



Nominal GDP and Real GDP Growth

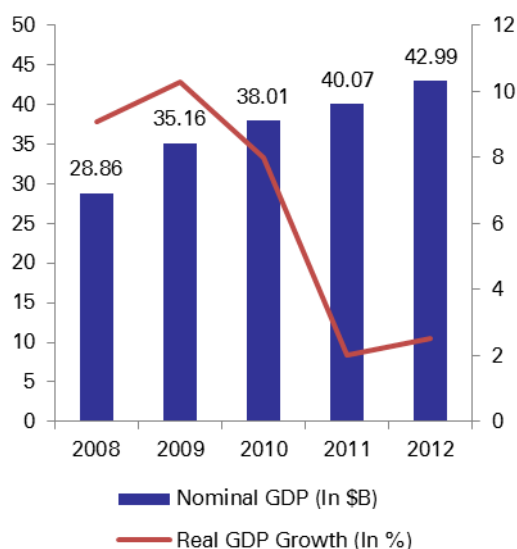
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Contact Information

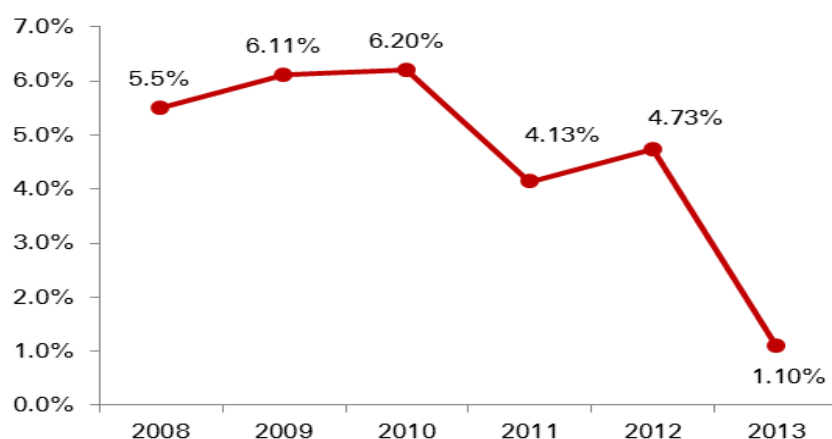
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Annual Inflation Rate



Source: Central Administration of Statistics, Blominvest Bank Research Department

In June 2014, the International Monetary Fund (IMF) team completed the staff report on Lebanon. The following lines discuss the issues, challenges, key developments and recommendations outlined by the IMF.

Key Developments over the Past Two Years

Prior to the Syrian crisis Lebanon was already suffering from a deceleration in economic growth after four years of strong performance. The eruption of the Syrian war amplified this downturn bringing real GDP growth down from 8% in 2010 to 2% in 2011, 2.5% in 2012 and 1.5% in 2013 as core drivers of growth such as construction, real estate and tourism were negatively impacted by the Syrian conflict.

Inflation remained contained, averaging 4% in 2013 and 2014. However, the IMF highlighted the presence of measurement issues: the housing prices were not regularly surveyed and the gap between old rent and new rent was only recently introduced in the Consumer Price Index (CPI).

The external account deficit remained large at 13% of GDP in 2012 and 2013. Exports were subdued and imports grew only marginally. The services balance was also affected by lower tourist spending from the GCC region. However, pressure on the services balance was somewhat contained by spending from non-resident Syrians (Unregistered refugees are treated as non-refugees in the balance of payments).

The Ramifications of the Syrian Crisis: Labor Market Hardly Hit

The spillovers from the Syrian crisis will generate not only an economic impact but also a social one. According to the World Bank, poverty is expected to increase by 4 percentage points in 2013, and labor supply is expected to rise by more than 50% by end 2014 especially impacting the unskilled labor (youth and women). Therefore the unemployment rate would surge to 20%. Amongst refugees, unemployment is estimated at 30% while more than 60% of the refugees work in the low skilled jobs, accepting much lower wages than the ones required by Lebanese workers.

Even before the Syrian crisis, the Lebanese labor market suffered from vulnerabilities. The unemployment rate of 11% in 2011 was already higher than the MENA average of 10%. One third of the labor force between the ages of 15-24 were unemployed, only 1 job was created for every six new entrants on the market and half of the labor force was employed in the informal sector. The IMF drafted a baseline scenario according to which the Syrian conflict is resolved by the end of 2016, date when the Syrian refugees start to gradually return to their country. Even under this assumption, unemployment would only be reduced to 18-19%. Growth might not be enough to bring down unemployment, only growth rates of 5-6% would help in bringing down joblessness.

