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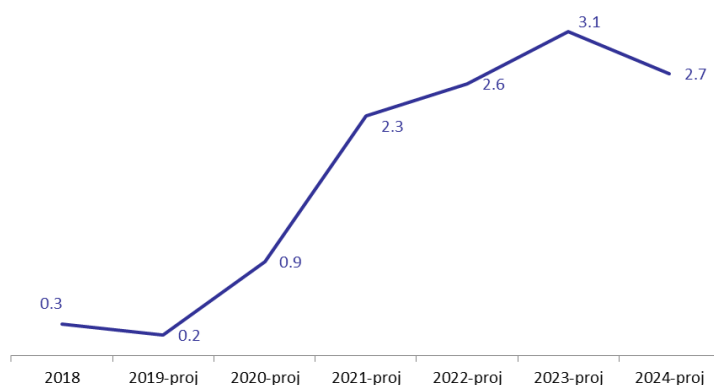
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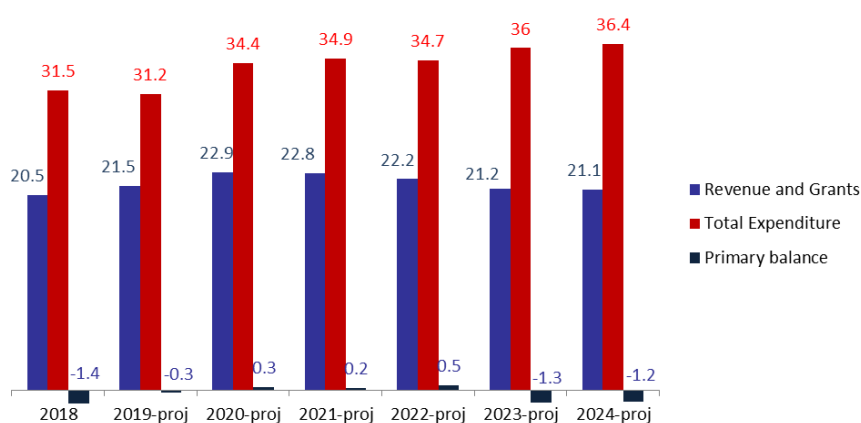
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Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Lebanon, the staff report has been released. In details, the Staff Report is prepared by a staff team of the IMF for the Executive Board's consideration on September 11, 2019, following discussions that ended on July 2, 2019, with the officials of Lebanon on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 21, 2019. Worth mentioning that the report was published on October 17, 2019 prior to the widespread social protests and the government's resignation. This paper aims to go through the whole report and focus on its main findings.

Annual percentage change in Real GDP(Market Prices)

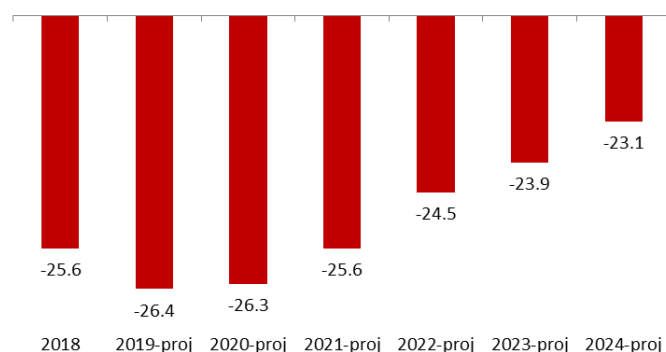


In percentage of GDP



Source: IMF

Current Account in % of GDP



Source: IMF

The Lebanese economy has been struggling in 2018 and the first half of 2019 over low confidence, high uncertainty, tight monetary policy and a substantial contraction in economic activity across the most sectors. The country's finances remained weak in 2018. In details, the public debt-to-GDP ratio continues to be on an unsustainable path, reaching 151 percent of GDP. In addition, the budget deficit increased significantly, reaching 11 percent of GDP in 2018, up from 8.6 percent in 2017, with the primary balance worsening from 0.5 to -1.4 percent of GDP. The rise in deficit can be attributed to the salary scale increase implemented in the second half of 2017. Although the government reduced its expenses by 28% through April 2019, it appears that this was mainly due to an accumulation of delayed payment orders, which were already above their usual level in 2018.

