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LEBANON ECONOMIC MONITOR

The Deliberate Depression

Fall 2020

WORLD BANK GROUP
Middle East and North Africa Region

Lebanon Economic Monitor

The Deliberate Depression

Fall 2020

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PREFACE

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

The *Lebanon Economic Monitor* is a product of the World Bank's Lebanon Macroeconomics, Trade and Investment (MTI) team. It was prepared by Wissam Harake (Senior Economist), Ibrahim Jamali (Consultant) and Naji Abou Hamde (Economic Analyst) with contributions from Lars Jessen (Lead Debt Specialist) and Haocong Ren (Senior Financial Sector Economist). Christos Kostopoulos (Lead Economist) and Mohammad Al Akkaoui (Consultant) prepared the Special Focus , based on contributions from the Lebanon Country Team. The *Lebanon Economic Monitor* has been completed under the guidance of Eric Le Borgne (Practice Manager). Zeina Khalil (Communications 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

For almost a year, Lebanon's macroeconomy has been assailed by compounded crises, beginning with an economic and financial crisis, followed by COVID-19 and lastly the explosion at the Port of Beirut. By October 2019, the economy plunged into a financial crisis brought about by a sudden stop in capital inflows, which precipitated systemic failures across banking, debt and the exchange rate.[1] This included, on March 7, 2020, a Government default on a $1.2 billion Eurobond redemption, marking the first ever sovereign default for Lebanon. Eleven days later, the Government declared a State of General Mobilization imposing a lockdown to counter COVID-19, including the closure of the borders (airport, sea and land), and public and private institutions. Lastly, on August 4, 2020, a massive explosion rocked the Port of Beirut (PoB), destroying much of the port and severely damaging the dense residential and commercial areas within 1- to 2-mile radius. Beyond the human tragedy, the economic impact of the explosion is notable at the national level despite its geographical concentration.

Of the three crises, the economic crisis has by far had the largest (and the most persistent) negative impact. Exchange market pressures stifle trade and corporate finance in the highly dollarized economy, constraining the importation of capital and final goods, and inducing disruptions all along the supply chain. Foreign exchange (FX) shortages are being reflected in a multiple exchange system that has discounted the Lebanese Lira (LL) by as much as 80 percent, albeit with heavy fluctuations. The Eurobond default precludes access to international markets for foreign financing, while the domestic banking system is severely impaired. Informal and *ad hoc* capital controls have implied a lack of harmonization of restrictions between banks, and between customers within and across banks, generating considerable popular backlash against banks and the central bank, the Banque du Liban (BdL).

Real GDP growth is projected to sharply decelerate to –19.2 percent in 2020, on the back of a –6.7 percent contraction in 2019. In a large part due to COVID-19, the tourism sector has been particularly hit; tourist arrivals fell by 71.5 percent, year-on-year (yoy), over the first five months of 2020 (5M-2020). Further, the BLOM-PMI index, which captures private sector activity, averaged 40.4 over January–September 2020 (9M-2020) (<50 represents a contraction of activity), the lowest recorded. Meanwhile, construction permits and cement deliveries, which are indicators of construction activities,

[1] We shall henceforth refer to these systemic macro-financial failures and their real economy and social implications as simply *the economic crisis*.

suffered yoy declines of 60 and 52 percent, respectively, in the first half of 2020 (H1-2020).

Crises conditions have weighed heavily on Lebanon's already precarious fiscal position. Revenues are expected to decline sharply as both tax and non-tax revenues tumble due to the sharp contraction in economic activity. However, this is more than offset by a sharp decline in interest expenditures, driven by Government's arrest of payment on its commercial foreign debt (a major share of its total expenditure), and a favorable deal with the central bank to halt coupon payments on Treasury bonds held by the latter. Overall, in 2020, the fiscal balance is projected to improve by 4.7 percentage points (pps) to reach –5.9 percent of GDP.

Exchange rate pass through effects on prices have led to high inflation. The 12-month inflation rate has risen steadily and sharply from 10 percent in January 2020, to 46.6 percent in April, 89.7 percent in June, and most recently in August, 120 percent. Inflation is a highly regressive tax, affecting the poor and vulnerable disproportionately, as well as people on fixed income, such as pensioners.

The sharp economic contraction implied a commensurate drop in imports, and consequently, an anticipated narrowing of the current account deficit. During the first eight months of 2020 (8M-2020), merchandize imports shrank by 50 percent, which drove a 59 percent decrease in the trade-in-goods deficit. We expect the current account deficit to contract, falling by 7 pps to reach 14.4 percent of GDP in 2020, compared to a medium-term (2013–2018) average deficit of 22.8 percent of GDP. Nonetheless, the sudden stop in capital inflows has implied a steady depletion of FX reserves at BdL, which will further exacerbate constraints on imports.

Poverty in Lebanon is likely to continue to worsen, surpassing half of the population by 2021. A contraction of the Lebanese GDP per capita in real terms and two-digit inflation in 2020 will undoubtedly result in substantial increase in poverty rates affecting all groups of population in Lebanon through different channels such as loss of productive employment, decline in real purchasing power, stalled international remittances and so forth.

In the lead up to the economic crisis point, Lebanon's macroeconomic fundamentals were weak compared to select groups of global crises comparators.[2] As such, we expect the adjustment process to be more painful and to take longer, even with optimal policy measures in place. In fact, one year into the economic crisis, such policies have not yet been decided, let alone implemented, which further pushes out the expected bottoming out of the economy and its recovery. Therefore, and as things stand, Lebanon's economic crisis is likely to be both deeper and longer than most economic crises.

The burden of the ongoing adjustment/deleveraging in the financial sector is highly regressive, concentrated on smaller depositors, the local labor force and smaller businesses. De facto lirafication and haircuts on dollar deposits are ongoing despite BdL's and banks' official commitment to safeguarding deposits. The burden of the ongoing adjustment/deleveraging is regressive and concentrated on the smaller depositors, who lack other source of savings, the local labor force, that is paid in LL, and smaller businesses. The banking sector is advocating for mechanisms that incorporate state owned assets, gold reserves, and public real estate in order to overhaul their impaired balance sheets. This constitutes a *bailout* of the financial sector and is inconsistent with the restructuring principles that protect taxpayers. These principles include *bail in* solutions based on a hierarchy of creditors, starting with banks shareholders. Government can also apply a wealth tax (on financial and real assets) as a tool to progressively restructure the financial sector.

The LEM Special Focus presents one approach to designing a comprehensive reform agenda aimed at addressing the root causes of

[2] We compare Lebanon's macroeconomic fundamentals to two groups of global crises comparators: group 1 (G1) includes the Asian crisis countries of 1997-98: Thailand, Malaysia, Indonesia, Philippine and South Korea; group 2 (G2) assembles a more eclectic set of crises that occurred in the 2000's: Argentina (2001), Greece (2008), Ireland (2008), Iceland (2008) and Cyprus (2012).

the economic crisis. The purpose of the reform agenda is to help set the stage for a more equitable, more efficient and more resilient economy. It puts governance reforms at the fore, alongside macroeconomic stabilization. The reform agenda presented is meant to feed into an open discussion among the citizens of Lebanon and between them and their government.

الموجز التنفيذي

تعرَّض الاقتصاد الكلي في لبنان لأزمات مضاعفة على مدى عامٍ تقريبًا، بدءًا من الأزمة الاقتصاديّة والماليّة، مرورًا بجائحة كوفيد19-، وصولاً إلى إنفجار مرفأ بيروت. بحلول تشرين الأول/أكتوبر 2019، غرق الاقتصاد في أزمة مالية بسبب التوقّف المفاجئ في تدفقّات رؤوس الأموال، ممّا سبّب إخفاقًا نظاميًا شاملاً في مجال سعر الصرف، والدين، والقطاع المصرفي.[3] في هذا السياق، أعلنت الحكومة في 7 آذار/مارس، عن عدم سداد سندات اليوروبوندز البالغة قيمتها 1.2 مليار دولار أميركي، ممّا شكّل أول عجز عن سداد الديون السيادية في تاريخ لبنان. بعد مرور 11 يومًا، أعلنت الحكومة حالة تعبئة عامة وفرضت إغلاقًا تامًا لمكافحة **جائحة** كوفيد19-، بما في ذلك إغلاق الحدود (الجويّة، والبحريّة، والبريّة) والمؤسسات العامة والخاصة. وأخيرًا، في 4 آب/أغسطس 2020، هزّ انفجار ضخم مرفأ بيروت، مدمّرًا الجزء الأكبر من المرفأ وملحقًا أضرارًا جسيمةً في المناطق السكنيّة والتجاريّة الواقعة في نطاق دائرة يبلغ شعاعها ميلاً إلى ميلين من موقع الانفجار. بالإضافة إلى المأساة البشريّة، يُعتبر الأثر الاقتصادي للانفجار ملحوظًا على المستوى الوطني بالرغم من تمركزه الجغرافي.

من الأزمات الثلاث التي تعرّض لبنان لها، كانت الأزمة الاقتصاديّة ذات الأثر الأكبر والأكثر سلبيةً وخطورةً. ففي اقتصاد مدولر بشكل كبير، تخنق ضغوط سوق الصرف تمويل المؤسسات والتجارة ، ممّا يفرض قيودًا على استيراد السلع الرأسماليّة والسلع النهائيّة ويسبّب اضطرابات على طول سلسلة الإمداد. وتنعكس حالات قصور العملات الصعبة في نظام صرف متعدّد أفقد الليرة اللبنانيّة 80 في المئة من قيمتها، وإن كانت التقلّبات كبيرة. ونظرًا إلى تخلف الحكومة عن سداد سندات اليوروبوندز، لم يعد بالإمكان الحصول على التمويل الأجنبي عن طريق الأسواق الدوليّة، بينما النظام المصرفي المحلي مشلول إلى حدّ بعيد. كما ولّدت القيود الرأسماليّة غير الرسميّة غياب الاتساق بين المصارف (وحتى بين فروع المصرف الواحد) في القيود المفروضة على عملائها، ممّا أثار غضبًا شعبيًا واسع النطاق ضد المصارف التجارية ومصرف لبنان المركزي.

يُتوقَّع أن يتراجع نمو إجمالي الناتج المحلي الفعلي بشكل كبير إلى 19.2- في المئة في العام 2020 إثر انقباض قدره 6.7- في المئة في العام 2019. تأثّر قطاع السياحة بشكل خاص، بسبب جائحة كوفيد19- بشكل كبير؛ فتراجع عدد المسافرين الوافدين إلى لبنان بنسبة 71.5 في المئة، على أساس سنوي، خلال الأشهر الخمسة الأولى من العام 2020 (5M-2020). إلى ذلك، سجّل مؤشّر مديري المشتريات التابع لبنك لبنان والمهجر (BLOM-PMI) الذي يعكس نشاط القطاع الخاص متوسطاً قدره 40.4 في فترة كانون الثاني/يناير – أيلول/سبتمبر 2020 (9M-2020) (تشكّل نسبة دون 50 تراجعًا في النشاط)، وهي أدنى نسبة مُسجّلة. في موازاة ذلك، تعرّضت تراخيص البناء وعمليّات تسليم الاسمنت، وهي من مؤشرات أنشطة البناء، إلى تراجع سنوي قدره 60 و52 في المئة على التوالي، في النصف الأول من العام 2020 (H1–2020).

أرخت الأزمات المتعاقبة بظلالها على الوضع المالي الهشّ أصلاً في لبنان. ويُتوقَّع أن تتراجع الايرادات بشكل حاد، بما أن الايرادات الضريبيّة والايرادات غير الضريبيّة تتراجع بسبب الانقباض الحاد في النشاط الاقتصادي. لكن، عوّض عن ذلك تراجع حاد في نفقات الفائدة، بسبب توقّف الحكومة عن سداد ديونها الأجنبيّة التجارية (وهي حصة كبيرة من إجمالي نفقاتها) واتفاق تفضيلي مع المصرف المركزي لإيقاف سداد الفوائد على سندات الخزينة التي بحوزة المصرف. بشكل عام، في العام 2020، يُتوقَّع أن يتحسّن الرصيد المالي بنسبة 4.7 نقاط مئويّة لبلغ 5.9- في المئة من إجمالي الناتج المحلي.

أدّى انتقال تغيرات سعر الصرف إلى الأسعار إلى ارتفاع التضخّم. ازداد معدّل التضخّم على مدى 12 شهرًا بشكل ثابت وحاد، فارتفع من 10 في المئة في كانون الثاني/يناير 2020 إلى 46.6 في المئة في نيسان/أبريل وإلى 89.7 في المئة في حزيران/يونيو، ومؤخّرًا إلى 120 في المئة في آب/أغسطس. يُعتبَر التضخّم ضريبة تنازليّة إلى حدّ كبير، تؤثّر على الفقراء بشكل كبير، كما على ذوي الدخل الثابت، على غرار المتقاعدين.

يترتب عن الإنكماش الإقتصادي الحاد انخفاضاً متناسباً في الواردات، وبالتالي، تراجعًا متوقّعًا في عجز الحساب الجاري. خلال الأشهر

[3] نُشير بالتالي إلى هذه الاخفاقات المنهجيّة الشاملة في المجال الماكرو مالي وانعكاساتها الاقتصاديّة والاجتماعيّة الفعليّة بالأزمة الاقتصاديّة بكل بساطة.

الثمانية الأولى من العام 2020 (8M-2020)، تقلّصت واردات السلع بنسبة 50 في المئة، ممّا أدّى إلى تراجع بنسبة 59 في المئة في عجز التجارة في السلع. ونتوقّع تقلّص عجز الحساب الجاري، متراجعاً بـ 7 نقاط مئويّة ليبلغ 14.4 في المئة من إجمالي الناتج المحلي في العام 2020، مقارنةً بمتوسّط العجزعلى المدى المتوسط (2013–2018) البالغ 22.8 في المئة من إجمالي الناتج المحلي. لكن الإنهيار في التدفقات الرأسمالية الوافدة أدى إلى استنفاذ احتياطي العملات الأجنبية لدى مصرف لبنان المركزي، مما يؤدي إلى تفاقم القيود على الواردات.

من المتوقع أن يزداد مستوى الفقر في لبنان سوءًا، ليتجاوز عدد الفقراء نصف عدد السكان مع حلول العام 2021. لا شك في أن انكماش إجمالي الناتج المحلي اللبناني الفعلي للفرد الواحد وتضخمًا ثنائي الرقم في العام 2020 سيؤدّيان إلى ازدياد ملحوظ في معدّلات الفقر التي تؤثّر على الفئات السكانيّة كلّها في لبنان، من خلال قنوات مختلفة، على غرار فقدان العمالة الإنتاجيّة، والتراجع في القوة الشرائيّة الفعليّة، وتعليق الحوالات الدولية، إلخ.

في سياق المقارنة، كانت أساسيات الاقتصاد الكلي في لبنان في الفترة التي سبقت الأزمة الاقتصادية ضعيفة مقارنةً مع أزمات عالميّة سابقة مُختارة[4]. وبالتالي، نتوقّع أن تكون عمليّة التعديل أصعب وأطول، حتى مع توفّر تدابير سياسة مثاليّة. في الواقع، بعد مرور عام على الأزمة الاقتصاديّة، لم يتم بعد تحديد هذه السياسات، ناهيك عن تنفيذها، ممّا يؤخّر بشكل أكبر الخروج من الأزمة الاقتصاديّة وإنعاش الاقتصاد مجدّدًا. وبالتالي، وكما هي الحال الآن، يُرجَّح أن تكون الأزمة الاقتصاديّة التي تضرب بلبنان أخطر وأطول مقارنةً مع غالبيّة الأزمات الاقتصاديّة.

يُعتبر عبء تقليص المديونية المالية/التعديل الجاري في القطاع المالي تنازليًّا إلى حدّ بعيد، حيث يُركّز على المودعين الأصغر، واليد العاملة المحليّة، والمؤسسات الأصغر حجماً. وبالتالي، يُعتبَر تحويل الودائع بالدولار الأميركي إلى الليرة اللبنانيّة والاقتطاع من الودائع في الدولار الأميركي أمراً واقعاً، بالرغم من الالتزام الرسمي، من جانب المصارف التجاريّة ومصرف لبنان المركزي، بحماية الودائع. يُعتبَر عبء تقليص المديونية المالية/التعديل الجاري في القطاع المالي تنازليًّا ومركّزاً على المودعين الأصغر الذين يفتقرون إلى أي مصدر آخر للمدخرات، واليد العاملة المحليّة التي تتقاضى أجورها ورواتبها بالليرة اللبنانيّة، والمؤسسات الأصغر حجمًا. يدعو القطاع المصرفي إلى اعتماد آليّات تأخذ بعين الاعتبار الأصول التي تملكها الدولة، واحتياطيات الذهب، والعقارات العامة من أجل تصحيح ميزانيات المصارف الضعيفة، مما يُشكّل إنقاذاً للقطاع المالي لا يتماشى مع مبادئ إعادة الهيكلة التي تحمي دافعي الضرائب. تشمل هذه المبادئ حلول الإنقاذ الداخلي بالإستناد إلى هرميّة الدائنين، بدءًا من مساهمي المصارف. كما يُمكن للحكومة أن تفرض ضريبة على الثروة (على الأصول المالية والحقيقية) كأداة لإعادة هيكلة القطاع المالي بشكل تقدمي.

يعرض الموضوع الخاص لهذا العدد من مرصد لبنان الاقتصادي نهجًا لإعداد أجندة إصلاحية شاملة تهدف إلى معالجة جذور أسباب الأزمة الاقتصادية. تهدف الأجندة الإصلاحيّة هذه إلى اقتراح تمهيد الطريق من أجل بناء اقتصاد أكثر مساواةً وأكثر كفاءةً وأكثر قدرة على الصمود. تضع الخطة إصلاحات الحوكمة في سلم الأولويّات، إلى جانب استقرار الاقتصاد الكلي. كما تهدف هذه الأجندة إلى إثراء نقاش مفتوح في صفوف المواطنين اللبنانيّين وفي ما بين المواطنين اللبنانيّين وحكومتهم.

[4] نُقارن مبادئ الاقتصاد الكلي في لبنان إلى مجموعتَين من عوامل مقارنة الأزمات العالميّة: تشمل المجموعة الأولى (G1) دول الأزمة الآسيويّة في العام 1997–1998: تايلند، وماليزيا، والفيلبين، وإندونيسيا، وكوريا الجنوبية؛ وتضم المجموعة الثانية (G2) مجموعة مُحدّدة من الأزمات التي وقعت في العقد الأول من القرن الحادي والعشرين: الأرجنتين (2001)، واليونان (2008)، وايرلندا (2008)، وايسلندا (2008)، وقبرص (2012).

1

THE POLICY CONTEXT

On April 30, 2020, the (then) cabinet endorsed a long-awaited financial recovery plan that aimed to regain macro-financial stability for Lebanon. The Government's program rested on central and interrelated pillars, including: (i) exchange rate adjustment; (ii) comprehensive debt restructuring; (iii) comprehensive financial sector restructuring; (iv) a phased fiscal adjustment; (v) growth enhancing reforms; (vi) social sector reforms; (vii) anti-corruption agenda; (viii) environmental reforms; and (ix) international financial assistance.

Lebanese authorities and the IMF began discussions in May 2020. The discussions eventually stalled as differences and inconsistencies emerged within the Lebanon team regarding the Government's financial recovery program. Key members on the authority's team subsequently resigned from position, amid highly publicized differences between Government and BdL (especially on debt; losses in the financial sector; banking sector restructuring).

BdL and the banking sector at large have expressed serious disagreements with the Government's plan and analysis, in particular, the identified losses in the financial sector.[5] This is a critical component as it determines the extent and modality of restructuring that would be needed in the financial sector (banks plus BdL). A key motivation for this disagreement has been the need for public debt restructuring, which would result in heavy losses in the financial system, given the large holdings of public debt by BdL and banks. Eventually, the Government resigned, and with efforts to form a successor government having failed so far, progress awaits the formation of new Government. Meanwhile, the economy keeps shrinking and the social cost of the crisis rises and widens.

The banking sector is advocating for mechanisms that incorporate state owned assets (SOEs), gold reserves, and public real estate in order to overhaul their impaired balance sheets. This constitutes a *bailout* of the financial sector and is inconsistent with the restructuring principles established in the wake of the Global Financial Crisis of

[5] The Government's plan identifies LL 62 trillion ($50 billion at the plan's assumed exchange rate $1=LL 3,500) in aggregated losses in BdL's balance sheet, which when added to losses in the banking sector and netting out equity, result in LL 154 trillion ($44 billion) in impaired liabilities for the financial sector.

2008 to protect taxpayers when financial institutions fail. These principles include *bail in* solutions based on a hierarchy of creditors, starting with banks shareholders. Government also has the prerogative and legal jurisdiction to apply a wealth tax on deposits as a tool to restructure the financial sector. A wealth tax applied on financial and real assets can be very progressive tool for needed macro-financial restructuring.

A year into the economic crisis, there have been limited policy responses by the authorities as Lebanon faces a dangerous depletion of resources, including human capital with brain drain an increasingly desperate option. In fact, Lebanon lacks a fully-functioning executive authority and is currently in the process of forming its third Government in less than a year. Following the failure of Moustapha Adib to form a Government, PM Saad Hariri was designated to be the next Prime Minister by President Aoun upon consultations with Parliamentarians. Meanwhile, social discontent has spilled over to street action even under COVID-19 conditions; internal political discord and fragmentation continues; and geopolitical tensions complicate solutions. In consequence, high skilled labor is increasingly likely to take up potential opportunities abroad, constituting a permanent social and economic loss for the country.

Lebanon needs to urgently adopt and implement a credible, comprehensive and coordinated macro-financial stability strategy, within a medium term macro-fiscal framework. This strategy would be based on: (i) a debt restructuring program toward achieving debt sustainability over the medium term; (ii) a comprehensive financial sector restructuring toward regaining solvency of the banking sector; (iii) a new monetary policy framework aimed at regaining confidence and stability in the exchange rate; (iv) a phased fiscal adjustment aimed at regaining confidence in fiscal policy; (v) growth enhancing reforms; and (vi) enhanced social protection.

2

RECENT MACRO-FINANCIAL DEVELOPMENTS

Output and Demand

The compounded crises, namely, the economic crisis, COVID-19 and the PoB explosion, have had staggered impacts on output and with differentiated magnitudes. Due to insufficient high frequency data, precise identification of each of those impacts is a challenging task. In order to draw empirical conclusions, we resort to a combination of methodologies and models, explained below and in the Annex. To gauge the impact of economic and financial crisis along with COVID-19 effects, we use Mixed-Data Sampling (MIDAS) methods (or models) to assess the state of the economic cycle using available higher frequency measures of economic activity (see Box 1). The findings indicate that the impact of the economic crisis on output has been by far the largest of the three crises, followed by that of COVID-19.[6] The economic impact of the PoB explosion has been estimated for the Rapid Damage and Needs Assessment (RDNA).[7,8]

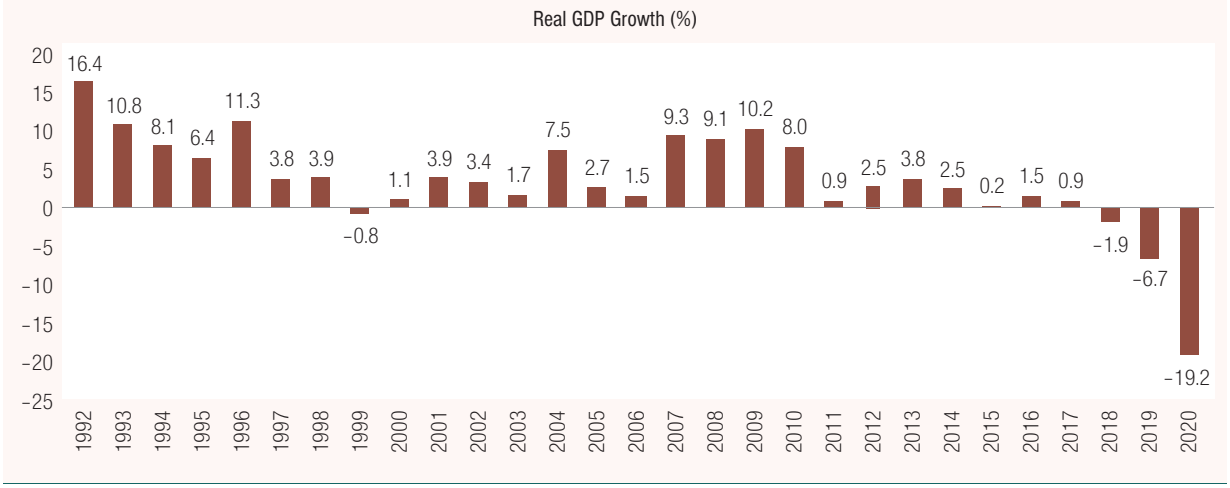
Real GDP is projected to decline by 19.2 percent in 2020 (Figure 1). The tourism sector in Lebanon has been particularly hit; tourist arrivals fell by 71.5 percent, year-on-year (yoy), over the first five months of 2020 (5M-2020), compared to an increase of 5.5 percent in the same period in 2019. While the decline in tourist arrivals has been in effect since October 2019 due to economic crisis conditions, it was highly concentrated from Spring 2020 and onwards due to COVID-19. Further, the BLOM-PMI index, which captures private sector activity, averaged 40.4 in 9M-2020 (<50 represents

[6] World Bank projections of real GDP growth back in Spring 2020 indicated a contraction of 11 percent in 2020. However, we now consider this contraction significantly understated due to (i) deteriorating economic and financial conditions since then (i.e., sharp depreciations in the black-market exchange rate, very high inflation rates, etc.) as well as an underestimation of COVID-19 duration.

[7] World Bank (2020), *Beirut Rapid Damage and Needs Assessment*, August 2020.

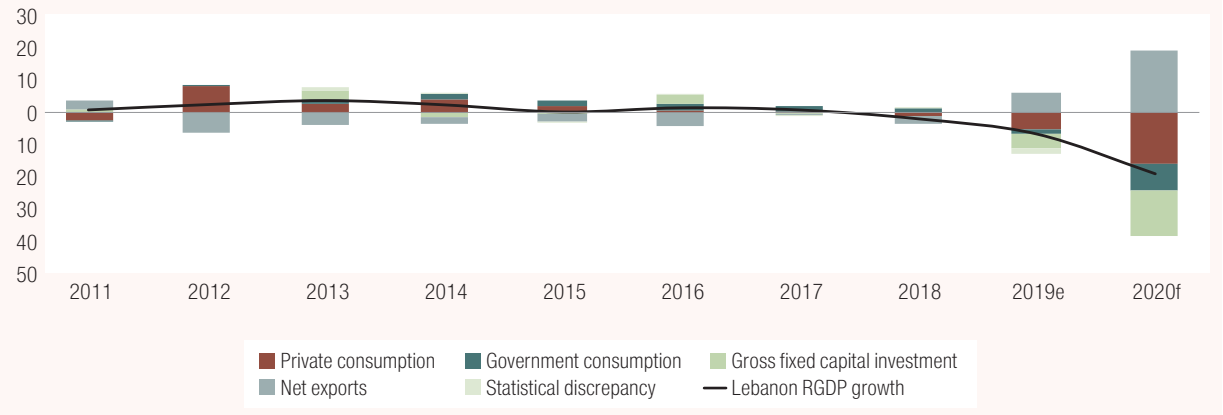
[8] According to the RDNA, the disaster event is estimated to cause (i) up to 0.4 and 0.6 percentage point (pp) declines in the growth rate of real GDP in 2020 and 2021, respectively, due to losses in the stock of physical capital; plus potentially (ii) import constraints that could subtract an additional of 0.4 and 1.3 pps from growth in 2020 and 2021, respectively.

FIGURE 1 • While the Contraction in Real GDP Commenced in 2018, It Is Heavily Concentrated in 2020



Sources: CAS and WB staff calculations.

FIGURE 2 • Net Exports Are Expected to Be the Sole Positive Contributor to Real GDP



Sources: CAS and WB staff calculations.

a contraction of activity), compared to 46.8 for 9M-2019. Even as the PMI index has indicated a persistent contraction of activity since 2013, the year it was first published, the 9M-2020 average is the lowest recorded. Similarly, the Byblos/AUB consumer confidence index registered a yoy decline of 60.6 percent in H1-2020. Meanwhile, the real estate sector has been subject to two offsetting factors; on the one hand, facilitation by the financial sector to allow real estate purchases using pre-October 2019 dollar deposits under conditions of capital controls (and therefore, a lack of alternatives to get those deposits out) has led to an increase in such purchases.[9] On the other hand, construction permits and cement deliveries, which are more accurate indicators of construction activities in the real estate market, suffered yoy declines of 60 and 52 percent, respectively, in H1-2020. This comes on the heels of significant contractions in H1-2019 amounting to 30.8 and 32.4 percent, respectively.

[9] Some of these purchases involved real estate collateral held on badly performing loans. Hence, this effectively constituted a netting out effect of assets and liabilities on banks' balance sheets.

