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Perhaps the most important document that was prepared on the Lebanese economy in the last few months is the government's reform plan¹. That does not necessarily mean that it is the best plan or the only one. But, understandably, it has attracted a lot of attention and debate, especially concerning the magnitude and sources of the financial losses that the Lebanese economy has amassed as a result of its financial crisis².

What I am interested in doing in this note is not to rekindle that debate, but to look at what the document has to offer in terms of deficit and debt reductions. This is partly because the Lebanese crisis has started primarily as a debt crisis before mushrooming into a currency and banking crises, but mostly because I think that the debt reduction process suggested by the document can be improved on.

To motivate this discussion, Table 1 below presents the basic data regarding the document's medium-term fiscal-macro framework (2020-24):

Table 1: Macro-Fiscal		Projections				
	2019	2020	2021	2022	2023	2024
Real Growth %	-6.9	-13.8	-4.4	1.6	2.9	3.1
GDP Deflator %	0.4	36.2	28.2	6.2	5.8	5.5
Budget Balance % GDP	-11.3	-5.3	-5.6	-4.8	-2.6	-0.7
Primary Balance % GDP	-0.9	-1.5	-3	-2.3	-0.2	1.6
Interest Payment %GDP	10.4	3.8	3.6	2.5	2.4	2.3
Nominal GDP Bn LBP	77,419	90,912	111,441	120,215	130,921	142,360
Nominal Debt Bn LBP	135,948	93,458	108,878	121,898	133,671	141,221
Debt to Ratio %	175.6	102.8	97.7	101.4	102.1	99.2

¹ "The Lebanese Government's Financial Recovery Plan". Government of Lebanon, Council of Ministers. April 2020.

² The main reason behind the attraction is that the document has formed the basis for negotiations with the IMF for a reform and financing program.

It is quite evident from Table 1 that the debt reduction medium-term framework relies first and foremost on debt cancellation. The debt is reduced by LBP 42,490 Bn in 2020 or close to 31.3% of total debt. As important, we see that interest payments (as a ratio of GDP) fall from 10.4% to 3.8%, the deficit ratio falls from 11.3% to 5.3%, and the debt ratio declines from 175.6% to 102.8%; and with the exception of the deficit ratio, these ratios stay more or less the same throughout the period.

I believe that front-loading the debt reduction in this drastic and quick manner is not the proper thing to do, for three reasons:

First, BDL and the banks hold close to 80% of the debt, so debt restructuring of this nature will be excessively hard on their balance sheets, undermining profitability, capital adequacy, and liquidity.

Table 2: Government Fiscal Consolidation	Projections				
	With Measures				
	2020	2021	2022	2023	2024
Total Revenue % GDP	17.9	17.5	18.4	18.7	18.7
Primary Expenditures % GDP	19.4	20.4	20.6	18.9	17.1
	Without Measures				
Total Revenue % GDP	17.2	15.8	16.9	15.2	15
Primary Expenditures % GDP	18.7	18.6	19.1	18.7	18.4

Second, it is a standard precept in the economic literature on debt restructuring that if a country exhibits consistent primary surpluses then debt cancellation and re-profiling is the right approach since interest payments is the driver behind budget deficits. Alternatively, if the country suffers from primary deficits consistently, then fiscal deficits are structural and fiscal consolidation is the answer, not debt restructuring. The trouble is that Lebanon exhibits both, needing both fiscal consolidation and interest payments reductions. And fiscal consolidation should tackle increasing revenues and reducing primary expenditures by essentially eliminating tax evasion and reducing an inflated public wage bill and transfers to EDL. From Table 2 above, we see that the government plan increases revenues to 18.7% of GDP, 3.7% more than the figure in the absence of consolidation measures; whereas it reduces primary expenditures to 17.1%, only 1.3% less than the figure without consolidation measures. These are limited adjustments and throw the burden of fiscal restructuring non-proportionally on debt cancellation which may have acted as a disincentive for stronger fiscal consolidation.

Third, another very important precept of the economics of debt sustainability is that the sufficient condition for debt stability states that the growth rate of the economy should exceed the interest rate, irrespective of the primary balance. However, from Table 1 we see that real growth reaches 3.1% only, and is assumed to prevail in the long-run. This is a very timid and low estimate, especially that a rigorous estimate of the potential real growth rate of the economy puts it at 5.5%³.

³ Bolbol, A. and Mouradian, A. (2018) "Potential Output and Unemployment in Lebanon", *Association of Banks in Lebanon (ABL) Monthly Bulletin*, No. 4/2018). As a matter of fact, in case of unemployment, the growth rate of GDP can exceed 5.5% due to the utilization of the backlog of unemployed resources; once full employment is reached, the growth rate will converge to the potential, long-run rate at 5.5% with the inflation rate estimated at around 3%.

What the above discussion clearly indicates is that a plan of fiscal sustainability should be three pronged, emphasizing debt restructuring, fiscal consolidation, and steady growth. Though imperfect, the available plan that comes close to this is the ABL plan⁴. And it is imperfect because it is shy on debt restructuring and falls short on real growth.