Weak Public Finances

Deteriorating Public Finances and Rising Public Debt

In millions of USD	2008	2009	2010	2011	2012	2013
Fiscal Balance	(2,950)	(2,961)	(2,894)	(2,341)	(3,925)	(4,220)
Primary Balance	600	1,078	1,231	1,661	(110)	(240)
Public Debt	47,000	51,100	52,589	53,656	57,686	63,462

Source: Ministry of Finance, Association of Lebanese Banks

Lebanon is up against another major vulnerability: higher fiscal imbalances. In 2012, Lebanon recorded its first primary deficit since 2006, representing 0.25% of GDP and the downward trend in the debt to GDP ratio was reversed standing at 134% of GDP. In 2013, debt represented 141% of GDP and the primary deficit rose to 1% of GDP.

According to the IMF, this fiscal deterioration reflects spending pressures and revenue declines. The latter were linked to three components: a weak economy, the VAT exemption on gasoil with an estimated annual impact of 0.5% of GDP and the cost of living adjustments for public sector wages with an estimated annual impact of 1.25% of GDP.

The structure of public finances is also in need of review. Over 70% of current spending is dedicated to transfers to the loss-making Electricité du Liban (EDL), public sector wages and interest payments. These funds are therefore being steered away from capital spending, already below the standards, and are widening Lebanon's infrastructure deficit.

Reform of the electricity sector is crucial to the sustainability of public finances. The government transferred 4.5% of its GDP to EDL in 2013. The IMF qualified the company's production as inefficient and insufficient. Around half of total electricity production costs are not recovered with 15% in technical losses (problems of transmission and distribution, use of fuel in two power plants designed to operate on natural gas) and 30% of non-technical losses (theft, uncollected bills and illegal connections). With a supply of only 18 hours/day, EDL's current production is 2,019 MW far below the peak demand of 3,195 MW. This is why private generators are solicited but with tariffs three times higher than those of EDL. Unsurprisingly, 75% of Lebanese firms have reported electricity as a key operational hurdle, compared to 52% in the MENA region.

Increasing EDL tariffs is an important step of the reform process. EDL tariffs have remained unchanged since 1996 when the oil price stood at \$23/barrel. Higher EDL tariffs would cut transfers by 0.8% of GDP while switching to gas will generate savings of 0.2% of GDP. These reforms need to be undertaken even if the IMF projects transfers to EDL to decline in the future on the hypothesis of lower oil prices ahead.

The large refugee population has exacerbated already weak public finances. According to the World Bank's assessment and over the period 2012-2014 the Syrian influx will inflate government expenditures by \$1.1B and will subdue government revenues by \$1.5, yielding a total fiscal impact of \$2.6B. An additional \$2.5B will be needed to bring back public services to their pre-crisis levels.

Fiscal Impact of the Salary Scale

The fiscal balance might face additional pressures down the road if higher public sector wages go into effect. In 2012, the minimum wage for public sector employees was upped from \$332 to \$448, a cost of living adjustment was applied, leaving the adoption of a new salary scale under heated debate until this day. The IMF noted that if approved, the new salary scale would add another \$643M annually to the wage bill. The latter already represents a substantial 30% of total government revenue.

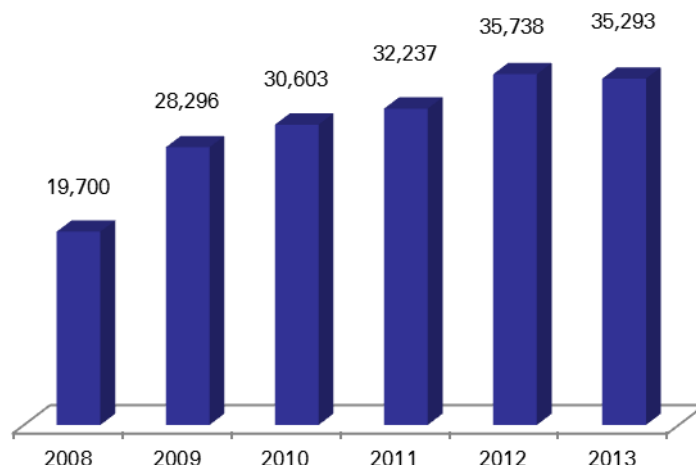
The IMF staff concluded that the proposed revenue measures are insufficient to curb the deficit. The suggestions consist of increasing the interest income tax from 5% to 7%, increasing the corporate income tax from 15% to 17%, introducing a new capital gain tax on real estate transactions, increasing tobacco excises, and increasing various stamp and fees. Combined, these measures will yield 1% of 2015's GDP. However, if the salary scale goes through, the budget deficit would rise to 12% of GDP and the primary deficit would increase to 2.5% of GDP in 2015.

Enforcing penalties on illegal seashore buildings and increasing VAT rates from 10% to 11% and from 10% to 15% for selected luxury items has also been put on the table. The IMF however advises against multiple VAT rates since it complicates tax administration.

