Lebanon: Staff Concluding Statement of the 2019 Article IV Mission

July 2, 2019

The new government has an opportunity to implement fundamental reforms to rebalance Lebanon's economy. Its starting position is difficult, including high twin deficits, a large public debt, and low growth. The authorities have already passed a crucial plan to reform the electricity sector and are now working on a budget that will reduce the fiscal deficit. These are very welcome first steps on a long road towards sustainability and growth that will have to involve further substantial fiscal adjustment and structural reforms to improve Lebanon's business environment and governance.

This statement highlights key findings and recommendations of the recent Article IV Consultation mission to Lebanon (June 19 – July 2, 2019), based on our discussions with a broad range of stakeholders. A more complete analysis of policy issues will be included in the forthcoming staff report. We thank the Lebanese authorities and other counterparts for their hospitality, and for a rich and fruitful set of discussions.

Key Messages

Strengthening the Lebanese economy requires action in three areas:

- A credible medium-term fiscal plan aiming for a substantial and sustained primary fiscal surplus that would steadily reduce the public debt-to-GDP ratio over time.
- Fundamental structural reforms to boost growth and external competitiveness, starting with improving governance as well as implementation of the electricity sector reform plan and recommendations of the Lebanon Economic Vision.
- Measures to increase the resilience of the financial sector through a stronger BdL balance sheet and continuing to build bank capital buffers.

I. Context

1. **This is an important moment for Lebanon.** The country has long suffered from large fiscal deficits which have left public debt at over 150 percent of GDP. The current account deficit is over 25 percent of GDP and growth has been low since the start of the Syrian crisis. The Banque du Liban (BdL) has skillfully maintained financial stability in difficult circumstances for some years, but the challenges it faces in doing so have grown. It is critical that Lebanon begin a process of significant fiscal adjustment and structural reforms to contain public debt and raise growth. Adjustment and reforms are the only path out of Lebanon's current situation.

2. **The government now has an opportunity to implement reforms and turn the tide.** It has approved a new plan, now approved by the parliament, to reform the electricity sector and reduce its fiscal cost. It has also submitted to parliament a budget proposal that aims to reduce the overall fiscal deficit in 2019. The electricity reform and the budget are the first steps on a long path to re-equilibrate the economy that will need to involve further fiscal adjustment and radical structural reforms.

3. **Reforms would encourage donors to disburse USD 11 billion in pledged concessional funding the authorities have secured for their Capital Investment Plan** (CIP) at the CEDRE conference in April 2018. The CIP aims to upgrade Lebanon's infrastructure while providing employment opportunities for host communities and Syrian refugees. The associated short-term growth boost can counteract the contractionary effect of the planned fiscal adjustment, especially if the authorities improve the public investment management framework early on in the CIP.

II. A Difficult Economic Environment

4. **Economic activity slowed further in 2018** . Low confidence, high uncertainty, tight monetary policy, and a substantial contraction in the real estate sector are estimated to have reduced growth to 0.3 percent last year. Average inflation reached over 6 percent in 2018 partly due to high prices of imported fuel but slowed down in the second half of the year and into 2019.

5. **The budget deficit reached 11 percent of GDP in 2018** , up from 8.6 percent in 2017. The primary balance deteriorated to -1.4 percent of GDP due to an unexpectedly costly salary scale increase implemented in late 2017 as well as new hiring. Tax revenues were also weaker than forecast. Given the large public debt (151 percent of GDP in 2018), interest payments now exceed 9 percent of GDP.

6. **The external imbalance widened further.** The current account deficit increased to over 25 percent of GDP in 2018, due to a combination of low export growth, higher fuel imports and weakening net remittances to Lebanon. The REER continued to appreciate and its estimated overvaluation remains significant.

7. **Deposit inflows virtually stopped and BdL's foreign reserves dropped** . Deposit growth in 2018 was the lowest since 2005 and the BdL reserves have now decreased by around US$6 billion since early 2018 despite BdL's continued financial operations, in part because of the Eurobond principal and coupon payments it made over the same period. Bank lending to the private sector declined, non-performing loans (NPLs) increased and deposit dollarization rose to over 70 percent.