BOX 1. NOWCASTING AND FORECASTING ECONOMIC ACTIVITY

Despite its importance for policymaking, GDP is typically observed at low frequencies, and in the case of Lebanon, with a long lag.[a] As such, central banks and policymakers endeavor to assess the state of the economy via higher frequency measures of economic activity. Since the important contribution of Ghysels, Santa-Clara and Valkanov (2004),[b] Mixed-Data Sampling (MIDAS) methods (or models) have gradually become essential tools at the disposal of central banks and policymakers for nowcasting GDP. A key advantage of MIDAS models is that they allow the combination of low frequency GDP data with higher frequency economic activity data in their estimations. As such, the use of MIDAS models has rapidly gained traction among policymakers and central bankers for nowcasting GDP.[c]

On the other hand, a caveat is that under crisis dynamics, linear relationships might not hold along tail end conditions. Indeed, MIDAS regressions assume a linear relation between GDP growth and the high frequency indicators. Nonetheless, the Almon lag specification used to relate the high frequency indicator to GDP growth can take various shapes using only a few parameters (Ghysels and Marcellino, 2018).[d] By estimating the weights that relate the high frequency indicators to real GDP growth, MIDAS regressions partially account for nonlinearity in the relationship. Unlike bridge equations in which observations on the high frequency indicators are weighted equally, the MIDAS approach allows for flexible weighting of the monthly observations on the high frequency indicators. As such, the MIDAS approach captures well the steep downward trend in the high frequency indicators in the latter part of the sample, i.e. the 2020 monthly observations on the high frequency indicators.[e] The high frequency indicators used to nowcast and forecast Lebanon's real GDP growth are, namely, yoy growth rates in: claims of the commercial banking sector on resident customers (*cl*), outstanding lines of credit for imports (*lc*), non-resident (*nr*) and resident (*r*) deposits; all sourced from BdL. That is, in the MIDAS setup, our vector of high frequency indicators is

$$x_t^H = (cl, lc, nr, r)$$

We aggregate information from the four high frequency indicators using principal components analysis. More specifically, we extract the first principal component from the four indicators and use it to nowcast or forecast real GDP growth. The MIDAS model, which uses the first principal component of the four indicators, is referred to as *the factor augmented MIDAS model.* The low frequency variable of interest in the nowcasting or forecasting exercises is

$$y_t^L = (gdpg)$$

where *gdpg* is the annual growth rate in GDP.

In forecasting Lebanon's GDP growth in 2020 and 2021, two setups are entertained. The first is referred to as the baseline setup and does not control for COVID-19 economic effects, whereas the pandemic is incorporated into the second setup. More specifically, the AR(1) model used to forecast the high frequency indicator is augmented with an indicator (i.e., dummy) variable taking the value one from April 2020 (i.e., at the start of the lockdown period) through first half of 2021 (H1-2021). In such a way, we are able to gauge the marginal impact of COVID-19 on growth. High data for frequency variables are available through May 2020, while the GDP data are available only until 2018. The dynamic (i.e., multi-step-ahead) forecasts of real GDP growth rates for 2020 and 2021 are generated using ADL-MIDAS model. The results are provided in Table 1.

It should be noted that the forecast of real GDP growth for 2021 is subject to considerably more uncertainty than that for 2020. The reasons for the uncertainty are twofold: (i) unlike 2020, the data for the high frequency indicators are not yet available; and (ii) the forecast of real GDP growth for 2021 builds on the forecast of real GDP growth of 2020.

TABLE 1 • MIDAS Forecasts for 2020 and 2021 Real GDP Growth for Baseline and COVID-19 Scenarios

	2020		2021	
	Baseline	COVID	Baseline	COVID
Non-resident deposit growth	−11.0%	−13.0%	−7.5%	−8.6%
Resident deposit growth	−16.7%	−18.1%	−11.4%	−12.5%
Claims on the resident sector	−14.7%	−16.2%	−16.3%	−16.9%
Lines of credit for imports	−16.8%	−21.5%	−10.2%	−11.0%
Factor Augmented MIDAS	−18.9%	−22.4%	−11.3%	−12.8%
Average (excl. min & max)	**−16.1%**	**−18.6%**	**−11.0%**	**−12.1%**

(continued on next page)

BOX 1. NOWCASTING AND FORECASTING ECONOMIC ACTIVITY *(CONTINUED)*

Average estimates of growth projections for 2020 and 2021 are 18.6 percent and 12.1 percent, respectively. Results from Table 1 also suggest that the estimated COVID-19 impact averages 2.5 pp of GDP in 2020 and 1.1 pp of GDP in 2021. A couple of factors can help understate the COVID-19 impact, specifically, (i) that the high frequency indicators used are more optimal for financial crisis dynamics, which is the largest of the three crises that the country is facing, that for COVID; and (ii) that the sample period used to estimate the MIDAS model is through May 2020, leaving only 2 months to account for the COVID-19 effects in Lebanon. As such, the COVID-19 impact estimation is likely to change (increase) as more data come in. The results for 2020 ad 2021 can be updated as more data come in for the high frequency indicators.

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[a] Lebanese GDP data are collected and disseminated by the Central Administration of Statistics (CAS).

[b] Ghysels, E., Santa-Clara, P., & Valkanov, R. (2004), *The MIDAS Touch: Mixed Data Sampling Regression Models*, Discussion paper UNC and UCLA.

[c] A comparative assessment of the nowcasting ability of MIDAS and bridge equations is provided in: Schumacher, C. (2016), *A Comparison of MIDAS and Bridge Equations*, International Journal of Forecasting, 32(2), 257–270.

[d] Ghysels, E., and Marcellino, M. (2018), *Applied Economic Forecasting using Time Series Methods*, Oxford University Press.

[e] Further, the existing literature shows that the predictive ability of nonlinear model is not superior to that of linear models (Clements, Franses and Swanson, 2004). This is particularly true for forecasting GDP growth and inflation (Marcellino, 2008). The data limitations in Lebanon (in particular, the historical availability of GDP data) as well as the unprecedented large movements in the high frequency indicators complicate estimation and prediction from nonlinear models.
Clements, M. P., Franses, P. H., & Swanson, N. R. (2004), *Forecasting Economic and Financial Time-Series with Non-Linear Models*, International Journal of Forecasting, 20(2), 169–183.
Marcellino, M. (2008); *A linear benchmark for forecasting GDP growth and inflation?* Journal of Forecasting, 27(4), 305–340.

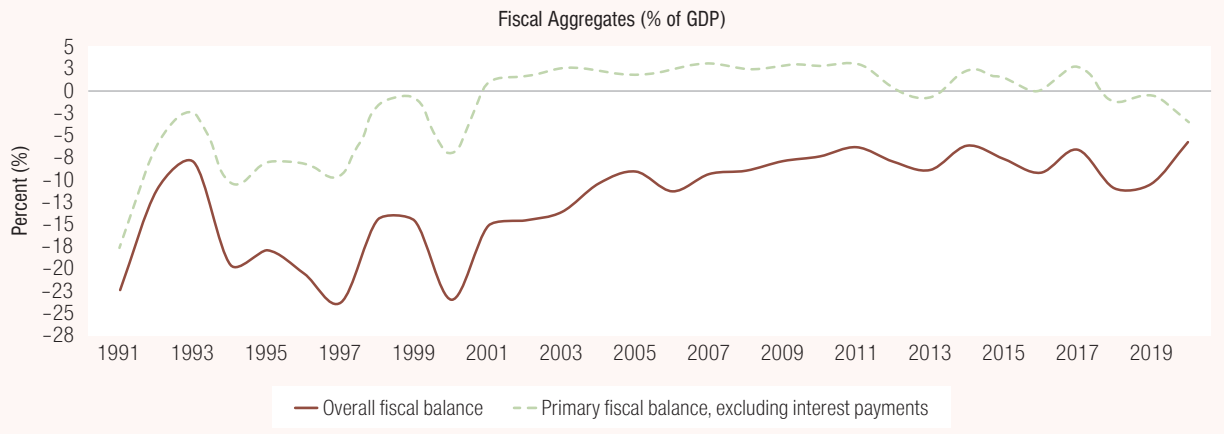
On the demand side, private, and to a lesser extent public, consumption and investments are expected to contract sharply, with consumption historically constituting more that 100 percent of output (Figure 2). Net exports, on the other hand, is expected be the sole positive contributor to GDP, driven by falling imports; according to Customs data, the total value of merchandize imports declined by 50 percent in 8M-2020, compared to the same period in 2019, while merchandize exports fell by 8.3 percent.

Fiscal Developments

Crises conditions have further deteriorated Lebanon's already precarious fiscal position. Revenues are expected to decline sharply as both tax and non-tax revenues tumble in absolute value due to the sharp contraction in economic activity. As a percentage to GDP, a sizable increase in nominal GDP (in LL), driven by a high GDP deflator (due to rising prices), will further reinforce the falling revenue ratio via a denominator-led effect. Total revenues in 2020 are thus projected to decrease by around 9 pps to reach 11.5 percent of GDP, compared to an average (2013–2018) of 20.7 percent. On the expenditure side, total spending is forecast to decline by almost 14 pps to be at around 17.3 percent of GDP. This will be driven by declines in primary expenditures—due almost exclusively to the denominator-led effect—and lower interest payments on debt. Overall, in 2020, the fiscal balance is forecast to improve by 4.7 pps to reach –5.9 percent of GDP (Figure 3). On the other hand, the primary balance is expected to endure a clear deterioration and is projected to be –3.6 percent of GDP, compared to a (2013–2018) average of 0.7 percent.

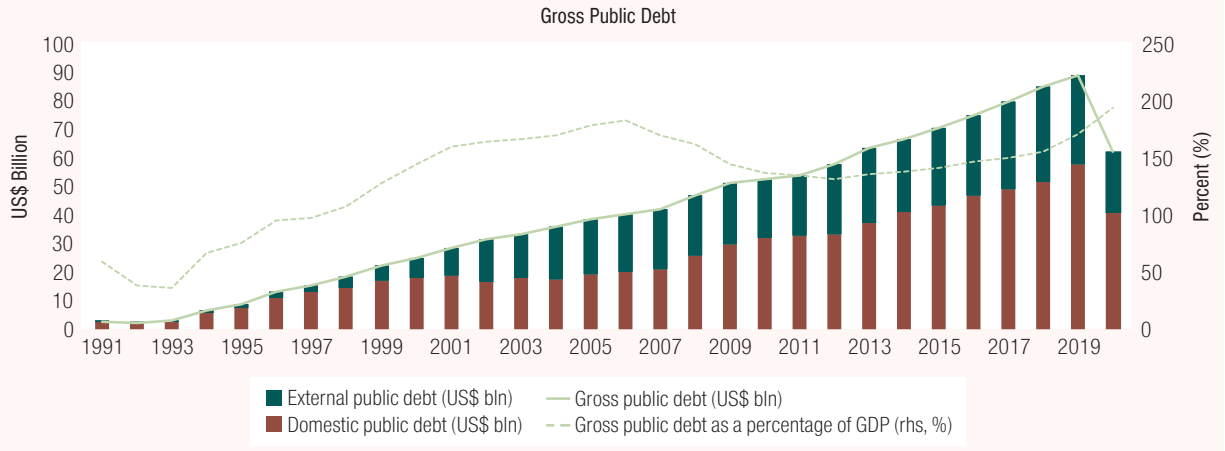
Partial-year fiscal data confirm severe fiscal stresses. Over the 6M-2020 period, total revenues declined by 19.8 percent (yoy), driven by 49.8, 44.4 and 32.4 percent yoy decreases in VAT, telecoms and customs revenues, respectively. We note that income tax and VAT are the two largest revenue sources for the Government, followed by transfers from telecoms and taxes on international trade (of which customs is a component). The sharp fall in VAT and customs are tempered by much smaller declines in other taxes so that total tax revenues fell by 27.9 percent over 6M-2019. On the non-tax side, treasury transaction resources (revenues) increased by 183 percent due to the "others" category, also helping to partially offset the sharp decline in telecom transfers. Total expenditures over 6M-2020 have also decreased by 16.2 percent. This, however, is largely due to cuts in interest payments on debt. In fact, over 6M-2020, interest payments on foreign debt fell by 87.6 percent (yoy),

FIGURE 3 • Large Shortfalls in Revenues Will Induce a Significant Deterioration in the Fiscal Position



Sources: Lebanese authorities and WB staff calculations.

FIGURE 4 • Valuation Effects from Exchange Rate Depreciations Will Pressure the Debt-to-GDP Ratio



Sources: Lebanese authorities and WB staff calculations.

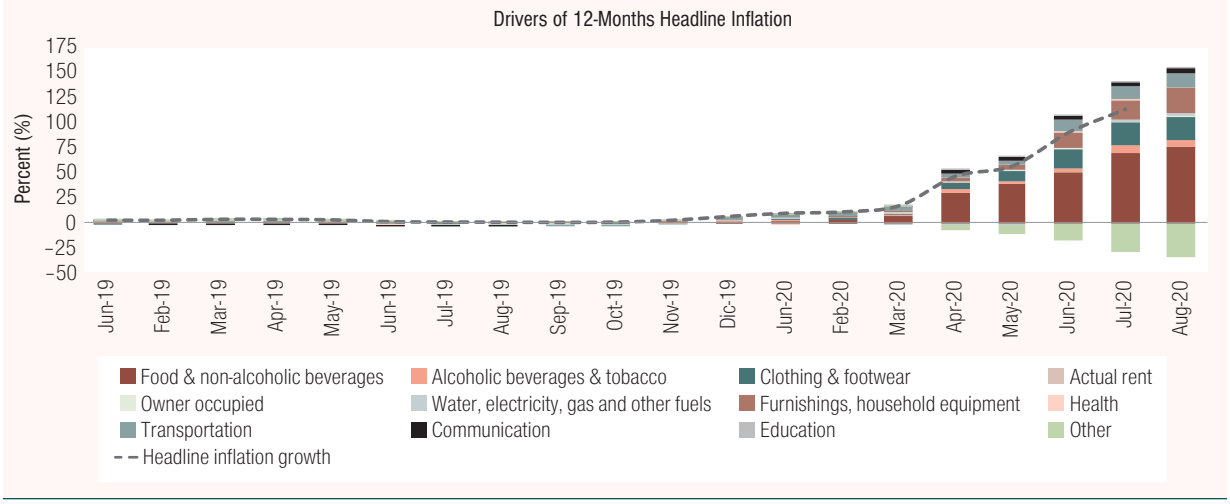
a result of the default decision on Eurobonds early in March 2020, while that on domestic debt decreased by 26.1 percent. The latter is due to an agreement with the central bank, by which BdL would not receive coupon payments on Treasury bonds it holds as part of fiscal relief for the Government.[10] Meanwhile, primary spending remained largely unvaried in nominal terms (but fell sharply in real terms as inflation has spiked).

The economic crisis has led to a sharp deterioration in Lebanon's public debt ratio, which has long been on an unsustainable path. By end-2020, the debt-to-GDP ratio is projected to reach 194 percent, compared to 171 percent end-2019 (Figure 4).[11] Taken at the official exchange rate, the share of outstanding stock of foreign currency-denominated debt was 37 percent in April 2020, mostly held by domestic banks. Of course, taken at the higher average exchange rate in the economy, this share increases dramatically (a doubling or tripling would be

[10] As of August 2020, BdL held 60 percent of gross local currency public debt.

[11] The default on the Eurobonds implies uncertainty over the final nominal value of foreign debt, whose new terms (i.e. face value, maturity, grace period etc.) need to be negotiated with foreign creditors. For our purposes, we assumed no principal and coupon payments take place for Eurobonds in 2020 and 2021.

FIGURE 5 • Triple-Digit Inflation Rates Driven by Basic Consumption Items



Sources: CAS and WB staff calculations.

consistent with some of the current various exchange rates in use in the country). Historically, interest cost has consumed about half of government revenues, averaging 9 percent of GDP over 2013–2018.

Money and Banking

Monetary conditions mirror the state of economic and financial crisis centered around exchange market pressures that triggered triple-digit inflation rates. Acute exchange market pressures in Lebanese markets are reflected by heavy fluctuations in the black-market exchange rate,[12] which has breached LL 10,000 per US$, before falling back down. This is within the context of a multiple exchange rate system, which includes the official exchange (LL 1,507.5/ US$) as well BdL-backed lower rates for critical imports. Subsequently, exchange rate pass through effects on prices have resulted in surging inflation; the 12-month inflation rate has risen steadily and sharply from 10 percent in January 2020, to 46.6 percent in April, 89.7 percent in June, and most recently in August, 120 percent. Inflation is a highly regressive tax, disproportionally affecting the poor and vulnerable, and more generally, people living on fixed income like pensioners. This is especially so in Lebanon's case where key basic items of the consumption basket are primary drivers of overall inflation. In fact, the average yoy inflation rate over the first 8 months of 2020 (8M-2020) for food and non-alcoholic beverages was 170.3 percent, while that for clothing and footwear was 195.4 percent, and 240.1 percent for furnishing and household equipment (Figure 5).

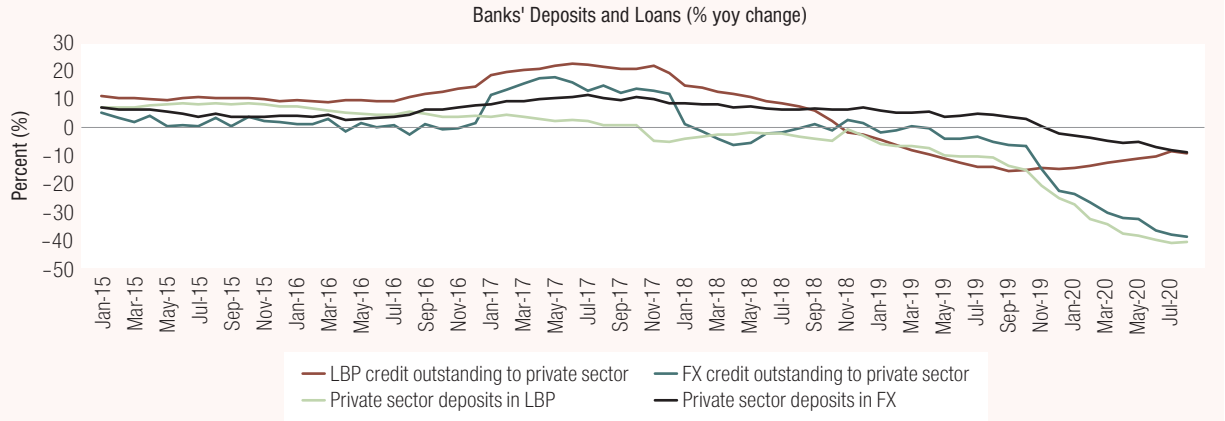
The severe restrictions on capital outflows have increased the monetary space for monetary authorities. From October 2019 to August 2020, BdL lowered interest rates on banks' LL and dollar deposits by 556 and 533 basis points (bps), respectively. Banks' lending rates in LL have mirrored this effect, falling by 405 bps over the same period, while rates for dollar loans have fallen by only 251 bps.

BdL has issued a series of circulars that reflect the central bank's vision of a crisis management strategy, along with some key political economy priorities. These initiatives can be divided into three main categories: (i) monetary and exchange rate policies; (ii) socio-economic support; and (iii) financial sector regulations. Annex A lists key circulars along with a description of main stipulations.

Lebanon's monetary system is fragmented with multiple and segmented arrangements with variable pricing and exchange rates. This includes:

[12] The black market has become a main supply channel for dollars for both real and financial activity, as commercial banks heavily restricted withdrawals and transfers of customers' dollar deposits.

FIGURE 6 • Heavy Deleveraging of Assets (Private Loans) and Liabilities (Private Deposits) in Financial Sector



Sources: BdL and WB staff calculations.

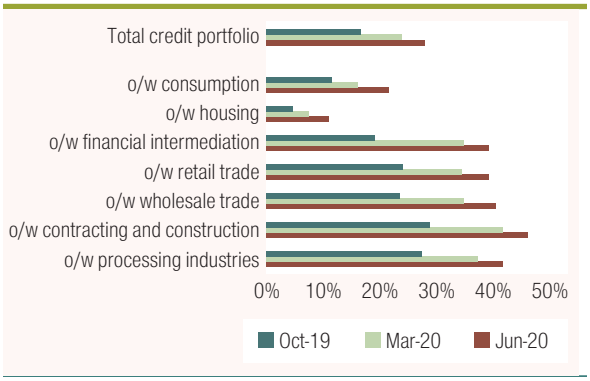
a. The pre-crisis dollar deposits in commercial banks. These electronic dollars are subject to severe capital controls and can only be (i) withdrawn in LL at the e-board rate and in limited quantities; (ii) transferred within the domestic banking system; (iii) cashed out in informal and nontransparent schemes though middlemen at large discounts.
b. The dollar banknote and new dollar deposits (fresh dollars). This is traded at the black-market rate. Most businesses need to access this dollar in order to import consumption and capital goods.
c. The Lebanese lira bank note. Limited economic utility for electronic dollars, along with scarcity of dollar bank notes, and minimum incentives to save in LL, all rendered the economy heavily cash-based in local currency. By August 2020, the stock of currency in circulation increased by 294 percent (yoy), even as M2 and M3 declined by 17.1 and 7 percent, respectively.

Heavy deleveraging in the financial sector. Total private sector deposits in commercial banks shrank by 10.2 percent, amounting to US$ 17.2 billion (at the official exchange rate), over 8M-2020, with distinct dynamics driving LL and dollar deposits (Figure 6). The former declined by 25.6 percent over the same period, dragged by both (i) demand for cash as the economy became heavily cash based in LL; and (ii) conversions to dollars as evidenced by an increasing dollarization rate, which by August 2020 reached 81 percent, compared to 77.3 percent by end-2019. Private dollar deposits, on the other hand, declined by a much lower 5.7 percent over 8M-2020. Hence, the higher dollarization was more than offset by a combination of outflows, dollar bank note hoarding and, importantly, the settlement of outstanding private sector loans in dollars. Regarding the latter, BdL and the Banking Control Commission (BCC) facilitated the settlement of outstanding private sector loans using pre-crisis dollar deposits in a netting out effect of assets and liabilities of banks' balance sheets. As a result, commercial banks' total credit to the private sector fell by 22.1 percent over 8M-2020, amounting to a decline of US$ 12.5 billion (at the official exchange rate).

Commercial banks' net foreign assets position has continued to deteriorate. As of August 2020, the banking sector, as a whole, had US$ 4.4 billion in placements at non-resident financial institutions (FIs), while its liabilities to non-resident FIs amounted to US$ 7.5 billion, a net foreign asset position of US$ −3.1 billion (compared to a net foreign asset position of US$ −2.1 billion end-2019).

The credit portfolio of the banking sector has substantially deteriorated during recent months. Wholesale and retail trade and processing

FIGURE 7 • A Steady and Sharp Deterioration in Credit Performance as Measure by NPL Ratio for Banks



Sources: BdL and WB staff calculations.

industries, among other economic sectors were severely affected, causing business closing and job losses/reduced salaries. Non-performing loan (NPL) ratio (gross NPLs including unearned interests as a percentage to total loans) stood at 28.3 percent as of June 2020, compared to 13.3 percent at end-June 2019 and 16.8 percent at the beginning of the crisis in October 2019. NPL ratio for construction, wholesale and retail trade, and processing industries stood at 47, 40 and 42 percent, respectively, at the end of June (Figure 7). With the devastating impact of the explosions on the economy, continued deterioration in the quality of the LL 70 trillion credit portfolio (US$ 47 billion at official exchange rate and two-thirds denominated in USD) would be expected.

The Average Exchange Rate

The fixed exchange rate regime, which has nominally held at Lebanese lira (LL) 1,507.5 to the US dollar ($) from 1997 to 2019, is *de facto* dislodged in favor of a system of multiple exchange rates. The average exchange rate in the economy is a key parameter for macroeconomists in their analyses and estimations, and its identification in a multiple exchange rate system is not a straightforward exercise. This is particularly so in the case of Lebanon due to a lack of high frequency transactions data across multiple exchange rates. Nonetheless, since Lebanon's economy is heavily consumption based,[13] a good proxy would be an average exchange rate calculated using consumption-based weights, henceforth denoted as AER. As Annex B details, AER is calculated from the following prevailing exchange rates:

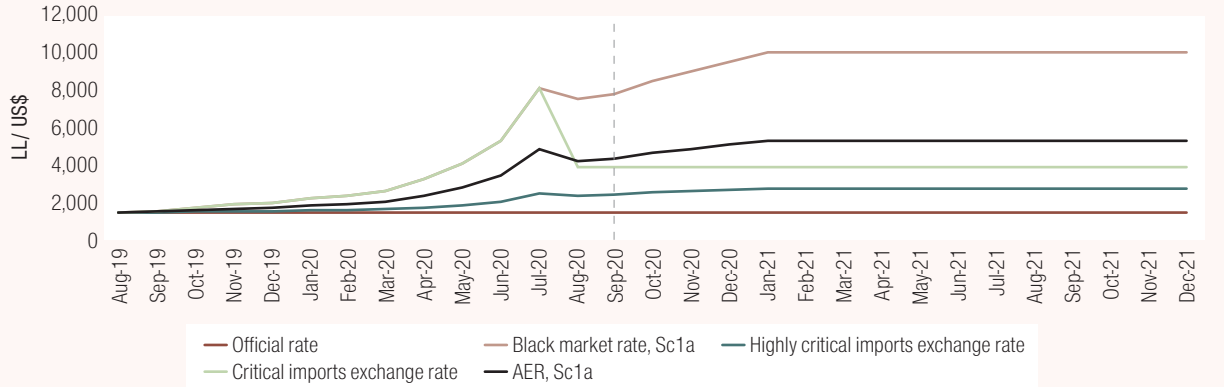
- The official exchange rate—LL 1507.5 per US$—which remains an anchor to many contracted prices in the economy and at which BdL is backing up the importation of highly critical goods, namely, fuel, medicines and wheat.
- The e-board exchange rate—LL 3,900 per US$—used for the importation of critical goods identified in the list of (FX-backed) items issued by Ministry of Economy and Trade (MoET) as well as the rate at which lirafication is taking place. Its level is administratively determined.
- The more volatile, market-determined, black-market exchange rate.

To project 2020 AER, we consider bad and worse case scenarios (a good case scenario remains unjustified in the current policy making environment). In the bad case scenario, denoted as Sc1a, we assume that the black-market rate continues deteriorating to reach LL 10,000 per US$ by January 2021, stabilizing thereafter. In the worse case scenario, denoted as Sc1b, we assume that the black-market rate deteriorates throughout 2021 to reach LL 15,500 per US$ by December 2021. We emphasize that both scenarios should be considered as illustrative and not projections, since high volatility in the black-market rate in current panic conditions implies very high uncertainty.

The results show that the estimated AER stabilizes in Sc1a, but continues to deteriorate in Sc1b, in reflection of our assumptions (Figures 8 and 9). Specifically, 2020 AER averages LL 3,550 per US$ in both Sc1a and Sc1b, depreciating by 129 percent compared to 2019. In 2021, the AERs for Sc1a and Sc1b diverge; for the former the AER depreciates by 49 percent to average around LL 5,303 per US$,

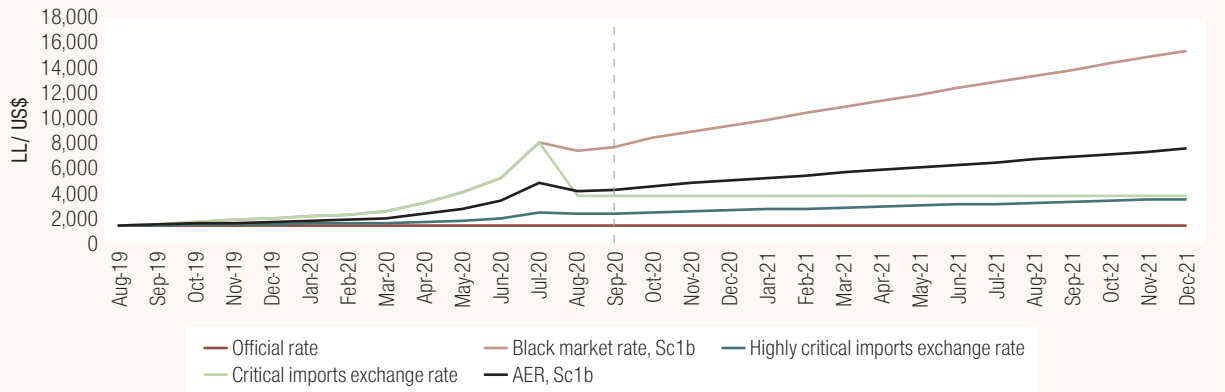
[13] Private consumption amounted to an average of 89 percent of GDP over the 2004–2018 period, while public consumption averaged an additional 15 percent of GDP.

FIGURE 8 • AER Simulations under Assumption of Stability of Black-Market Rate by end-2020



Sources: WB staff calculations based on data from authorities.

FIGURE 9 • AER Simulations under Assumption of Instability of Black-Market Rate through 2021



Sources: WB staff calculations based on data from authorities.

whereas it continues deteriorating in the latter scenario, by 82 percent, to average around LL 6,465 per US$.

