9	23.4
Total public debt									
Total debt stock (US$ million)[c]	70,315	74,959	79,530	85,139	88,900	56,813	39,903	37,718	32,936
Debt-to-GDP ratio (percent)	140.8	146.6	150.0	155.1	172.3	179.2	172.5	179.7	181.3
Memorandum items									
Nominal GDP (LBP billion)	75,268	77,105	79,939	82,764	80,196	116,954	271,916	573,282	1,559,451
Exchange rate, WB-AER (LBP/US$)	1,508	1,508	1,508	1,508	1,554	3,688	11,755	27,309	85,828
Nominal GDP (US$ million)[c]	49,929	51,147	53,028	54,902	51,606	31,712	23,132	20,992	18,169

[a] Our forecasts for 2023 do not take into account the impact of the current conflict on the Lebanese economy given the uncertainty of the evolving situation; however, our Special Focus provides a preliminary analysis of the impact of the current conflict on Lebanon's GDP, in addition to an analysis of the various channels through which the conflict can affect Lebanon's economy and the welfare of its citizens.

[b] We base our per-capita calculation on population estimates produced by UN population division. These estimates have been significantly revised down, for Lebanon, to 5.5 million, from 6.7 million, in 2022. This change has a prominent effect on Real GDP per capita growth and Nominal GDP per capita.

[c] The WB-AER is used to calculate the total debt stock and nominal GDP in US$ million for 2019 onwards.

SPECIAL FOCUS: THE IMPACT OF THE CONFLICT IN THE MIDDLE EAST ON THE LEBANESE ECONOMY

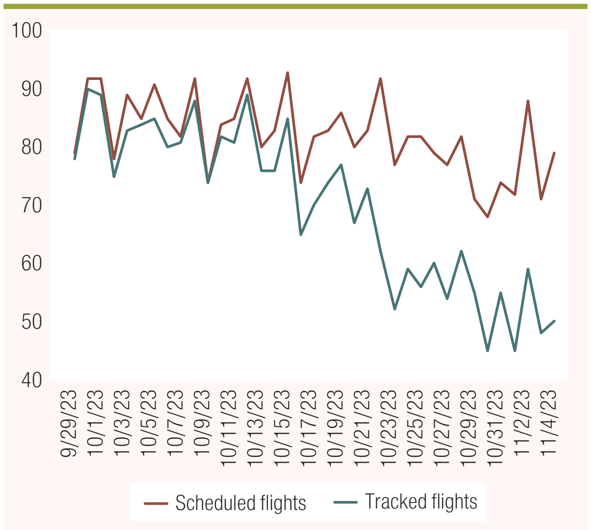
Assuming that the spillovers of the current conflict into Lebanon remain contained, the special focus finds that real GDP growth will contract by 0.6 percent to 0.9 percent (depending on the extent of the tourism contraction), reversing the positive pre-conflict baseline, of 0.2 percent growth in 2023. Our working assumption is that the current situation of containment (military operations limited to border areas) persists for the remainder of the year. Should the current conflict significantly escalate, the human, economic, and social toll will also grow. A high-level analysis of key channels of impact is provided.

Military operations unfolding along Lebanon's southern border have escalated from low- to high-intensity fighting since October 2023. The ongoing military operations have already caused the internal displacement of around 50,000 persons as of November 30th.[30] Among these, 57 percent of internally displaced persons (IDPs) are residing with host families while 28 percent of IDPs are renting apartments across the country. In addition to the disruption of local economic activity along the border area, increased demand for rental apartments has resulted in rental price pressures in some regions such as Mount Lebanon, Beirut and the Chouf.

