INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/312

LEBANON

October 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; INFORMATIONAL ANNEX; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR LEBANON

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 following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 11, 2019 consideration of the staff report that concluded the Article IV consultation with Lebanon.
- The **Staff Report** 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.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Lebanon.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Press Release No. 19/378 FOR IMMEDIATE RELEASE
October 17, 2019

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2019 Article IV Consultation with Lebanon

On September 11, 2019, the Executive Board of the International Monetary Fund (IMF) concluded its 2019 Article IV consultation[1] with Lebanon.

Lebanon's economic growth slowed to around 0.3 percent in 2018 on the back of low confidence, high uncertainty, tight monetary policy and a substantial contraction in the real estate sector. Most high-frequency indicators point towards a continuation of weak growth in 2019. Inflation spiked to 6 percent in 2018, up from 4.5 percent in 2017, partly due to high prices of imported fuel but slowed down in the second half of the year and into 2019.

The headline fiscal deficit increased significantly, reaching 11 percent of GDP in 2018, up from 8.6 percent of GDP in 2017, partly due to an increase in the public sector salary scale and new hiring despite the hiring freeze. The budget approved by Parliament in July 2019 targets a deficit of 7.6 percent of GDP based on various revenue and expenditure measures. Staff estimates that the deficit will likely be higher due to optimistic assumptions in the budget about growth and the impact of revenue measures. Public debt is projected to increase to 155 percent of GDP by the end of 2019.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Deposit inflows, which finance Lebanon's twin deficits, slowed down in 2018. The BdL has continued its financial operations to facilitate banks offering high returns on USD deposits, with the aim of attracting USD deposits to the banking sector and maintaining a high level of foreign reserves.

During 2018–19, the authorities have also taken some important structural measures. Parliament has approved a plan to reform the electricity sector in April 2019, which is expected to contribute to a reduction of the fiscal deficit over the medium term. Other laws approved include a code of commerce and a law on judicial intermediation. These and other planned reforms could encourage donor disbursements of concessional financing for the Capital Investment Plan (CIP) committed at CEDRE in April 2018.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They acknowledged that Lebanon has shown unique resilience in the face of long-standing economic challenges, but noted that strong and steadfast efforts are critically needed to ensure macroeconomic stability against a difficult economic situation with high debt, twin deficits and a weak external position. Directors noted that the ongoing Syrian conflict has exacerbated Lebanon's challenges. In this regard, they commended the authorities for their generous support in hosting the refugees and agreed that Lebanon needs continued international support.

Directors emphasized the need for a multi-year fiscal adjustment to reduce public debt to sustainable levels. While the approval of the 2019 budget by parliament is an important first step, Directors noted that achieving the authorities' primary surplus goals and rebalancing the economy will require credible measures–both on the revenue and expenditure sides—and sustained implementation. They viewed that fiscal measures should include raising the VAT rate, broadening the tax base and removing exemptions, as well as increasing fuel excises and eliminating electricity subsidies. Directors noted that these measures should be complemented by a thorough expenditure review to achieve sustained fiscal savings. They noted that a

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

successful implementation of the government's Capital Investment Plan, financed on concessional terms, could help mitigate the contractionary effect of the adjustment on growth. To protect the most vulnerable people, Directors underscored the need for a stronger social safety net.

Directors commended the Banque du Liban (BdL) for maintaining financial stability while emphasizing the need to rebuild its financial strength. They encouraged the BdL to step back from quasi-fiscal operations, strengthen its balance sheet and require banks to build up their own buffers further. Directors highlighted the importance of implementing AML/CFT measures efficiently to continue to mitigate risks and ensure a positive MENA Financial Action Task Force assessment.

Directors noted that the fiscal adjustment effort needs to be complemented by fundamental structural reforms to raise growth and improve Lebanon's fiscal and external position. While the approval of the new electricity sector plan and legislative process on the government's CEDRE vision reforms are important first steps, they saw the need for decisive actions to remove growth bottlenecks and enable external adjustment in the context of the currency peg. Directors also called on the authorities to address governance weaknesses that increase Lebanon's vulnerability to corruption.

Lebanon: Selected Economic Indicators, 2018–24							
	2018	2019	2020	2021	2022	2023	2024
	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Output and prices	(Annual percentage change)						
Real GDP (market prices)	0.3	0.2	0.9	2.3	2.6	3.1	2.7
GDP deflator	5.3	3.7	2.3	2.1	2.1	2.1	2.1
Consumer prices (end-of-period)	4.0	3.4	2.4	2.4	2.4	2.4	2.4
Consumer price (period average)	6.1	3.1	2.6	2.4	2.4	2.4	2.4
Investment and saving	(In percent of GDP)						
Gross capital formation	22.0	21.5	22.5	23.0	21.9	19.3	18.2
Government	1.6	1.6	2.7	3.6	3.5	3.4	3.3
Nongovernment	20.4	19.9	19.9	19.4	18.4	15.9	14.9
Gross national savings	-3.3	-4.0	-3.2	-2.3	-2.6	-4.9	-5.4
Government	-9.5	-8.2	-9.0	-8.6	-9.1	-11.5	-12.1
Nongovernment	6.1	4.2	5.8	6.3	6.5	6.6	6.7
Central government finances (cash basis)	(In percent of GDP)						
Revenue (including grants)	20.5	21.5	22.9	22.8	22.2	21.2	21.1
Expenditure	31.5	31.2	34.4	34.9	34.7	36.0	36.4
Overall balance (including grants)	-11.0	-9.8	-11.5	-12.1	-12.5	-14.8	-15.3
Primary balance (including grants)	-1.4	-0.3	0.3	0.2	0.5	-1.3	-1.2
Total government debt 1/	151	155	162	167	172	178	185
Monetary sector	(Annual percentage change, unless otherwise indicated)						
Broad money 2/	3.6	4.0	6.0	5.0	4.0	3.0	3.0
Deposit dollarization (level)	70.7	70.0	68.0	68.0	69.0	70.0	70.0
Interest rates (period average, in percent)							
Three-month treasury bill yield	9.0	10.2	9.3	9.1	9.7	10.2	10.5
Five-year treasury bill yield	6.8	8.0	8.0	8.0	8.0	8.0	8.0
External sector	(In percent of GDP, unless otherwise indicated)						
Exports of goods and services (in US$, percentage change)	2.3	7.3	5.1	4.9	5.2	5.6	5.6
Imports of goods and services (in US$, percentage change)	3.2	1.5	3.3	2.8	2.2	3.9	3.4
Balance of goods and services	-24.3	-21.8	-21.2	-20.1	-18.6	-17.7	-16.7
Current account	-25.6	-26.4	-26.3	-25.6	-24.5	-23.9	-23.1
Foreign direct investment	2.4	3.0	3.8	4.6	4.6	4.1	3.5
Total external debt 3/	191	196	207	215	219	219	219
Gross reserves (in billions of U.S. dollars) 4/	36.5	31.7	30.2	29.1	27.0	23.4	19.2
In months of next year imports of goods and services	12.9	10.9	10.1	9.5	8.5	7.1	8.7
In percent of short-term external debt 5/	44.2	36.1	32.1	28.6	24.9	20.3	15.9
In percent of banking system foreign currency deposits	29.6	25.0	23.1	21.2	18.6	15.4	12.3