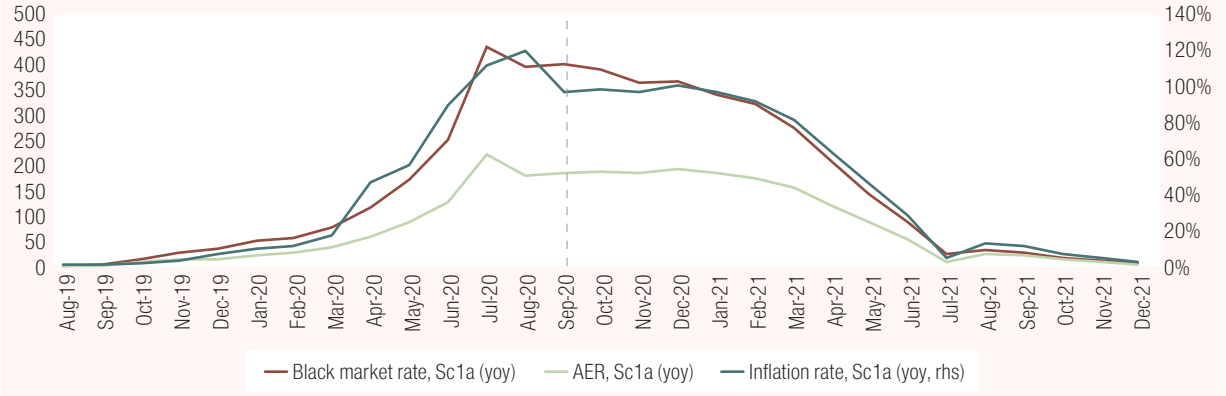
Pass Through Effects on Prices

Prices of goods and services have surged as a result of the depreciating exchange rate and in reflection of the high import component of the consumption basket. A simple calculation based on the AER and actual inflation data from September 2019 to August 2020 suggest an exchange rate-pass through rate of 52 percent.[14]

The results, which are presented in Figures 10 and 11 show inflation abating much more rapidly in Sc1a than in Sc1b, in reflection of our assumptions. Specifically, the inflation rate averages 72 percent in 2020 for both Sc1a and Sc1b, but

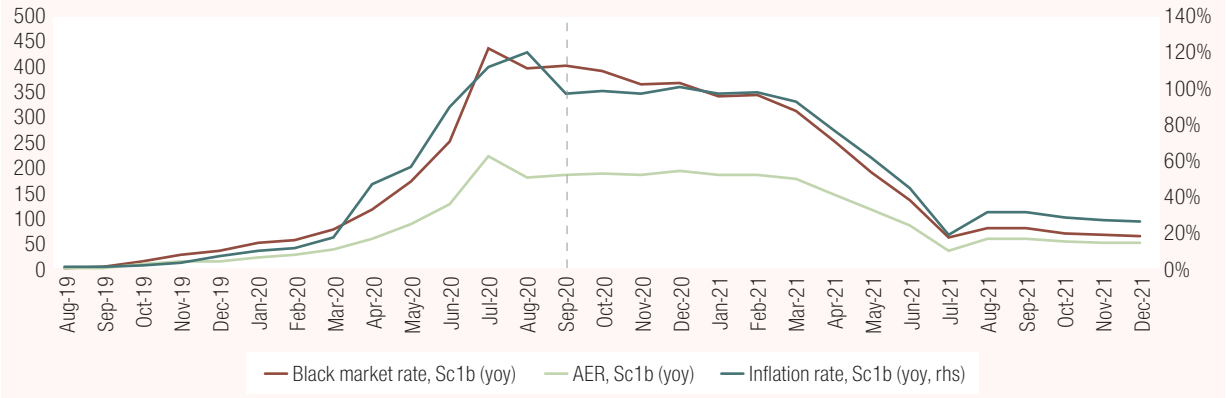
[14] To calculate exchange rate pass-through effects on inflation, we divided the inflation rate by the AER depreciation rate for the same month and multiply by 100. This generates a series of pass-through rates for the time period August 2019 to August 2020, which we averaged out. We also tested lagging effects by generating two more series where (i) the inflation rate is divided by the AER depreciation rate in the previous month; and (ii) the inflation rate is divided by the two months prior AER depreciation rate. We calculated the standard deviation for the three series and chose the series with the lower standard deviation, which was that

FIGURE 10 • Under Sc1a, the Inflation Rate Abates toward the End of 2021, Whereas …



Sources: WB staff calculations based on data from authorities.

FIGURE 11 • … in Sc1b, It Remains Elevated Driven by the Continued Depreciation of the Exchange Rate



Sources: WB staff calculations based on data from authorities.

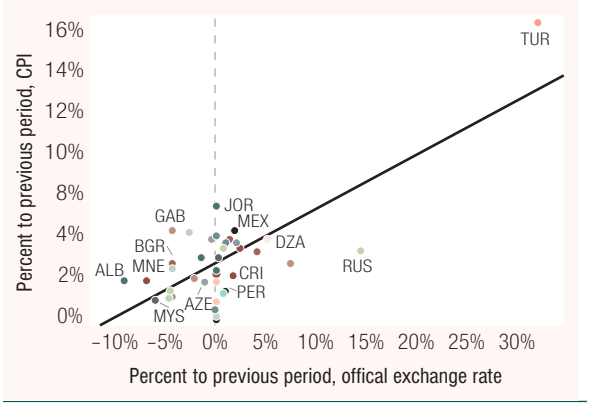
diverges in 2021, so that it falls to an average of 38 percent in the former scenario, but is more sticky at 53 percent in the latter scenario. A caveat to highlight is that we do not model/incorporate dynamics in inflation expectations,[15] which could make these expectations self-fulfilling and a main driver of macro-economic instability.

The above estimated exchange rate-to-prices pass through rate for Lebanon is analogous to global comparators. Figures 12 and 13 illustrate exchange rate to prices pass through rates for upper middle income and low income countries, respectively, calculated as the correlation between changes in the exchange rate and changes in the consumer price index (CPI). For upper middle-income countries, the exchange rate to prices pass through rate is estimate at 30 percent, while that for low income countries it is estimated at 67 percent.

generated from dividing the inflation rate by the same month AER depreciation rate. The estimated exchange rate pass-through rate will likely change as more actual data are populated. With longer time series, we can use more sophisticated econometrics, which would also help capture lagging effects.

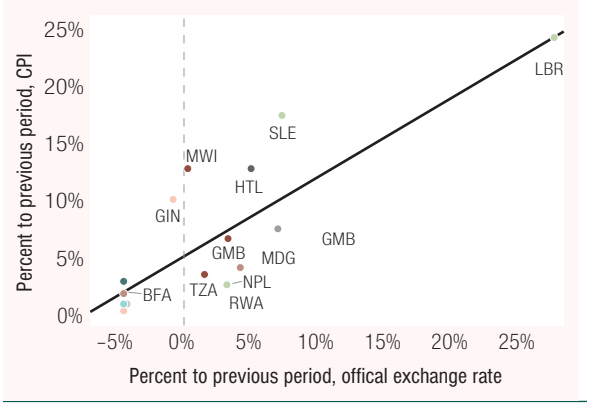
15 Firms and consumers who have been "fooled"/surprised once by the depreciation of the local currency and/or spike in inflation, look to protect themselves in the future and expect high inflation rates in the proceeding periods.

FIGURE 12 • CPI-Parallel Exchange Rate Pass through at 30 Percent for Upper Middle-Income Countries



Sources: WB staff calculations based on WDI data.

FIGURE 13 • CPI-Parallel Exchange Rate Pass through at 67 Percent for Lower Income Countries



Sources: WB staff calculations based on WDI data.

The External Sector

The sharp economic contraction—in the heavily consumption- and import-based economy—is naturally concentrated on imports, which is projected to lead a narrowing of the current account deficit. In fact, over 8M-2020, a 50 percent decline in merchandize imports, drove a 59 percent decrease in the trade in goods deficit. Meanwhile, net remittances, which accounted for 6 percent of GDP in 2019, is subject to offsetting dynamics in 2020; on the one hand, remittances inflows will be negatively impacted by an impaired banking sector—the traditional conduit for such transfers—and by the COVID-19 global impact. On the other hand, remittances inflows can increase due to the well documented "insurance"[16] and other countercyclical[17] behaviors observed in countries with large diasporas. Meanwhile, the change in remittances outflows from Lebanon is expected to be clearly in one direction—a significant decline. Overall, we expect the current account deficit in 2020 to contract, falling by 7 pps to reach 14.4 percent of GDP, compared to a medium-term (2013–2018) average of 22.8 percent of GDP.

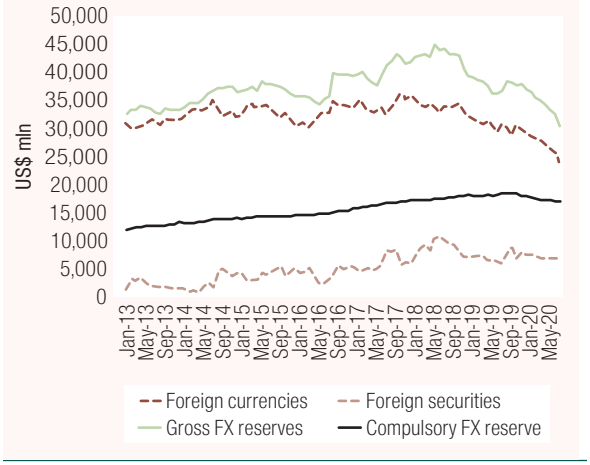
The sudden stop in capital inflows has implied a steady depletion of FX reserves at BdL (Figure 14). As of end-September, 2020, BdL's gross foreign asset position (excluding gold reserves) reached $25.9 billion, declining by $11.3 billion since end-2019. The gross position, however, differs widely from its net reserves (i.e., FX reserves at the central bank net of FX liabilities to others); BdL, contrary to other central banks, does not publish net reserves. BdL's gross position includes US$ 5 billion in Lebanese Eurobonds and an unpublished amount lent out to banks since October 2019, leaving much of the remainder as required reserves on banks' customer FX deposits, which is estimated at US$ 17.5 billion.

A high import ratio for the consumption basket, along with the shortage of dollars in the market suggest an implicit tradeoff between (i) importation of goods and services and (ii) BdL's stock of foreign exchange reserves. This compelled authorities to prioritize imports. First, and early on in the crisis, BdL identified a list of highly critical goods, C1—namely, fuel, medicine and wheat—to be backed by its stock of foreign

[16] The "insurance" behavior suggests that diaspora increases remittances back home in case of natural disasters. That is expected to be reinforced by a change in policy by the central bank following the PoB explosion, allowing transfers via non-banking financial institutions (money transfer companies) to be paid out in dollars. Just prior to the disaster, BdL mandated that these transfers were to be disbursed in LL after being converted at a below market exchange rate, in effect, imposing a large tax on remittances.

[17] During economic hardships in the home country, expatriates can also boost transfers back home in support of family.

FIGURE 14 • A Steady Depletion in the Gross Foreign Exchange Position at BdL



Sources: BdL and WB staff calculations.
Note: Compulsory FX reserves are World Bank estimates based on published data, and a 15 percent required reserve ratio on FX deposits in commercial banks.

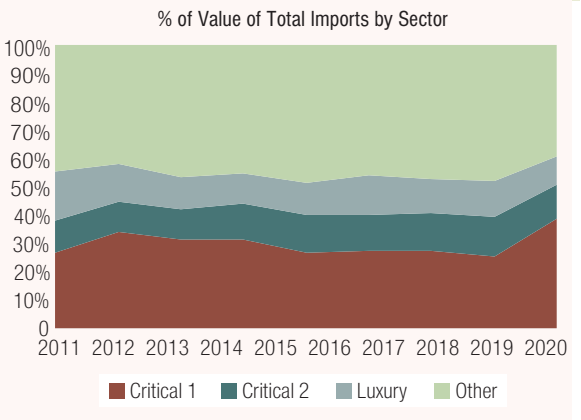
exchange reserves at the official exchange rate.[18] The Government followed suit in July 2020 with a list of other critical goods, C2, issued by the Ministry of Economy and Trade, which BdL agreed to back up at the e-board rate (LL 3,900 per US$).

An examination of historical and recent trends for C1 and C2 imports are revealing. The shares of C1, C2, luxury and other imports to total imports are presented annually from 2011 and monthly over 2019–20 in Figures 15 and 16, respectively. The former illustrates relative stability in the respective shares until 2019. Indeed, the 2011–18 average value shares of C1, C2, luxury and other imports were 29, 12, 13 and 46 percent, respectively. Meanwhile, as foreign exchange constraints became binding, the ratios of C1 imports, and to a lesser extent C2 imports, rose at the expense of those for luxury and other goods (Figure 16); over the 2019–20 period, average value shares of C1, C2, luxury and other imports became 36, 15, 10 and 39 percent, respectively. We expect this trend to persist.

Importers from across the economy compete for access to these FX-backed facilities. However, less transparent demand is also well-documented in countries with capital controls and multiple exchange rate systems; specifically, corruption and misclassification of imports to benefit from cheap foreign exchange. As importers adapt to capital controls and more depreciated black-market rates, this incentive will grow.

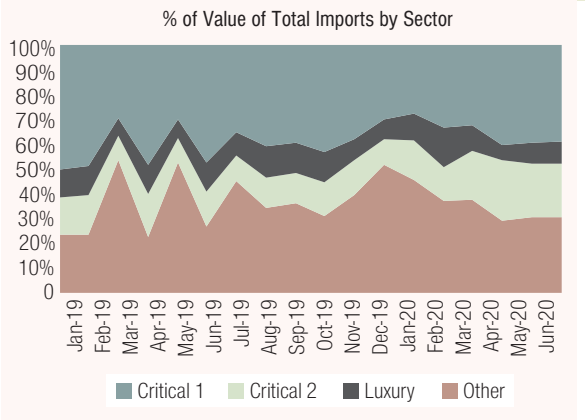
[18] BdL set up a mechanism via commercial banks whereby importers of highly critical goods can exchange LL for dollars at the official exchange rate for 85 to 90 percent of the cost of their imports, while sourcing the remaining 15 to 10 percent from the market at the black market rate.

FIGURE 15 • Ratios of C1, C2 Luxury and other Imports Were Stable until Period Leading to Crisis …



Sources: Customs, MOET, BdL and WB staff calculations.

FIGURE 16 • … when Ratios of C1 and C2 Imports, Rose at the Expense of those for Luxury and other Goods



Sources: Customs, MOET, BdL and WB staff calculations.

3

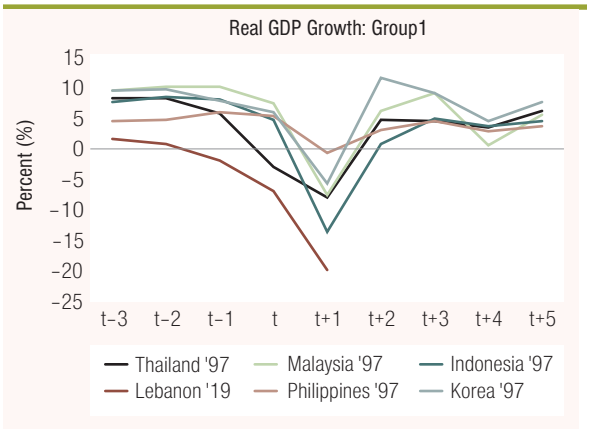
GLOBAL CRISES COMPARATORS: FUNDAMENTALS MATTER

To help further inform on the outlook for Lebanon, we compare the country's economic fundamentals with those of other crises countries, henceforth referred to as global crises comparators. Inherent to any crisis episode is the large uncertainty on the outlook, as economic indicators diverge significantly from medium-term averages. Earlier in the LEM, we attempt to ground our outlook using country-specific models and econometrics. Further guidance can be construed from evidence offered by global crises comparators. Critically, macroeconomic fundamentals leading up to the crisis can provide insight on post-crisis dynamics. That is, the state of the pre-crisis macroeconomy identifies resources and buffers that are available for the economy as it emerges from the crisis. In turn, this can inform on the scale and scope of the economic challenges ahead. It is important to note, however, that each crisis episode involves strong idiosyncrasies, and that global crises comparators are not a perfect set of episodes.

We divide our set of global crises comparators into two groups. Group 1 (G1) includes the Asian crisis countries of 1997–98: Thailand, Malaysia, Indonesia, Philippine and South Korea; group 2 (G2) assembles a more eclectic set of crises that occurred in the 2000's: Argentina (2001), Greece (2008), Ireland (2008), Iceland (2008) and Cyprus (2012). Both G1 and G2 episodes are expounded on in Annex D. We cross compare Lebanon's economic fundamentals with those for G1 and G2 countries over the years leading to the crisis point and observe dynamics in years that followed. Specifically, we present two charts for each macroeconomic indicator: (i) Lebanon with G1 countries; and (ii) Lebanon with G2 countries.[19] As we shall see below, strong differences in macroeconomic fundamentals is an important feature that distinguishes G1 from G2, and their recovery process.

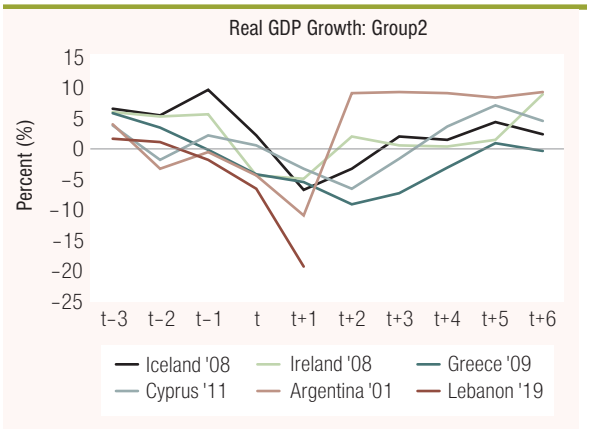
[19] In these charts, the indicator is plotted from 3 years prior to crisis year (t–3), to 5 (or 6) years post-crisis (t+5 or t+6), of course going through crisis year (t). In such a way, even when crisis years differ (say 2008 for Greece and 2001 for Argentina), plotting in reference to a crisis point rather than the calendar year superimposes the same indicator for Lebanon with global crises comparators on one chart. This allows us to cross-compare how the macro indicator developed as the crisis is approached, and how it evolved afterwards.

FIGURE 17 • Real GDP for G1 Global Crises Comparators



Sources: WDI, CAS and WB staff calculations.

FIGURE 18 • Real GDP for G2 Global Crises Comparators



Sources: WDI, CAS and WB staff calculations.

Output

Lebanon's growth faltered since 2011 and compares poorly with growth in G1 and G2 countries in the lead to the crisis point; only Argentina's pre-crisis growth is comparable. In fact, G1 countries demonstrated robust growth from t–3 until t–1, consistent with their medium-term performance at the time (Figure 17). The Asian financial crisis occurred in 1997 (t), with a recession ensuing in 1998 (t+1) for all G1 countries, the most severe being in Indonesia. For G2 countries, Ireland and Iceland replicate the Asian countries' performance in the years just prior to the crisis, exhibiting robust growth that is also consistent with their medium-term performance at the time (Figure 18). Meanwhile, growth in Greece and Cyprus fluctuated as they approached crisis year, with the latter falling into a recession in t–2, recovering somewhat in t–1. Argentina is the closest comparable to Lebanon as it experienced a strong recession starting in t–2 and t–1; Lebanon, which has been in sluggish growth since 2011, has been in an outright recession since t–1 (2018).

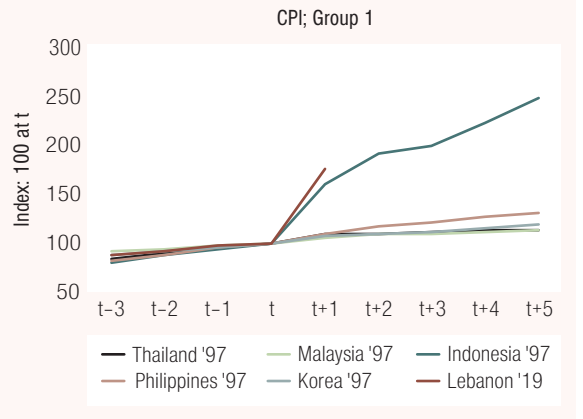
G1 countries rapidly regained growth, while performances in most G2 countries lagged with Greece standing out as a particularly painful episode. Only Argentina from the G2 countries was able to achieve robust growth immediately following the crisis, while Ireland, Iceland and Cyprus took a few years to recover. Greece's experience was particularly difficult as it suffered 6 years of consecutive recessions (from t–1 to t+4), growing marginally in t+5, before falling back into recessions for two more years.

The contraction in Lebanon's real GDP is already one of the worst among crisis countries, despite not having reached the trough yet. Crisis peak to trough changes in the real GDP (P-T) were much milder for the G1 countries that G2 countries; specifically, P-T changes in the real GDP ranged from –0.6 percent in the Philippines, to –5.5 percent in Korea, –7.4 percent in Malaysia, –10.2 percent in Thailand, to –13.1 percent in Indonesia.[20] As for G2 countries, P-T changes in real GDP registered –9.3 percent in Ireland, –10 percent in Iceland, –11.5 percent in Cyprus, –18.4 percent in Argentina, and –26.5 percent in Greece.[21] Latest GDP projections for t+1 (2020) for Lebanon suggest that the real GDP would contracted by 26.1 percent since its peak in t–3 (2017), making the country already one of the worst performers among crisis countries even though the crisis is still in its worsening phase.

[20] G1 countries' real GDP peaks and troughs occurred, respectively, in t and t+1 for each of The Philippines, South Korea, Malaysia and Indonesia, and in t-1 and t+1 in Thailand.

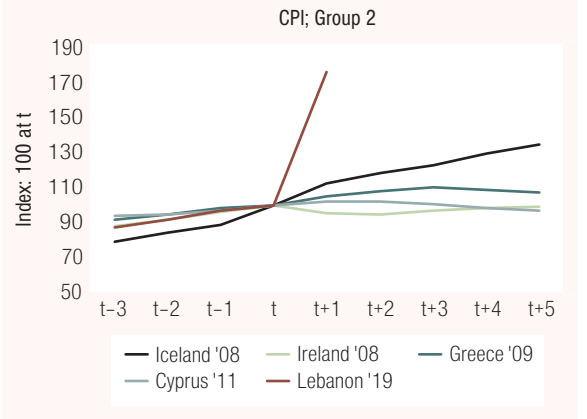
[21] G2 countries' real GDP peaks and troughs occurred, respectively, in, t–1 and t+1 in Ireland, t and t+2 in Iceland, t and t+3 in Cyprus, t–3 and t+1 in Argentina, and t–1 and t+5 in Greece (taking only the 6-year span).

FIGURE 19 • CPI Indices for G1 Global Crises Comparators



Sources: WDI, CAS and WB staff calculations.

FIGURE 20 • CPI Indices for G2 Global Crises Comparators



Sources: WDI, CAS and WB staff calculations.

Inflation

Lebanon's inflation was subdued since the early nineties;[22] **this is in reflection of exchange rate stability, which was also a factor in G1 and G2 countries**. Mild inflation and exchange rate stability in G1 countries (Figure 19) stemmed from general macroeconomic stability that was part of the Asian growth model at the time. This stability persisted in the recovery phase, except for Indonesia, where in t+1, the exchange rate depreciated by 244 percent and inflation spiked to almost 60 percent. As for G2 countries, Ireland, Greece and Cyprus successfully retained membership of the Euro monetary area, helping to contain inflation (Figure 20). While official inflation data for Argentina for that period is lacking, the failure of the currency board rendered inflation a main vulnerability in the post-crisis period. Iceland, on the other hand, exhibited a classical price adjustment; in t and t+1, the Krona depreciated by 37 and 41 percent, respectively, while inflation reached about 12 percent in both years, with pressures on the exchange rate and inflation subsiding thereafter.

Fiscal

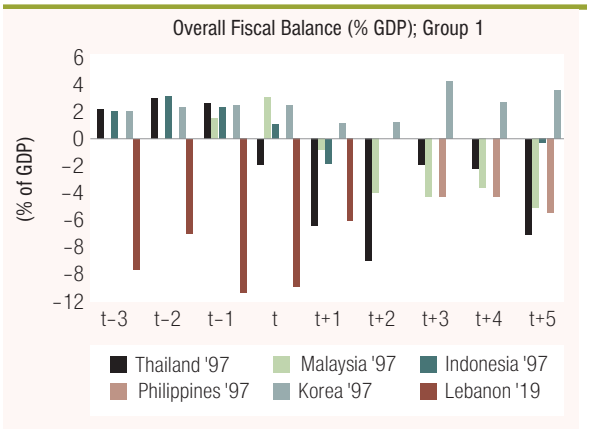
Lebanon's overall fiscal balance stands out as a main vulnerability in the lead to the crisis, comparable to, but even worse than, Greece's. Here again, G1 countries enjoyed fiscal surpluses prior to the crisis as part of a more general policy of macroeconomic stability, while G2 countries displayed variation (Figures 21 and 22). Of the latter, Argentina, Cyprus and Greece, in increasing order, entered the crisis with a deficit position.

Crises typically induce a significant worsening of the fiscal position, with some mitigation from high inflation. Even G1 countries experienced a deterioration in the fiscal balance in the aftermath of the crisis. This typically stems from sharper declines in tax and non-tax revenues—due to economic hardship—than declines in expenditure which can involve countercyclical fiscal stabilizers. Other relevant fiscal dynamics can be illustrated by a couple of notable cases here, specifically: (i) Indonesia, whose fiscal balance as a ratio to GDP deteriorated only marginally, mitigated by high inflation; and (ii) Iceland where, despite high inflation, the fiscal balance ratio did deteriorate sharply, driven by higher cost of debt.[23] Hence, while inflation can help correct fiscal imbalances, it can be offset by either higher interest rates (i.e., due to exchange market pressures), or valuation

[22] This is the case since the last exchange rate collapse, which saw the currency depreciate by over 400 percent from January 1990 until Fall of 1992.

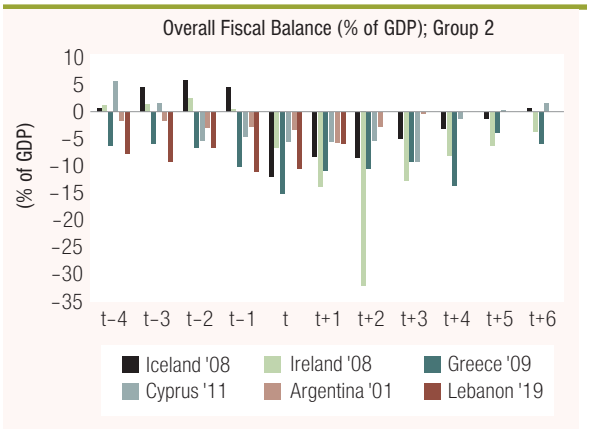
[23] Interest payments surged from 2 percent of GDP or less in the pre-crisis period, to 5.6 percent of GDP in t+1.

FIGURE 21 • Overall Fiscal Balance for G1 Global Crises Comparators



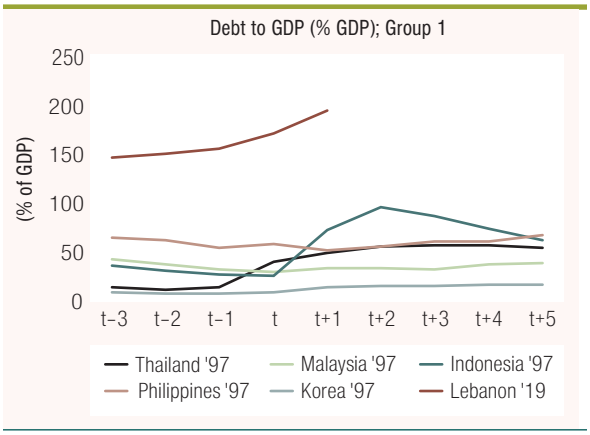
Sources: WDI, MoF and WB staff calculations.

FIGURE 22 • Overall Fiscal Balance G2 Global Crises Comparators



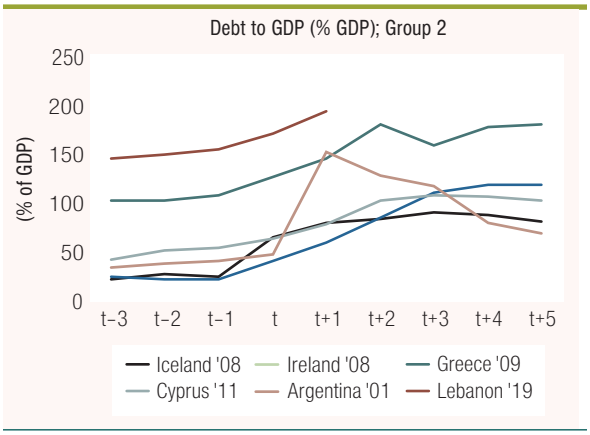
Sources: WDI, MoF and WB staff calculations.

FIGURE 23 • Gross Debt for G1 Global Crises Comparators



Sources: WEO and WB staff calculations.

FIGURE 24 • Gross Debt for G2 Global Crises Comparators



Sources: WEO and WB staff calculations.

effects on the foreign currency-denominated component of public debt as a result of an exchange rate depreciation.