Real time high-frequency data suggest that Lebanon is the hardest hit among neighboring countries by the current conflict. Alternative data on scheduled and tracked flights for Lebanon, shows that the ratio of tracked-to-scheduled flights (i.e., a higher ratio implies that a larger number of flights have been completed as planned and, hence, indicates fewer disruptions) dropped precipitously from 98.8 percent on October 7 to 63.3 percent on November 4 (Figure 18). While flight activity to Egypt and Jordan was also disrupted, the ratio of tracked-to-scheduled flights was significantly higher than Lebanon's (Figure 19). Tracked-to-scheduled flights

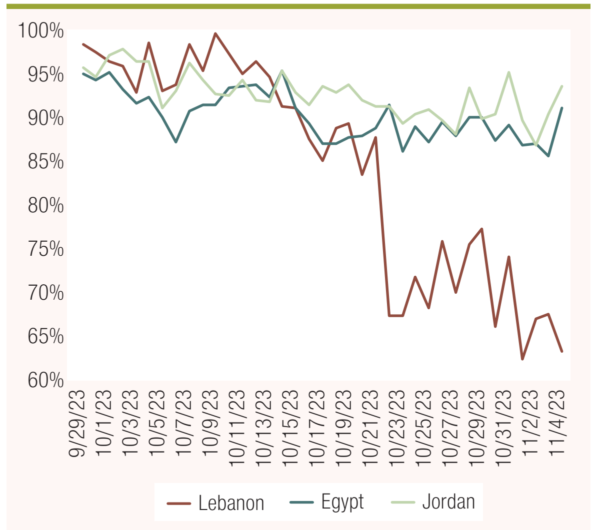
[30] Link International Organization for Migration (IOM).

FIGURE 18 • Ratio of Tracked to Scheduled Flights Shows Significant Travel Disruptions



Source: Flight Radar 24.

FIGURE 19 • Lebanon Experienced the Most Pronounced Disruptions to Travel among Neighboring Countries



Source: Flight Radar 24.

stood, on average, at 90 and 92.1 percent, respectively, for Egypt and Jordan relative to 81.3 percent for Lebanon over the period October 7 to November 6. Moreover, alternative and high frequency data on maritime freight activity—gauged from the Automatic Identification System (AIS)—indicate that, consistent with rising insurance premiums, trade activity has noticeably slowed down, with maritime import and export volumes down by about 50 and 64.6 percent (yoy), respectively, in October 2023 (Figure 20).

Lebanon's Eurobonds suffered from a selloff starting October 9, suggesting worsening market-implied sentiment of economic and debt restructuring prospects. The forward-looking nature of financial markets provides a natural gauge for measuring changes in risk premiums. With Lebanon in default, typical market gauges of credit risk, such as changes in CDS and EMBI spreads, have become less pertinent. Heightened risk perceptions can be gauged, however, from Lebanese Eurobonds whose prices have tumbled across all maturities since October 9 (Figure 21.).[31] Having increased to more than 8 percent of face value across all maturities in September 2023 possibly due to a vigorous tourism season and the start of gas exploration, Eurobond prices have recorded a single day decline ranging from 0.6 to 0.8 percentage points of face value, depending on the maturity. The downward trend in price continued throughout October and November, indicating waning sentiment by Eurobond investors concerning economic and debt restructuring prospects. Eurobonds traded at 6.3 percent of face value in November, indicating lower recovery value. Consistent with a slowdown in economic activity, the BLOM-PMI index (capturing private sector activity), dropped from 49.1 in September to 48.9 in October, suggesting a widening of the contraction in economic activity (a PMI reading of less than 50 is indicative of a contraction).

The Lebanese authorities have, on October 31, put in place a national emergency plan to cope in the event of a significant escalation of the conflict.[32] The crisis response strategy is predicated on assumptions that mimic the repercussions of the 2006 conflict in Lebanon. More specifically, the response plan envisages an air and maritime blockade, the healthcare sector coming under pressure as well as the internal displacement of around one million Lebanese over 45 days. The emergency plan includes setting up

[31] Bond prices and yields move in opposite directions. The sharp decrease in Eurobond prices implies that yields have risen.

[32] Please refer to this article.