In percent of total banking system deposits	20.9	17.5	15.7	14.4	12.9	10.8	8.6
Memorandum items							
Nominal GDP (in billions of U.S. dollars)	56.4	58.6	60.5	63.1	66.1	69.6	73.0
Non-resident deposits (staff estimate, percent change)	4.2	5.1	6.1	5.1	4.0	3.0	3.0
Commercial bank total assets (percent of GDP)	443	443	455	458	455	445	438
Real effective exchange rate (annual average, percent change)	2.2	...	...	...	...	...	...

Sources: Lebanese authorities; IMF staff estimates.

1/ Does not include the bridge loan from the central bank.

2/ Defined as currency in circulation plus resident and nonresident deposits.

3/ Includes nonresident deposits.

4/ Excluding gold and encumbered assets.

5/ Short-term debt on a remaining maturity basis, including short-term nonresident deposits.

INTERNATIONAL MONETARY FUND

LEBANON

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

August 21, 2019

KEY ISSUES

Context. Lebanon's economic position continues to be very difficult, with very low growth, high public debt and large twin deficits. While financial stability has been maintained, deposit inflows, critical to finance the budget and external deficits, slowed down during the past year, reducing the authorities' room for maneuver. The new government has taken some important policy steps to start the needed policy adjustment, which could help raise confidence among investors and donors. The parliament has approved a plan to reform the electricity sector and reduce its fiscal cost as well as a budget that aims to reduce the overall fiscal deficit in 2019. However, substantial new measures are still needed to reduce the exceptionally large domestic and external imbalances and mitigate Lebanon's vulnerabilities.

Policy Priorities. The highest priority is the implementation of a sustainable fiscal adjustment that will bend down the path of the public debt-to-GDP ratio through a combination of revenue and expenditure measures. This needs to be complemented by structural reforms and concessionally financed investment to raise Lebanon's growth potential and help external adjustment, as well as policies to build further buffers in Lebanon's financial sector.

Key Recommendations. The authorities should adopt and implement a comprehensive multi-year reform plan.

- Fiscal adjustment needs to target a primary surplus of 4–5 percent of GDP over the medium term. It will require both significant revenue measures, such as a higher and broader VAT, and expenditure measures. Beyond eliminating electricity subsidies, the authorities should conduct an expenditure review to identify further savings opportunities.
- Structural reforms are essential to both unlock Lebanon's growth potential and help improve Lebanon's external position. Reforms should prioritize reforming the electricity sector, removing impediments to and lowering the cost of doing business, as well as improving governance and reducing corruption.
- The authorities should also build buffers in the country's financial system. The BdL should gradually reduce the support it provides to the government and strengthen its balance sheet. It should also require banks to increase their own capital buffers.
- As reforms are implemented, donors should accelerate disbursement of project financing committed at the CEDRE conference in April 2018.

Approved By
Thanos Arvanitis (MCD) and Yan Sun (SPR)

Discussions took place in Beirut during June 18–July 2, 2019. The staff team comprised Messrs. Jarvis (head) and Ricka, Ms. de Soyres (all MCD), Ms. Nakhle (local economist), Mr. Walker (FAD), Ms. Togo (SPR), Mr. Vardy (MCM) and Mr. Berkhout (LEG). Mr. Geadah (OED) joined some of the policy discussions. The team met with President Michel Aoun, Prime Minister Saad Hariri, Central Bank Governor Riad Salamé, Minister of Finance Ali Hassan Khalil, Minister of Economy and Trade Mansour Bteish, Minister of Energy and Water Nada Boustani, Minister of Labor Camille Abou Sleiman, various government officials and representatives of the private sector, civil society, and the international community. Jawed Sakhi provided research assistance; Laila Azoor and Cecilia Pineda contributed to the preparation of this report.

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CONTEXT

1. Lebanon's already difficult economic position worsened further in 2018. The country has long suffered from large fiscal deficits which have left public debt at around 150 percent of GDP, and large current account deficits that have brought external debt close to 190 percent of GDP. Growth has been low since the start of the Syrian crisis. Against a background of policy inaction due to the lack of an approved government after the May 2018 parliamentary elections, economic imbalances grew further in 2018. Economic growth effectively stalled, the budget deficit reached 11 percent of GDP, and the current account deficit exceeded 25 percent. The Banque du Liban (BdL) has skillfully maintained financial stability in difficult circumstances, often with unconventional measures, but the cost of these operations has grown, and the financial challenges Lebanon faces have intensified.

2. The new government formed in January 2019 has taken important first policy steps to help raise confidence among investors and donors. The parliament has approved a plan to reform the electricity sector and reduce its fiscal cost as well as a budget that aims to substantially reduce the overall fiscal deficit in 2019. Such reforms can 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 communities hosting Syrian refugees as well as the refugees themselves.

3. The long path to reduce vulnerabilities and re-equilibrate the economy will need to involve further fiscal adjustment and radical structural reforms. The government needs to develop and decisively implement a comprehensive multiyear reform strategy to strengthen confidence and restore fiscal and external sustainability. Vulnerabilities in the Lebanese economy have increased significantly, and fundamental economic reforms represent the best path forward. The growth boost from the CIP can counteract the contractionary effect of the planned fiscal adjustment, especially if the authorities move quickly to improve the public investment management framework.

A DIFFICULT ECONOMIC ENVIRONMENT

4. Economic activity slowed in 2018, and the slowdown appears to be continuing in 2019. 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. Most high frequency indicators showed negative readings in the first half of 2019, including a decline of 16 percent in the value of cleared checks and 31 percent in the number of construction permits. The one notable exception is tourism, with tourist spending up 12 percent in the first half of 2019 relative to 2018. 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. **Social conditions remain difficult.** Lebanon hosts approximately 1.5 million Syrian refugees (equivalent to a quarter of the population). Unemployment rate is estimated at about 20 percent with youth unemployment even higher at 30 percent. Already in 2010, before the influx of Syrian refugees, half of the labor force worked in the informal sector, without access to social insurance.

6. **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 public debt-to-GDP ratio continues to be on an unsustainable path, reaching 151 percent of GDP (from 130 percent in 2012), although the pace was dampened last year by the higher-than-usual inflation, and thereby the relatively high nominal output growth.