8. **Reflecting these challenges, credit rating agencies downgraded Lebanon again this year.** Developments in fiscal performance, deposit flows and sovereign yields led to a sovereign downgrade by Moody's to Caa1 and a change of outlook to negative on the B- ratings of Standard and Poor's and Fitch.

9. **The economic outlook depends on progress in reform and on developments outside Lebanon.** Strong implementation of the government's fiscal adjustment efforts in 2019–20 and planned structural reforms have the potential to shore up confidence, give breathing space to the economy, and encourage donor disbursements of concessional financing for the CIP committed at CEDRE. But risks and vulnerabilities remain. The government's failure to achieve its targets and advance reforms or a breakdown in political and social consensus could erode confidence. On the other hand, there are upside risks, which, if realized, could help the government's adjustment effort. Resolution of the Syrian conflict

and normalization of relations would benefit Lebanon through involvement in Syrian reconstruction. Also, the potential discovery of a natural gas field in Lebanon's territorial waters, where exploration is expected to start by the end of the year, would boost growth and improve the country's external balance.

III. Policy Priorities

10. **Decisive implementation of a strong and coherent reform program is critical to maintain confidence.** Rebalancing the economy in the current framework of an exchange rate peg requires strong implementation of a large and credible fiscal adjustment and ambitious structural reforms. Only a significant improvement of Lebanon's business climate and governance can boost investment, growth and exports.

A. Front-Loaded and Sustained Fiscal Consolidation

11. **The 2019 budget aims for a large adjustment.** The budget submitted to parliament targets a deficit of 7.6 percent of GDP, aiming to reverse last year's slippages and catch up with the path committed to under CEDRE. It relies on a large number of revenue and expenditure measures, the most important of which are for three years only, including: (i) increasing the tax on interest income from 7 to 10 percent; (ii) a 2 percent tax on imported goods; (iii) a freeze of public sector hiring and early retirement. Other measures include a tax on taxi license plates and license plates with three or four digits and increased general security fees (on work permits, visas, etc.).

12. **IMF staff preliminary estimate is that the budget measures will reduce the cash-basis fiscal deficit to around 9¾ percent of GDP.** Although the budget has not yet been approved and there is uncertainty about what form the approved budget will take, on the basis of current information, the projected deficit is likely to be well above the authorities' stated target. There remains also uncertainty about the stock of outstanding payment orders and the process for their clearance which will affect the cash deficit for 2019. The projected deficit nonetheless benefits from temporary savings on interest payments due to the delay in Eurobond issuance.

13. **The measures proposed in the budget together with savings from electricity sector reforms are projected to reduce the primary deficit in 2020-22 but leave debt on a rising path.** The full-year effect of measures for which IMF staff has details is estimated at 2.3 percent of GDP, which will help turn the primary balance slightly positive in 2020. In the medium term, the large projected savings from the electricity sector reform plan, if fully implemented, will replace lost revenues from the expiration of the temporary measures in the 2019 budget and result in a small primary deficit. However, without additional measures, the primary deficit will remain above its debt stabilizing level, and the already unsustainable public debt-to-GDP ratio will remain on an increasing path.

14. **It is therefore critically important for debt sustainability that a medium-term fiscal plan is announced based on credible and permanent measures that will yield a substantial primary fiscal surplus over the medium-term** . IMF staff projects that a primary surplus of around 4.5 percent of GDP would be needed to noticeably reduce the debt-to-GDP ratio over the medium to long run. Identifying and agreeing on the measures upfront to support such a plan could provide a lasting boost to confidence. On current plans about 0.5 percent of the 2019 revenue measures will be permanent, and the authorities' current electricity plan can yield a further 2 percentage points of GDP in savings over the medium term. The authorities will need to identify and implement additional permanent fiscal measures to achieve the necessary primary surplus.