Lebanon's economy has traditionally relied on foreign direct investment and remittance inflows from the diaspora to sustain economic activity and fund the fiscal and current account deficits. Declining cross-border capital inflows over the past few years have led the Banque du Liban (BdL, the central bank) to draw on its existing stock of foreign exchange reserves to ensure foreign currency debt service payments by the government, while maintaining the currency peg and financial sector stability. Moreover, the BDL held financial operations to provide high returns on new USD deposits in an effort to attract and retain USD deposits in the banking sector.

Given the critical situation and significant recession, Lebanon needs to implement policies and long term reforms in the upcoming period in order to restore investors' confidence and unlock external support package through CEDRE investments. The report focuses on 3 main priorities in order to raise growth and improve Lebanon's fiscal and external position: credible *fiscal adjustments* which aim to reduce public debt to sustainable levels in addition of important *structural reforms* toward improving the country's business climate and governance and finally changes in the *monetary policy*.

Over the medium term, Lebanon can take advantage of the potential discovery of a natural gas field and possible reconstruction projects in Syria noting that the Syrian conflict had exacerbated Lebanon's situation. However, the report mentioned some local and external risks that can lead to a fall in confidence and economic and financial crisis. For instance, any domestic political disagreements preventing the implementation of budget 2020 will lead to conflicts and security incidents.

Policy Priorities

1. Front-Loaded and Sustained Fiscal Consolidation

The 2019 budget targets a deficit of 7.6% of GDP from 11.1% in 2018. The Lebanese has set revenue and expenditure measures in order to reduce its deficit including:

- Increasing the tax on interest income from 7 to 10%
- 3 percent tax on imported goods which are subject to VAT, excluding fuel, industrial equipment and raw materials
- Recruitment and hiring freeze in the public sector until the Government conducts a comprehensive count of the number of employees and their positions
 - A 3 year suspension of the early retirement option for civil servants and most army personnel.
 - Retirees prohibited from receiving multiple pensions from various positions held in the public sector.

Worth mentioning that the IMF's staff projects a reduction of the cash-basis fiscal deficit to around 9.75% of GDP if the above measures are implemented.

The government has started to implement the Electricity Reform Plan (ERP) agreed in April 2019. The ERP is set to eliminate the deficit of Electricite du Liban (EDL), the state electricity company, in 2022-2023. In details, the plan aims to reduce non-technical and technical losses, switch fuel to natural gas to reduce production costs at existing plant, increase EdL's capacity to meet demand, and subsequently raise tariffs to eliminate electricity subsidies of about 2½ percent of GDP by 2023.

The above fiscal reforms will result in a primary surplus in 2020-2022. However, additional reforms must be done to reach a primary surplus of around 4-5% of GDP and therefore reduce the debt to GDP ratio for the medium and long term. In this context, the report suggests a raise in the Value-added-tax (VAT), increase in fuel excises and removal of exemptions on item such as foreign-registered yachts, diesel used for electricity generation, and road vehicles. The report highlights the importance on the improvement in the compliance front. In fact, this will help realize the revenue potential of VAT and other tax increases and limit tax evasion which might otherwise increase at higher rates.

2. Growth- and Export-Enhancing Structural Reforms

Despite the fact that Lebanon is highly open both to trade and foreign direct investment, the country lacks fundamental structural reforms preventing the improvement of its external competitiveness. In fact, in addition to the high cost of doing business, two priority areas for reforms are electricity provision, where the authorities have already approved a plan, and reducing corruption.

Lebanon faces important problem in the area of "Doing Business". In this context, the report suggests the following: *"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."*

Corruption has become a vital issue in Lebanon preventing its development and prosperity and affecting several business-related areas. According to the World Bank's Business Enterprise Survey (2013), 61.4% of firms identify corruption as a major constraint compared to 49.1% in the MENA region. In 2017, the Parliament approved the Access to Information Law after a decade of deliberations while work on an anti-corruption strategy was initiated. More recently, a draft public procurement law has been prepared with assistance from the World Bank. An Anti-Corruption Law, which allows for the establishment of a national anti-corruption commission, and whistleblower Protection legislation has also been adopted.