7. **A large part of the deficit increase was due to higher spending following the salary scale increase implemented in the second half of 2017.** The new salary scale was more expensive than anticipated, as it also translated into higher pensions and a spike in lump-sum payments associated with early retirements. New hiring despite a hiring freeze further raised spending on personnel, underscoring the need to strengthen fiscal governance. Because of the large public debt, interest payments exceeded 9 percent of GDP. Tax revenues in 2018 were lower than forecast, with all tax revenue categories disappointing in the slow economy except taxes on income and profits.

8. **In anticipation of an approved budget, the authorities made an effort to rein in spending in the first months of 2019, but this may have resulted in delayed payments.** Expenditures through April declined by 28 percent year-on-year, which can be attributed to efforts to limit outlays in the run-up to the 2019 budget approval. However, there appears also to have been an accumulation of delayed payment orders, which were already above their usual level in 2018. There are numerous reports and statements from government officials and the private sector of arrears to the social security fund, hospitals, and suppliers. However, despite its request, staff has not received sufficient specific information on arrears and delayed payment orders from the authorities. On the revenue side, overall tax collections were 9 percent lower through April 2019.

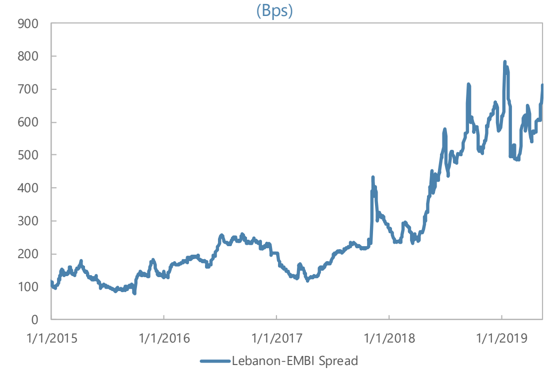
9. **The current account deficit remained largely unchanged at over 25 percent of GDP in 2018, accentuating external financing pressures.** The trade deficit is estimated to have widened further in the first five months of 2019. The external position continues to be substantially weaker than the level consistent with medium-term fundamentals and desirable policy settings. Although standard models have limitations given weaknesses in Lebanon's balance of payments statistics, the estimated overvaluation of the real effective exchange rate (REER) is significant (see Annex II).

10. **BdL's efforts to secure external financing have come under strain as deposit inflows have declined and the BdL's gross foreign exchange reserves have fallen** (see Box 1). The BdL has continued its financial operations to provide high returns on new USD deposits in an effort to attract and retain USD deposits in the banking sector and maintain a high level of foreign reserves. Yet deposit inflows have decreased, with deposit growth net of interest accrual turning negative. The BdL's foreign reserves declined by USD 7.5 billion from their previous peak. At the same time,

the financial operations contributed to very tight monetary conditions, in which private credit declined and non-performing loans increased.

11. Reflecting the weakening fundamentals and sentiment, Eurobond yields have increased, and Lebanon was subject to a ratings downgrade. Spreads with other emerging markets temporarily rose to record heights in January 2019. They subsequently dropped somewhat but remain volatile and above those seen in November 2017 during the crisis of Prime Minister (PM) Hariri's temporary resignation. Moody's downgraded Lebanon's sovereign rating to Caa1 in January 2019 and Standard and Poor's and Fitch changed the outlook to negative on their B- rating.

Lebanon-EMBI Spread
(Bps)

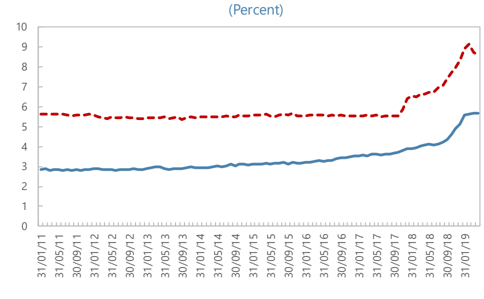


Source: Bloomberg.

Box 1. The BdL's Financial Operations and their Impact on the Financial Sector

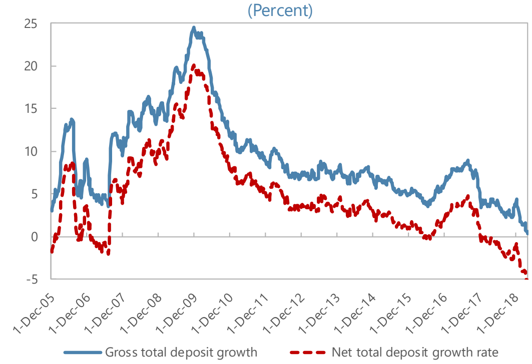
The BdL has continued to use unconventional financial operations to attract inflows and support the peg.[1] The operations have provided high marginal returns in LBP and in USD on new bank USD deposits at the BdL. For example, for each new deposit at the BdL in USD, a bank would earn a 6.5 percent interest in USD and in addition have an opportunity to borrow a slightly larger amount in LBP at 2 percent and re-deposit it at the BdL at 10.5 percent for 10 years. These operations have boosted the BdL's dollar holdings without affecting rates on older deposits at the BdL or on government debt. Until recently, effective combined yields in LBP and USD were approximately 17 percent on a 10-year placement. Starting in July 2019, an additional operation offers a higher total return on 3-year deposits. The latest operation also allows banks to record future profits from the operation upfront as long as the profits are retained as capital. The volume of these financial operations has been large in recent years: the operations in place since fall of 2017 have attracted over USD 24 billion from banks through February 2019 in sales to or deposits at the BdL.

Average Interest Rate on Deposits in Commercial Banks
(Percent)



Source: BdL.

Deposit Growth, year-on-year
(Percent)

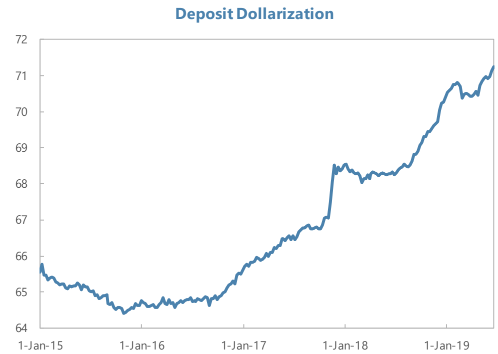


Source: BdL.

[1] The de jure exchange rate arrangement is free floating, and the de facto exchange rate arrangement is classified as stabilized. Since October 1999, the BdL has been intervening to keep the pound around a mid point parity of LL 1,507.5 per USD 1, with a bid-ask spread of LL+/-6.5.