FIGURE 20 • Significant Decline in Estimated Export and Import Trade Volumes since October 2023

Source: World Bank Data Lab.

FIGURE 21 • Eurobonds Prices Have Declined across All Maturities since October 9th

Source: Bloomberg.

centers to host the internally displaced and addressing the sectoral impacts of the conflict in terms of provision of healthcare, electricity, water, and humanitarian assistance as well as ensuring food security.

Our working assumption is that the current situation of containment of military operations to the southern border persists for the remainder of the year. The main impact channel under the current situation is a fall in receipts from tourism services that is driven by a decrease in tourist arrivals. A containment situation does not entail a drop in remittances. Should the current conflict significantly escalate, the human, economic, and social toll will be severe. *A high-level analysis of the economic costs of a significant escalation of the conflict in Lebanon is offered due to the uncertainty surrounding its manifestation,* as well as the difficulty of discerning the impact on real GDP growth in view of the multiple channels of impact.

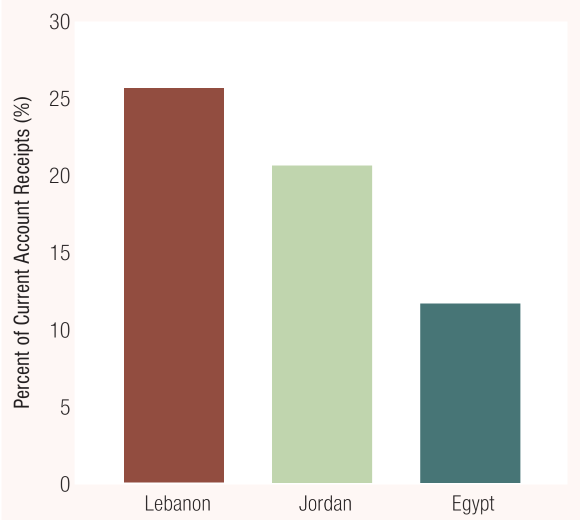
I. Impact of Current Situation (Containment) on Economic Growth

Lebanon's reliance on tourism receipts makes growth and current account dynamics very susceptible to a continuation or escalation of the current conflict. Lebanon's tourism revenues accounted for 25.6 percent of total current account receipts in 2022.[33] The latter share is larger than Jordan and Egypt's, which stood at 20.6 and 11.6 percent, respectively (Figure 22). In view of the buoyant tourism activity in the first half of 2023, tourism receipts were projected to increase further. Nonetheless, the eruption of the conflict along Lebanon's southern border is expected to jeopardize touristic activity and thus depress tourism receipts, which is especially damaging in December (a peak tourism month). This would, in turn, weigh on growth. The net effect of the military confrontation on losses in foreign currency reserves is, however, unclear in view of the projected compression in imports that can be gleaned from the high frequency data on maritime and air freight activity.

The strong upward trajectory in tourism activity and tourism receipts will be dented by the current conflict, pulling Lebanon's fragile economy back into a recession. As indicated in section II, tourist arrivals are estimated to have increased by 26.4 percent (yoy) in September 2023 and by 25.3 percent in 9M-2023 relative to 9M-2022.

33 Standard and Poor's (2023). "Lebanon Tourism Likely to Take a Hit from Israel-Hamas War", November 6, 2023.

FIGURE 22 • Lebanon Is the Most Reliant on Tourism Receipts to Finance its Current Account, Compared to Jordan and Egypt



Source: Standard and Poor's.