15. **Revenue measures should include raising the value-added tax (VAT) and increasing fuel excises as well as efforts to increase tax compliance.** The temporary increase of interest income tax in the 2019 budget could also be made permanent. Further raising revenue reliably and rapidly will require measures based on existing tax collection infrastructure, such as the VAT and fuel excises. Significant further revenue could also be raised by broadening the VAT base through the removal of exemptions on items such as foreign-registered yachts, diesel used for electricity generation, and road vehicles. The authorities should also improve tax administration, which could deliver meaningful additional revenue, including from those who currently evade taxes. Better tax collection will, however, require concrete action. Requiring businesses to only use financial statements certified by the Ministry of

Finance (as part of their tax return filing process) to obtain loans from banks, is one such option. Successful improvement in the collection of existing taxes may reduce the need to increase tax rates.

16. **Eliminating electricity subsidies is the most significant potential expenditure saving.** The government electricity sector plan aims to switch fuel to natural gas to reduce production costs at existing plants, increase EdL's capacity to meet demand, and subsequently raise tariff to eliminate electricity subsidies. The authorities need to ensure that the plan incorporates a tariff increase that is sufficient to close EdL's deficit in the medium term under robust and realistic assumptions about the reduction of technical and non-technical losses. It is crucial to start increasing tariffs as soon as possible to generate fiscal savings, possibly targeting the largest consumers first.

17. **The authorities should also conduct a thorough public expenditure review to identify other potential areas for savings.** This can build on their ongoing efforts to study reform options for the wage bill and pensions. Overall expenditures on capital and education are low and may need to increase over the medium run to enable higher growth. Yet spending on wages and benefits in the public sector, including in education, is often inefficient and presents opportunities for savings.

18. **Fiscal tightening should be complemented with scaled-up targeted transfers to the poor and vulnerable.** Lebanon's current social safety net (SSN) is limited. In order to cushion the impact of the needed fiscal adjustment, the authorities should allow for an additional 0.5 percentage points of GDP in SSN spending. Most of it could be channeled through a scaled-up version of an existing National Poverty Targeting Program.

B. Growth- and Export-Enhancing Structural Reforms

19. **Fundamental structural reforms are key to boosting growth and improving external competitiveness.** Lebanon has witnessed years of low growth and large current account deficits, both of which reflect a significant erosion of external competitiveness as well as the adverse effects of regional developments. The cost of doing business in Lebanon must be lowered to raise potential growth. Likewise, given the currency peg, deep export-enhancing structural reforms will be essential for external adjustment. Two priority areas for reforms are electricity provision, where the authorities have already approved a plan, and improving governance. In addition, the government's own CEDRE vision provides specific ideas for reforms which need to be implemented. All these efforts are needed to resolve external imbalances even if some upside events are realized over the long run, including development of gas fields and a resolution to the Syria conflict.

20. **The authorities should approve and implement legislation of key growth-enhancing reforms identified in its CEDRE vision.** This includes accelerating implementation of already-approved reform laws such as the code of commerce and the law on judicial intermediation as well as the approval of a new customs law, regulation on closing a business, bankruptcy law, insolvency practitioner law and law on secured lending. The authorities should also resolve regulatory obstacles to development of industrial zones that could benefit from a possible Syria reconstruction.

21. **In addition, the recommendations of the Public Investment Management Assessment technical assistance should be implemented ahead of execution of most of the CIP.** It is crucial that the most important improvements to the country's public investment management framework are in place before the execution of most of the CIP projects to maximize the growth benefits of the planned investments. Key reforms include incorporating Council for Development and Reconstruction (CDR) spending in the budget and passing a public procurement law.

22. **The electricity sector plan should be advanced without delay** . Increasing electricity supply by the EdL to 24/7 would eliminate one of the biggest constraints to doing business in Lebanon.

23. **Further concrete steps must also be urgently taken to reduce corruption.** The authorities have passed public information transparency and anti-corruption legislation, including the access-to-information law, whistleblower protection law, law establishing a national anti-corruption commission and law on oil and gas sector transparency. This legislation should be promptly and effectively implemented, including by the appointment of an independent, sufficiently empowered and

resourced anti-corruption commission, and supplemented by the adoption of the pending illicit enrichment and asset declaration legislation. Other priorities include the adoption of an anti-corruption strategy and undertaking corruption investigations and prosecutions to obtain a number of corruption convictions and confiscations commensurate with risks. The latter would also be important for the upcoming MENAFATF AML/CFT assessment (see below).