Box 1. The BdL's Financial Operations and their Impact on the Financial Sector (continued)

Yet bank customer deposit inflows have slowed, and some deposits have been converted to dollars. Even though banks have partially passed the higher returns to higher deposit rates, total private deposits (including interest accrual) increased only by 3.4 percent in 2018, the slowest pace since 2005. Excluding accrued interest, deposit growth is estimated to have been slightly negative last year. The deposit growth rates declined further in the first six months of 2019. At the same time, deposit dollarization rose to over 71 percent.

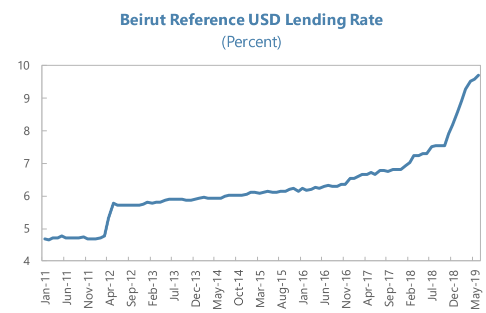


Source: BdL.

Given the limited interest by banks and the private sector, the BdL financed most of the 2018 fiscal deficit. The banking system as a whole provided almost 12 percent of GDP of new financing to the government (more than the overall deficit since foreign investors reduced their Eurobond holdings), with about ¾ of the financing coming directly from the BdL.

Gross international reserves dropped by over USD 7.5 billion to around USD 36.5 billion, between their previous peak at the end of February 2018 and May 2019, declining below 90 percent of the ARA metric (see Annex II). The central bank accumulated foreign currency liabilities through its financial operations.

BdL's operations also contributed to tight monetary conditions. The high rates bank can earn on USD deposits at the BdL have affected USD lending rates for bank customers, with the USD reference lending rate rising from around 7 percent in early 2018 to 9.7 percent in June 2019. These have in turn translated into higher LBP lending rates. In addition, the BdL has discouraged new lending in LBP by setting limits on the size of the LBP loan book relative to total bank lending. These limits have helped the BdL keep LBP liquidity tight in addition to the effect of its regular LBP products. As a result, lack of LBP liquidity at some banks has temporarily pushed overnight interbank LBP rates over 50 percent on several occasions.



Source: Association of Banks in Lebanon.

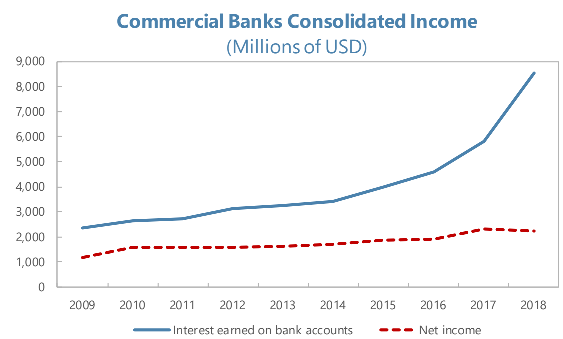
The higher lending rates combined with the challenging economic environment facing businesses led to a decline in lending to the economy. Private sector credit fell by 2.5 percent in 2018, and a further 5 percent by May 2019. The more recent sharp fall has been broad-based across the economy. Non-performing loans (NPLs) increased from 12.5 to 13.8 percent[2] over the course of 2018, with a particularly pronounced increase from about 15 to 19 percent in construction loans.

The central bank operations also raised the banks' combined exposure to the BdL and government to 69 percent of their total assets (more than 8 times Tier 1 capital) by May 2019, up from 62 percent at the end of 2017. The increase was largely due to the rise of banks' deposits at the BdL. Banks thus earned

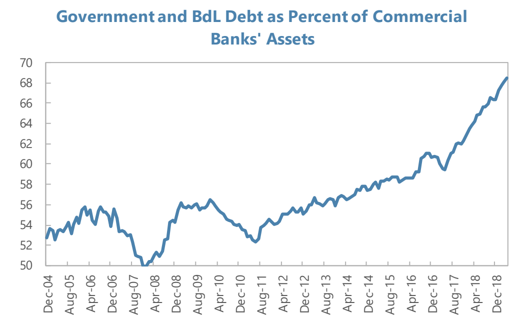
[2] Includes figures related to two banks under liquidation. Excluding these banks, NPLs increased from 9.2 to 10.3 percent.

Box 1. The BdL's Financial Operations and their Impact on the Financial Sector (concluded)

an additional USD 2.7 billion in income from interest earned on their bank accounts, most of which are at the BdL, in 2018 relative to the year before. This produced stable net income of USD 2.2 billion in 2018 in an otherwise weak economy and despite higher taxes, rising NPLs and declining credit to the private sector.



Source: BCC.



Source: BdL.

OUTLOOK AND RISKS

12. **Against this precarious backdrop, the economic outlook depends critically on policy actions and reforms in the period ahead.** The government's fiscal adjustment efforts in 2019–20 and planned structural reforms aim at shoring up confidence, giving breathing space to the economy, and accelerating disbursements of concessional financing for the CIP committed at CEDRE. Higher public investment spending can stimulate growth in the near term and help a gradual recovery. Yet the fiscal adjustment in the budget will not suffice to bend down the public debt-to-GDP ratio and public debt will remain unsustainable. Likewise, structural reforms proposed thus far will not substantially reduce the current account deficit or lift growth to levels sufficient to reduce unemployment. Many of the benefits of government reforms are temporary in the medium-term projections. Growth begins decreasing by 2024 as the initial boost of the CIP and the fiscal stimulus of phasing out temporary fiscal measures disappear. Deposit growth declines and interest rates increase by 2023 as fiscal outcomes deteriorate and confidence declines.

13. **Over the medium-term, some domestic and external events could provide an upside to this challenging outlook.** Lebanon stands to benefit from a major reconstruction effort and the possible gradual return of refugees if the situation in Syria is resolved. Also, the potential discovery of a natural gas field in Lebanon's territorial waters, where exploration just started, would boost growth and improve the country's external balance.

14. **However, risks are tilted to the downside in the short run and large vulnerabilities remain that threaten the baseline outlook** (see Risk Assessment Matrix). Vulnerabilities have been growing with increasing domestic and external imbalances. The economy and the financial system in particular are highly vulnerable and moderate negative external or domestic events can precipitate a fall in confidence and potentially an economic and financial crisis. Possible domestic events include the government's failure to achieve its fiscal targets and advance reforms, political infighting, and

social tensions. On the external side, intensification of security risks in parts of the Middle East could have serious spillover effects in Lebanon.