Debt

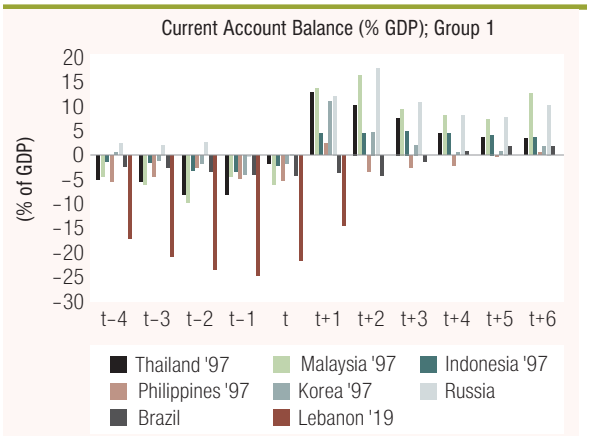
Public debt in Lebanon has consistently been one of the highest globally, and as a result, a key source of macroeconomic instability, comparable to only Greece among the G1 and G2 countries. Leading to the crisis year, the public debt-to-GDP ratio was below 60 percent for both G1 and G2 countries (Figures 23 and 24), with the exception of Greece and the Philippines.[24] However, in all cases, except for possibly Malaysia and the Philippines, the debt-to-GDP ratio deteriorated significantly, even for Greece which benefitted from a large haircut on its public debt.

External Position

A deteriorating current account balance was a common factor to G1 and G2 countries in the lead

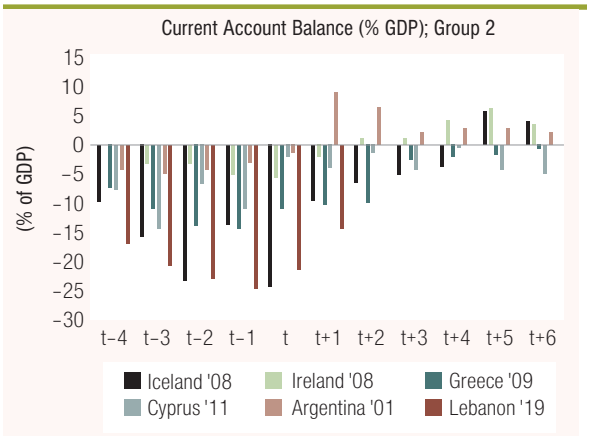
[24] The 60 percent of GDP is the debt ceiling identified by the Maastricht Treaty, which set macroeconomic targets for countries to qualify for the Euro membership.

FIGURE 25 • Current Account Balance for G1 Global Crises Comparators



Sources: Customs, MOET, BdL and WB staff calculations.

FIGURE 26 • Current Account Balance for G2 Global Crises Comparators



Sources: Customs, MOET, BdL and WB staff calculations.

to the crises (Figures 25 and 26)**.** This is a classic dynamic in emerging economies where a worsening of the external position raises risk exposures to external shocks and increases dependence on more volatile portfolio financing. In the late eighties, South Korea, Malaysia and the Philippines experienced years of positive current account balances, consistent with the Asian export-based growth model. This was not the case for Thailand and Indonesia, whose economies maintained a more structural external deficit position. From early to mid-nineties, current account balances for all G1 countries were decidedly in the negative, with a clear deterioration in the years leading to the crisis. Only Ireland from the G2 countries demonstrated a positive current account position consistently over the prior decade, with the rest holding a structurally negative position. Here again, a general deterioration in the external position in the lead to the crisis is evident for all G2 episodes.

A clear implication of the crises on both G1 and G2 countries is a sharp correction in the external position. Variations between the sample groups are notable. For G1 countries, the correction in the current account balance occurred as a result of sharp depreciations in the exchange rates, which increased the competitiveness of their economies. The Asian export-oriented growth model was well positioned to benefit from the repricing in its favor. Argentina and to a lesser extent Iceland both shared a similar adjustment mechanism. This channel, however, was not available for Greece, Ireland and Cyprus, as their strategic objective was to remain in the Eurozone. Instead, for the Euro countries, the correction in the external position occurred as a result of an internal adjustment mechanism, typically more painful and prolonged.

Overall

The main distinctions between G1 and G2 countries concern macroeconomic fundamentals and crisis geneses. G1 countries share a contagion effect as a cause to their crises; additionally, they can be regarded as having relatively strong macroeconomic fundamentals on the eve of the crisis, notwithstanding certain vulnerabilities. G2 episodes have varying causes and suffer more obvious macroeconomic vulnerabilities (with the possible exception of Ireland). As a result, recovery for the G1 group was much more swift and sustainable, whereas G2 recoveries suffered, to variable degrees, from long-term structural weaknesses; oversized and badly regulated financial sectors in Iceland and Cyprus; a non-transparent and unsustainable public sector in Greece; an over-valued rigid exchange rate regime in Argentina.

Lebanon's fundamentals in the lead to the crisis fared worse than that those for both G1 and G2 countries. As such, we expect the adjustment process to be more painful and to take longer, even with optimal policy measures in place. As it currently stands, however, the absence of a comprehensive and consistent adjustment strategy can only make this more difficult.

4

OUTLOOK AND RISKS

Subject to unusually high uncertainty, we project real GDP to contract by a further 13.2 percent in 2021. Our projection assumes the following key factors: COVID-19 effects carry through H1-2021, macro policy responses continue to be lacking, and limited reconstruction and recovery efforts in the aftermath of the PoB explosion.

Lebanon's recession is likely to be arduous and prolonged given the lack of necessary policy-making. Exchange market pressures will continue to stifle trade finance and corporate finance in the highly dollarized economy, constraining the importation of capital and final goods, and inducing disruptions all along the supply chain. This implies an inability to tap international markets for foreign financing, and an impaired domestic banking system. As a result, capital controls will continue to be needed, but are also expected to become less effective over time, in line with international evidence.

In the absence of formal capital controls, the lack of harmonization between banks, and between customers within the same bank, has generated considerable popular backlash against banks and the central bank. A key shortcoming of current applications of informal capital controls is the lack of accountability on non-compliance, and the large discretionary space for banks to pursue *ad hoc* applications. Whereas most customers are subject to severe (and increasing) restrictions on dollar withdrawals and transfers, it is perceived that some have managed to transfer large sums of money out of the country since controls have been in place (October 2019). There are vociferous demands for that money to be returned and for those engaged in such transfers be held to account.

The burden of the ongoing adjustment/ deleveraging in the financial sector is highly regressive, concentrated on smaller depositors, the local labor force and smaller businesses.. De facto lirafication and haircuts on dollar deposits are ongoing despite BdL's and banks' official commitment to safeguarding deposits. When paying out dollar deposits to customers—other than a minimal (and diminishing) amount paid out in dollar bank notes—banks are exchanging at rates lower than the black-market rate and paying it out in LL, thereby effecting lirafication. Haircuts occur to the extent that the LL amount is being used to either purchase goods and services, whose prices are rising, or exchange for dollars bank notes, both lead by the black-market

market rate. The burden of the ongoing adjustment/deleveraging is regressive and concentrated on the smaller depositors, who lack other source of savings, the local labor force, that is paid in LL, and smaller businesses.

A steady depletion in FX reserves at BdL presents a realistic downside risk of an inflationary-depreciation spiral, which our baseline does not assume. BdL officials have made statements to the effect that FX reserves levels will reach require reserves on banks' customer FX deposits in the next few months, at which point they will be unable to back up critical imports at lower exchange rates.[25] This will dangerously stoke inflationary-depreciation pressures. When BdL arrests its back up of critical goods, especially, energy products, medicine and food essentials, importers will fully revert to the black market for the needed hard currency. This would exacerbate inflationary pressures with both flow and stock implications. On the flow side, inflationary pressures arise due to a direct effect and to re-iterative effects. Through the direct effect, the inflation rate rises as prices for critical products will immediately reflect the full black-market exchange rate.[26,27] Additionally, there are also re-iterative effects as the increased demand for dollars in the black market further worsens the exchange rate, fueling inflation. With surging inflation, the stock of narrow money increases, putting increased pressure on the exchange rate. Moreover, under panic conditions, inflation and exchange rates are key observables that drive sentiment, and their deterioration re-enforces the inflationary-depreciation cycle. Regarding stock implications, high inflation imposes a wealth effect via transfers from creditors to debtors; *ceteris paribus* borrowers would owe less—and hence, creditors would receive less—in real terms than what was determined at the time the contract was signed. Consequently, public debt denominated in local currency would be worth less in real terms, providing a fiscal benefit.

Poverty in Lebanon is likely to continue to worsen, surpassing half of the population by 2021. A contraction of the Lebanese GDP per capita in real terms and two-digit inflation in 2020 will undoubtedly result in substantial increase in poverty rates affecting all groups of population in Lebanon through different channels such as loss of productive employment, decline in real purchasing power, stalled international remittances and so forth. A World Food Programme (WFP) and World Bank (WB) survey[28] illustrates sharply declining purchasing power, severely hampering the ability of Lebanese households to meet essential needs such as food and access to adequate healthcare services (Box 2).

Lebanon needs to adopt and implement a credible, comprehensive and coordinated macro-financial stability strategy, within a medium term macro-fiscal framework. This strategy would be based on: (i) a debt restructuring program toward achieving debt sustainability over the medium term; (ii) a comprehensive financial sector restructuring toward regaining solvency of the banking sector; (iii) a new monetary policy framework aimed at regaining confidence and stability in the exchange rate; (iv) a phased fiscal adjustment aimed at regaining confidence in fiscal policy; (v) growth enhancing reforms; and (vi) enhance social protection.[29]

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[25] While BdL's declaration suggests safeguarding FX reserves at levels of required reserves, it is more symbolic than a credible re-assurance of solvency. Liquidity and solvency issues are primarily determined by the FX gap between assets and liabilities in BdL's balance sheet. For example, banks' total (LL and FX) deposits in BdL amount to over US$ 106 billion (July 2020, at official exchange rate). This is mainly sourced from the US$ 115 billion in FX deposits in commercial banks. Meanwhile, as mentioned earlier (Paragraph 27), BdL's foreign assets position is subject to key pressure points and non-observables (BdL, contrary to other central banks, does not publish net reserves). As such, a credible audit of BdL is needed to identify the FX gap.

[26] We note that energy products are final and intermediate goods, and changes to their prices impose economy-wide effects.

[27] While this will naturally reflect on volumes imported—since consumers will cut down on purchases, and there will be some substitutional effects for food products that can be manufactured locally (a process likely ongoing)—being highly critical goods, they will still be demanded in substantial volumes.

[28] WFP and WB (2020), *Lebanon: m-VAM Vulnerability and Food Security Assessment*, *July–August 2020*.

[29] This can include, for example, scaling up the e-card food voucher of the National Poverty Targeting Program

BOX 2. RESULTS FROM m-VAM VULNERABILITY AND FOOD SECURITY ASSESSMENT

The questionnaire was jointly developed by WFP and WB and includes the following sections: i) demographics, ii) food consumption, iii) reduced coping strategy index, iv) access to food and markets, v) access to health services, vi) employment, vi) access to social protection services. Remote data collection through phone surveys started in Lebanon in July 2020 and continued until end of August. The data collection methodology consists of a countrywide survey covering the eight governorates of Lebanon. The survey targets Lebanese nationals only and reached a total of 2,335 household since the beginning of the data collection in July. Out of these, of 1,459 respondents were reached in August. The following are key findings.

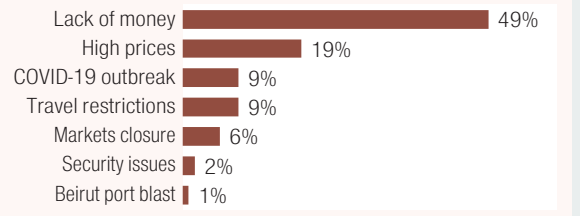
Deteriorated purchasing power is the main reason why households could not make ends meet, as 49 percent reported not to have enough money for their purchases and another 19 percent stated goods were not affordable due to high prices (Figure 27).

Unemployment rate amongst the respondents reached 49 percent in August compared to 37 percent in February. The highest increase was observed among respondents with lower levels of education (Figure 28).

The reported median take-home income respondents earned in July was 900,000 LBP (a little over US$ 100 at the black-market exchange rate), representing an 18 percent increase compared to February 2020. Nevertheless, the level of increase in nominal wages was much lower than the steep increase in prices that have been observed in the last ten months, reflecting a sharp decline in real wages.

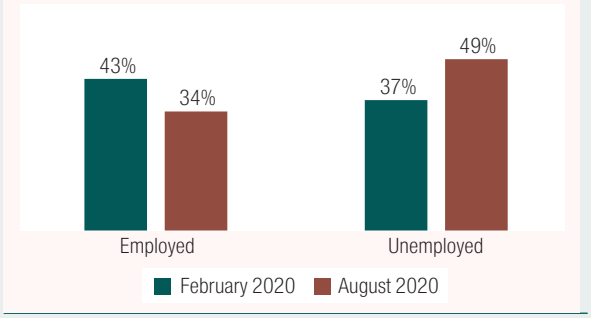
Wages or salaries was the main source of income for 58 percent of reported households. The proportion of households reporting assistance as their main source of income was high at 23 percent (both for assistance provided by the government and by non-governmental organizations); 14 percent of households reported return on investments as the main source of income, and 11 percent rely on remittances from abroad (Figure 29).

FIGURE 27 • Main Reasons Why Accessing Food and other Basic Needs Was Challenging, July-August 2020



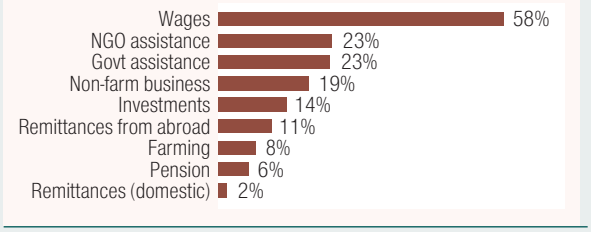
Sources: WFP and WB (2020).

FIGURE 28 • Labor Force Participation Status in August 2020 and pre Lockdown (Feb 2020)



Sources: WFP and WB (2020).

FIGURE 29 • Main Income Sources Over the Past 12 Months in July



Sources: WFP and WB (2020).

Over the medium term, Lebanon will have to prioritize building better institutions, good governance, and a better business environment alongside physical reconstruction. However,

(NPTP); providing an education cash transfer for children from extreme poor households who are vulnerable to dropping out of schooling; increasing access to quality healthcare for poor Lebanese.

given Lebanon's state of insolvency (sovereign, banking system) and its lack of adequate foreign exchange reserves, international aid and private investment will be essential for comprehensive recovery and reconstruction. The extent and speed to which aid and investments are mobilized will depend on whether the authorities and the Parliament can swiftly act on much needed fiscal, financial, social, and governance reforms. Without reforms, there can be no sustainable recovery and reconstruction, and the social and economic situation will continue to worsen.

The Special Focus of the LEM presents one approach to designing a comprehensive reform agenda aimed at addressing the root causes of the economic crisis. The purpose of the reform agenda is to help set the stage for a more equitable, more efficient and more resilient economy. It puts governance reforms at the fore, alongside macroeconomic stabilization. The reform agenda presented is meant to feed into an open discussion among the citizens of Lebanon and between them and their government. Its aim is to contribute to the debate that needs to take place on the path out of the ongoing crisis, the sequencing of reforms and the long-term development vision.

TABLE 2 • Selected Macroeconomic Indicators for Lebanon; 2015-2021

	2016	2017	2018	2019	2020	2021
				Est.	Proj.	
Real sector						
Real GDP	1.5	0.9	-1.9	-6.7	-19.2	-13.2
Real GDP per capita[a]	-1.2	-0.6	-2.5	-6.8	-19.6	-13.6
Agriculture (share of GDP)	4.0	4.5	4.4	5.0	4.7	4.7
Industry (share of GDP)	12.8	12.3	12.0	10.6	13.3	13.3
Services (share of GDP)	71.5	71.6	72.2	74.3	78.3	78.0
Net indirect taxes (share of GDP)	11.7	11.6	11.4	10.1	3.7	4.0
Money and prices						
CPI inflation (p.a)	-0.8	4.5	6.1	2.9	75.0	40.0
Money[b]	7.3	4.2	3.0	-6.7	130.0	60.0
Investment & saving						
Gross capital formation	22.7	21.4	20.8	18.5	6.3	4.2
o/w private	21.3	19.9	19.1	17.2	5.2	2.4
Gross national savings	2.2	-1.5	-3.5	-2.7	-8.1	-3.7
o/w private	-1.0	-4.8	-5.3	7.9	-3.4	-1.0
Central government finance						
Revenue (including grants)	19.4	21.9	21.0	20.6	11.5	13.5
o/w tax revenues	13.7	15.5	15.4	15.5	7.8	8.8
Total expenditure and net lending	28.6	28.6	32.0	31.2	17.3	18.1
Current	27.3	27.1	30.3	29.9	16.2	16.2
o/w interest payment	9.3	9.4	9.8	10.0	2.3	2.4
Capital & net lending (excluding foreign financed)	1.4	1.5	1.7	1.3	1.2	1.9
Overall balance (deficit (-))	-9.3	-6.7	-11.0	-10.5	-5.9	-4.6
Primary balance (deficit (-))	0.0	2.7	-1.2	-0.5	-3.6	-2.2
External sector						
Current account balance	-20.5	-22.9	-24.4	-21.2	-14.4	-8.0
Trade balance	-23.6	-24.7	-24.8	-24.9	-4.4	2.7
o/w export (GNFS)	37.3	36.0	35.7	35.4	35.0	44.6
Exports of goods	7.7	7.6	7.0	9.3	13.9	17.5
Exports of services	29.6	28.4	28.7	26.1	21.1	27.1
o/w import (GNFS)	60.9	60.8	60.5	60.3	39.3	41.9
Imports of goods	35.0	34.7	34.4	35.0	22.7	24.2
Imports of services	25.9	26.1	26.1	25.2	16.6	17.7
Net private current transfers:	4.8	2.3	2.5	5.6	-10.4	-11.2
Net remittances	6.6	5.2	4.2	6.1	10.1	14.1
Net income reciepts	-1.7	-0.5	-2.1	-1.9	0.4	0.5
Gross reserves (months of imports GNFS)[c,d]	15.2	15.6	14.3	14.3	23.8	12.5
Total public debt						
Total debt stock (in million US$)	74,900	79,530	85,139	88,900	62,276	55,464
Debt-to-GDP ratio (percent)	146.3	149.7	154.9	171.0	194.0	211.7
Memorandum items:						
GDP (in million US$)	51,205	53,141	54,961	51,992	32,103	26,200

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

[a] Population figures, which include Syrian refugees registered with the UNHCR, are taken from the United Nations Population Division

[b] Prior to 2020 this is M3, including non-resident deposits; 2020 and after, this is M0 (currency in circulation)

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

[d] Total Imports using the BOP data from the Quarterly Bulletin of BDL

SPECIAL FOCUS A REFORM AGENDA TO TURN THE COUNTRY AROUND: PROPOSAL FOR DISCUSSION[30]

Lebanon is in the midst of three mega-crises, each capable of extending the current trough into a long-term catastrophe. Lebanon faces an economic crisis, the COVID-19 pandemic, and the aftermath of the Port of Beirut (PoB) explosion. The most disruptive of the three is the economic crisis. It stems from longstanding structural fiscal and external account imbalances and an overvalued currency, all sustained through sovereign debt issuance and financed by expatriate deposits. The long duration of the imbalances contributed to oversized bank balance sheets that had extensive exposure to Government and BdL debt. The preceding section of the LEM explains how policy inaction is sowing the seeds of an economic and social catastrophe for Lebanon. This Special Focus of the LEM presents a comprehensive reform agenda that will address the nested causes of the economic crisis and deliver a more equitable, efficient, and resilient economy. The reform agenda puts governance improvements at the fore, alongside macroeconomic stabilization. Before any financing for an economic recovery can take place, Lebanon must restore the trust between government and citizens, between government and investors, and between government and donors. Under a no-reform scenario, Lebanon's economy is forecast to contract for the next two years; to mitigate this, decisive action must be taken to save Lebanese citizens and refugees from an economic and humanitarian catastrophe.

Citizens' decisions. The reform agenda presented below is meant to fertilize an open discussion among the citizens of Lebanon as well as between the citizens and their government. The perspective of the reform agenda is technical, based largely on principles of efficiency, equity, and governance. The decisions will have social and economic consequences and must therefore be ultimately political. Several good proposals have been published in Lebanon, mostly at the beginning of the economic crisis. The current proposal is different in that it is being published after a year of stalemate and policy inaction, and puts governance reforms at the fore. Its aim is to contribute to the debate that needs to take place regarding (i) the path to exit the crisis; (ii) the sequencing of reforms;

[30] This Special Focus section is a product of the Lebanon country Team.

and (iii) the long-term development vision. The Special Focus begins with a grim reminder of the reasons for policy inaction, which were unfortunately visible as early as 2016 and need to be addressed.

Governance Failure and Causes of Policy Inaction

Lebanon's economic crisis has its roots in elite capture and regional conflict, both of which served to block reform and development when it did not benefit all confessional leaders. The World Bank's 2016 Systematic Country Diagnostic (SCD) placed the root of Lebanon's economic underdevelopment in the presence of two mutually reinforcing and overarching constraints: (1) elite capture behind the veil of confessionalism and confessional governance and (2) conflict and violence, stemming, in part, from the broader dynamics of conflict in the Middle East.[31] These overarching constraints created a fragile and dysfunctional political system, and a state that was unable to regulate political conflict and exercise sovereign authority. The SCD estimated the cost of confessional governance at nine percent of GDP annually, at the time of its publication. Lack of political consensus on national priorities limited the government's ability to implement long-term and visionary development policies. Inaction fueled several additional constraints to development (these can also be referred to as derivative or nested constraints) because they emerged due to the overarching constraints. In 2016, these constraints were identified to be macroeconomic instability, the weak business environment, insufficient investment in infrastructure (especially in lagging regions), skills mismatch with labor market needs, and weak institutions and regulatory framework. All contributed to poor service delivery across the board and to poor development outcomes. In 2020, this list of constraints needs to be extended to include defaulted public debt, an insolvent banking sector, high inflation, and multiple exchange rates.

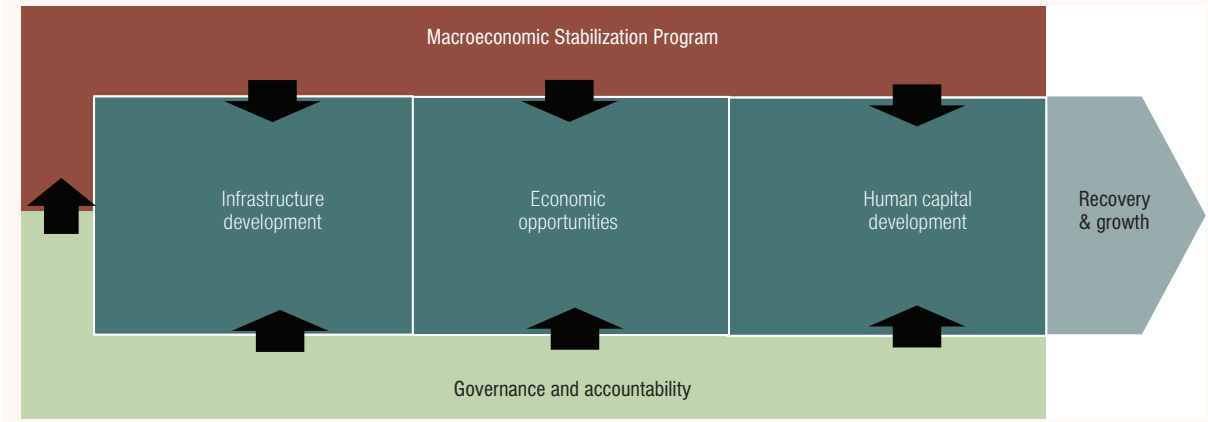
Resolving elite capture is key for a sustained recovery. In 2016 the SCD recommended two strategies for reform, neither of which were followed:

- ***The First Strategy (FS)*** carries the potential of a large development payoff, but, given the deep-rooted and symbiotic nature of the overarching constraints, it will take time to bear fruit. Examples include implementing key outstanding elements of the Taef Accord, such as adopting a decentralization law and creating a lower chamber of parliament to be elected on a non-confessional basis, improving access to (statistical) information, and promoting political stability and institutional reform and development.
- ***The Second Strategy (SS)*** is more suited to delivering gains in the short term, but given the weight of the overarching constraints, these gains are likely to be more limited in scope. Examples include conducting a political economy and conflict exposure analysis of nested sectors, devising a grand-bargain package of reforms, adopting an opportunistic approach (that is, readiness to seize windows of opportunity when they arise), working around elite capture, showing a willingness for "horizontal" social engagement, and managing the influx of Syrian refugees.

This Special Focus of the LEM presents detailed elements of a Second Strategy of reform. The purpose here is to identify the necessary policy and institutional changes needed to put the economy on a stable footing, start to root out corruption, and

[31] Lebanon's elite capture branches from its sectarian-fueled fifteen-year civil war. The 1989/1990 Taef Accord ended the conflict and aimed to establish an equitable confessional system. However, its partial implementation enabled the wartime elite to solidify their power behind the veil of confessionalism and resulted in a government and state operating at the 'lowest common denominator' in terms of efficiency and quality of services, a result of religious veto power. Syria facilitated decision making as an external power broker; its military withdrawal in 2005 created a new political dynamic, exposing Taef's weaknesses represented in severe polarization and consolidation of the sectarian state-within-a-state phenomenon, resulting in persistent political deadlock (World Bank, 2016).

FIGURE 30 • Reform Pillars



restore economic efficiency. These reforms address the secondary, derivative, and nested constraints. Several of these reforms were presented during the *Conférence économique pour le développement, par les réformes et avec les entreprises (CEDRE)* which took place in Paris in April, 2018, were reviewed in the World Bank's Assessment of the Capital Investment Plan (CIP), 2018, were presented in the Government's Financial Recovery Plan in April 2020, and were more recently included in the French Initiative. In order for the reforms to be launched, and to be effective and sustainable, they will need to be accompanied by foundational agreements among Lebanon's elite, which will require the concurrent implementation of the First Strategy.

A Reform Agenda for Stabilization, Economic Efficiency, and Restoration of Trust

At the heart of the proposed reform agenda are governance and accountability reforms that seek to strengthen overall economic management in Lebanon in a way that is more inclusive and more accountable; in doing so, the proposed reform agenda seeks to rebuild trust. The agenda is based on the strong assumption that the Lebanese policymakers want to rebuild a more productive, equitable, and resilient economy. The reform agenda compromises five pillars, which are anchored on macro stabilization and better governance and accountability (Figure 30).

- ***A Macroeconomic Stabilization Program***: Given that Lebanon's macroeconomic conditions are rapidly and continuously deteriorating, this reform agenda needs to start with a comprehensive and credible macroeconomic stabilization plan. Lebanon needs to arrest high inflation, rapid currency depreciation and the proliferation of multiple exchange rates. It needs to put in place a path to public debt sustainability based on debt restructuring and a sustainable fiscal framework, and to include a strong social protection package. The challenges of fiscal adjustment, and the necessary banking sector restructuring will require full realization of resulting losses according to international accounting norms, which will need to be distributed according to the hierarchy of claims and in an equitable manner taking into consideration past realized benefits.
- ***A Governance and Accountability Reform Package***: Internal failures resulting *on the one hand* from corruption and inefficiencies in policymaking and in public sector management *and on the other hand* from the implications of the broader conflict dynamics of the Middle East have become mutually reinforcing and persistently limit development. Lebanon needs to address the primary sources of corruption and inefficiency in the

public sector in order to create budgetary savings, improve development impact, and begin to rebuild trust between government and citizens. Reforms under this package aim to rebuild trust by: (1) strengthening management of public funds through public finance, investment, and debt management reforms; (2) reforming public procurement, in part to increase fair private sector participation; (3) improving transparency and inclusion through complying with and joining the Open Government Partnership (OGP); and (4) boosting accountability through anti-corruption and judicial reforms. These reforms can be viewed as the building blocks of a public sector reform that is needed to rebuild the Lebanese state.