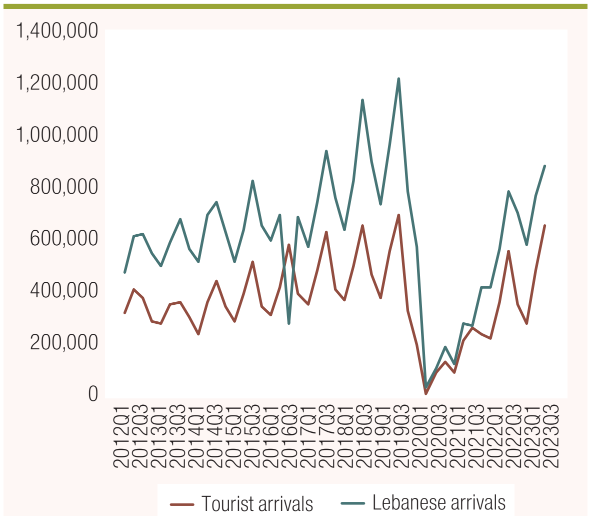
The data suggest that Lebanon was expected to enjoy a stronger tourism season compared to 2022, itself a record year in the post-crisis period. Lebanese expatriates, which are not considered to be part of tourist flows, have accounted for about 44.3 percent of total arrivals in 9M-2023 and sustained consumption (Figure 23).[34] The bulk of tourist arrivals has historically occurred in second and third quarters of every year.[35] Nonetheless, tourist arrivals in the fourth quarter have also been substantial. Absent the military conflict, tourist arrivals would have been projected to increase by 42.1 percent (yoy) in Q4–2023.[36] In line with the decrease in tourist arrivals and tourism receipts following the onset of the financial crisis in October 2019 and the outbreak of COVID-19 pandemic in 2020 (Figure 24), which brought about lockdowns and travel restrictions, the current conflict is projected

[34] Lebanese expatriates accounted for 43.4 percent and 45.9 percent of total arrivals in 2021 and 2022, respectively. Arrivals by citizens of Arab countries accounted for 77.5 percent of total arrivals in 9M-2023.

[35] Receipts from travel services in the fourth quarter averaged US$ 269.4 million over the period 2019 to 2021. This represents a significant decline relative to an average (for the fourth quarter) of US$ 481.1 million over the period 2012 to 2018.

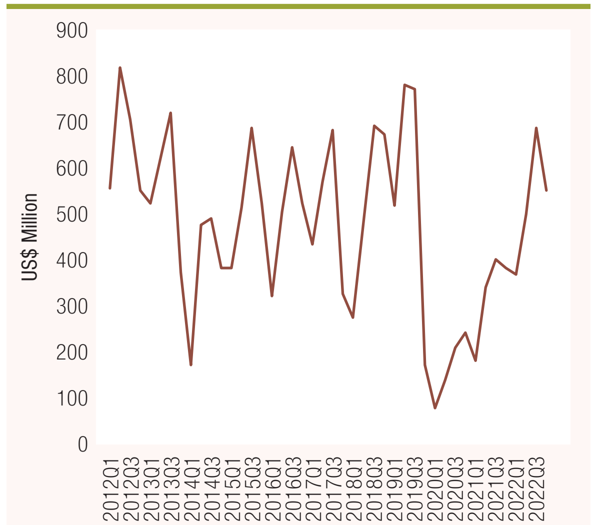
[36] This projection is obtained from a well-specified Autoregressive Moving Average (ARMA) model, which accounts for the seasonal pattern in tourist arrivals that can be gleaned from Figure 23. Formal econometric tests (using seasonal dummy variables) confirm that tourist arrivals and receipts from travel services exhibit a seasonal pattern.

FIGURE 23 • Upward Trajectory of Tourist Arrivals to Lebanon Prior to October 2023



Source: WB staff estimates based on CAS.

FIGURE 24 • …and of Travel Services Receipts Prior to October 2023



Source: BdL.