Lebanon: Risk Assessment Matrix[1]

Nature/Sources of Risk	*Relative Likelihood*	Expected Impact If Realized	Policies to Mitigate Risks
Materialization of policy slippages or political risks, such that domestic political disagreements prevent the implementation of the budget, which can, at worst, lead to a conflict or security incidents.	***High***	***High*** Could trigger a loss of confidence, lower deposits, higher financing costs, difficulties rolling over public debt, mounting exchange-rate pressure, falling reserves.	Maintain a high level of reserves, implement sustainable fiscal policy adjustment and pass key legislation, to demonstrate a credible policymaking framework. Further strengthen banks' capital and liquidity buffers.
Weaker-than-expected global growth (Europe). Weak foreign demand, Brexit, or concerns about some high-debt countries makes some EU businesses delay investment, while faltering confidence reduces private consumption. Inflation expectations drift lower, and the region enters a prolonged period of anemic growth and low inflation.	***High***	***High*** Could lead to a slowdown in financial inflows and to significant funding pressure for both banks and the sovereign, increasing pressure on reserves.	Maintain a high level of reserves and encourage improvement in domestic competitiveness to reduce reliance on foreign inflows.
Intensification of security risks in parts of Africa, Asia, Europe, Latin America, and/or the Middle East cause regional socio-economic and political disruptions, with potential global spillovers.	***High***	***High*** Could lead to lower remittance and deposit inflows as well as inbound tourism income. Could also hurt confidence and lead to higher financing costs, increasing exchange-rate pressures, falling reserves.	Maintain a high level of reserves and implement sustainable fiscal policy. Further strengthen banks' capital and liquidity buffers.
Further economic sanctions could affect financial services, especially related to correspondent banking.	***Medium***	***Medium*** Could hurt cross-border payments, trade finance, and remittances.	Continue to make progress to strengthen the AML/CFT and risk assessment framework. Continue to address identified gaps with regards to international tax compliance and exchange of information.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

POLICY PRIORITIES

15. Decisive implementation of a strong reform program is critical to maintain confidence. Rebalancing the economy in the current framework of an exchange rate peg requires the steadfast implementation of a large and credible fiscal adjustment and ambitious structural reforms. These need to sharply reduce imbalances and significantly improve Lebanon's business climate and governance as well as reduce corruption, which in turn can boost investment, growth and exports.

16. Regaining fiscal and external sustainability will require a consistent, multiyear effort. Bending down the path of the public debt-to-GDP ratio will require achieving primary surpluses of 4–5 percent of GDP and sustaining them for several years. Decreasing the debt ratio to 70 percent, the debt sustainability analysis (DSA) debt burden benchmark for emerging markets, will require maintaining such surpluses for about 20 years. This fiscal effort coupled with structural reforms will gradually improve the current account and allow a reduction of the economy's reliance on deposit inflows. Bringing the current account deficit down further to its norm would require the realization of events that remain upside risks over the medium term, including development of gas fields and a resolution to the Syria conflict, or further structural reforms with an equivalent impact.

A. Front-Loaded and Sustained Fiscal Consolidation

17. Lebanon has no fiscal space. The scale of Lebanon's debt burden and financing needs are putting Lebanon's overall fiscal position under severe stress. The large budget and current account deficits are exacerbating the already-serious vulnerabilities.

18. The 2019 budget aims for a large adjustment. The budget approved by parliament in July, 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. To deliver a 3½ percent of GDP adjustment in half a year, it relies on various revenue and expenditure measures, the most important of which are legislated to be temporary for three years, including: (i) increasing the tax on interest income from 7 to 10 percent; (ii) a 3 percent tax on imported goods which are subject to VAT, excluding fuel, industrial equipment and raw materials;[1] and (iii) a freeze of public sector hiring and early retirement. Other measures include a tax on private electricity generators, license plate taxes and increased General Security fees (on work permits, visas, etc.).

19. IMF staff's projection is that the budget measures will reduce the cash-basis fiscal deficit to around 9¾ percent of GDP. Staff projects a wider cash-basis overall deficit than the authorities due to more conservative assumptions about the speed of implementation of revenue measures, underlying revenue trends, the extent to which the budget constrains spending on a cash basis, and the level of nominal GDP. As noted earlier, there also remains uncertainty about the stock of arrears and 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

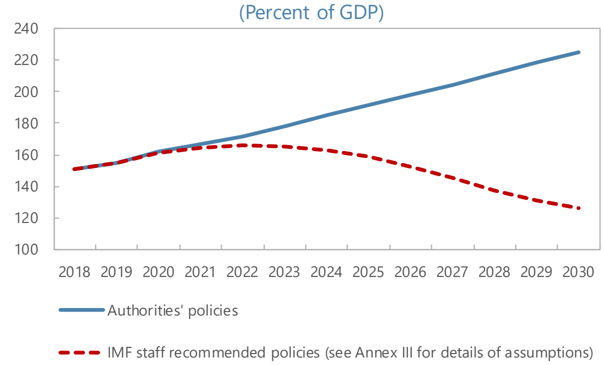
[1] The detailed list of goods is yet to be prepared by the Cabinet.

payments due to the zero-interest BdL bridge loan (not included in the debt figures) covering a delay in Eurobond issuance.

20. The government has also adopted a new plan to eliminate the large subsidies to the electricity company, EdL. The electricity sector plan (the third in the last 10 years) aims to reduce non-technical and technical losses, switch fuel to natural gas to reduce production costs at existing plants, increase EdL's capacity to meet demand, and subsequently raise tariffs to eliminate electricity subsidies of about 2½ percent of GDP by 2023. Thus far in 2019 the authorities have already increased electricity bill collections by about 0.2 percent of GDP and completed the high-voltage lines in Mansourieh which will reduce technical losses by 1 percent. Nonetheless, staff estimates regarding the plan's impact based on discussions with World Bank energy experts are somewhat more conservative, suggesting that if the plan is fully implemented it could achieve 1.9 percent of GDP savings by 2025 (see Box 2).

21. The measures proposed in the budget together with savings from electricity sector reforms are projected to result in a primary surplus in 2020–22 but leave debt on a rising path. The full-year effect of revenue measures and budget reductions which IMF staff is aware of is estimated at just over 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 some of the lost revenues and savings from the expiration of the temporary measures in the 2019 budget. 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.

Government Debt
(Percent of GDP)



Source: IMF staff calculations.

Key Recommendations

22. It is critically important 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. While achieving such surpluses is very ambitious and would depress growth in the short run, it is not unprecedented (e.g., Jamaica) and is essential given Lebanon's level of public debt and vulnerabilities. Identifying and agreeing on the measures upfront to support such a plan would increase its credibility and help boost confidence. On current plans about 1 percentage point of GDP of the 2019 revenue measures will be permanent. The authorities' current electricity plan can yield a further 2.7 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 position. They also need to ensure that the measures are sufficient to achieve the primary balance target without resorting to further build-up of delayed payments and arrears as well as allow for their expeditious clearance.