- ***An Infrastructure Development Reform Package***: Lebanon's dilapidated infrastructure is a developmental constraint. Among the vital basic services that are needed, Lebanon lags behind in (1) electricity, (2) telecommunications, (3) port system, (4) transportation, and (5) water and sanitation. Lebanon needs urgent investment in these sectors, which the state can ill afford, and which the private sector is unwilling to undertake, given opacity and weak regulatory governance. Immediate transparency initiatives and policy and regulatory changes are required to attract donor and private financing, which can trigger initial investments and contribute to job creation and recovery. The 2018 Capital Investment Plan (CIP) can be an effective tool in preparing an Infrastructure Development Reform package. A World Bank assessment in 2018 found that the CIP choice of sectors was appropriate for Lebanon, and that many of the listed projects were relevant, and some critical, to help alleviate infrastructural bottlenecks. Given the depth of the current crises and financing constraints, investment priorities and phasing will need to be reviewed. Reforms to limit fiscal and quasi-fiscal deficits of state-owned enterprises, strengthen management, regulation and governance, and encourage private investment will need to be prioritized.[32]
- ***An Economic Opportunities Reform Package***: Lebanon's private sector needs to drive economic growth. The economic crisis will bring new opportunities that primarily stem from domestic price adjustments and the depreciated currency. Enterprises and finance must identify these opportunities and use them to create new jobs. Lebanon will need to lighten the burden that it places on its enterprises by simplifying processes and procedures, reduce operating costs, and undertake fundamental reforms to level the playing field. Lebanon will also need to ensure that the banking sector has the ability to perform its intermediation function. These reforms can be supported by an economic development plan that ensures markets work efficiently and are unhindered by specific sectoral constraints to growth.
- ***A Human Capital Development Reform Package:*** The deteriorating quality of Lebanon's human capital will need to be arrested and reversed. According to the World Bank's Human Capital Index (HCI) a worker of the next generation in Lebanon will be only 52 percent productive relative to her potential productivity with complete education and full health. This figure is down from 56 percent in 2012 and is below the current averages for both upper-middle income and MENA countries, which stand at 56 and 57 percent respectively. As such, a key aspect of sustainability and growth for Lebanon's economy is recapturing the human capital potential. For Lebanon, part of the challenge is the fiscal constraint of supporting necessary public services. The other part of the challenge is sector efficiency and management. A strategy for stabilization, economic efficiency, and restoration of trust needs to include

[32] The Capital Investment Plan (CIP) includes over 280 infrastructure projects across the country divided among energy, transport, water, wastewater, solid waste treatment, telecommunications, special economic zones and culture and tourism. Sectorally, the largest investment share is allotted to the transportation sector, amounting to 32 percent of the total CIP, of which 8 percent is allocated to land expropriation. Almost one quarter of the investments are reserved for the energy sector, while water and wastewater amount to 22 percent and 12 percent, respectively.

TABLE 3 • High Priority: 7-Actions, 5-Programs and 3-Reviews

7-Actions	5-Programs	3-Reviews
1. Adopt 2021 Budget, and 2021-2022 sustainable macro-fiscal framework	1. Expand the Social Safety Net System (the National Poverty Targeting Program)	1. Review of new Competition Law and reform exclusive agencies regulations
2. Exchange rate unification and capital controls law and BdL audits	2. Implement broad-coverage compensation scheme for Subsidy Reform	2. Review and assess role and governance arrangements of CDR and other public institutions (incl. SOEs/PCs) that carry out public investments
3. Restructure public debt	3. Adopt Electricity Regulatory Strengthening Package, launch EdL Audit and ensure transparency in the procurement processes	3. Launch Public Investment Management reform program and prioritization review for an infrastructure investment plan
4. Adopt effective bank resolution framework	4. Adopt and launch tax compliance and reform package	
5. Remove bank secrecy law	5. Launch Citizens' Groups that develop expertise on key issues or line ministry programs	
6. Implement public procurement law		
7. Establish a High-level Justice Reform Committee, announce an Action Plan to Improve Justice and Rule of Law and implement Anti-Corruption Strategy		

necessary strategic and efficiency reforms that support the development of human capital, and at the same time create fiscal space to inscribe such expenditure to support such reforms in a sustainable budget framework. However, the first element of the human capital development reform package needs to be a strong social protection package that is an integral ingredient of the macroeconomic stabilization program.

Implementation of the reform agenda will require a new form of economic governance that is inclusive, transparent, and accountable. Decisions will need to be based on rigorous analysis, publicly available evidence, and consensus on the economic and social trade-offs. This approach could develop into a sixth reform pillar, to be developed in collaboration with civil society and with government. Challenges to policy formulation and consensus building have been the hallmark of policymaking in Lebanon. While Lebanon struggles to reach consensus, governance models based on transparency and public dialogue aimed at building consensus on particular issues should be piloted. Based on the "Whole of Lebanon" approach introduced in the Beirut Rapid Damage and Needs Assessment (RDNA) it is possible to envision fora that bring together government, civil society, the private sector, activist groups, youth groups, think tanks, academia and the international community. These fora can be issue focused, and address pubic spending, taxation, social safety nets, electricity provision, rebuilding the Port of Beirut better, etc.[33]

While the rest of the Special Focus presents a detailed set of short and medium term reforms, the most critical immediate reforms needed to jump start the economy and rebuild trust are presented in Table 3. Several of these reforms would form part of a macroeconomic stabilization plan.[34] Many reforms would need to be adapted to a new growth strategy and a new development model for Lebanon.

[33] The RDNA adopted a "Whole of Lebanon" approach in which a multi-disciplined team closely engaged with representatives and stakeholders from distinct spheres and segments of Lebanese society. This approach has helped to inform RDNA findings, analyses, and recommendations on emerging needs and priorities of the affected population.

[34] This list is adapted from Priority Reforms for the Government of Lebanon, World Bank Policy Paper, 2017, given the deteriorated macroeconomic conditions in the country. That paper had identified the following priority reforms: (1) ratification of the 2017 budget, (2) ratification of the 2013 public procurement law (completed), (3) fiscal reforms to cap transfers to EdL, (4) cabinet adoption of draft PPP Law (completed), (5) launch of tender for LNG, (6) increasing power generation, (7) prepare Beirut public transport project, (8) scale up of NPT, (9) parliamentary approval of solid waste management law, and (10) improved business environment.

Pillar I: Macroeconomic Stabilization: A Necessary, but not Sufficient, Condition to Growth

High inflation, loss of foreign currency reserves and a worsening fiscal deficit, all argue for urgent action and a comprehensive program to stabilize the economy. Delayed action maintains high inflation and foreign reserve losses with enormous costs to households and enterprises. However, a program that is not comprehensive and does not put public debt on a sustainable path, introduce a credible monetary and exchange rate policy, and restore solvency in the banking sector will not succeed in stabilizing the economy. Partial solutions will signal that current challenges risk being repeated and will likely not restore investor confidence or set foundations for a new growth model.

Element 1: Monetary Stabilization

Over the past 12 months, fiscal, monetary, and exchange rate policies fueled high inflation, the proliferation of multiple exchange rates, and a rapid depreciation of the Lebanese Lira. Stop-gap measures as well as new policies are needed. The Lebanese Lira depreciated from the official rate of 1,507.5 per USD in August 2019 before the crisis fully materialized to about LL 8,500 in October 2020 on the dollar note market (that market peaked at about LL 10,000 per USD). The depreciation resulted from the loss of confidence in the economy and the deterioration in the fundamentals (discussed earlier in the LEM). The central bank's efforts to ration foreign exchange and slow the loss of reserves led to multiple exchange rates and are unsustainable. Additional depreciation pressures arise from the need to finance the fiscal deficit (mainly salaries, transfers, and debt payments notwithstanding the selective debt default) in light of the collapse in revenues. To reduce inefficiencies in the foreign exchange market:

- ***Lebanon's policy response needs to comprise in the short term*** 1) BdL independent audits; (2) capital controls law; and (3) policy actions on exchange rate and monetary policy framework.
- ***Lebanon's policy response needs to comprise in the medium term*** strengthen BdL's balance sheet.

Element 2: Public Debt Restructuring

With public debt projected to reach 194 percent of GDP at end-2020 and interest costs at 10 percent of GDP, Lebanon needs to negotiate a medium-term debt plan with creditors to return to fiscal sustainability. On March 9, 2020, Government defaulted on its marketable foreign currency debt. Reducing debt to a sustainable level is necessary to regain prospects for market access and to address the economy's financing limitations caused by a defaulted credit rating. This requires negotiating with creditors (domestic and external) over a medium-term debt plan, based on a solid macroeconomic framework, in order to restore public debt sustainability.

- ***Lebanon's policy response needs to comprise in the short term*** (1) Macroeconomic and Debt Sustainability Framework; (2) domestic debt - Medium Term Plan; and (3) temporary body to handle debt restructuring.
- ***Lebanon's policy response needs to comprise in the medium term*** agree on external and domestic debt restructuring plans and on losses with creditors, subject to equitable burden sharing.

Element 3: Financial Sector Restructuring and Resolution

Lebanon's banking sector needs to address its worsening portfolio before playing an active role in Lebanon's economic recovery. The fundamental restructuring of the banking system (BdL and banks) is imperative to resolving the ongoing financial crisis and paving the way to recovery. Given the banking sector's large exposure to the sovereign (government and central bank), this implies recognition of banking sector losses and requires restructuring of the sector to attain solvency. The aforementioned debt restructuring will result in unprecedented losses to the local banking sector. The recognized losses

would form a key parameter in the financial sector restructuring strategy, ensuring the recapitalization of systemically important banks, equitable burden-sharing, and the orderly exit of insolvent non-systemic banks. This strategy should be supported by the legislative initiatives that are necessary to establish an effective bank resolution framework. The intertwining of balance sheets of government, commercial banks, and the central bank suggests a similar restructuring of BdL's balance sheet will be required.

- ***Lebanon's policy response needs to comprise, in the short term*** (1) update bank resolution framework; (2) implement banking sector restructuring; and (3) restructuring of BdL's balance sheet.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) improve supervisory early intervention mechanisms; and (2) improve emergency liquidity assistance arrangements.

Another result of the ongoing crisis is the drastic deterioration of the credit portfolio, which must be be resolved. NPL ratio (including unearned interests) increased to 28.3 percent as of June 2020, up from 13.3 percent at end-June 2019. NPL ratio for construction, wholesale and retail trade, and processing industries stood at 47 percent, 40 percent, and 42 percent, respectively. Improving the frameworks for insolvency and out-of-court workout could help resolve both the widespread corporate distress and NPLs in the banking sector and facilitate the ultimate recovery of the economy. Authorities should also consider imposing regulatory requirements to promote timely NPL recognition and provisioning, providing supervisory guidance for banks to develop a credible NPL management and recovery strategy.

- ***Lebanon's policy response needs to comprise in the short term*** (1) develop an out-of-court workout framework; and (2) improve regulatory guidelines on NPL recognition and provisioning.

An update of Lebanon's deposit insurance framework is important. This would serve two purposes: first, to clarify depositor protection in the context of the resolution of the current crisis and second, to restore public confidence in the banking sector going forward. Updating the framework would include clarifying coverage, recapitalizing the deposit insurance fund, improving governance arrangements and enhancing the role of deposit insurance in resolution, such as options to finance asset and liability transfers, under the "least cost" criterion, to support resolution.

- ***Lebanon's policy response needs to comprise in the short term*** an update of the deposit insurance framework.

Lebanon's insurance sector has also been adversely affected by the crises. Given the insurance sector's large exposure to the sovereign, a restructuring and development strategy for the sector will be essential to strengthen the sector and close the protection gap highlighted in the PoB explosion. The insurance sector also faces challenges as it has seen the value of its assets deteriorate in light of the deteriorating quality of government bonds and a surge in claims due to the PoB explosion. Beyond immediate priorities of supporting claim settlement in the aftermath of the PoB explosion, authorities should closely monitor and manage insurer solvency, including establishing policies on solvency forbearance, industry consolidation and defining the scope and modalities for potential direct assistance to policyholders of failed insurers. To address these issues:

- ***Lebanon's policy response needs to comprise in the short term*** (1) develop insurance sector restructuring development strategy; and (2) update and enact Insurance Law.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) initiate insurance sector restructuring; and (2) improve regulatory governance.

Element 4: Fiscal Deficit Reduction

Lebanon's widening primary balance is driven by inefficient and unaffordable current expenditures (with subsidies and generous

pensions causing economic distortions) and weak and declining revenues. A credible and sustainable path to fiscal sustainability needs to introduce efficiencies in public spending and revenue collection, and to create fiscal space for an adequate social protection scheme. In the latest 'pre-crisis' year, 2018, Lebanon's non interest expenditures were 21.9 percent of GDP and were broken down as follows: public employment bill was 11.4 percent of GDP,[35] subsidies to EdL came to 3.1 percent of GDP, other current transfers came to 5.5 percent of GDP, while capital expenditures were 1.5 percent of GDP. Total revenues and grants came to 20.5 percent of GDP and the primary balance was −1.4 percent of GDP. The 2018 figures mark a departure from the early part of the decade, when the primary balance was almost +1 percent (2000–17). This departure highlights the burden of debt on public coffers. Lebanon's long-term challenge was its inefficient and inequitable composition of public spending, and the lack of sustained incremental efforts to obtain a primary surplus, which were hindered by governance challenges outlined earlier. In 2020, with a projected primary balance of −3.6 percent of GDP, Lebanon's debt is projected to increase if no action is taken. To reverse the trend, Lebanon needs to amend the 2020 budget and prepare a 2021 budget consistent with a macroeconomic and debt sustainability framework negotiated with debt holders. With the framework, Lebanon will need set the building blocks to achieving fiscal sustainability over the medium and long-term. To start, Government should introduce measures to boost direct and indirect tax compliance and revamping Lebanon's tax structure, including, but not limited to, income tax unification and raising VAT.[36] Several institutions have proven useful in reaching fiscal targets; for Lebanon, a fiscal council can aid evaluation and adjustment in the context of short to medium-term macroeconomic objectives. As such:

- ***Lebanon's policy response needs to comprise, in the short term*** (1) adjusting 2021's budget and preparing 2022's on time; (2) fiscal council becomes operational; (3) implementing the Macroeconomic and Debt Sustainability Framework; (4) reducing transfers to EdL (phased);[37] (5) VAT and Customs Reform (phased); (6) unified Income Tax Code and automatic income tax declaration; (7) subsidy reform; (8) address SOE revenue/dividend transfer framework and cash management hurdles; and (9) civil service review by an independent international institution.[38]
- ***Lebanon's policy response needs to comprise, in the medium term*** (1) property taxation reform; (2) review move from a scheduler to a global income tax base; and (3) adjusting excises.

[35] Of the public employment bill, 34 percent went for retirees, pensions, and end of service compensations, which cover about 10 percent of the labor force.

[36] Lebanon's income tax structure has large disparities across sources, distorting the flow of savings away from productive investment. Bank deposits in Lebanon have yielded relatively high returns, a policy intended to support public debt and the overvalued exchange rate. Meanwhile, tax rates on interest earned are 10 percent, far below the 17 and 15 percent rates on corporations and individuals, respectively. It is estimated that the largest 1 percent of depositors hold 50 percent of total deposits, while the largest 0.1 percent of accounts hold 20 percent of total deposits (WB-IMF FSAP, 2017), skewing the lower financial income tax rate towards the very rich.

[37] Transfers to EDL can be reduced through (a) reducing network and commercial losses on EDL's system and improving collections and to increase EDL's revenue, (b) accelerating switching to natural gas for power generation to reduce EDL's generation costs, (c) increasing electricity tariffs, targeting higher consumption blocks, and adopting an automatic indexation mechanism to pass to targeted consumers fuel cost and foreign exchange fluctuations.

[38] Maintaining a sound fiscal positioning is key for achieving macroeconomic stability. While voters and financial markets punish fiscal mismanagement, they are often late. Independent scrutiny by a transparent fiscal council can contribute towards achieving fiscal discipline by incentivizing governments to allocate and manage public resources in an efficient manner. The council can consist of independent experts entrusted to provide information to push policymakers in the

Element 5: Social Protection and Pension Reform

Lebanon's economic crisis has led to a deepening of overall and extreme poverty with continued poor prospects unless a reform program were to be adopted. The World Bank estimates that total poverty reached 45 percent of the population in 2019, up from about a third in 2018 and from 27.4 percent in 2011–2012, while extreme poverty reached 22 percent in 2019. A slow recovery of the economy and reduction in public spending (including pensions and subsidies) will place an additional burden on the poor and near poor, which will have immediate effects on food consumption, but also more permanent effects from lower consumption of education and health services. Currently, Lebanon spends only 0.35 percent of GDP on targeted social safety nets (compared to well over 3.5 percent of GDP on subsidies and untargeted SSNs). To mitigate the impact:

- ***Lebanon's policy response needs to comprise, in the short term*** (1) COM approval of a National Social Protection Strategy;[39] (2) expand National Poverty Targeting Program (NPTP) per the Emergency Social Safety Net (ESSN) program and provide financing in 2021 Budget; and (3) establish National Social Registry.

Public pension expenditures amounted to 3.9 percent of GDP in 2018, while only benefiting 10 percent of the Labor force. The majority of pension costs are financed through the budget and the pensions deficit exceeds 3 percent of GDP. On the other hand, coverage among the private sector does not exceed 20 percent of the employed. In short, Lebanon's current pension system serves few of the country's citizens, crowds out other social programs, and adds to budget deficit. Current circumstances require a decisive set of measures that would bring both short term fiscal relief and address the long run structural deficiencies in the design of the pension schemes. The outcome of the reform measures would need to be a fiscally, economically, socially, and actuarially fair national pension system serving all citizens.

- ***Lebanon's policy response needs to comprise, in the short term*** (1) initiate Public Pension Reform; (2) conduct audit of NSSF; and (3) parliament to pass Pension Law for private sector workers.
- ***Lebanon's policy response needs to comprise, in the medium term*** (1) Public Pension Reform; (2) initiate financial and governance reform of NSSF; and (3) implement new Pension Law.

Element 6: Consensus on an Economic Recovery and Growth Plan

The lack of consensus on an alternative economic vision for Lebanon is a contributing factor to the current crisis. Lebanon's economic performance since 2011 is noteworthy in that it proved resilient to regional crises and the absorption of 1.5 million Syrians (which amounted to about 30 percent of Lebanon's population); economic growth averaged 1.8 percent per year between 2011 and 2017 (see Table 4). But the rate of growth and the quality of growth were unsatisfactory because unemployment remained high, the economy did not produce the quantity and types of jobs needed to absorb the majority of the labor force, and the economy did not innovate, except in the area of financial services and possibly construction. One reason was the large public debt and the overvalued exchange rate needed to support it and the currency peg, which provided contradictory incentives to diversification and large scale export development.[40] Another reason was the lack of contestability in the domestic economy which did not create market incentives for innovation or competitiveness. To chart an

direction of implementing more responsible and efficient policies. (Cangiano, Curristine & Lazare, 2013).

[39] Including the design of a centralized and transparent grievance redress mechanism and a corresponding online platform to capture information on the changing needs of those impacted, the accessibility and awareness of services, and perception of fairness in the provision of services.

[40] Final consumption expenditure averaged 104 percent of GDP between 2011 and 2017.

efficient course for macroeconomic stabilization and to realign its macroeconomic fundamentals to support the development of a more equitable, efficient and resilient economy:

- ***Lebanon's policy response needs to comprise in the short term,*** following the revision of existing growth plans, agreement on an economic vision for Lebanon and action plan tailored for promoting sustainable and equitable economic growth and resilient financial inflows. A comprehensive investment strategy (private, public) review, reprioritization and operationalization and export development strategy coupled with a corresponding strategy tailored for the agricultural and industrial sectors, which can serve as a source of job creation and export proceeds, is also required. The foundation for the strategy has to be a sustainable macroeconomic framework, a competitive exchange rate reflective of Lebanon's new economic fundamentals, and as noted below, a level playing field for the private sector. These policies can set Lebanon in a direction of equitable growth based on productivity gains.

Pillar II: A Governance and Accountability Reform Package

Early sequencing of governance and accountability reforms can reduce corruption, boost public sector efficiency and begin to restore trust between the government and its three critical partners: citizens, investors and donors. According to Transparency International's Corruption Perception Index, Lebanon ranks 137 out of 180 countries, indicating high corruption levels. A robust agenda on governance and accountability reforms can overturn some of the principal sources of corruption and elite capture in Lebanon. These reforms would form the building blocks of state building and be critical contributors to the success of other reform pillars. The purpose of the governance and accountability reform package would be to boost efficiency in public financial management, provide for judicial independence, reduce corruption, and strengthen oversight bodies.

Element 1: Public Procurement Reform

Strengthening public procurement is a critical element of government reform. Public procurement

TABLE 4 • Empirical Evidence behind Lebanon's Pre-Crisis Economic Slowdown

Contribution to Total Real GDP Annual Growth (in percentage points)					
Expenditure Type	1992–2017	1992–2000	2001–2007	2008–2010	2011–2017
Annual GDP Growth	**4.4**	**5.2**	**4.4**	**9.0**	**1.8**
By Expenditure					
Consumption	4.5	3.4	2.3	9.7	3.9
Households/NPISHs Consumption	*3.9*	*2.2*	*2.1*	*9.1*	*3.4*
Government Consumption	*0.6*	*1.2*	*0.2*	*0.6*	*0.4*
Investment	1.0	0.7	1.0	2.8	0.2
Exports	1.7	2.7	2.8	3.4	-0.3
Imports	-2.8	-1.5	-1.5	-6.9	-2.0
By Sector					
Agriculture	0.2	0.4	0.0	0.2	0.1
Industry	0.6	0.7	0.8	1.0	0.0
Services	3.7	4.1	3.6	7.8	1.7

[a] Data Sourced from World Development Indicators (1992–2017).
[b] Growth rates are weighted by the average share of total Value Added in the beginning and end years.
[c] Expenditure growth rates weighted by their average share in total expenditure (evaluated in the mid-point between beginning and end of the period).

is governed by the 1963 Public Accounting Law and is supplemented by several decrees. The main areas of the law that require attention are: (1) a weak control environment that cannot implement rules and procedures; (2) lack of an independent regulatory body and independent mechanism for handling procurement complaints; (3) lack of procurement performance information/data; (4) weak competition for contracts; and (5) weak implementing agencies. Resolving these issues demands reforming toward a well-governed public procurement system that helps increase public trust, enhance quality of services, build a prosperous, broader, and more equitable access to the procurement market for the private sector (including SMEs, women, and youth), facilitate access to information, and increase inclusion of stakeholders including civil society.

- ***Lebanon's policy response needs to comprise in the short term*** (1) development and validation of a public procurement strategy; (2) public procurement law enacted; (3) secondary legislation drafting and adoption; (4) standard bidding documents developed (phased); (5) establishment and operationalization of an independent procurement regulatory body and Policy and Oversight and Complaints Handling Units; and (6) assessment of e-procurement initiatives.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) capacity building and professionalization of the procurement function; (2) development of e-procurement strategy and functions; and (3) deployment of the validated e-procurement platform at decentralized level and training (phased).

Element 2: Public Financial Management (PFM) and Public Investment Management (PIM) Reform

Strengthening the PFM system is a crucial strategic choice to improve transparency, accountability, and efficiency in managing public finances and investments. Lebanon's PFM system is based on the Constitution and the outdated and rigid 1963 Public Accounting Law (PAL). The control environment is weak, leading to a lack of enforcement of rules and guidelines and severe fragmentation in the budget and treasury functions. In parallel, public oversight institutions are also weak, as both internal control and audit functions are almost absent in the public sector, which increases the risk of misuse of public funds in budget execution. These key PFM challenges have negative effects on fiscal policy, budget transparency, debt and cash management, public investment management, and public service delivery in Lebanon. As a result, PFM reforms are a high priority. In order to develop a well-functioning PFM system that promotes trust and accountability:

- ***Lebanon's policy response needs to comprise in the short term*** (1) revamp and revitalize a national PFM steering committee; (2) update cash safety buffer; (3) integrate cash and debt management and prepare analysis reports; (4) ratify a revised Court of Account Law and enlarge scope of audits; (5) complete assessment and recommendations for institution Internal Audit (IA); (6) update macro fiscal models; (7) formalize data flow from/to Macro-Fiscal Department (MOUs); and (8) review of Budget System Law (BSL).
- ***Lebanon's policy response needs to comprise in the medium term of*** (1) develop and implement action plan for consolidating cash accounts; (2) enact/ amend related treasury single account laws & decrees; (3) treasury single account operational; (4) strengthen the independence and capacity of the Central Inspection and Court of Accounts (including forensic audits); (5) finalize the audit of previous financial statements; (6) issue Ministerial decrees for establishment of IA; (7) develop IA Strategy, charter and manuals, and carry out capacity building; carry out the IA function ; (8) introduce quarterly economic evaluation reports, including policy impact assessments, public finance monitor (PFM) and fiscal risk reports; (9) implement new accounting procedures; (10) transition to IPSAS; (11) update BSL and/or regulations; and (12) implementation review of updated BSL and regulations.

Lebanon's Public Investment Management (PIM) is also weak. The development of public

infrastructure is hindered by low investment quality and inefficiency. Lebanon displays an efficiency gap of 43 percent compared to the most efficient countries with similar capital stocks. The gap partly stems from weak procedures and practices governing public investment. Many of the country's policies and procedures, as well as practices governing public investment are either partially or not at all aligned with good practices. PIM faces significant challenges: (i) fragmentation of public investment between several institutions; (ii) absence of fiscal policy formulation; (iii) non-alignment of the strategic planning with available resources; (iv) non-existence of a unified and comprehensive approach for project appraisal and selection; (v) weak project oversight and monitoring; (vi) outdated legal framework; and (vii) weak oversight of investment, including procurement. These challenges contribute to the efficiency gap in PIM.

- ***Lebanon's policy response needs to comprise in the short term*** (1) review functions of the Council for Development and Reconstruction (CDR), Council of the South, Higher Council of Refugee's, line ministries and other public institutions including SOEs and Public Corporations; (2) develop mechanisms for enhanced MoF oversight over SOE and Public Corporations; (3) implement WB-IMF PIMA 2018 recommendations (phased); and (4) launch Forensic Audit of SOEs.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) adopt legislation regarding management large projects; (2) launch PIM framework; (3) develop Public Sector Balance Sheet; (4) enhance capacity of MoF to financial control SOEs; and (5) review establishment of a SOE and Public Corporations management entity.

Element 3: Reinforcing Public Debt Management

In order to promote better debt management, government can strengthen debt management institutions. Signs of debt unsustainability had preceded Lebanon's Eurobond default by years. However, deficiencies in debt management practices hindered a credible response. The sustainability of a creditor approved medium-term debt restructuring framework and its underlying macroeconomic framework demands a revision of the public debt management law and practices. Ensuring debt sustainability is vital to exit this crisis and avoid a double dip. Between 1980 and 2012, out of the 44 countries that restructured their debt, 86 percent had more than one restructuring (Lebanon's 2020 restructuring is the first in the country's history); improving public debt management is paramount for GoL to avoid a double dip. Moreover, improving debt management aids in raising credit ratings and achieving market access. This requires a medium term debt management legal framework, and the establishment of new functions, and strategies (medium term debt management; communication and investor relations).

- ***Lebanon's policy response needs to comprise in the short term*** (1) implement a medium-term debt management strategy (MTDS); and (2) design a framework for issuing, monitoring and managing risks related to contingent liabilities and longer-term fiscal commitments (Fiscal Commitment and Contingent Liabilities).
- ***Lebanon's policy response needs to comprise in the medium term*** (1) revise/ ratify public debt management law; (2) establish independent debt management body; (3) prepare communication and investor relations strategy; and (4) establish a primary dealer group.

Element 4: Open Government

Citizens and government can also capitalize on technology to rebuild trust. In 2020 according to the United Nation's 2020 e-Government survey Lebanon ranked 127 out of 193 countries on e-government development. Restoring credibility demands a new era for governance—an era that can be ushered in by implementing an inclusive and accountable government process through membership in the Open Government Partnership (OGP) and supported by a whole of government digital transformation. Upon attaining the OGP membership, citizen groups would be able to collaborate with government to develop Open Government Action Plans and help to monitor all aspects of public service, thus empowering public

accountability. Moreover, the use of digital technology can increase transparency while reducing physical interactions to help to reduce opportunities for corruption.

- ***Lebanon's policy response needs to comprise in the short term*** (1) full transactional govt administrative e-services available on Internet, mobile, etc. at central and municipal levels; (2) commit to join Open Government Partnership (OGP); and (3) publish executive budget and audit reports.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) strengthen institutional capacity and deploy digital assurance and performance management systems; (2) implement a Whole of Government Digital Transformation Strategy; (3) promote public access to asset disclosure forms and data; (4) apply for OGP membership; Co-create first OGP National Action Plan, NGO stakeholders; and (5) implement first OGP National Action Plan.

Element 5: Anti-Corruption and Judicial Reform

Anti-corruption and judicial reforms strengthen the rule of law and the country's ability to fight corruption and limit elite capture. According to the Arab Barometer (2019), 91 percent of Lebanese citizens report corruption as a problem within state institutions to a large or medium extent. Lebanon's overarching governance crisis can be partially attributed to underdeveloped anti-corruption frameworks and widespread judicial dependence on political parties. In the aftermath of the Port of Beirut explosion, strengthening state institutions and making them more inclusive and accountable are top priorities; these reforms feed into providing constraint against elite capture, the country's most prominent development roadblock.

- ***Lebanon's policy response to strengthen the anti-corruption framework needs to comprise in the short term*** (1) accede to the 1997 OECD treaty on combating corruption; (2) create an anti-corruption commission and fully staffing it; and (3) adopt and implement the Illicit Enrichment Law and assets declaration law.
- ***Lebanon's policy response to strengthen the anti-corruption framework needs to comprise in the medium term*** (1) fully implement the National Anti-Corruption Strategy; (2) conclude UNCAC Assessment of Lebanon's anticorruption efforts; and (3) conduct and publish monitoring report on implementation of first year of Anti-Corruption Strategy (to include UNCAC assessment recommendations).
- ***Lebanon's policy response to strengthen the rule of law needs to comprise in the short term*** (1) establish high-level Justice Reform Committee and announce Action Plan to Improve Justice and Rule of Law; and (2) adopt Court of Accounts Law.
- ***Lebanon's policy response to strengthen the rule of law needs to comprise in the medium term*** (1) judicial independence law submitted to parliament and approved; (2) initiate justice sector assessment, and roundtables with justice stakeholders and CSOs; (3) judiciary revises and implements court performance improvement plans based on findings of justice sector assessment; (4) judiciary continues implementing court performance improvement plans; and (5) High-level Justice Reform Committee submits annual progress report with roundtables.
- ***Lebanon's policy response to strengthen transparency needs to comprise in the short term*** (1) fully implement the Access to Information Law; (2) implement the whistleblower protection law; and (3) lift Banking Secrecy Law.