Table 3 below depicts ABL's fiscal consolidation measures, its macro outlook, and its projections of the debt to GDP ratio. We can conclude the following from it:

Table 3: ABL Fiscal Consolidation	Projections				
	With Measures				
	2020	2021	2022	2023	2024
Total Revenue % GDP	17.2	19	19.6	20	20.5
Primary Expenditures % GDP	18.8	19	19	18.9	18.4
	Without Measures				
Total Revenue % GDP	17.2	15.8	15.9	15.2	15
Primary Expenditures % GDP	18.7	18.6	19.1	18.7	18.4
	ABL Macro Outlook				
Real Growth %	-13.8	2	2.5	3	4
GDP Deflator %	36.2	11	6.2	5.8	5.5
	ABL Debt to GDP Estimates %				
	2019	2020	2021	2022	2023
	175.6	170.7	176.5	154.3	143.8
	2025	2026	2027	2028	2029
	116.5	103.7	95.2	87.1	79.5

First, its revenue measures are expected to yield a sizable 5.5% in excess of no measures; whereas its primary expenditures are neutral at 18.4%. However, the ABL document records a decent 4% improvement in primary expenditures due to the measures, though the entire savings are spent on social protection.

Second, the real growth rate of GDP is higher at 4%, but that is still a conservative estimate, especially if we also consider the infrastructural investments promised by Cedre.

Third, the debt to GDP ratio takes longer to fall: by 2024, the Government plan has the debt at about 99%, whereas the ABL plan at about 132%. That is because the ABL plan relies in its debt restructuring measures on debt re-profiling (changes to interest rates and maturities for both domestic and foreign debt), not on debt cancellation.

Fourth, had the ABL plan accepted some debt cancellation and allowed for more real growth, its debt to GDP ratio would have come down faster and sooner.

Lastly, assume that the desired debt to GDP ratio is 72% -- the ratio arrived at in the ABL plan in 2030 -- which is notably below the critical threshold of 90%⁵. If by then, the economy is growing at its long-run, potential growth rate of 8.5% (5.5% real growth and 3% GDP deflator growth), then what would be the sustainable deficit ratio that would maintain the desired level of debt?⁶ To answer this question, let the debt ratio be $d = D/Y$, where D is public debt and Y is GDP. As a result, the percentage change in the debt ratio is equal to:

$$\Delta(D/Y)/(D/Y) = \Delta D/D - \Delta Y/Y$$

⁴ "Contributions to the Lebanese Government's Financial Recovery Plan" ABL. May 2020.

⁵ Reinhart, C. and Rogoff, K. (2010). "Growth in a Time of Debt". *AER*, 100, 2. Notwithstanding the empirical irregularities that accompanied the calculation of this threshold.

⁶ See footnote 3 for more on the potential growth rate.

If the desired debt ratio is reached at d^* , then the debt ratio would be constant and as a result $\Delta(D/Y)/(D/Y) = 0$. Hence:

$$\Delta D/D = \Delta Y/Y$$

Multiplying the above equation by D/Y , we get:

$$\Delta D/Y = D/Y \cdot \Delta Y/Y$$

Since the change in the debt ΔD is equal to the budget deficit BD , and since D/Y is at the desired level d^* , the above equation becomes:

$$BD/Y = d^* \cdot \Delta Y/Y$$

The equation arrived at above is very interesting, because it shows that if in the long-run d^* is 72% and $\Delta Y/Y$ is 8.5%, then the sustainable deficit ratio BD/Y should be 6.1%. Not surprisingly, if the desired debt ratio is lower, then the sustainable deficit ratio should be lower too. More importantly, if fiscal restructuring enables the economy to reach a sustainable debt ratio in the long run, then it is the economy's growth rate that will determine and maintain the corresponding sustainable deficit ratio.

In closing, I would like to end with two conclusions. First, reducing debt to sustainable levels is important, but what is more important is how to get there with minimal damage to the domestic financial system (not to mention international reputation and access to global capital markets). A combination of limited debt cancellation, fiscal consolidation, and steady growth should do the trick: limited debt cancellation reduces the burden of interest and principal payments; fiscal consolidation is important in its own right but also in terms of reducing corruption and restoring governance to the public sector; and steady growth is essential, even sufficient, for the short run reduction in the debt ratio and its long run sustainability. One can't really overemphasize the importance of steady growth and the reform policies that will bring it about; and, more important, to have it based on strong fundamentals not occasional booms, and to be a product of higher and wider productivity.

Second, unless there is an obtuse political imperative to drag the reform and recovery process into the unknown, the government and the financial community should put the debate on financial losses behind them, and start attacking the reform agenda with the rigor and urgency that it needs. This is the more so given that a lot of the desired reforms are largely independent of these losses. The economic pie is shrinking and shrinking fast, and only a concerted reform effort can make it grow out of the "black hole" that it is sinking in.

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