23. Revenue measures should include raising the value-added tax (VAT) and increasing fuel excises as well as efforts to increase tax compliance. Further raising revenue reliably and rapidly will require measures based on existing tax collection infrastructure, such as the VAT (which at 11 percent is relatively low) 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 temporary increase of interest income tax in the 2019 budget could also be made permanent. The authorities should also make a decisive effort to improve tax administration, which could deliver meaningful additional revenue, including from those who currently evade taxes. Improving compliance would also help realize the revenue potential of VAT and other tax increases and limit tax evasion which might otherwise increase at higher rates. Better tax collection will, however, require concrete and sustained action. The recent decision by the BdL to require 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 encouraging in this regard. Successful improvement in the collection of existing taxes may reduce the necessary future increase in tax rates.

24. Eliminating electricity subsidies is the most significant potential expenditure saving. As previous plans have faltered and not been successful at addressing the problems in the electricity sector, the authorities need to ensure that the current plan is effectively implemented, notwithstanding resistance from vested interests. In this regard, it should incorporate a tariff increase that is sufficient to close EdL's deficit 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.

25. The authorities should also conduct a thorough public expenditure review to identify potential areas for savings. This can build on their ongoing efforts to study reform options for the wage bill and pensions, which absorb a disproportionate share of revenue. Savings in current spending would also provide some space to increase expenditures on education, which are relatively low and may need to increase over the medium run to enable higher growth.

26. Fiscal tightening should also 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 including electricity tariff increases, 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 the existing National Poverty Targeting Program.

Yield of Budget and Other Potential Fiscal Adjustment Measures (Lebanese authorities and IMF staff estimates, percent of GDP, full-year effect)	
Revenue measures included in the 2019 budget 1/	
Raising tax on interest income from 7 to 10 percent 2/	1.1
3 percent tax on imports 2/	0.3
License plate taxes	0.3
Increased customs collection from reduced smuggling	0.2
Exceptional revaluation of assets 3/	0.1
General Security fees	0.1
Other revenue measures	0.4
Principal expenditure reductions in the 2019 draft budget 4/	
Exceptional and emergency spending	0.1
Equipment	0.2
Buildings under construction	0.3
Maintenance	0.1
Total	3.3
Medium-term savings from implementation of the authorities' electricity plan	2.0
Other potential measures recommended by IMF staff	
Revenue	
Increase VAT from 11 percent to 15 percent	1.6
Increase VAT from 11 percent to 20 percent	3.6
Remove most of VAT exemptions	1.2
Increase total revenue from property taxes by 50 percent	0.6
Increase the excise on gasoline by LL5,000 per 20 liters	0.8
Expenditure	
Fully eliminate subsidies to EdL 5/	0.7
Scaled-up targeted transfers to the poor and vulnerable	-0.5

Source: IMF staff calculations

1/ Annualized IMF staff estimates, actual yields will depend on the number of months of collection.

2/ To be cancelled after three years.

3/ One-off revenues, with reduction in revenues in subsequent years due to claims for depreciation.

4/ Compared with the 2018 budget and based on 2019 GDP. Staff does not have details of expenditure measures in the 2019 budget approved by Parliament.

5/ Estimated savings under 2019 oil price assumptions.

Authorities' Views

27. The authorities were confident that the measures incorporated in the 2019 budget would deliver their target deficit. In particular, they believed that many of the measures would begin yielding revenue and savings very soon after budget approval. They also stated that additional measures could be put in place to compensate for any possible fiscal underperformance. The authorities stressed the importance of the expenditure restraint embedded in the budget and already implemented before the budget approval, which achieved substantial savings on a cash basis in the first months of 2019. They also highlighted their commitment to work on and approve the 2020 budget during 2019. They intend to further reduce the overall deficit below the 2019 outcome as a result of the full-year impact of the 2019 measures, effects of the electricity plan and further fiscal reforms. They noted that any further adjustment would have to be more gradual so as not to threaten economic growth and focus first and foremost on addressing governance issues and wasteful spending.

B. Growth- and Export-Enhancing Structural Reforms

28. 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 reducing corruption. 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.

Key Recommendations

29. The authorities should approve and implement legislation of key growth-enhancing reforms identified in its CEDRE vision. These initiatives aim to remove the various hurdles that businesses face today and thus reduce the effective cost of doing business. 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.

30. In addition, the recommendations of the Public Investment Management Assessment (PIMA) technical assistance should be implemented ahead of execution of most of the CIP. It is crucial that the key 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. They include incorporating Council for Development and Reconstruction (CDR) spending in the budget and passing and implementing a public procurement law. The authorities should also improve the legal and institutional arrangements for the management of fiscal implications of public-private partnerships (PPPs), as recommended by a recent IMF technical assistance mission.

31. The electricity sector plan should be advanced without delay (see Box 2). Increasing electricity supply by the EdL to 24/7 would eliminate one of the biggest constraints to doing business in Lebanon, in addition to its positive effects on income distribution, the balance of payments, the environment and the fiscal deficit.

32. Further concrete steps must also be urgently taken to reduce corruption. The authorities should enact pending anti-corruption legislation in line with best practices, including the illicit enrichment and asset declaration legislation, and finalize and implement a prioritized anti-corruption strategy focusing on higher-risk areas. An effective fight against corruption requires full implementation of the legal framework, including operationalizing a strong and independent

Box 2. The 2019 Electricity Plan

The electricity sector is highly inefficient in Lebanon and is imposing a significant economic and social cost. Electricité du Liban (EdL) is faced with three main issues: (i) installed capacity is well below consumers' demand; (ii) losses (technical, non-technical and non-collection) represent 43 percent of production—i.e. only 57 percent of electricity produced is actually transmitted, billed, and collected; and (iii) electricity tariffs are subsidized, which imposes a heavy burden on the government budget.

Reforming the electricity sector is an important component of CEDRE's commitment to reduce the fiscal deficit. In the past years, several reform plans have been produced but were never implemented—the most recent ones are the Policy Paper for the Energy Sector in 2010 and the Energy Sector Salvation Plan in 2017. The parliament has now approved an update of the 2010 Policy Paper. The plan has four objectives:

- ***Reduce losses***. There are two projects to reduce losses: (i) improve the Distribution Service Provider (DSP) framework and the distribution grid to reduce technical losses; and (ii) install smart meters to reduce non-technical losses. Based on cross-country experience, staff's estimates suggest that a reduction of losses to 20 percent of production can be expected in the medium-term.
- ***Increase capacity***. Given that building new power plants takes at least two years, the authorities are planning to implement a temporary solution in parallel to reach a 24/7 supply in 2020. As a temporary solution is likely to be more expensive than a permanent one, combining the two in a Power Purchasing Agreement (PPA) would make it possible to backload the cost of the temporary solution. Staff's estimates suggest that the increase in capacity could start by end 2020.
- ***Reduce production* costs**. Using gas as input to electricity could bring substantial fiscal savings. The authorities are planning to negotiate a PPA to import LNG by ship, build three Floating Storage Regasification Units (FSRUs) and an underwater pipeline from ship to shore. Staff's assessment suggests that gas could be used as input starting in 2022.
- ***Increase tariffs***. The goal is to raise average tariffs from the current level of USD 9.6 to USD 14.4 cents/kWh after increasing capacity and to adopt an automated fuel indexation mechanism. However, staff's estimates suggest that a higher increase in tariffs to USD 16.2 cents would be necessary to close the primary deficit, accounting for both (i) capital expenditures; and (ii) a more realistic timeline for the plan implementation.