TABLE 4 • The Economic Effect of Lost Tourism Spending: Revised Real GDP Growth in 2023 under Three Scenarios

	Real GDP growth (percent)	Nominal GDP (US$ million)
Pre-conflict baseline	0.2	18,169
Revised GDP growth and nominal GDP: 50% decline in travel receipts and spending by Lebanese expatriates in Q4 2023	−0.6	17,847
Revised GDP growth and nominal GDP: 70% decline in travel receipts and spending by Lebanese expatriates in Q4 2023	−0.7	17,718
Revised GDP growth and nominal GDP: 80% decline in travel receipts and spending by Lebanese expatriates in Q4 2023	−0.9	17,653

Note: Given the uncertainty surrounding the impact of the current conflict on Lebanon, specific forecasts for 2023 that take this conflict into account are not produced. However, the Special Focus analyzes the various impacts and channels through which the current conflict could affect Lebanon's economy and the welfare of its citizens.

to significantly lower the revenues from the export of tourism services.

A scenario analysis is undertaken to assess the effect of the drop in tourism spending on economic growth. The scenarios exploit data on tourist arrivals, a forecast of tourist arrivals for Q4-2023, as well as estimates of the elasticity of receipts from travel services to tourist arrivals.[37] Forecasts of receipts from travel services for 2022 and 2023 are produced at the quarterly frequency using (i) a well-specified model and (ii) growth in tourist arrivals for 2023, the forecast of receipts from travel services for 2022 as well as the elasticity of receipts from travel services to tourist arrivals.[38] Moreover, a forecast of arrivals of Lebanese citizens for Q4-2023 is generated from a well-specified time series model.

Receipts from travel services underestimate actual tourist spending. Travel receipts for the first three quarters of the year have been realized and, therefore, the impact of the military operations along the southern border is confined to the touristic activity in the fourth quarter. However, receipts from travel services are likely to underestimate actual tourism spending due to (i) the prevalence of cash transactions in the economy,[39] and (ii) some Lebanese expatriates, particularly those who have left the country recently, being misclassified as residents. To better estimate lost tourism receipts, the spending by Lebanese expatriates is accounted for as follows: average spending per tourist in Lebanon is first computed and then multiplied by the number of Lebanese expatriates.

Three scenarios are employed to reflect the uncertainty pertaining to the potential drop in receipts from travel services and spending by Lebanese expatriates. These scenarios assume 50, 70, and 80 percent declines in total tourism spending, defined as the sum of receipts from travel services and spending by Lebanese tourists, in the fourth

37 The elasticity of receipts from travel services to tourist arrivals is estimated using quarterly data for the period Q1-2012 to Q2-2022.

38 Receipts from travel services are a component of the current account. From the national income accounting identities, $GNDI = C_p + IF_p + C_g + IF_g + IN + CAB$, where C_p is private consumption IF_p is private fixed investment, is government consumption, IF_g is government fixed investment, and IN is inventory investment. The current account balance is $CAB = X - M + NFI + TR$, where X are exports, M are imports, NFI is net factor income from abroad and TR are transfers from or to abroad.

39 For a more detailed discussion of the size of the cash economy in Lebanon, please refer to the special focus of the *Spring 2023 Lebanon Economic Monitor* entitled "Gauging the Size of the Cash Economy in Lebanon". The balance of payments statistics in Lebanon are compiled according to the IMF's Balance of Payments Manual 5 (BPM5). Receipts from travel services are computed based on data on passenger arrivals multiplied by average spending by nationality, payment card statistics and withdrawals by nonresidents, and (iii) data from the real-time gross settlement system (and money transfer companies). For further information, please refer to: BdL's External Sector Statistics Methodology. With the increasing reliance on cash transactions, card payment data significantly underestimate the size of the transactions.

quarter of 2023. After computing the loss in tourism spending, the effect on real GDP growth for each of these scenarios is examined.

The scenario analysis indicates that irrespective of the magnitude of the decline in tourism spending, the tepid growth projection in real GDP growth for 2023 will be reversed. More specifically, real GDP growth declines, respectively, to −0.6 percent, −0.7 percent, and −0.9 percent under the 50 percent, 70 percent, and 80 percent scenarios relative to the baseline of 0.2 percent growth (Table 4). That is, the loss in real GDP growth (i.e., difference between the growth under the baseline and each of the scenarios) ranges from 0.8 to 1.1 percent. The decline in real GDP is not expected to be long-lived because Lebanon will not suffer from destruction in physical and human capital. Should the shock to tourism spending be lower than 50 percent, real GDP growth would be near zero.