C. Monetary Policy and Financial Stability

24. **The BdL has been the linchpin of financial stability and the guardian of the peg** , but at the cost of intensifying sovereign-bank linkages and weighing down its balance sheet. Over the past few years BdL's financial operations have provided high marginal returns in Lebanese pounds on new bank U.S. dollar deposits at the BdL. These have boosted the BdL's dollar holdings without affecting rates on older deposits at the BdL and on government debt. They have also allowed banks to offer high interest rates to their own depositors to attract new or retain existing funding while maintaining their profitability. On the other hand, as a consequence, government securities and deposits at BdL now account for 14 and 55 percent of bank assets, respectively, for a total exposure to the sovereign of 68.5 percent of assets (more than 8 times Tier 1 capital).

25. **The BdL was forced to adopt a tight monetary stance to offset loose fiscal policy, and this has contributed to a decline in productive lending to the economy** . The BdL's operations enabled banks to offer high deposit rates to retain and attract deposits that have long financed Lebanon's twin deficits. Yet they have also produced high lending rates, with the USD reference rate rising from 6.8 percent in November 2017 to 9.7 percent by June 2019. These have in turn exacerbated a decline in lending to the private sector and a rise in NPLs stemming from a challenging economic environment. These developments underline the urgency of fiscal adjustment that will allow for lower interest rates.

26. **BdL should gradually step back from quasi-fiscal operations and strengthen its balance sheet.** It should step back from government bond purchases and let the market determine yields on government debt. Buying the proposed low-interest government debt would worsen the BdL's balance sheet and undermine its credibility. There should also not be any pressure on private banks to purchase the low-interest debt instead. The BdL should gradually phase out its financial operations once fiscal adjustment and the subsequent decline in yields demanded by investors allow it to do so.

27. **Action should be taken to continue building up banks' capital buffers and strengthen deposit insurance.** Fully aligning risk weights placed on the banks' holdings of BdL instruments with Basel III requirements represents a good mechanism to raise effective capital requirements. In line with the 2016 Financial Sector Assessment Program (FSAP) advice, the authorities should also increase deposit insurance coverage levels and provide for insured depositors' preference under the creditor hierarchy rules applicable in resolution and liquidation of failed banks.

28. **Continued effective implementation of AML/CFT measures is necessary to mitigate intrinsic ML/TF risks and ensure a positive MENAFATF AML/CFT assessment** . The authorities have strengthened the AML/CFT framework. In preparation for the upcoming assessment, authorities are required to also focus on the effectiveness of the framework, in line with the revised 2012 FATF assessment methodology. Failure to effectively mitigate AML/CFT risks or a negative AML/CFT assessment could adversely affect investment and banks' continued access to correspondent banks. To this end, authorities are encouraged to share the outcomes of their risk assessments with relevant private and public sector entities. Furthermore, effective implementation of the existing framework requires continued mitigating measures and improvements, among others (i) in relation to risk based AML/CFT supervision; (ii) the application of preventive measures; (iii) implementation of measures related to the transparency of legal entities and (iv) targeted financial sanctions; (v) access to financial information by law enforcement and judicial bodies; and (vi) increasing the numbers of prosecutions and convictions for ML, in line with Lebanon's risks. We support the BdL's plans to fully abolish numbered accounts (also referred to as secret accounts).

29. **The authorities should review the tools available to cope with financial distress in systemic institutions.** The BCC has made progress in recovery planning. It should now proceed to

identifying critical functions performed by systemic institutions that need to be preserved and develop bank-specific resolution plans.

MEDIA RELATIONS

PRESS OFFICER: WAFA AMR

PHONE: +1 202 623-7100 | **EMAIL:** MEDIA@IMF.ORG