Based on a realistic assessment of the plan, it could start reducing EdL's deficit by 0.1 percent of GDP in 2020 and 0.9 percent of GDP in 2021 (see Table). Then, savings would increase gradually as losses are reduced and achieve 1.9 percent of GDP in 2025.

The authorities should both increase tariffs and simplify the tariff structure. Consumers should pay electricity tariffs high enough for EdL's budget to be balanced in the medium-term—including capital expenditures, the overall recovery cost is estimated at around USD 16.2 cents/kWh after the reforms. The tariff increase should take place as soon as possible, possibly targeting the largest consumers (industrials) first. As planned in the reform package, consumer tariffs should be indexed to the evolution of input prices once EdL's budget is balanced. Finally, it is essential to both simplify the tariff structure to improve fairness and design it to incentivize consumers to reduce their consumption.

Table 2. Projected Savings under the Electricity Plan

(In percent of GDP)

	2019	2020	2021	2022	2023	2024	2025
1. Reduction of losses from 43 to 20 percent by 2025 1/	0.0	0.1	0.2	0.3	0.4	0.5	0.5
2. Increase capacity to achieve zero outage by end 2020 2/	0.0	-0.1	-0.8	-0.8	-0.9	-0.9	-0.8
3. Use of gas as input starting in 2022 3/	0.0	0.0	0.0	0.7	0.7	0.7	0.7
4. Increase tariff from 9.6 to 14.4 cents/kWh in 2021	0.0	0.0	0.7	0.7	0.7	0.7	0.6
Electricity Plan - Total Savings 4/	**0.0**	**0.1**	**0.9**	**1.6**	**1.7**	**1.9**	**1.9**
Memorandum items.							
EdL's primary deficit under unchanged policies 5/	2.7	2.5	2.4	2.4	2.4	2.3	2.3
EdL's primary deficit under the plan	2.7	2.4	1.5	0.8	0.6	0.5	0.4

Source: IMF Staff estimates.

1/ Non-technical losses are reduced from 21 to 10 percent, technical losses from 17 to 10 percent and non-collection losses from 5 to zero percent. These assumptions follow cross-country experience and represent a lower reduction than in the authorities' plan in the medium-term.
2/ Capacity is expected to be increased gradually to reach zero outage by end-2020. It is increased through a temporary solution (barges) over 2020-2022, while the permanent solution (new power plants) is expected to start producing electricity in 2023.
3/ Gas is used as an input to power plants in 2022.
4/ Savings of the four components of the plan do not sum to total savings because of significant interactions between the components.
5/ The primary deficit excludes interest payments.

anti-corruption commission, investigating and prosecuting corruption cases consistent with Lebanon's risks, and strengthening governance across a range of state functions (see Annex IV).

Authorities' Views

33. The authorities highlighted the good progress they have made in implementing the various growth-supporting structural reforms identified in their CEDRE vision published in the spring of 2018. They are also confident that the electricity plan will be implemented without delays and have already achieved important first goals including the completion of the high-voltage lines in Mansourieh which reduces technical losses by 1 percent. The authorities also stressed their recent efforts to improve governance and announced the intention to join the Open Government Partnership.

C. Monetary Policy and Financial Stability

34. The BdL has been the linchpin of financial stability and protecting the peg, but at the cost of intensifying sovereign-bank linkages, which pose risks to banking sector stability, and weighing down its balance sheet while protecting banks' profitability (see Box 1). The BdL's latest operation aims, among other objectives, to build up banks' capital buffers by letting them record future profits earned through the operation immediately as long as they are retained.

Key Recommendations

35. The BdL should gradually step back from quasi-fiscal operations and strengthen its balance sheet. The BdL is commended for not buying the T-bills with 1 percent interest rate whose issuance had been proposed by the government. There should also not be any pressure on private banks to purchase them instead. The BdL should step back from government bond purchases and providing other financing facilities including a zero-interest overdraft facility and bridge financing, and let the market determine yields on government debt. While immediate cessation of financial operations would increase risks, the BdL should gradually phase them out as fiscal adjustment and the subsequent decline in yields demanded by investors allow it to do so.

36. Action should be taken to continue building up banks' capital buffers and strengthen deposit insurance. Gradually fully aligning risk weights placed on the banks' holdings of BdL foreign currency denominated instruments with Basel III requirements represents a good mechanism to raise effective capital requirements.[2] 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.

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[2] Risk weights are currently set at 50 percent for foreign currency denominated BdL debt, below the 100 percent as per Basel Capital Accord.

37. Continued effective implementation of AML/CFT measures is necessary to mitigate ML/TF risks and to ensure a positive MENAFATF AML/CFT assessment. The authorities have strengthened the AML/CFT framework and should continue making further improvements and focus on its effectiveness (see Annex IV). Failure to do so could lead to a negative MENAFATF assessment and adversely affect investment and banks' continued access to correspondent banking relationships.

38. The authorities should review the tools available to cope with financial distress in systemic institutions. The Banking control Commission (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.

Authorities' Views

39. The authorities agreed that the BdL can step back from its financial operations once fiscal and structural reforms have reduced financing needs of the government and the economy. They highlighted that the banking sector is well-capitalized, with capital adequacy substantially above the minimum levels required by Basel III regulation. They argued that the risk weights on bank holdings of BdL debt are appropriate given the BdL's placement of its reserves in safe assets. They also stressed that they received a positive MENAFATF AML/CFT assessment. They stated that they already meet the majority of criteria for a positive assessment under the revised FATF assessment methodology and are working address any remaining shortcomings in time for the next assessment.

STAFF APPRAISAL

40. Lebanon has shown unique resilience in the face of long-standing economic challenges, but its vulnerabilities have continued growing and it is now at a critical moment. Over the years, Lebanon has time and again coped with external and domestic challenges that would have proved too large for many other countries. Yet by 2018 economic imbalances have reached exceptional levels, giving rise to acute financial challenges. The fiscal deficit rose over 10 percent of GDP for the first time in a decade, the current account deficit remains around 25 percent of GDP and the external position remains substantially weaker than the level consistent with medium-term fundamentals and desirable policy settings. Bank deposits inflows that used to finance the twin deficits have largely dried up. Lebanon's difficult external economic environment and especially the ongoing Syria conflict have exacerbated Lebanon's challenges. Economic growth has virtually stopped, and unemployment is high.