The social impact of the crisis is likely to be significant. Prior to October 2023, preliminary data from the 2022–2023 Lebanon Household Survey (LHS) suggested that poverty continues to rise and household living conditions continue to deteriorate. Around three out of every five households considered themselves to be poor or very poor.[40] As a direct result of a contraction in economic activity due to a disruption in tourism, and political uncertainty, hundreds of tourism jobs will be put at risk. Internal displacement will also undermine IDPs' access to crucial services, not limited to education and healthcare.[41,42]

The human and infrastructure impacts are expected to be limited. In the current situation of contained clashes, limited impact on infrastructure, beyond weak and faltering infrastructure in the absence of capital expenditure and large-scale investments in the current crisis, is envisioned. The human toll will also be restricted to the border areas in view of the displacement from Southern Lebanon as people flee border areas.

II. Significant Escalation of the Conflict in Lebanon-High Level Analysis

The human toll of a significant escalation of the conflict in Lebanon would likely be large. The 2006 conflict resulted in a death toll exceeding 1,000, left more than 4,000 civilians injured, and displaced more than a quarter of the population.[43] One clear distinction between the present situation and the 2006 conflict is that the land borders with Syria were open in 2006, allowing several thousand Lebanese to seek refuge in a neighboring country. The current war in Syria prevents this option. Therefore, massive internal displacement is likely, with not much certainty on where is deemed safe. Another important distinction between the present situation and the 2006 conflict is the presence of close to one million Syrian refugees in Lebanon. Finally, an escalation in the conflict could spur another wave of departure of skilled workers, which will contribute to an additional toll on the country's human capital.

The escalation of the conflict could lead to a severe and long-lasting impact on Lebanon's already weak infrastructure in the electricity, water, and transportation sectors. If key infrastructure in Lebanon is targeted (airport, major bridges, the port, southern suburbs of Beirut), massive destruction is likely. Unlike the 2006 conflict, financing from Lebanon's own resources, the Arab Gulf and other states is not likely to be forthcoming. Restoring the damaged infrastructure to its pre-conflict state will likely be a long process, which would exact a heavy toll on the country's potential output and citizens' welfare.

A significant escalation of the conflict would also permanently scar Lebanon's growth potential and carry grave economic implications. If the operations of the banking sector, which is contending with a systemic crisis and whose functions are grossly impaired, and money transfer companies are disrupted during the conflict, the inflow of remittances would slow down depriving the economy of

[40] World Bank (2023), Macro Poverty Outlook – Lebanon (Link).

[41] From the latest crisis update, covering the month of October.

[42] For further information, please refer to Mercy Corps' (2023). "Flash report: Palestinian-Israeli conflict: Humanitarian and development implications for Lebanon", October 2023.

[43] Government of Lebanon (2006). "Rebuilding Lebanon Together… 100 days after", November 21, 2006.

much-needed foreign exchange liquidity.[44] Tourism will come to a sudden stop at least for the duration of the active conflict. Any private sector activity stabilization will also be reversed. Thus, a sharp contraction of economic activity is likely, with a lasting effect, depending on the damage and length of the escalation of conflict. The destruction in human and physical capital will likely have a long-lasting effect on Lebanon's growth potential.

Lebanon is ill-equipped to manage the sectoral effects of any escalation in the conflict. As the country is grappling with binding financing, revenue, and foreign exchange constraints, it is unlikely to be able to address the humanitarian, economic, infrastructure, social, and environmental effects of a significant escalation of the conflict (Mercy Corps, 2023). The situation is likely to worsen living conditions further; with shortages in fuel and food threatening to plunge the country into a humanitarian emergency. Deprived of fuel and essential medical supplies, the healthcare sector is unlikely to be able to cope with a large-scale emergency.