3. Monetary Policy and Financial Stability

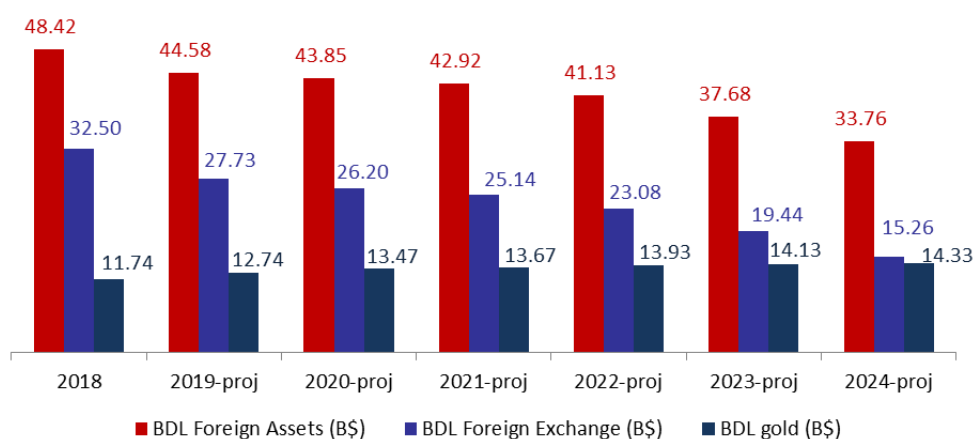
Banque du Liban (BDL), started in 2016 a series of unorthodox financial operations in order to attract inflows and protect the peg. It proceeded to banks with an offer to enter into a transaction in which they would have to bring US dollars from abroad to bdl against loans at low interest rates in LBP that would be placed back at the Central Bank at high interest rates. Moreover, in the latest operation, banks were able to record their yields as profit provided they are retained as capital.

In its report, the IMF urges Lebanon's Central Bank to step back from financial engineering and focus instead on normal financial operations and strengthen its balance sheet. Moreover, the IMF advised BDL to allow the market determining yields on government debt and step back from government bond purchases.

Buffers in the banking system should continue to be increased by aligning sovereign risk weights with the Basel Accord and encouraging banks to engage in forward-looking capital planning in line with their risk profiles.

The authorities should also strengthen their crisis management and AML/CFT [anti-money laundering/combating the financing of terrorism] frameworks. In fact, a negative assessment could adversely affect investment and banks' continued access to correspondent banks. The report proposes the following:

- Sharing the outcomes of the national risk assessments with private and public sector stakeholders.
- Improving risk-based supervision and ensuring the effective application of preventive measures (including those related to politically exposed persons) among all financial institutions and designated non-financial businesses and professions.
- Ensuring the timely availability of accurate beneficial ownership information.
- Improving targeted financial sanctions requirement.
- Increasing the numbers of prosecutions and convictions for ML commensurate with risks.



Source: IMF

Annex: External Debt Sustainability Analysis

In one of the annexes, the IMF discusses the unsustainability of Lebanon's external debt.

External debt is the portion of a country's debt that was borrowed from foreign lenders, including commercial banks, governments, or international financial institutions. These loans, including interest, must usually be paid in the currency in which the loan was made.

Lebanon's external debt is estimated at about 190 percent of GDP in 2018. In details, 77% of the external debt is non-resident deposits, most of which are short-term with maturities less than one year.¹ while Government debt only accounts for about 10% of total external debt, with only about a third of the outstanding Eurobond estimated to be held by foreign investors. The remainder of the external debt is debt owed by the BdL, bank non-deposit liabilities, and non-bank liabilities.

The use of the foreign exchange reserves helped to ease the surge in external debt given the fact that the Non-resident deposits started to decrease in 2018. The government did not issue any Eurobonds in the market. Instead, they were issued to BdL, which then re-sold part of them to the market at a discount to attract foreign exchange.

The scenario presented in the report shows Lebanon's sensitivity to an exchange rate shock.

It becomes crucial to reduce external imbalances and rely on external financing. In fact, a real depreciation shock of 30% would increase external debt to over 300% of GDP.

According to the report a decisive external adjustment is needed in order to restore external sustainability. *"Over the medium term, structural reforms, particularly in the energy sector that would shift the inputs from oil to gas, can yield gains from production efficiencies and reduction of losses. Potential extraction of gas inside Lebanon can help to reduce the demand for expensive fuel imports, including diesel."*

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