With stronger anti-corruption measures and the increased rule of law, the implementation of the whistleblower protection law (approved previously by parliament) creates a line of defense against statewide corruption, fueled by elite capture, that is hindering Lebanon's development.

Element 6: Reforming Municipalities

The Government of Lebanon needs to enhance the role of municipalities as a provider of basic service provider and empower them with adequate technical and financial capacity for local development

in Lebanese cities. Municipalities are at the forefront of local development and service delivery in Lebanon. Municipalities also play a key role in disaster response as was evident from their role following PoB explosion. Historically, however, financial and capacity constraints have limited the effectiveness of the municipal services provided by Lebanese municipalities. Key challenges include, among others, decline in municipal investments, weak own source revenues, unpredictable intergovernmental transfers, and a hiring freeze and retrenchment of municipal employees. These developments have eroded living standards, accelerated environmental degradation, and undermined public confidence in local governments. Also, a combination of a difficult macro-economic and fiscal situation, the large influx of Syrian refugees, an alarming outbreak of the COVID-19 pandemic and the recent PoB explosion have further contributed to the deterioration of both the level and quality of municipal services.

- ***Lebanon's policy response to strengthen transparency needs to comprise in the short term*** (1) enhance role of municipalities in implementing integrated spatial planning frameworks for local development; (2) public disclosure of decisions and financial statements; (3) improved capacity for financial management; (4) introduce transparency, accountability, predictability and reliability of intergovernmental fiscal transfers; and (5) establish a municipality One-Stop-Shop with sub-windows.
- ***Lebanon's policy response to strengthen transparency needs to comprise in the medium term*** (1) coordinate of responsibilities with stakeholders; (2) promote private investments; (3) engage with citizens; (4) incentive mechanisms for improved municipal performance; and (5) implement reforms for improved administration of intergovernmental fiscal transfer (IMunF).

Pillar III: Infrastructure Development Reform Package

The under-provisioning of infrastructure in Lebanon has created gaps in service delivery, worsened productivity, and put the country on a lower growth trajectory. According to the World Economic Forum's (WEF) Competitiveness Index Lebanon's infrastructure is a major constraint to growth; Lebanon ranks 89 out of 140 countries for the quality of infrastructure. Lebanon lags in several basic areas: electricity, telecommunications, transportation, and water and sanitation. The PoB explosion added to Lebanon's infrastructure needs. Improving the quality of infrastructure demands sizable investments and governance and regulatory reforms. Challenges on the public sector financing side, and international experience in provision of quality infrastructure services suggest that a much larger role in infrastructure provision can be accorded to the private sector in Lebanon. With a clear governance and regulatory reform agenda at the sectoral level, clear visions, judicious use of the public private partnerships (PPP) framework would allow Lebanon to create the right opportunities for private sector participation and financing. Out of the box solutions can also be utilized to pool capital from investors in to diversified funds. In addition, given the uncertainty surrounding the policy environment in Lebanon, instruments for additional guarantees/risk mitigation could be developed. To this end:

- ***Lebanon's policy response needs to comprise in the short term*** (1) Enable and fully staff the Higher Council for Privatization (HCP); and (2) conclude review of PPP regulatory framework, currently being undertaken by EBRD.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) include PPP commitments in the FCCL framework and MTDS; (2) widen use of public-private partnerships; and (3) develop a comprehensive diagnostic and strategy for infrastructure planning and finance in Lebanon, covering public, PPP private sector investment.

Element 1: Electricity

Lebanon's power sector has undermined fiscal sustainability and economic growth objectives

for many years. Transfers to EdL between 1998 and 2019 accounted for 30 percent of GoL's debt at end-2019; reforming the sector is paramount for jumpstarting a recovery and achieving debt sustainability. Lebanon's energy sector has been a development bottleneck for many decades. The influx of Syrian refugees further exacerbated the power sector's challenges. Several attempts to reform it by various governments and by development partners, including the World Bank, have been unsuccessful. Budget transfers to EdL averaged 3.54 percent of GDP between 2011 and 2017. The sector's deficit is the byproduct of non-cost-reflective tariffs and high costs from operational inefficiencies—key among them is the utilization of highly polluting and expensive diesel and heavy fuel oil rather than cleaner and more economical natural gas or renewables, which, in fact, would have a significant balance of payments benefit. In response, the World Bank outlined solutions in a paper entitled "Lebanon Power Sector Emergency Action Plan – 2020". The plan aims at implementing the core requirements of Law 462 with subsequent amendments,[41] which was promulgated in 2002 but not implemented. The law called for restructuring the sector by limiting EdL's role to transmission system operations while migrating the distribution and generation assets to private sector ownership and operation, with oversight from an independent and autonomous regulator. The plan also targets modernizing operations, governance, and transparency according to international standards, and promotes adopting a utility-scale renewable energy program to comply with announced 2030 renewable energy targets. In order to implement the plan:

- ***Lebanon's policy response needs to comprise in the short term adoption of an Electricity Regulatory Strengthening Package:*** (1) update sector policy note to reflect the country's current conditions; (2) implement Law 462 with subsequent amendments; (3) staff and empower the Electricity Regulatory Authority (ERA); (4) adopt a least-cost generation expansion plan; (5) prepare EDL audited financial statements for previous years; (6) launch tenders for new thermal power plants and advance on existing renewable energy initiatives; (7) agreement on concession model for the distribution sector; (8) competitively select concessionaires; (9) reduce distribution network system and commercial losses, consistent with targets established in the Sector Policy paper adopted in April 2019, modified to reflect developments since 2019 (phased); (10) adjust tariffs to cost reflective levels while ensuring affordability for poor and less advantaged consumers (phased); and (11) prioritize capital investments needed to increase generation and transmission capacity to ensure adequacy and reliability of electricity supplies (phased).
- ***Lebanon's policy response needs to comprise in the medium term***[42] (1) operationalize the ERA; (2) start construction of new thermal and renewable energy plants; (3) launch process to privatize publicly owned generation plants; (4) install and operate private-sector floating gas import terminals; (5) complete negotiation of concession agreements and mobilization/transfer of control of the distribution system; (6) start construction of requisite transmission upgrades; and (7) revise building codes and facilitate concessional financing to incentivize energy efficiency and renewable energy upgrades.

Element 2: Telecommunications

Lebanon's telecom sector is heavily set back by opacity, high cost to consumers, and low service quality, and it has fallen behind other middle-income countries along most metrics.[43] The sector suffers from high costs and low quality;

[41] Given the reform agenda's wide scope, Law 462 requires amendments to facilitate the establishment of concessions, rebuilding the destroyed EdL building (due to the PoB explosion) and boarder restructuring of the sector.

[42] Reforms can be supported by updating the 2010 electricity sector policy note.

[43] Telecommunications Sector Reform: Fiscal Impact Assessment of Different Liberalization Scenarios, World Bank analysis, June 2020.

as a result, it has fallen behind other middle-income countries. Lebanon ranked 95 out of 141 countries in ICT adoption in 2019, according to the World Economic Forum, and 195 out of 221 countries in broadband speed in 2020 according to Cable's Worldwide Broadband Speed League; moreover mobile data and voice prices are about 2–3 times its regional peers (Morocco and Egypt) according to GoL's 2018 economic vison. Crucial reforms include the adoption of a unified vision for the sector that highlights: (1) the direction of reform policy; (2) a liberalization roadmap; (3) potential legal framework changes; and (4) an implementation timeline. Current telecom Law No. 431 of 2002 merits a fresh look to ensure it is still suited to the fast-evolving sector, and to guarantee citizens access to high-speed, reliable, and affordable broadband. Any potential revision should address the sector's regulatory framework and the emergence of new services and business models. To this end:

- ***Lebanon's policy response needs to comprise in the short term***[44] (1) appoint Telecom Regulatory Authority (TRA) Board; (2) review telecom Law No. 431 for potential revision; and (3) create a standard license for Data Service Providers.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) develop a unified Telecom Sector Vision; and (2) create a reference offer for access to MoT's ducts.

Element 3: Port System

The Lebanon port sector mixes different institutional models that do not promote efficiency nor transparency. Reforming the Lebanese port sector requires addressing these two criteria, and would be best achieved, according to international best practices, by adopting a three tiered structure: (i) a national port administration setting policies and national strategies; (ii) port-level port authorities structured on the landlord port model (in the form of a corporatized public entity); and (iii) operations delegated to the private sector through PPP, concession, or licensing agreements. The new framework shall also recognize and define the role of port communities in the management of the sector and the monitoring of its performance. Other needed reforms target customs and trade facilitation as well as cost accounting and tariffs. To enhance the overall resilience of the port sector, optimize operations throughout the national coastline, and balance public and private investments, there is also a need to prioritize development of a national strategy for maritime clusters, ports, logistics, and corridors, taking into consideration potential complementarities between the Lebanese ports.

- ***Lebanon's policy response needs to comprise in the short term*** (1) enact corridor-based strategic planning vision; (2) adopt port sector reform principles; (3) pass new port sector law; (4) establish a port management authority; (5) approve a Customs & Special Economic Zones Modernization program; (6) update the PoB master plan; and (7) establish port communities.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) build capacity at the ministerial and port authority levels; (2) digitalize processes: port community system, maritime single window and national single window; (3) enact port tariff reform; (4) implement cost accounting in POB and POT; (5) identify potential public-private partnerships (PPPs) and ensure competitive bidding.

Element 4: Transportation

Endemic traffic congestion was estimated to cost Lebanon 8 percent of GDP annually (World Bank, 2017). Road transport holds the lion's share of passenger, freight, and commerce transport in Lebanon; it accounts for 25 percent of all energy consumption. Despite its relevance, Lebanon's road network ranks 127

[44] Developing the telecommunications sector can benefit from adopting of a unified vision for the sector through stakeholder engagement (technical and legal experts) that highlights: (i) reform policy direction; (ii) a liberalization roadmap; (iii) changes in legal frameworks; and (iv) implementation of the roadmap.

out of 140 countries in terms of quality[45] (WEF 2019), driving up congestion. The problem is further amplified by the lack of a well-functioning public transportation system, thereby requiring that residents move closer to the capital. While the transport sector generates significant fiscal resources to the government (ports, airport, taxes on vehicles and gasoline) its revenues lack transparency; moreover, expenditures and financing into the sector lack planning and have been low and inefficient. A National Transport Strategy is essential to assess the complementarity of the transport sub-sectors, institutions, and projects to improve the synergies among them and therefore the efficiency of the whole transport sector. To this end:[46]

- ***Lebanon's policy response to improve road transport needs to comprise in the medium term*** (1) adopt the transport sector strategy and master plan; and (2) adopt a Road Asset Management System and a road safety strategy.
- ***Lebanon's policy response to improve public transport needs to comprise in the short term*** (1) develop a national transport sector strategy master plan; and (2) adjust policies on parking, public transport and other related regulation.
- ***Lebanon's policy response to improve public transport needs to comprise in the medium term*** introduce private sector financing modalities.
- ***Lebanon's policy response to improve civil aviation needs to comprise in the short term*** (1) review the 2002 Civil Aviation Law and associated 2004 decree; and (2) improve institutional and regulatory framework of the Civil Aviation Sector.
- ***Lebanon's policy response to improve civil aviation needs to comprise in the medium term*** transition to the new regulatory framework for the aviation sector.
- ***Lebanon's policy response to improve railway transportation needs to comprise in the short term***[47] (1) reviewing Railway and Public Transport Authority (RPTA) organizational chart and functions, and strengthen its capacity to manage the sector; and (2) developing a railway rehabilitation plan.

Element 5: Water

Lebanon needs to accelerate water sources diversification and implement demand management measures to cope with natural and human-made shocks. Today, Lebanon stores only 6 percent of its total water resources, considerably lower than the MENA average of 85 percent. Despite relatively high network coverage (79 percent on average), water service delivery quality is sub-standard with intermittent supply shortages and limited wastewater treatment. This situation notably impacts the poor who spend up to 15 percent of total household income on alternative water supply sources, often at high environmental and public health costs. The influx of Syrian refugees, the socio-economic crisis, the COVID-19 pandemic, and the explosion of PoB further exacerbated the water sector's challenges and jeopardized the Water Establishments' (WEs) ability to collect fees and ensure the continuity of water and wastewater services. The four regional WEs have witnessed a substantial drop in revenues, caused by: (1) a significant decrease in collection rates since the onset of the crisis; (2) suspensions of invoicing water bills during part of the COVID crisis; and (3) suspension of invoicing water bills in the areas impacted by the explosion at the PoB. As a result, the water sector's proposed readjustments could entail a three-pronged approach towards preserving the sector, pursuing reforms/transparency and infrastructure maintenance and development.

- ***Lebanon's policy response for better sector management needs to comprise in the short term*** (1) ratify the Water Code and the related decrees; (2) approve an updated National Water Sector Strategy 2020; (3) establish the Water

[45] The economic cost of road traffic fatalities and injuries in Lebanon is equivalent to 6 percent of national GDP.

[46] Improving Lebanon's public transportation system can benefit from the development and adoption of a National transport sector strategy, master plan, and a corresponding budgeted medium-term expenditure framework.

[47] Developing a railway rehabilitation plan is necessary for reinvigorating public transport.

Executive Committee; and (4) cost recovery action plan for Water Establishments.

- ***Lebanon's policy response for better SOE management needs to comprise in the medium term*** (1) promote private sector participation in operations and management; (2) design and implement a mechanism/platform of a stakeholder oversight; (3) start publishing annual financial statements; and (4) adopt an operations and management HR plan.

Pillar IV: An Economic Opportunities Reform Package

Lebanon's future trajectory will depend on its economy's ability to attract investment and to create good jobs. Relative to 2018, the economy will need to raise its productivity and find new sources of growth. Lebanon will need a new growth model, and its business environment and institutions will need to be open and flexible to allow this new economic model to emerge. According to the World Bank Groups' Doing Business report, Lebanon ranks 143 out of 191 economies in the ease of doing business, highlighting the multiple challenges and high regulatory burden faced by businesses from entry to exit. Also, widespread monopolistic activities have limited business entry and resulted in economic deadweight losses. The combination of a hostile business environment and an overvalued currency have contributed to the poor productivity, the decline of the tradable sectors and the worsening of Lebanon's trade deficit. The process can be reversed, driven by the depreciated exchange rate, which can incentivize domestic production. Lebanon can expect a boost in agriculture, and possibly regional trade; according to the World Bank 2019, 62.5 percent of firms in Lebanon used inputs of foreign origin, in line with regional and income peers, while 19.4 percent of firms export goods directly, exceeding both regional and income peers. Lebanon can also expect a resurgence and growth in services (including exports), given the prevalence of highly skilled and well trained Lebanese. However, Lebanon's financial sector will also need to respond to financing needs of the private sector and provide wider access to financial services. In addition, Lebanon's regulatory frameworks will need to evolve, by becoming more efficient, by being applied evenly and fairly, and by ensuring that the economy is more contestable, which will help drive productivity improvements. These changes will take time as Lebanon's economy goes through a period reorganization and discovery.

Element 1: Setting Financial Sector Foundations

Promoting the development of Lebanon's financial sector to support businesses and individuals necessitates adopting a sector-wide digital transformation strategy. Despite playing a pivotal role in Lebanon's post-war development, the financial sector has been slow in adopting digital transformation. Regulatory and market barriers prevent digital financial services from taking off and reaching a large untapped market. According to the Global Findex 2017 data only 33.1 percent of Lebanese adults have made or received digital payments in 2017. Account ownership is below global income averages, reflecting strong urban-rural disparities (45 percent headline transaction account; 25 percent for women; 58 percent of nationals according to BDL's survey). Digital finance can promote financial inclusion and reduce the cost of financial transactions and makes businesses more efficient and productive. A set of policy and regulatory prerequisites can enable broader use of digital financial services in the medium-term:

- ***Lebanon's policy response needs to comprise in the short term*** (1) pass fundamental regulatory enablers for digital financial services; (2) improve interoperable digital payments infrastructure; and (3) update regulations related to (i) data privacy and protection laws and (ii) cybersecurity and cybercrime prevention.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) agree on a vision for the financial sector; and (2) develop open and transparent pathways for financial innovation including technology firms (fintech).

Element 2: Enabling a Nation of Entrepreneurs

Though Lebanon is perceived as economically liberal, monopolistic behaviors are widespread. Lebanon's Legislative Decree No. 34 of 1967 grants exclusive agencies and sole distribution rights to importers of all products, excepting foodstuffs and washing products. This undermines competition through reinforcing dominance and limiting entry, undermines efficiency and facilitates collusive behavior. Tamping down the exclusive agencies' regulations will likely reduce economic deadweight losses and encourage market entry. Lebanon can also benefit from a competition law. Adopting and implementing such a law would establish an antitrust enforcement framework prohibiting anticompetitive arrangements, abuse of market power, and anticompetitive merger and acquisition activities. To this end:

- ***Lebanon's policy response needs to comprise in the short term*** (1) enact new competition law; and (2) establish and empower a competition commission.
- ***Lebanon's policy response needs to comprise in the medium term*** building capacity on market competition and antitrust matters.

Businesses in the commerce and industry sectors have been hard hit by the economic crisis post October 2019. Surveys estimates that 12 percent of firms already ceased their operations between October 2019 and January 2020, and one-third reduced their workforce by 60 percent on average. The World Bank/EBRD/EIB Enterprise Surveys show that real sales dropped by 11.1 percent year-on-year during 2019, 7.9 percent of firms introduced new products/services, compared to the upper middle income country (UMIC) average of 34.2 percent, and 1 percent of firms introduced a process innovation, compared to the UMIC average of 25.6 percent. These figures are likely to further deteriorate in light of the policy inaction and the PoB explosion. In addition, fast-tracking business environment reforms will be critical to accelerate the recovery process. Other non-financial development demands for the short and medium and longer term: (1) incentivizing formality; (2) improving investment policy and promotion legislation; (3) supporting integration with global value chains; and (4) amending positioning to benefit from multilateral and bilateral trade agreements (requiring a sector by sector analysis to pinpoint Lebanon's trade advantages):

- ***Lebanon's policy response needs to comprise***[48] (1) improving investment policy and promotion; (2) developing a Business Environment Action Plan; (3) updating the Code of Commerce; (4) streamlining process and reducing time and costs to starting a business; (5) streamlining licenses and permits; (6) introducing secured lending; (7) streamlining tax payment and inspection process; (8) streamlining, automating and reducing costs of trading across borders; (9) modernizing insolvency framework; (10) implementing the Judicial Mediation Law; (11) improving labor regulation; and (12) modernizing Intellectual Property Framework and improving enforcement.

Lebanon's businesses are also in need of financial support as a result of the economic crisis, the pandemic, and the PoB explosion. Firms have an urgent need for immediate and short term support to replenish working capital and establish foreign exchange credit lines.

- ***Lebanon's immediate policy response needs to comprise*** (1) working capital; and (2) foreign exchange lines of credit.

Element 3: Promoting Agriculture Resilience

The ongoing crisis has amplified existing problems in Lebanon's agricultural sector; supporting its resilience is vital for food security. According to IDAL, the agricultural sector made up 3.2 percent of Lebanon's GDP in 2018 despite directly employing

[48] Detailed in the matrix below.

6 percent of the population; the sector averaged 6.8 percent of GDP between 1994 and 2007; however, shifting consumer preferences and currency appreciation have resulted in its decline. The sector's potential is hampered by a number of structural issues, including the extremely high share (up 90 percent) of small farms and agri-food enterprises, lack of public investment which would encourage much-needed private investment, a poor food safety system, as well as its unmitigated exposure to an array of production and price risks. On a policy level, the lack of planning, lack of strategic alignment of state support with the sectoral priorities, and administrative clogs created a bottleneck that hampers effective state support. Furthermore, Lebanon's ongoing crisis has disrupted supply chains and created adverse effects further downstream. As a result, Lebanon has also not been able to benefit from the opportunities presented by its various trade agreements. At the same time, the currency depreciation caused a mismatch between revenues and production costs. The high dependency (up to 80 percent) on food imports presents fiscal challenges especially given the local currency depreciation and limited foreign exchange earnings. Adjustment costs and the sector's potential for job creation and export income generation warrant further reliance on domestic agro-food production.

- ***Lebanon's policy response needs to comprise in the short term*** (1) enact a Food Safety Law; (2) assess effectiveness of agricultural support schemes; (3) provide short-term input support to farmers; (4) introduce a risk sharing mechanism for private financing; and (5) develop comprehensive export development strategy for the sector.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) improve food safety and quality system; (2) adopt a legal framework for agriculture zoning; (3) adopt a private land consolidation and exchange program; (4) introduce support instruments for promoting sustainable solutions; (5) support private investment mobilization; (6) implement PPP program for investment in marketing infrastructure; and (7) establish the institutional framework and system for risk management in the sector.

Pillar V: A Human Capital Development Reform Package

As a result of the ongoing economic crisis, and after decades of disregard for human capital development, Lebanon is suffering from a human capital crisis. Prior to the economic crisis : (1) relatively low public spending on human capital coupled with high inefficiencies and high private spending needs had placed a burden on poor and middle-class households; (2) despite an increase in enrollment, drop out among the poorest families is increasing in secondary education further exacerbating the high inequality in the sector; (3) hospitalization resources have been disproportionately allocated and formal health insurance coverage has been low in the best of cases; (5) little spending on safety nets had resulted in low coverage for poor and vulnerable households to shocks; and (6) high youth unemployment and inactivity (40 percent of youth neither in employment nor in education or training) had led to loss of human capital through migration, mostly of the educated youth. The economic crisis has exposed these vulnerabilities, leading to unprecedented rise in poverty. A human capital development package is a must. At this stage it should encompass reforms related to education, healthcare, environment, and social sustainability and inclusion.

Element 1: Education

Human Capital outcomes are worryingly low in Lebanon, risking the future for generations of children.[49] The World Bank's Human Capital Index (HCI) indicates that a child born in Lebanon today will reach, on average, only 52 percent of his/her potential productivity when s/he grows up. This is lower than the average estimates for the Middle East and North Africa (MENA) region and Upper middle-income countries. Lebanon's poor performance on the HCI is largely attributed to the education

[49] see Lange, Wodon, and Carey 2018.

outcomes calculated for the index. If *actual* years of schooling, which are around 10.2 years on average in Lebanon, are adjusted for actual learning, the *effective* years of schooling are 40 percent less—on average, only 6.3 years of actual learning (World Bank 2020). Behind Lebanon's educational system's underperformance are: (1) ineffective utilization of teachers; (2) infrastructure deficiencies; (3) persisting and increasing school dropouts; (4) weak alignment between skills supply and labor market demand leading to high unemployment; (5) inequitable and inefficient public spending; and (6) inadequate sector coordination. A comprehensive reform agenda, that focuses on learning for all, and re-centers the education sector on the learner, is urgently needed.

- ***Lebanon's policy response needs to comprise in the short term***[50] (1) localize the back to school plans; (2) enhance coordination and synergies in the Ministry of Education; (3) support remote learning; (4) address and support the lowest performing schools; and (5) integrate psychosocial wellbeing into scholastic programming and beyond.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) prepare a new 5-year plan for the education sector; (2) commit to a new national curriculum framework and set ambitious learning and reading targets; (3) improve the efficiency of public education financing; (4) sanction bullying and violence in schools; (5) address and support the lowest performing schools; (6) improve the relevance of higher education ; (7) regulate the private sector for quality delivery of services; and (8) reform repetition policy and assessment frameworks.

Element 2: Health

Lebanon's residents face grave health security risks; policies and reforms are urgently needed to prevent a catastrophe in the short term and later on providing healthcare services to all those in need. Lebanon's health sector is predominately private, accounting for 85 percent of hospital beds, with 80 percent of primary health care centers (PHCCs) operated by non-governmental organizations (NGOs). More than 90 percent of drugs and 100 percent of medical equipment and supplies are imported. Health insurance coverage is low, with around 49 percent of Lebanese citizens being uninsured, resulting in high out-of-pocket spending on health. This problem is expected to exacerbate poverty which is already deepening from the ever-compounding crisis. Even before the explosion, Lebanon's health system was suffering from the consequences of a crippling economic crisis starting in October 2019. Multiple economic and financial problems greatly constrained the health sector's ability to provide accessible and affordable services. These include: (i) protracted delays in government payments of its arrears to hospitals; (ii) a dollar shortage along with unregulated restrictions on depositors' access to their funds, hindering the import of essential medical equipment, medicine, and supplies; and (iii) an increase in unemployment rates leading to an increase in the number of uninsured citizens requiring government assistance, especially among middle-income groups. The COVID-19 pandemic further exacerbated financial strains on the health sector; as such the following is warranted:

- ***Lebanon's short-term policy response needs to comprise*** (1) prepare and publish a National COVID-19 Response Strategy and Plan and allocate resources as needed, including private sector participation; (2) introduce and deploy a national COVID-19 vaccine strategy and operational plan including e-health; (3) identify those in need of healthcare subsidies and provide emergency funding; (4) allocate financial resources for healthcare subsidies; (5) establish financing instruments for pharmaceutical and medical imports; and (6) clear government hospital arrears and inject emergency resources.
- ***Lebanon's medium to long-term policy response needs to comprise*** (1) extend health insurance coverage under the NSSF after

[50] Reforming education can be aided by (1) adoption of a new vision for the educational sector based on stakeholder engagement; and (2) adoption of a 5-year plan that focuses on immediate, medium, and long-term needs for better learning.

unemployment; (2) develop and implement a UHC strategy; and (3) redistribute efficiently public primary healthcare and prevention spending.

Element 3: Housing

The three mega crises have aggravated Lebanon's hostile market housing conditions; resolving those conditions is paramount for social safety. Renters make up 55 percent of the housing market in Beirut. Over time, poverty, disinvestment, and real estate speculation have created a bifurcated housing market bookended by high-rise residences. Many of these were held aside for short-term tourist rentals, while migrants, refugees and low-income Lebanese occupy overcrowded informal rental units and rooms. A slow transition to market-oriented regulation of the rental market has led to the deterioration of many buildings, often those housing the lowest-income households. The multiple crises that have affected Lebanon since 2011 have negatively affected the housing sector, including the influx of Syrian refugees, the economic collapse, the impairment of the banking sector, and the PoB explosion. The sheer number of repair and reconstruction projects resulting from the explosion is expected to strain the entire housing value chain, from materials supply to engineering, finance, permitting, and inspections. Developing a housing strategy is essential to safeguard Lebanon's population from a housing crisis. Institutional reforms and arrangements for housing strategy should focus on: (1) planning and monitoring; (2) building standards; (3) preserving historic properties; (4) stakeholder support; and (5) housing market reforms.

- ***Lebanon's policy response needs to comprise in the short term*** (1) expand building permitting and inspection capacity; (2) guidelines on tenure security for renters; and (3) develop a national housing policy with emphasizing affordable housing.
- ***Lebanon's policy response needs to comprise in the medium term*** (1) develop a rehabilitation and reconstruction strategy for historic buildings; (2) update of the building regulatory system (online permitting, energy efficiency, green building, etc.); and (3) taxation of vacant housing.

Element 4: Environment

Environmental pollution and degradation of natural resources in Lebanon pose significant risks to economic development and threaten its citizens' health and well-being. In 2011 the World Bank estimated the cost of environmental degradation at 3.4 percent of GDP; according to the UNDP, that figure rose to 4.4 percent in 2018. Environmental degradation in Lebanon is a result of mismanagement across all sectors and has been exacerbated by the influx of Syrian refugees. Despite alarming environmental degradation, the environment has remained a secondary priority at the political level; domestic political interests have weighed heavily against establishing a strong basis for environmental governance and slowed down needed legal and institutional reforms. For example, the CIP has only addressed solid waste management, and GoL's reform plan fails to address the urgent need to shift towards a "Green Economy."

- ***Lebanon's policy response to resolve waste management needs to comprise in the short term*** (1) develop and implement priority regulations under ISWM Law; and (2) implement the Strategic Environmental Assessment for the draft ISWM strategy and adopt the ISWM strategy.
- ***Lebanon's policy response to resolve waste management needs to comprise in the medium term*** (1) strengthen the monitoring and enforcement of regulations under ISWM Law and under the legal framework for the management of chemicals and hazardous material, including environmental health and safety regulations; and (2) develop an ISWM plan for the city of Beirut.
- ***Lebanon's policy response to promote environmental conversation needs to comprise in the short term*** (1) establish modalities for enhancing private sector engagement in environmental investments; (2) establish a collaborative platform with civil society; and (3) develop a participatory strategic framework for greening the reconstruction agenda including climate action.
- ***Lebanon's policy response to promote environmental conversation needs to comprise in the medium term*** (1) identify financing and user

charges for the sustainability of environmental investments and management systems; (2) establish a sustainable financing mechanism for pollution prevention, including fiscal instruments; and (3) mainstream the strategic guidelines for greening the reconstruction agenda (including climate action) across all sectors.