The 2006 conflict in Lebanon is estimated to have led to 10.5 percent of GDP in lost economic output and damages of US$ 3.1 billion (direct and indirect). The 34-day conflict (July 12-August 14, 2006) provides a benchmark for the potential effects of an escalation of the conflict. The World Bank estimates forgone output in 2006 alone to be US$ 2.3 billion, equivalent to about 10.5 percent of nominal GDP, and that 30,000 jobs may have been permanently lost whereas 200,000 people may have emigrated during the hostilities.[45,46] Lebanon's infrastructure was also severely damaged. The output loss from the 2006 conflict turned out to be smaller than anticipated by the World Bank, and the infrastructure was rapidly repaired due to significant bilateral and multilateral funding in the immediate aftermath of the conflict.[47]

The economic impact of an escalation of the conflict, is estimated to materially exceed that of the 2006 conflict given Lebanon's current vulnerabilities. The intensity of the conflict could be markedly higher than the 2006 conflict, which, in view of the significantly lower US$ nominal GDP in 2023 (relative to 2006), would imply that the economic cost of a significant escalation of the conflict would prove to be massive relative to GDP. More specifically, an escalation of the conflict could lead to a double-digit decline in real GDP relative to the baseline projection of tepid growth. This decrease in real GDP is unlikely to be short-lived given the country's binding financing constraints and the fact that sizeable bilateral and multilateral financing—akin to 2006 and 2007—will not be forthcoming due to geopolitical factors and amid a sovereign default.

Imports are expected to be severely affected, with risks of shortages of food, fuel, and essential goods, and possible total blackouts. The import compression is expected to be severe if all trade routes are deemed inaccessible (port, airport). The compression in imports will alleviate the loss of foreign currency reserves albeit at a significant cost in terms of consumption and economic growth. Given that Lebanon is almost entirely dependent on fuel imports for private alternatives to electricity generation, an escalation of the conflict, causing fuel shortages, could plunge the country into darkness.

The exchange rate is expected in the short to medium term to come under significant pressure. This will arise despite the compression in imports, which is helping to alleviate exchange rate pressures. As import activity resumes, deposit outflows materialize, and 'precautionary' demand for US$ increases. The steady depletion in BdL's reserves implies that the scope for exchange rate intervention will be limited.

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44 For example, akin to October and November 2019, banks could declare a banking holiday to stem a possible outflow of 'fresh' dollar deposits whereas money transfer companies might limit their operations should an intense bombardment occur.

45 World Bank (2007). "Lebanon Economic and Social Impact Assessment: From Recovery to Sustainable Growth", January 20, 2007, Washington DC.

46 The economic costs of environmental degradation stemming from the 34-day conflict in 2006 with Israel have also been significant. For further information, please refer to World Bank (2007). "Republic of Lebanon: Economic Assessment of Environmental Degradation Due to July 2006 Hostilities", October 11, 2007, Washington DC.

47 The Paris III conference that was held on January 25, 2007, succeeded in raising US$ 7.6 billion of multilateral funding, thereby sustaining economic growth in 2007.

A significant escalation of the conflict is estimated to halt and, ultimately, reverse the meager investment and capital inflows into the country. In contrast to the 2006 conflict (and PM Hariri's assassination in 2005) following which capital outflows reversed rapidly, outflows (including of 'fresh' funds in banks) could prove to be more long-lasting. In fact, the heightened risk premiums following the conflict would make the required return on capital, which is already high due to the sovereign default and systemic banking crisis, prohibitively elevated, thus rendering capital and investment inflows to Lebanon completely unattractive. Investment sentiment is also likely to be strongly affected and the prospects of finding investment opportunities in a country sinking into infrastructural, institutional, and economic decay will be slim. An escalation of the conflict could also disrupt the ongoing stabilization in private sector activity and adversely affect investor sentiment for a long period of time.

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