The decision making process needs to be more enlightened. The IMF notes that basing the feasibility of the new salary scale on basic salaries can be misleading since public sector employees receive around 20 different allowance and indemnities, exceeding their basic salaries in some cases. Moreover, the impact of the new salary scale extends to pension benefits which are drawn for a substantial period of time (a retiree's surviving spouse receives benefits if unemployed) and which are adjusted in light of salary increases granted to those in active duty in addition to cost of living adjustments.

Banque du Liban (BDL): Ensuring Stability, Financing the Government and Boosting the Private Sector

Gross Foreign Reserves at the Central Bank of Lebanon (In Millions of USD)



Source: Banque du Liban

Despite all the above mentioned risks, rates on treasury-bills (T-bills) have remained unchanged. Only in March 2012, as per the IMF's recommendation, were interest rates on T-bills with maturity below 7 years increased by 50 basis points (bps) so as to reduce the government's reliance on Banque du Liban's (BDL) financing. Since then, the government kept T-bill rates unchanged and resorted to issuances of longer-term, higher yielding bills, and continued to rely on BDL purchases.

BDL is continuously maintaining stability. The consistent deposit inflows growing at an annual 7-8% are constantly fueling bank's foreign exchange deposits at the BDL and therefore boosting the central bank's foreign assets position. According to BDL figures, gross foreign reserves stood at a comfortable level of \$35B in 2013 covering 19.9 months of imports in 2013 and 32% of broad money supply. However, the IMF stated that although deposit inflows have indeed fueled reserves, their accumulation is associated with sterilization costs which have weakened the BDL's balance sheet. Hence, deposit growth of around 8% would be sufficient to maintain reserves at a comfortable level without higher sterilization costs.

BDL remains a major financier for the government. On the pound side, as commercial banks shy away from T-bills with maturities lower than 7 years and to mop up the banks' pound liquidity, BDL is offering banks long-term deposits (above 7 years) with yields matching those of similar maturity T-bills. This liquidity is then utilized by the BDL to cover demand shortfalls in T-bill auctions. On the shorter term, BDL has reduced its interest rate on commercial banks' deposits by 26 bps, in an attempt to boost the bank's appetite for government paper and away from deposits at the central bank.

However, the IMF recommends BDL to gradually retreat from T-bill auctions. Lower government reliance on BDL financing can only be sustained when fiscal vulnerabilities are tackled. Fiscal restraint is essential for putting debt on a more sustainable path and lowering the government's financing needs.

BDL is also boosting private sector financing. In 2013 it has provided \$1B of low-cost funds to commercial banks so they can lend them to various sectors, it allocated \$400M for commercial banks to finance start-ups in the knowledge economy and introduced an \$800M stimulus package for 2014.

Commercial Banks: The Resilient Government Financiers

As for commercial banks, they have been resilient amidst a challenging operating environment. Expansion in the region has been halted due to the ongoing instability where scope for private sector lending is currently narrow. Although banks' profitability has deteriorated, with return on assets of around 1%, liquidity buffers, of which large deposits with the central bank, remain strong.

Since banks remain exposed to the sovereign, the IMF called for stronger capital buffers. By end-2015, the BDL has required an additional capital buffer of 1.5% on top of the Basel III minimum requirements plus a 2.5% conservation buffer. The IMF staff has however called for more consistency in the banks' exposure to the government and to the central bank. Currently, the risk weight on foreign currency deposits at the BDL has been reduced from 100% to 50% while holdings of foreign-currency denominated government debt still carries a risk weight of 100%.

Down the road, the IMF believes banks could reconsider their current business model of channeling deposits to the public sector. If and when the government's financing needs are significantly reduced and if regional expansion remains narrow, banks might have to downsize their balance sheets.

Key Policy Recommendations

In terms of fiscal policy, the deterioration of public finances must be halted. Primary surpluses need to be restored to avoid losing market confidence and ensure debt sustainability. Once fiscal consolidation is put into place, the impact of an increase in public sector wages could be mitigated.

In terms of monetary policy, BDL's high reserves need to be preserved. However, BDL should withdraw from T-bill auctions and improve its balance sheet over time. T-bill auctions should be rendered more transparent and allow interest rates to reflect true market conditions. If fiscal equilibrium is not restored, rates on T-bills might have to increase to remain attractive for commercial banks.

The financial sector should be strengthened further. Capital buffers need to be enhanced, loan classification and restructuring rules as well as Anti-Money Laundering/Combating the Finance of Terrorism need to be improved.

Structural reforms are crucial in the path back to high-productivity growth. Reforming the electricity sector and lowering the cost of doing business have the potential to promote jobs and to enhance social living conditions.

Lebanon's growth potential can also be boosted by Public Private Partnerships (PPP). The legal framework for this partnership is still a pending issue and passing it would allow for better governance and transparency.

In conclusion, the IMF believes that Lebanon can turn its situation around the same way it did many times before. Still, the current shock (Syrian conflict) is different from those suffered in the past due to its "multi-faceted" and "prolonged" nature.

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