Element 5: Social Sustainability and Inclusion

The economic crisis, the pandemic and the explosion at the PoB will significantly exacerbate vulnerabilities and needs among poor and vulnerable populations. Even before these shocks, vulnerabilities were on the rise, with overall poverty having increased, which was compounded by the influx of an estimated 1.5 million displaced Syrians, themselves affected by high poverty. In addition to its impact on livelihoods, shelter, and other basic needs, the explosion will further aggravate vulnerable citizens' situation in the Greater Beirut area, especially among the children, women, persons with disabilities, the elderly, the displaced, and migrant workers. Expanding cash transfer programs, as indicated in the first pillar of this reform agenda, is necessary to mitigate the effects Lebanon's compounded crisis on those in need, however more measures are needed.

- ***Lebanon's policy response needs to comprise in the short term*** support the provision of social services through SDCs, NGOs, and UN agencies.
- ***Lebanon's policy response needs to comprise in the medium term*** reinforce the role of MOSA and the social development centers to provide sustainable social services.

Support proactive, credible, and systematic stakeholder engagement by establishing a "people's platform"—as this will likely be key to a successful recovery. The October 2019 protests were followed by widespread popular demands for more transparent and inclusive citizen engagement. It will be crucial to develop a systematic, inclusive, and responsive approach to collaborate with a broad range of stakeholders to promote large scale participation, including civil society, communities, private sector, and academia. This will be essential to rebuild trust, inform the selection and implementation of reforms, and improve the transparency of rulemaking, budgets, and public participation through greater transparency, accountability, and inclusion. If not addressed, the lack of transparency could exacerbate the existing mistrust and social tensions, so it is essential to ensure the reforms are informed by a participatory process and equitable distribution of aid assistance.

- ***Lebanon's policy response needs to comprise in the short term*** (1) initiate a 'People's Platform' and linkages with other NGO-UN-donor-led initiatives; and (2) launch training program for procurement and budget monitoring and social audits for CSOs and volunteers.
- ***Lebanon's policy response needs to comprise in the medium term***[51] (1) consolidate advisory services offered by People's Platform for a range of sectors (e.g. VSEs); (2) consolidate advisory services offered by People's Platform for a range of sectors (e.g. VSEs); (3) enact a law on regulatory governance emphasizing transparency and public participation; (4) develop a National Social Inclusion and Engagement Strategy and a 3-year implementation strategy; (5) pilot training program on transparency and public engagement for executive branch and oversight institutions (national and local); (6) fine tune pilot training program on transparency and public engagement for executive branch and oversight institutions (national and local level); and (7) join the international CSO and government-led transparency and public participation initiatives (GIFT, OGP).

[51] A key pillar for promoting social inclusion is the development of a National Social Inclusion and Engagement Strategy and 3-year Implementation Plan with an indicative budget outlay.

TABLE 5 • Summary of Reform Matrix, by Pillar

Reform Area	2021	2022	2023	2024–2025
Pillar I: Macroeconomic Stabilization				
Monetary Stabilization	BdL independent audits	Strengthen BdL's balance sheet		
	Capital controls law			
	Policy actions on exchange rate and monetary policy framework			
Public Debt Restructuring	Macroeconomic and Debt Sustainability Framework Domestic debt - Medium Term Plan			
	Temporary body to handle debt restructuring	Agree on external and domestic debt restructuring plans and on losses with creditors, subject to equitable burden sharing		
Financial Sector Restructuring and Resolution	Update bank resolution framework Implement banking sector restructuring Restructuring of BdL's balance sheet	Improve supervisory early intervention mechanisms Improve emergency liquidity assistance arrangements		
	Develop an out-of-court workout framework Improve regulatory guidelines on NPL recognition and provisioning			
	Update deposit insurance framework			
	Develop insurance sector restructuring and development strategy Update and enact Insurance Law	Initiate insurance sector restructuring Improve regulatory governance		
Fiscal Framework Formulation	Adjusting 2021's budget and preparing 2022's on time Fiscal council becomes operational			
	Implementing the Macroeconomic and Debt Sustainability Framework			
	Reducing transfers to EdL	Reducing transfers to EdL	Reducing transfers to EdL	Reducing transfers to EdL
	VAT and Customs Reform	VAT and Customs Reform	VAT and Customs Reform	
	Unified Income Tax Code and automatic income tax declaration	Property taxation reform Review move from a scheduler to a global income tax base		
	Subsidy reform	Adjusting excises		
	Address SOE revenue/dividend transfer framework and cash management hurdles			
	Civil service review by an independent international institution			

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Social Protection	COM approval of a National Social Protection Strategy			
	Expand National Poverty Targeting Program (NPTP) per the Emergency Social Safety Net (ESSN) program and provide financing in 2021 Budget. Establish National Social Registry			
	Initiate Public Pension Reform Conduct audit of NSSF Parliament to pass Pension Law for private sector workers	Public Pension Reform Initiate financial and governance reform of NSSF Implement new Pension Law		
Review of growth plans	Revision of existing growth plans Agreement on an economic growth vision for Lebanon			
	Comprehensive investment strategy (private, public) review, reprioritization and operationalization Comprehensive export development strategy			
Pillar II: A Governance and Accountability Reform Package				
Public procurement reform	Development and validation of a public procurement strategy Public procurement law enacted Secondary legislation drafting and adoption	Capacity building and professionalization of the procurement function		
	Standard bidding documents developed			
	Establishment and operationalization of an independent procurement regulatory body and Policy and Oversight and Complaints Handling Units			
	Assessment of e-procurement initiatives	Development of e-procurement strategy and functions	Deployment of the validated e-procurement platform at decentralized level and training	
PFM	Revamp and revitalizing a national PFM steering committee			
PFM - Treasury Single Account (TSA)	Update cash safety buffer Integrate cash and debt management and prepare analysis reports	Develop and implement action plan for consolidating cash accounts	Enact/ amend related treasury single account laws & decrees	Treasury single account operational
PFM - External Auditing	Ratify a revised Court of Account Law and enlarge scope of audits	Strengthen the independence and capacity of the Central Inspection and Court of Accounts (including forensic audits)		Finalize the audit of previous financial statements
PFM - Internal Auditing	Complete assessment and recommendations for institution Internal Audit (IA)	Issue Ministerial decrees for establishment of IA Develop IA Strategy, charter and manuals, and carry out capacity building; carry out the IA function		

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
PFM - Macro- fiscal Analysis	Update macro fiscal models Formalize data flow from/to Macro-Fiscal Department (MOUs)	Introduce quarterly economic evaluation reports, including policy impact assessments, public finance monitor (PFM) and fiscal risk reports		
PFM - Accounting and Reporting		Implement new accounting procedures	Transition to IPSAS	
PFM - Budgeting	Review of Budget System Law (BSL)	Update BSL and/or regulations	Implementation review of updated BSL and regulations	
PFM - Public investment management	Review functions of the Council for Development and Reconstruction (CDR), Council of the South, Higher Council of Refugee's, line ministries and other public institutions including SOEs and Public Corporations	Develop PIM legal and regulatory framework Adopt legislation regarding management large projects	Launch PIM framework	
	Implement WB-IMF PIMA 2018 recommendations			
PFM - SOE management	Develop mechanisms for enhanced MoF oversight over SOE and Public Corporations	Develop Public Sector Balance Sheet Enhance capacity of MoF to financial control SOEs.		
	Launch Forensic Audit of SOEs	Review establishment of a SOE and Public Corporations management entity		
Reinforcing Public Debt Management	Implement a Medium-term debt management strategy (MTDS) Design a Financial Commitments and Contingent Liabilities (FCCL) framework	Revise/ratify public debt management law	Establish independent debt management body	
		Prepare communication and investor relations strategy	Establish a primary dealer group	
Open Government	Full transactional government administrative e-services available online	Strengthen institutional capacity and deploy digital assurance and performance management systems	Implement a Whole of Government Digital Transformation Strategy	
	Commit to join the Open Government Partnership (OGP)	Promote public access to asset disclosure forms and data	Apply for OGP membership; Co-create first OGP National Action Plan, NGO stakeholders	Implement first OGP National Action Plan
	Publish executive budget and audit reports			

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Anti-corruption and Judicial Reform	Accede to the 1997 OECD treaty on combating corruption Create an anti-corruption commission and fully staffing it Adopt and implement the Illicit Enrichment Law and assets declaration law	Fully implement the National Anti-Corruption Strategy Conclude UNCAC Assessment of Lebanon's anticorruption efforts	Conduct and publish monitoring report on implementation of first year of Anti-Corruption Strategy (to include UNCAC assessment recommendations)	
	Establish high-level Justice Reform Committee and announce Action Plan to Improve Justice and Rule of Law Adopt Court of Accounts Law	Judicial independence law submitted to parliament and approved Initiate justice sector assessment, and roundtables with justice stakeholders and CSOs	Judiciary revises and implements court performance improvement plans based on findings of justice sector assessment	Judiciary continues implementing court performance improvement plans High-level Justice Reform Committee submits annual progress report with roundtables
	Fully implement the Access to Information Law Implement the whistleblower protection law			
	Lift Banking Secrecy Law			
Reforming Municipalities	Enhance role of municipalities in implementing integrated spatial planning frameworks for local development	Coordinate of responsibilities with stakeholders Promote private investments		
	Public disclosure of decisions and financial statements	Engage with citizens		
	Improved capacity for financial management	Incentive mechanisms for improved municipal performance		
	Introduce transparency, accountability, predictability and reliability of intergovernmental fiscal transfers	Implement reforms for improved administration of intergovernmental fiscal transfer		
	Establish a municipality One-Stop-Shop with sub-windows			
Pillar III: Infrastructure Development Reform Package				
Public Private Partnership Legislation	Enable and fully staff the Higher Council for Privatization (HCP)	Include PPP commitments in the FCCL framework and MTDS	Widen use of public-private partnerships	
	Conclude review of PPP regulatory framework, currently being undertaken by EBRD	Develop a comprehensive diagnostic and strategy for infrastructure planning and finance in Lebanon, covering public, PPP private sector investment		

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Electricity	Update sector policy note to reflect the country's current conditions Implement Law 462 with subsequent amendments[a]			
	Staff and empower the Electricity Regulatory Authority (ERA) Adopt a least-cost generation expansion plan Prepare EDL audited financial statements for previous years	Operationalize the ERA		
	Launch tenders for new thermal power plants and advance on existing renewable energy initiatives	Start construction of new thermal and renewable energy plants	Launch process to privatize publicly owned generation plants	
		Install and operate private-sector floating gas import terminals		
	Agreement on concession model for the distribution sector Competitively select concessionaires	Complete negotiation of concession agreements and mobilization/transfer of control of the distribution system Start construction of requisite transmission upgrades		
		Revise building codes and facilitate concessional financing to incentivize energy efficiency and renewable energy upgrades		
	Reduce distribution network system and commercial losses, consistent with targets established in the Sector Policy paper adopted in April 2019, modified to reflect developments since 2019			
	Adjust tariffs to cost reflective levels while ensuring affordability for poor and less advantaged consumers			
	Prioritize capital investments needed to increase generation and transmission capacity to ensure adequacy and reliability of electricity supplies			
Telecommunications	Appoint Telecom Regulatory Authority (TRA) Board Review telecom Law No. 431 for potential revision	Develop a Unified Telecom Sector Vision		
	Create a standard license for Data Service Providers	Create a reference offer for access to MoT's ducts		

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Port	Enact corridor-based strategic planning vision Adopt port sector reform principles			
	Pass new port sector law Establish a port management authority Approve a Customs & Special Economic Zones Modernization program	Build capacity at the ministerial and port authority levels Digitalize processes: port community system, maritime single window and national single window		
		Enact port tariff reform Implement cost accounting in POB and POT		
	Update the PoB master plan	Identify potential public-private partnerships (PPPs) and ensure competitive bidding		
	Establish port communities			
Transport		Adopt the transport sector strategy and master plan	Adopt a Road Asset Management System and a road safety strategy	
	Develop a national transport sector strategy master plan Adjust policies on parking, public transport and other related regulation	Introduce private sector financing modalities		
	Review of the 2002 Civil Aviation Law and associated 2004 decree Improve institutional and regulatory framework of the Civil Aviation Sector	Transition to the new regulatory framework for the aviation sector		
	Review Railways and Public Transport Authority (RPTA) Develop a railway rehabilitation plan	Private sector financing for mass transit and public transport operations.		
Water	Ratify the Water Code and the related decrees	Promote private sector participation in operations and management		
	Approve an updated National Water Sector Strategy 2020 Establish the Water Executive Committee	Design and implement a mechanism/platform of a stakeholder oversight		
		Start publishing annual financial statements		
	Cost recovery action plan for Water Establishments	Adopt an operations and management HR plan		

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Pillar IV: Economic Opportunities Reform Package				
Emergency Financing	Introduce working capital and foreign exchange lines of credit			
Facilitating financial sector development	Pass fundamental regulatory enablers for digital financial services	Agree on a vision for the financial sector		
	Improve interoperable digital payments infrastructure Update/strengthen regulations related to (i) data privacy and protection laws and (ii) cybersecurity and cybercrime prevention	Develop open and transparent pathways for financial innovation including technology firms (fintech)		
Building an effective competition framework	Enact draft competition law and Reform Exclusive Agencies Regulations Establish and empower a competition commission	Building capacity on market competition and antitrust matters		
Improving investment policy and promotion	Develop and adopt an investment strategy for retaining and attracting FDI or Non-Equity Modes of financing	Develop a proactive investor outreach program Establish a one-stop shop for investors at IDAL		
	Review and update the investment law and decrees to strengthen Investment Development Authority of Lebanon (IDAL) and include investor protection guarantees			
		Prepare and discuss proposals for improving functioning of SEZ and their expansion		
Developing a Business Environment Action Plan	Develop and approve a comprehensive Business Environment Action Plan Establish governance structure for business environment reforms			
Updating the Code of Commerce	Update the Code of Commerce			
Streamlining process and reducing time and costs to starting a business	Abolish the paid in capital requirement Waive mandatory use of intermediaries (notaries, lawyers)	Establish an integrated, online one stop shop to register a business		
Streamlining licenses and permits	Undertake and assessment of operating licenses and permits	Streamline key operating licenses and permits		
Introducing secured lending	Enact secured transactions draft law Draft and approve secured transactions executive regulations Launch the procurement process for the registry provider	Operationalize electronic movable assets registry Raise awareness and develop the capacity of public and private stakeholders		

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Streamlining Tax payment and inspection process	Publish online all tax compliance requirements Set up hotline/grievance mechanisms during tax inspections Mandate tax inspectors to provide timely inspection reports	Simplify VAT collection and expediting refunds Digitize tax filings and payment		
Streamlining, automating and reducing costs of trading across borders	Approve customs strategy Develop an inventory of all administrative fee schedules Conduct a Time Release Study	Adopt Effective Risk Management (RM) and Post Clearance Audits (PCA) systems Develop a national e-Single Window	Implement the national e-Single Window	
Modernizing insolvency framework	Enact the draft Insolvency and Insolvency Practitioner (IP) laws Draft and approve executive regulations for both laws Develop a training curriculum for IPs and for judges training	Build the capacity of judges on the new insolvency regime Raise awareness on the new insolvency regime with main stakeholders Train and license the first cohort of the new generation of IPs		
Implementing the Judicial Mediation Law	Draft and approve the Judicial Mediation executive regulations Build judges capacities on the new mediation mechanism			
Improving labor regulations	Update the Labor Law	Introduce special visas and work permits for high-skilled foreign experts		
Modernizing Intellectual Property Framework and improving enforcement	Modernize IP laws Enhance IPPO's financial and human resources	Establish specialized court to hear IPR claims		
Agriculture	Enact a Food Safety Law	Improve food safety and quality system		
	Assess effectiveness of agricultural support schemes	Adopt a legal framework for agriculture zoning		Adopt a private land consolidation and exchange program
	Provide short-term input support to farmers Introduce a risk sharing mechanism for private financing	Introduce support instruments for promoting sustainable solutions Support private investment mobilization	Implement PPP program for investment in marketing infrastructure	
	Develop comprehensive export development strategy for the sector	Establish the institutional framework for risk management in the sector		

(continued on next page)

TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Pillar V: Human Capital Development Reform Package				
Education	Localize the back to school plans	Prepare a new 5-year plan for the education sector	Commit to a new national curriculum framework and set ambitious learning and reading targets	
	Enhance coordination and synergies in the Ministry of Education	Improve the efficiency of public education financing	Sanction bullying and violence in schools	
	Support remote learning Address and support the lowest performing schools		Improve the relevance of higher education	Regulate the private sector for quality delivery of services
	Integrate psychosocial wellbeing into scholastic programming and beyond		Reform repetition policy and assessment frameworks	
Health	Prepare and publish a National COVID-19 Response Strategy and Plan and allocate resources as needed, including private sector participation Introduce and deploy a national COVID-19 vaccine strategy and operational plan including e-health			
	Identify those in need of healthcare subsidies and provide emergency funding Allocate financial resources for healthcare subsidies	Extend health insurance coverage under the NSSF after unemployment	Develop and implement a UHC strategy	
	Establish financing instruments for pharmaceutical and medical imports Clear government hospital arrears and inject emergency resources		Redistribute efficiently public primary healthcare and prevention spending	
Housing	Expand building permitting and inspection capacity	Develop rehabilitation and reconstruction strategy for historic buildings;	Update of the building regulatory system	
	Guidelines on tenure security for renters	Tax vacant housing		
	Develop a national housing policy with emphasizing affordable housing			

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TABLE 5 • Summary of Reform Matrix, by Pillar *(continued)*

Reform Area	2021	2022	2023	2024–2025
Environment ***Resolve waste management***	Develop and implement priority regulations under ISWM Law and implement regulatory improvements for the chemicals and hazardous material management framework Implement the Strategic Environmental Assessment for the draft ISWM strategy and adopt the ISWM strategy	Strengthen the monitoring and enforcement of regulations under ISWM Law and under the legal framework for the management of chemicals and hazardous material, including environmental health and safety regulations Develop an ISWM plan for the city of Beirut		
Promote environmental conversation	Establish modalities for enhancing private sector engagement in environmental investments	Identify financing and user charges for the sustainability of environmental investments and management systems	Establish a sustainable financing mechanism for pollution prevention, including fiscal instruments	
	Establish a collaborative platform with civil society Develop a participatory strategic framework for greening the reconstruction agenda including climate action	Mainstream the strategic guidelines for greening the reconstruction agenda (including climate action) across all sectors		
Social Sustainability and Inclusion	Support the provision of social services through SDCs, NGOs, and UN agencies	Reinforce the role of MOSA and the social development centers to provide sustainable social services		
	Initiate a 'People's Platform' and linkages with other NGO-UN-donor-led initiatives	Consolidate advisory services offered by People's Platform for a range of sectors (e.g. VSEs)	Enact a law on regulatory governance emphasizing transparency and public participation	Develop a National Social Inclusion and Engagement Strategy and a 3-year implementation strategy
	Launch training program for procurement and budget monitoring and social audits for CSOs and volunteers	Pilot training program on transparency and public engagement for executive branch and oversight institutions (national and local)	Fine tune pilot training program on transparency and public engagement for executive branch and oversight institutions (national and local level)	Join the international CSO and government-led transparency and public participation initiatives (GIFT, OGP)

[a] Given the reform agenda's wide scope, Law 462 requires subsequent amendments to facilitate the establishment of concessions, rebuilding the destroyed EdL building (due to the PoB explosion) and boarder restructuring of the sector.

ANNEX

Key BdL Circulars since October 2019

BdL has issued a series of circulars that reflect policy initiatives under three main categories: (i) monetary and exchange rate policies; (ii) socio-economic support; and (iii) financial sector regulations. These policies have laid a clear distinction between deposits that existed prior to the closure of the banking sector (October 2019) and the new (or fresh) deposits that came in later.

Monetary and Exchange Rate Policies

Circular 536

Circular 536 (December 4, 2019) stipulated:

- An interest rate ceiling on new and renewed LL and US$ deposits set at 8.5 percent and 5 percent, respectively;
- The lower deposits rates to reflect on lending rates through a lower Beirut Reference Rate (BRR) to which private loans are benchmark;
- In regard to the interest earned on banks' holdings of dollar-denominated CDs and dollar time deposits at BdL, the central bank would pay half in LL and the other half in dollars;
- Banks to pay half of the interest earned on customers' foreign currency deposits with it in LL and the other half in dollars.

Circular 149

In circular 149 (April 3, 2020), BdL established a special unit that exchanges foreign currencies compromising BdL, banks and exchange bureaus. An electronic board is launched that publishes exchange rates, including those in dollars. We henceforth refer to this exchange rate as the e-board rate, mostly recently set at LL 3,900 per US$.

Circular 148, 151, 549, 565

These circulars allowed the withdrawal of pre-crisis deposits at exchange rates that are higher

than the official rate, but lower than the black-market rate. For example, the first such circular (148, April 3, 2020) allowed account holders of deposits up to LL 5 million in total in a bank, to request withdrawal of their deposits, such that:

i. Bank would convert LL account to dollars at the official exchange rate;
ii. Bank then converts dollars from step 1 back to LL at market rate (which was first set at LL 2,600 per US$ and later changed to the e-board rate) and pays out to customer, thus closing the account.

Circular 148 also allowed account holders of (pre-crisis) deposits up to $3000 in total in a bank, to request withdrawal of deposits, such that:

i. Bank converts dollars in deposit to LL at market rate (which was first set at LL 2,600 per US$ and later changed to the e-board rate) and pays out to customer, thus closing the account.

Circular 151 (April 21), then removed the limits on accounts, allowing all holders of pre-crisis deposits to benefit, subject to individual bank limits on amount withdrawn.

Circular 150

Circular 150 (April 9) removed reserve requirements on new (fresh) dollar deposits.

Circular 551, 566

On April 22, BdL issued circular 551 compelling non-bank money transfer institutions (NbMT) to pay transfer recipients in LL and not in dollars, having reversed policy on this a number of times in a couple of months. Expatriates were increasing using NbMTs in response to banking sector constraints. BdL assigned a special exchange rate at which NbMTs would convert transfers (starting at LL 2,600/US$).

This policy was once again reversed by circular 566 on August 6, in the aftermath of the explosion at the Port of Beirut. Circular 556 mandated that transfers would once again be disbursed in US dollars.

Circular 568

Circular 568 (August 26) instructs banks to accept repayments by resident clients of their dollar retail loans—with limits of $US 800,000 for housing loans and $US 100,000 for retail loans—in LL at the official exchange rate.

Socio-Economic Support

Circular 535, 556, 557, 561, 564

In circular 535 (November 26, 2019) and 561 (July 8 2020), BdL formalized its backup of critical imports; specifically, BdL's provision of foreign currency at the official exchange rate for 90 percent of the import bill for fuel products and 85 percent for wheat, medicine, medical equipment and baby milk imports.

In circular 556 (May 27, 2020), banks were allowed to solicit foreign currency from BdL for 90 percent of the value of raw materials imported by the industrial sector, up to $US 100 million in total for each bank and $US 300 thousand for each client. Circular 557 (May 27) further targeted this scheme to agribusinesses, removing the limits.

Circular 564 (July 8, 2020) allowed for foreign currency back up at the e-board rate for another list of essential goods imports identified by the Ministry of Economy and Trade (MoET).

Circular 547, 552

These circulars (23 March and April 22, 2020) permitted the rollover of private sector loans in LL and dollars that were coming due between March–June 2020, at zero interest rate and 5-year maturity. It also allowed business over the same period to borrow at the same terms in order to pay wages and necessary expenses. In return, and as an incentive to banks, BdL would extend loans in dollars to banks at zero interest rates at the value of the LL or dollar loans to banks' customers.

Circular 152, 569

These circulars (August 6, August 26, 2020) allowed banks to extend loans at zero interest rates and 5-year maturity to those affected by the PoB explosion. In return, and as an incentive to banks, BdL would extend loans in dollars to banks at zero interest rates at the value of the LL or dollar loans to banks' customers.

Circular 153

This circular (August 19) permitted the transfer of up to US$ 10,000 of pre-crisis deposits to students abroad. However, in practice, this remained subject to banks' liquidity constraints.

Banking Sector Regulations

Circular 567

Key stipulations for circular 567 (August 26) include:[52]

- Banks and financial institutions operating in Lebanon must apply a statutory Expected Credit Loss (ECL) of 1.89 percent on foreign currency placements with the Central Bank (including certificate of deposits) and 45 percent on foreign currency placements with the Government. The provisions of the circular, however, do not require the constitution of any statutory ECL on LBP placements with the Government and with the Central Bank. These provisions will be constituted progressively over a period of five years.
- Banks and financial institutions must not downgrade delinquent loans (between February 1, 2020 and December 31, 2020) for borrowers affected by the COVID-19 pandemic.
- Banks are required to refrain from distributing profits to shareholders for the years 2019 and 2020, and increase by December 31, 2020 their common equity tier one capital by 20 percent from the 2018 level.
- Banks must apply the minimum capital adequacy ratios, noting that banks are forbidden from distributing profits if these ratios drop below 7 percent for common equity tier 1 ratio, 10 percent for tier 1 ratio, and 12 percent for total capital ratio.
- Banks must also constitute a capital conservation buffer on common equity of 2.5 percent of risk weighted assets.
- Every bank must prepare a comprehensive plan to conform to the minimum capital requirements set forth by the regulator.
- Banks can also take the following exceptional measures:
  - During the years 2020 and 2021: Add to common equity tier 1 capital 100 percent of the provisions taken on Stage 1 and Stage 2 on balance sheet financial assets and off balance sheet financial commitments. The previously mentioned provisions do not include those taken in local and foreign currency sovereign placements including those with BDL.
  - Starting 2022 till the end of year 2024: The aforementioned provisions taken as part of common equity tier 1 capital will be gradually amortized to 75 percent in 2022, 50 percent in 2023 and 25 percent in 2024.
  - A supporting factor of 0.1 is applied on the provided exceptional loans' capital requirements over a period of five years starting June 30, 2020.
  - Banks are prohibited from distributing profits generated from the sale of real estate and real estate acquired in settlement of debt.

Circular 154

Key stipulations for circular 15 (September 14) include:[53]

- The Central Bank required banks to complete a fair value assessment of their assets and

[52] Source: Credit Libanais, *Weekly Market Watch*, August 29–September 4, 2020.

[53] Source: Credit Libanais, *Economic Insights*, August 31, 2020.

liabilities and set a plan that helps in complying with all applicable regulations, notably those related to liquidity and capital adequacy, while also demanding banks to increase the level of services provided to their clients to the pre-October 2019 level.

- Banks must boost their liquidity with their foreign correspondent banks by incentivizing clients who have transferred more than $0.5 million (or its equivalent in foreign currencies) of their deposits abroad since July 1, 2017 to channel back 15 percent of said amount to Lebanon, 30 percent for banks' Chairmen, members of Board of Directors, large shareholders and top management, and 30 percent for Politically Exposed Persons (PEPs). Always in the same vein, the circular stipulates that funds that are retransferred to Lebanon will be deposited in "special" saving accounts having a term of 5 years, bearing in mind that said account will not be subject to reserve requirements.
- Banks must encourage importers to transfer from outside Lebanon an amount equivalent to 15 percent of the value of documentary credits opened in any of the years 2017, 2018 or 2019, with the transferred amounts also being deposited in "special" saving accounts.
- Banks to constitute by end of February 2021, an external account at their correspondent banks equivalent to 3 percent of the size of foreign currency deposits as of July 31, 2020.
- Banks must also, and according to the previously mentioned plan, submit a request to the Central Council at BDL to reconstitute/raise their capital to the required levels by the end of the first quarter of the year 2021.
- In this vein, banks must offer their depositors the option to convert their deposits into shares or into redeemable, tradable and convertible bonds that can grant priority to subscribe in any future capital increase, subject to the following conditions:
  - Listing all of the bank's shares on the Beirut Bourse;
  - Separating the Chairman of the Board of Directors function from the bank's management.

Averaging Lebanon's Multiple Exchange Rates

We use consumption-based weights to estimate the average exchange rate in Lebanon. To proceed, we adopt the following nomenclature:

- C_g denotes share of goods in the consumption basket;
- C_s denotes share of services in the consumption basket;
- C_g^m denotes ratio of imported goods to total goods in the consumption basket;
- C_s^m denotes ratio of imported services to total services in the consumption basket;
- M_g^{c1} denotes ratio of highly critical goods imported (at LL 1,507.5 per US$) to total imports of merchandise goods in value;
- M_g^{c2} denotes ratio of critical goods imported (at LL 3,900 per US$) to total imports of merchandise goods in value;
- M_g^o denotes ratio of all other goods imported (at black market rate) to total imports of merchandise goods in value;
- E^o denotes the official exchange rate LL 1507.5 per US$;
- E^{c1} denotes the exchange rate used for the importation of highly critical goods, which we refer to as critical 1 (C1);
- E^{c2} denotes the exchange rate used for the importation of critical goods (LL 3,900 per US$), which we refer to as critical 2 (C2);
- E^b denotes the black-market exchange rate.

C_g and C_s are derived from the weights for different components in the Consumer Price Index (CPI). Specifically, Cs is calculated by summing up the weights of CPI components that are assumed to be focused on the consumption of services.[54]

[54] Components assumed focused on the consumption of services and their associated weights are: Housing, rent (weight = 3.4%); Housing, owner occupied (13.2%); Health (7.8%); Transportation (13.1%); Communication (4.6%); Recreation, amusement and culture (2.3%); Education (5.9%); and Restaurant & hotels (2.6%).

Remaining components in the CPI are assumed to be focused on the consumption of goods. Hence,

$C_s = 53\%$

$C_g = 1 - Cs = 47\%$[55]

We assume *Cs* and *Cg* remain unchanged throughout our projection period.

We assume that 85 percent of goods in the consumption basket are imported, whereas only 40 percent of services in the consumption basket are imported. Hence,

$C_g^m = 85\%$

$C_s^m = 40\%$

We assume C_g^m and C_s^m remain unchanged throughout our projection period.

We can calculate the value ratios of highly critical, critical and other goods imported to total merchandise imports from actual data.

- BdL guarantees 85% to 90% of highly critical imports, C1, in value at the official exchange rate, while importers have to revert to the black market for the remaining 15% to 10%;
- Since July 2020, BdL has guaranteed 100% of the critical imports, C2, in value at LL 3,900/US$;
- All other imports are traded at the black-market rate.
- Hence, for C1 goods,

$E^{c1} = 0.85*E^o + 0.15* E^b$

- while for C2 goods,

$E^{c2} = E^b$ from October 2019 through July 2020

and

$E^{c2} = 3{,}900$ since August 2020.

Based on the above, the exchange rate for merchandise imports, Eg^m becomes

$E_g^m = M_g^{c1} * E^{c1} + M_g^{c2} * E^{c2} + M_g^o * E^b$

Earlier we made the strong assumption that 85 percent of goods in the consumption basket are imported; we now also assume that the remaining 15 percent of goods are linked to the official exchange rate. This stems from the fact that Lebanon is a highly dollarized economy and that even LL-denominated transactions are either psychologically or contractually linked to the exchange rate. In fact, key contracted prices, such as wages, real estate rent, university and school tuition etc. continue to be linked to the official exchange rate, which partly explains why inflation has so far lagged the depreciation of the black-market rate (inflation expectations will, however, adjust over time to the new hyperinflation reality and might become a key driver of it). The consumer exchange rate for goods, E^g, is thus

$E^g = C_g^m * E_g^m + (1 - C_g^m) * E^o$

Earlier we made the assumption that 40 percent of services in the consumption basket are imported; we now also assume that the remaining 60 percent of services are linked to the official exchange rate. Hence, the consumer exchange rate services, E^s, is as follows

$E^s = C_s^m * E^b + (1 - C_s^m) * E^o$

The consumption-based average exchange rate (AER) can thus be calculated as,

$AER = C_g * E^g + C_s * E^s$

VAR Estimations of Impact of Currency Devaluations on Economic Activity.

Exchange rate stability was at the heart of Lebanon's post-civil war growth model, and thus, its instability over the crisis period is a

[55] While the above components that are assumed focused on the consumption of services also include goods (i.e. communication), we can assume that this is offset by components that are assumed focused on the consumption of goods but that also include services.

TABLE 6 • VAR Results on the Impact of Currency Devaluations on Main Economic Variables.

	Currency Devaluation = 100%			*Currency Devaluation = 129%*			*Currency Devaluation = 49%*		
	Estimate	95% confid. interv.		Estimate	95% confid. interv.		Estimate	95% confid. interv.	
Growth rate in		Min	Max		Min	Max		Min	Max
CPI (inflation)	11.1%	5.0%	17.2%	14.3%	6.4%	22.1%	5.4%	2.4%	8.4%
CI	**-16.3%**	**-22.1%**	**-10.6%**	**-21.1%**	**-28.5%**	**-13.6%**	**-8.0%**	**-10.8%**	**-5.2%**
Imports services	22.1%	18.1%	26.0%	28.5%	23.3%	33.6%	10.8%	8.8%	12.7%
Imports goods	-26.7%	-31.4%	-22.0%	-34.5%	-40.5%	-28.4%	-13.1%	-15.3%	-10.8%
Exports services	14.3%	9.0%	19.7%	18.5%	11.6%	25.4%	7.0%	4.4%	9.6%
Exports goods	11.6%	5.3%	17.9%	14.9%	6.8%	23.0%	5.7%	2.6%	8.7%

main drag on economic activity. We generate unconditional and conditional forecasts from a Vector Autoregressive (VAR) model to quantify the impact of the AER devaluations estimated above on main macroeconomic variables, including the World Bank's coincident indicator.[56]

The VAR includes the following variables: the logarithm of the Nominal Effective Exchange Rate (NEER, from IFS database), the logarithm of the World Bank Coincident Indicator (CI),[57] the logarithms of exports of goods (from BdL), exports of services(from BdL), imports of goods(from BdL), imports of services (from BdL) as well as the logarithm of the consumer price index (CPI; from Central Administration of Statistics—CAS; 2007 base year). The sample period employed in the analysis extends from January 2008 to December 2019.

Conditional and unconditional forecasts from a VAR model are generated under the assumption of a 100 percent depreciation in the NEER, as well as the AER depreciations that we have identified in 2020 and 2021, namely, 129 and 49 percent, respectively. Table 2 presents the results.

We note the following caveats: (i) the sample period used to estimate the VARs, and upon which the forecasts are based, reflect for the most part non-crisis conditions, and hence do not factor into panic dynamics; and (ii) the sample period also precludes COVID-19 and PoB explosion effects. Considering foreign exchange constraints and panic conditions that are currently prevailing, we limit our conclusions to the impact on the CI.

VAR results suggest large contractions in the CI in 2020 and 2021 as a result of the devaluation in the AER. Specifically, based on an assumption of a 129 percent depreciation in the AER in 2020, CI is estimated to grow between –13.6 and –28.5 percent (within a 95 percent confidence interval). In 2021, the assumed 49 percent depreciation in the AER can cause an estimated growth of between –5.2 and –10.8 percent (within a 95 percent confidence interval).

Global Financial Crises Episodes

The Asian Financial Crisis of 1997-98

In July 1997, Thailand devalued the Thai baht under intense speculation, with the Government subsequently requesting technical assistance from the International Monetary Fund (IMF). A regional contagion effect ensued such that by October

[56] Matta, S. (2015), *New Coincident and Leading Indexes for the Lebanese Economy,* Review of Middle East Economics and Finance, 11 (3), 277–303).

[57] We use the CI as a general gauge of growth as opposed to a one to one indicator of growth.

1997, Malaysia, Indonesia, the Philippines, Hong Kong and South Korea were subsequently targeted by heavy speculation. The contagion effect also traversed the region to reach Russia and Brazil. Only Hong Kong was able to successfully defend the currency board that had been in effect since the parity was set at 7.8 Hong Kong dollars to 1 US$ in October 1983.

While macroeconomic imbalances did plague the region on the eve of the crisis—namely, large current account deficits, real exchange rate appreciations and the concentration of investment in the non-tradable sector—it is generally accepted that Asian macroeconomic fundamentals warranted neither the scale nor the scope of the Asian Financial Crisis.[58] Instead, causes were concentrated on financial excesses in the private sector, and not the public sector (Katz, 99).[59] Furman et al. (1998)[60] specifically identifies principal culprits to be rapid financial liberalization and capital account convertibility. Domestically, the former did not allow time for the proper development of credit assessment and risk-monitoring skills, placing complex financial instruments beyond the expertise of bankers and supervisors. Internationally, the latter shifted foreign capital flows toward short-term investments in a primarily private-to-private affair.

Thailand, South Korea and Indonesia entered into IMF programs, which totaled around US$35 billion. Another US$85 billion was committed from other multilateral and bilateral sources, although not all of this financing actually materialized (IMF, 2000).[61] The IMF called for monetary policy tightening in defense of the exchange rate and to counter inflationary-depreciation effects. Fiscal policy stressed surpluses within overly optimistic growth projections, which in effect rendered them contractionary. As the depth of the crisis was realized, some of the fiscal measures were subsequently relaxed. On the structural side, financial and corporate restructurings were expansive further exacerbating liquidity constraints.

Malaysia opted out of an IMF program and instead adopted what was at time considered heterodox macroeconomic policies that included targeted and temporary capital controls, a fixed exchange rate and a loosening of monetary and fiscal measures. The Philippines adapted its policies, including through the floating of the peso, tightening of monetary policy and strengthening of the banking system. It eventually relaxed its fiscal and monetary policies as stabilization took hold in mid-1998 (IMF, 2000). Hong Kong vigorously defended its currency board with punitive interest rates. It also intervened heavily in the stock markets to counter speculative attacks that aimed to cause exchange market pressures through the collapse of stocks.[62]

The Argentinian Financial Crisis of 2001-02

The Argentine Currency Board—via the so-called *Convertibility Law*—pegged the Argentine peso

[58] The Asian crisis countries generally enjoyed fiscal surpluses, low inflation and positive real interest rates.

[59] S. Stanley Katz (1999), *The Asian Crisis, the IMF and the Critics*, Eastern Economic Journal, Vol. 25, No. 4, Symposium: Liberalization and Crisis in Developing and Transitional Economies, Fall, 1999: pp. 421–439.

[60] Furman, Jason, Joseph E. Stiglitz, Barry P. Bosworth, and Steven Radalet (1998), *Economic Crises: Evidence and Insights from East Asia*, Technical Report, The Brookings Institute.

[61] IMF (2000), *Recovery from the Asian Crisis and the Role of the IMF*, Issues Brief, June 23, 2000.

[62] "In August 1998, market speculation against the HK dollar took a distinct form whereby the currency and the stock markets were attacked simultaneously. The modus operandi of this 'double-market play' involved selling short the HK dollar on the spot and forward markets, while simultaneously shorting Hong Kong stocks on the cash and futures markets. The shorting of HK dollars was expected to squeeze interbank liquidity by pushing up the HIBOR and in turn inducing a sharp fall in the stock and futures markets. In the event that this occurred, speculators could reap high rewards even if the exchange-rate peg were maintained. Facing this prospect, Hong Kong authorities launched a 'double-counter play', intervening in both the foreign exchange and stock markets. Over a period of ten working days from August 14 to August 28, the Hong Kong Monetary Authority (HKMA) spent a total of HK$118 billion (US$15 billion) to buy stocks directly." (Harake and Meade, 2014).

Harake, Wissam and Ellen Meade (2014), *Hong Kong's Currency Crisis: A Test of the 1990s 'Washington Consensus' View*, International Finance, Volume17, Issue 3, 2014: pp. 1–24.

to the U.S. dollar at a parity from March 1991, until its failure in January 2002 (Spiegel, 2002).[63] Argentina adopted the hard peg in an attempt to eliminate hyperinflation and stimulate economic growth following an tumultuous economic performance in the 1980s. While successful initially, it became a main constraint on the economy's competitiveness in general, and on countercyclical macroeconomic management in particular. Moreover, there was a large degree of financial dollarization in the economy with the banking system functioning mainly in US dollars. The banking system's dollar-denominated, short-term liabilities exceeded its stock of dollar assets—namely liquidity held by banks and international reserves. As the system lacked a lender of last resort in dollars, the financial system was inherently unstable, subject to bank runs (Kiguel, 2016).[64]

In the period just prior to the abandonment of the currency board (1998–2001), the economy witnessed a deep contraction, exposing mounting vulnerabilities in the economy. The hard peg and a lack of fiscal space precluded countercyclical macroeconomic measures. In response, in January 2001, the IMF approved an augmentation of financing, boosting an existing Stand-By Arrangement (SBA) program, to an equivalent of US$ 14 billion, centered on fiscal adjustment and accelerated structural reforms (IMF, 2003).[65] However, this failed to achieve stability. So did various attempts by the Government for voluntary debt arrangements. The IMF approved a new program, disbursing US$ 5 billion immediately and pledging another US$ 3 billion in support of prospective debt restructuring.

The crisis broke with a run on private deposits, which fell by more than US$ 3.6 billion (6 percent of the deposit base) over November 28–30, 2001. The authorities responded with a wide range of controls on banking and foreign exchange transactions. As the economy faltered, social and political unrest ensued, forcing the resignation of President de La Rua on December 20, followed by 4 other (Congress-appointed) Presidents within 3 weeks. On December 23, President Sáa declared a default on Government debt; on January 3, 2002, President Duhalde announced the end of the convertibility regime (IMF, 2003).

The Iceland Financial Crisis of 2008

While Iceland was not a member country of the European Monetary Union, it was part of the European Economic Area (EEA), which facilitated financial European integration via the so-called *Single Passport*.[66] In the early 2000s, the Central Bank of Iceland (CBI) increased interest rates to temper a heated economy. This raised the interest rate differential between the Icelandic Krona and international currencies, generating large capital inflows. Insufficient macro- and micro-prudential oversight allowed the Icelandic banking system to grow at a blistering pace in the years leading up to the crisis (Baudino *et al.*, 2020).[67] This resulted in an outsized banking sector as it allowed Icelandic banks to amass assets reaching 900 percent of GDP by end-2007 (IMF, 2008a).[68]

According to Baudino *et al.* (2020), total assets of the three largest Icelandic banks—Kaupthing, Glitnir and Landsbanki—more than doubled in 2004 and again in 2005. The authors describe how the three banks accessed international finance using wholesale, retail and official instruments, namely: (i) wholesale financing via Medium-Term Notes issued in both European and US markets;[69]

[63] Spiegel, Mark (2002), *Argentina's currency crisis: lessons for Asia*, Federal Reserve Bank of San Francisco, December 2002.

[64] Kiguel, Miguel (2016), *Argentina's 2001 Economic and Financial Crisis: Lessons for Europe*, Brookings, June 2016.

[65] IMF (2003), *Lessons from Argentina*, Washington DC, October 2003.

[66] The so-called Single Passport allowed a bank headquartered in the EEA to open a branch in any other EEA county without the need to apply for a license from the host EEA supervisory authority, as banking regulations at the national level are derived from common EU rules.

[67] Baudino, Patrizia, Jon Thor Sturluson and Jean-Philippe Svoronos (2020), *The banking crisis in Iceland*, Bank for International Settlements, Financial Stability Institute, Crisis Management Series No. 1, March 2020.

[68] IMF (2008a), *Iceland: Request for Stand-By Arrangement*, IMF Country Report No. 08/362, Washington DC.

[69] According to Baudino *et al.* (2020), from 2004 to 2008, issuance by Icelandic banks totaled €45 billion, accounting for a large share of their combined balance sheet in 2008.

(ii) retail financing via deposits from foreign European jurisdictions using the internet, with Landsbanki and Kaupthing being particularly aggressive in the United Kingdom and Landsbanki in the Netherlands;[70] and (iii) collateralized borrowing from central banks, in particular the CBI and the European Central Bank (ECB).

The eruption of the Global Financial Crisis exposed the currency and maturity mismatches of Iceland's three largest banks. The sovereign risk premium as well as the perceived riskiness of Icelandic banks, as measured by CDS spreads, increased markedly. A rapid loss of confidence in the Icelandic banking system ensued. By end-September, 2008, the three banks were resorting to the Icelandic Government for backing, which could not be attained due to the large volumes of foreign currency needed. Lacking a lender of last resort, the three banks essentially became insolvent and collapsed in October 2008. The Krona depreciated by more than 70 percent in the offshore market, equity prices fell by more than 80 percent and the crisis severely stressed balance sheets in the corporate, household and banking sectors (IMF, 2009).[71]

Faced with the unfolding crisis, the Icelandic government acted rapidly to stem the exchange rate depreciation and safeguard the stability of the banking sector. The authorities enacted capital controls in 2008 and adopted a "new bank/old bank system" approach for the three collapsed banks. Under this approach, new banks would service domestic needs while foreign liabilities were allocated to the old banks. That is, the three banks were placed under receivership and the remaining banks were recapitalized.

On November 19, 2008, the authorities also sought and secured, a US$ 2.1 billion SBA from the IMF (IMF, 2008b)[72] and the central bank entered into swap agreements with other Nordic central banks in May 2008 (IMF, 2008a). The SBA was predicated on three tenets: (i) stabilizing the exchange rate and restoring confidence in the banking sector, (ii) limiting the collapse of the banking sector and (iii) implementing a comprehensive and sound banking system strategy (IMF, 2008a). In tandem, the government borrowed €300 million to boost reserves and the central bank increased liquidity provision, reduced capital requirements and eased the rules on the eligibility of collateral (IMF, 2008a). After two years of negative real GDP growth (–6.8 and –3.4 percent in 2009 and 2010, respectively), real GDP growth turned positive in 2011 (1.9 percent). Iceland's economic recovery continued, imbalances in the balance sheets were reduced and the country embarked on phased fiscal consolidation. Capital controls were eventually lifted on March 14, 2017.

Crises in the European Monetary Union 2008–13

Countries of the EMU, namely, Greece, Portugal, Ireland, Spain, Italy and Cyprus, were all subject to systemic crises over the period 2008–2013. Important financial and economic linkages as well as common fundamentals warrant a collective look at this group. Nonetheless, each episode retains important idiosyncratic factors, which translated into differentiated remedies and recovery paths. Greece, Portugal, Ireland, Spain and Cyprus all required direct assistance in the form of bailout packages provided by *The Troika* of the IMF, the European Commission and the European Central Bank (ECB).

Naturally, as part of the EMU, member states surrender exchange rate and monetary policies. On the other hand, until the EMU crises, each exercised considerable prudential and regulatory authority over its own financial sector.[73] Common to all is a form of perceived economic security

[70] According to Baudino *et al*. (2020), by mid-2008, foreign deposits had increased to €16 billion, or 15 percent of Landsbanki's and Kaupthing's combined balance sheet.

[71] IMF (2009), *Iceland: Staff Report for First Review Under Stand-By Arrangement and Requests for Extension of the Arrangement, Waivers of Nonobservance of Performance Criteria, and Rephasing of Access*, IMF Country Report No. 09/306, Washington DC.

[72] International Monetary Fund (2008b), *Press Release: IMF Executive Board Approves US$2.1 Billion Stand-By Arrangement for Iceland*, Washington DC.

[73] As part of financial reform measures introduced to address causes of the Euro area crises, prudential and regulatory supervision of large and systemic European banks came under the jurisdiction of European Central Bank.

afforded by being part of the EMU that encouraged excesses, either public of private. In this section, we shall focus on Ireland, Greece and Cyprus.

The Irish Financial Crisis of 2008

Ireland enjoyed a rare economic boom in the two decades prior to the crisis, transforming itself into one of the most vibrant economies in Europe to be aptly described as the "Celtic Tiger" economy (O'Sullivan and Kennedy, 2010).[74] GDP increased by an average of 7 percent annually, the highest among EU-15 at the time; in terms of GDP per capita, Ireland went from the 22nd richest country in 1997 to the 5th richest by 2007 (O'Sullivan and Kennedy, 2010). Ireland's growth model was bolstered by large Foreign Direct Investments (FDI) owing to a favorable tax regime and the business-friendly environment.

Ireland's entry into the EMU on 1 January 2002 offered opportunities and challenges common with its peers; a boost of confidence, easier access to international finance and a rise in factor prices. Excesses converged on the real estate market, as the property market demonstrated signs of an asset price bubble; demand for housing soared, with loan approvals rising from €4.4 billion in 1997 to over €31.4 billion in 2006. Supply of housing surged to meet demand as the total stock of house completions increased by over 430,000 units in six years (2001–2007) (O'Sullivan and Kennedy, 2010). Meanwhile, net indebtedness of Irish banks to the rest of the world rose from 10 percent of GDP at end-2003 to over 60 percent by early 2008 (Honohan, 2009).[75] As a result, on the eve of the crisis, the Celtic Tiger had developed a "heavy reliance on building investment, sharp increases in house prices, and rapid credit growth, especially to property-related sectors" (IMF, 2006).[76]

In the wake of the Global Financial Crisis of 2008, international finance dried up and the extent of spillovers on the Irish banking sector quickly materialized. This came in the form of crashing stock prices of banks' and inability (of one particular bank) to roll-over wholesale foreign debt. In response, on September 30, 2008, the Government announced an unprecedented blanket guarantee scheme to depositors and creditors of six domestic banks (IMF, 2015).[77] This was followed by the nationalization of Ireland's third largest bank, a €7 billion recapitalization of its two other large banks and the creation of a "bad bank" (National Asset Management Agency) to manage the billions of nonperforming or toxic loans in the banking system (O'Sullivan and Kennedy, 2010).

In November 2010, the Irish government enlisted the help of *The Troika*, who offered a package in the amount of €85 billion (IMF, 2015). The IMF Extended Fund Facility arrangement of €22.5 billion was predicated on restoring the health of the financial system and establishing a smaller and more robust banking sector. Strong Irish ownership of the program and prompt action by the authorities resulted in rebuilding banks' lending capacity, resolving high nonperforming loan (NPLs) ratios and improving business sentiment and consumer confidence (IMF, 2014).[78] As a consequence, after contracting in 2008 and 2009 by 4.5 percent and 5.1 percent, respectively, real GDP resumed growth in 2010 at 1.8 percent.

The Greece Financial Crisis of 2009

Greece's accession to the EMU in 2001 did not correct structural imbalances that included large internal and external deficits coupled with a low growth environment. Public sector net borrowing averaged around 7 percent of GDP annually in the Euro-but-pre-crisis period (2002–2008), compared to 6.7 percent in the pre-Euro period (1994–2000). Public debt remained relatively stable

[74] O'Sullivan, K.P.V and Tom Kennedy (2010), *What Caused the Irish Banking Crisis?* Journal of Financial Regulation and Compliance 18 (July): 224–242.

[75] Honohan, Patrick (2009), *Policy paper: Resolving Ireland's Banking Crisis*, The Economic and social review 40(2): 207–231.

[76] IMF (2006), *Ireland, Staff Report for the 2006 Article IV Consultation*, International Monetary Fund, Washington DC.

[77] IMF (2015), *Ireland: Ex Post Evaluation of Exceptional Access under the 2010 Extended Arrangement*.

[78] IMF (2014), Ireland: First Post-Program Monitoring Discussions.

over the former period fluctuating between 100 and 110 percent of GDP. Externally, the current account deficit rose from a pre-Euro average of 3.3 percent of GDP to Euro-pre-crisis average of 10.5 percent. Moreover, external debt also rose decidedly from about 100 percent of GDP end-2003, to 133 percent by end-2008. Clearly, the EMU facilitated easier access to foreign financing for both the public as well as the private sectors; by 2009, private sector external debt stood at 175 percent of GDP (IMF, 2017a).[79] The adoption of the Euro also adversely affected the Greek economy's competitiveness relative to its trading partners, given that wages in the European periphery countries rose relative to the core countries (Hale, 2013).[80] Hence, on the eve of the crisis, Greece was gripped with deep twin structural deficits, lack of competitiveness as wage growth outpaced productivity growth and a real exchange rate overvaluation (IMF, 2012a).[81]

The onset of the global financial crisis exacerbated the mounting imbalances of the Greek economy. After the failure of Lehman brothers in September 2008, the spread between the Greek Government bonds and the German bunds soared to 100 basis points (IMF, 2013)[82] and led to downgrades by Standard and Poor's. A main trigger to the Greek episode was data revision by the authorities in October 2009, which entailed a sizeable increase in the projected fiscal deficit from 4 to 12.5 percent of GDP.[83] This roiled markets further, weakened confidence in the Greek economy and prompted a downgrade by Fitch (IMF, 2013). The loss of confidence in the Greek economy prompted capital outflows from the banking sector estimated at 30 percent of the deposit base. It also suspended Greece's access to financial markets by significantly widening yields on Greek bonds to unaffordable rates.

Given that Greece is an EMU member, a nominal currency devaluation that corrects the built-up imbalances was not possible. Instead, under *the Troika*, Greece underwent a very sharp internal devaluation, including a reduction in the wage bill and pension benefits. A deep recession ensued over the next decade.

In return, the Greek authorities secured a €30 billion Stand-By Arrangement from the IMF in May 2010, complemented with a cooperative package of financing from the European Union amounting to €110 billion (IMF, 2012b).[84] The SBA was underpinned by a stringent fiscal consolidation program that aimed at putting Greek debt on sustainable footing. However, key SBA macro-fiscal targets, namely, fiscal and current account indicators, failed to be met. The SBA was subsequently cancelled in 2012 and was replaced with an Extended Fund Facility (EFF) arrangement on March 15, 2012, also under *the Troika*. The EFF arrangement included financing of about €173 billion over four years.

Critically, and as a prior action for the EFF, a Private Sector Initiative (PSI) was announced on June 2011 for a voluntary debt swap of Greek sovereign bonds involving a haircut on private creditors who were represented by the Institute of International Finance. This haircut, which was subsequently implemented on March 2012, was equivalent to a 53.5 percent cut in the face value (principal) of the bonds, corresponding to an approximately €107 billion reduction in Greece's debt stock.[85]

The internal adjustment proved harsh and counter-productive, as macro-fiscal targets remained elusive due to unaccounted for

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79 IMF (2017a), *Greece: Ex-Post Evaluation of Exceptional Access Under the 2012 Extended Arrangement*, Washington DC.

80 Hale, G. (2013), *Balance of Payments in the European Periphery*, Federal Reserve Bank of San Francisco Economic Letter.

81 IMF (2012a), *Greece: Request for Extended Arrangement Under the Extended Fund Facility*, Washington DC.

82 IMF (2013), *Greece: Ex-Post Evaluation of Exceptional Access Under the 2010 Stand-By Arrangement*, Washington DC.

83 The data revision came amidst concerns raised by Eurostat—the statistical office of the European Commission—regarding the quality of Greece's fiscal data on five occasions over the period 2005–2009.

84 IMF (2012b), *Press Release: IMF Executive Board Approves €30 Billion Stand-By Arrangement for Greece*.

85 The European Stability Mechanism: https://www.esm.europa.eu/content/what-was-private-sector-debt-restructuring-march-2012#:~:text=Also%20known%20as%20the%20PSI,lighten%20Greece's%20overall%20debt%20burden.

economic contractions and an unsustainable public debt that persisted despite the PSI. This translated into social pain and political instability. A banking sector crisis ensued in 2015, which required the introduction of capital controls. Once again, the EFF program faltered and was eventually cancelled in January 2016 (IMF, 2017a). The prolonged economic contraction helped drive the debt-to-GDP ratio to a peak of 180 percent of GDP in 2016. In July 2017, the IMF approved a precautionary €1.6 billion SBA for Greece (IMF, 2017b).[86] This time the program explicitly notes that, without debt relief, Greece's debt will continue to be unsustainable.

The Cyprus Financial Crisis of 2011-13

Cyprus has been part of the EMU since January 2008. In the lead to the crisis, especially over 2009–2010, Cyprus increased its reliance on foreign sources for sovereign debt financing, as the lure of lower foreign interest rates was too great a temptation to resist in the face of falling tax revenues and higher government expenditures (Mikaelides, 2016).[87] Additionally, the banking sector attracted sizeable non-resident inflows due to Cyprus's tax regime, accumulating assets that stood at more than eight times GDP. The non-resident deposit flows financed the country's current account deficits, contributed to a worsening of Cyprus' international investment position and spurred a domestic credit boom (IMF 2013).[88] The Cypriot banking sector was also heavily exposed to Greece; Cypriot banks' loans to Greek residents stood at 130 percent of GDP, while holdings of Greek sovereign debt amounted to 30 percent of GDP (IMF, 2013).

By Fall 2011, losses on Cypriot sovereign debt as well as losses on holdings of Greek debt—due to the EU negotiated Private Sector Initiative for Greece—induced significant pressures on Cypriot banks, which were subsequently deprived of access to international financial markets (Orphanides 2016).[89] Specifically, two major banks with sizeable operations in Greece came under intense pressure in early 2012, and a full-blown banking crisis ensued following the restructuring of Greek debt. IMF (2013) notes that the banking sector lost 10 percent of its domestically raised deposits while Cyprus' second largest bank lost one-third of its deposits.

In response to the crisis, Cypriot authorities instituted capital controls, resolved and restructured two insolvent banks, and recapitalized the banking sector. The authorities also embarked on a fiscal consolidation plan that aimed at a primary budget surplus of 4 percent of GDP. This was underpinned by a three-year extended fund facility arrangement from the IMF of about 1 billion euros and an additional support of 9 billion from the European Stability Mechanism (IMF, 2013).

The Cyprus case stands out as the first to implement a *Bail In* resolution framework for the banking sector, where uninsured depositors would be called upon to recapitalize their banks, and a hierarchy of losses implied the wipeout of bank shares.

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[86] IMF (2017b), *Greece: Request for Stand-By Arrangement*, Washington DC.

[87] Mikaelides, Alexander (2016), *Cyprus: From Boom to Bail-In: Policy Lessons from the Cyprus Economic Crisis*, 59th Economic Policy Conference, April 2016.

[88] IMF (2013), Cyprus: *Request for an Arrangement Under the Extended Fund Facility*, Country Report No. 13/125, Washington DC.

[89] Orphanides, Athanasios (2016), *What Happened in Cyprus? The Economic Consequences of the Last Communist Government in Europe*, The Cyprus Bail-in, The Policy Lessons from The Cyprus Economic Crisis, pg. 163.

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