41. The new government has a narrow window to reverse the current unsustainable trends. The authorities understand that the room for maneuver has narrowed significantly and have embarked on fiscal and structural reforms to correct the course of the economy. The parliament has recently passed the 2019 budget with ambitious fiscal adjustment goals, but it is based on optimistic projections, and staff estimates that its effects will be more limited. Importantly, some of its key measures are temporary, when durable measures are necessary to underpin the needed adjustment. The government is also keen on improving Lebanon's growth prospects through a set of structural reforms, including a new electricity sector plan.

42. **Reducing the current imbalances and rebalancing the Lebanese economy will require further simultaneous actions on several fronts sustained over many years.** The authorities' efforts thus far are welcome first steps. Yet returning the country on a path towards sustainability demands stronger fiscal adjustment complemented by fundamental structural reforms that both raise growth and improve Lebanon's external position. These efforts will need to be sustained for many years in order to return to fiscal and external sustainability and will require determined implementation and broad political and social support.

43. **A multi-year fiscal adjustment is a key element of the necessary reforms.** Lebanon needs a credible strategy to improve its primary balances to 4–5 percent of GDP in the next 2–3 years. The size of adjustment involved implies that reforms will have to include both substantial revenue and expenditure measures. Given Lebanon's institutional capacity it would be hard to avoid a significant rise in the VAT rate and removal of exemptions as well as higher fuel excises. The authorities also need to implement tangible measures to improve tax collection across the economy. The electricity plan must not be delayed, including a price increase sufficient to eliminate subsidies to the EdL. This needs to be complemented by a thorough expenditure review to achieve sustained fiscal savings. A stronger safety net protecting the most vulnerable and the government's CIP, financed on concessional terms, can help mitigate the contractionary effect of the adjustment on growth.

44. **In addition, structural reforms are essential to revive growth and enable external adjustment.** The implementation thus far of the electricity sector plan and legislative progress on the government's CEDRE vision reforms are a good start. But Lebanon's deep structural issues require many more far-reaching changes to remove growth bottlenecks and enable external adjustment in the context of the currency peg. In particular, the authorities must tackle the pervasive issue of corruption with great resolve.

45. **The BdL has long protected the country's economy and maintained financial stability but now it must also start rebuilding its own financial strength.** The years of bearing the brunt of responsibility for the country's economic stability have left its mark on the BdL's balance sheet and have intensified sovereign-bank links. While the BdL may need to continue its financial operations for a while even if the underlying economic situation improves, it should limit its support to the government and place more importance on the strength of financial system, both in terms of its balance sheet and requiring commercial banks to build up their own buffers further. Effective implementation of AML/CFT measures should continue to mitigate ML/TF risks and to ensure a positive MENAFATF AML/CFT assessment.

Staff propose that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Lebanon: Selected Economic Indicators, 2018–24

	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.
Output and prices	(Annual percentage change)						
Real GDP (market prices)	0.3	0.2	0.9	2.3	2.6	3.1	2.7
GDP deflator	5.3	3.7	2.3	2.1	2.1	2.1	2.1
Consumer prices (end-of-period)	4.0	3.4	2.4	2.4	2.4	2.4	2.4
Consumer prices (period average)	6.1	3.1	2.6	2.4	2.4	2.4	2.4
Investment and saving	(In percent of GDP)						
Gross capital formation	22.0	21.5	22.5	23.0	21.9	19.3	18.2
Government	1.6	1.6	2.7	3.6	3.5	3.4	3.3
Nongovernment	20.4	19.9	19.9	19.4	18.4	15.9	14.9
Gross national savings	-3.3	-4.0	-3.2	-2.3	-2.6	-4.9	-5.4
Government	-9.5	-8.2	-9.0	-8.6	-9.1	-11.5	-12.1
Nongovernment	6.1	4.2	5.8	6.3	6.5	6.6	6.7
Central government finances (cash basis)	(In percent of GDP)						
Revenue (including grants)	20.5	21.5	22.9	22.8	22.2	21.2	21.1
Expenditure	31.5	31.2	34.4	34.9	34.7	36.0	36.4
Overall balance (including grants)	-11.0	-9.8	-11.5	-12.1	-12.5	-14.8	-15.3
Primary balance (including grants)	-1.4	-0.3	0.3	0.2	0.5	-1.3	-1.2
Total government debt 1/	151	155	162	167	172	178	185
Monetary sector	(Annual percentage change, unless otherwise indicated)						
Broad money 2/	3.6	4.0	6.0	5.0	4.0	3.0	3.0
Deposit dollarization (level)	70.7	70.0	68.0	68.0	69.0	70.0	70.0
Interest rates (period average, in percent)							
Five-year Eurobond yield	9.0	10.2	9.3	9.1	9.7	10.2	10.5
Five-year treasury bill yield	6.8	8.0	8.0	8.0	8.0	8.0	8.0
External sector	(In percent of GDP, unless otherwise indicated)						
Exports of goods and services (in US$, percentage change)	2.3	7.3	5.1	4.9	5.2	5.6	5.6
Imports of goods and services (in US$, percentage change)	3.2	1.5	3.3	2.8	2.2	3.9	3.4
Balance of goods and services	-24.3	-21.8	-21.2	-20.1	-18.6	-17.7	-16.7
Current account	-25.6	-26.4	-26.3	-25.6	-24.5	-23.9	-23.1
Foreign direct investment	2.4	3.0	3.8	4.6	4.6	4.1	3.5
Total external debt 3/	191	196	207	215	219	219	219
Gross reserves (in billions of U.S. dollars) 4/	36.5	31.7	30.2	29.1	27.0	23.4	19.2
In months of next year imports of goods and services	12.9	10.9	10.1	9.5	8.5	7.1	8.7
In percent of short-term external debt 5/	44.2	36.1	32.1	28.6	24.9	20.3	15.9
In percent of banking system foreign currency deposits	29.6	25.0	23.1	21.2	18.6	15.4	12.3
In percent of total banking system deposits	20.9	17.5	15.7	14.4	12.9	10.8	8.6
Memorandum items							
Nominal GDP (in billions of U.S. dollars)	56.4	58.6	60.5	63.1	66.1	69.6	73.0
Non-resident deposits (staff estimate, percent change)	4.2	5.1	6.1	5.1	4.0	3.0	3.0
Commercial bank total assets (percent of GDP)	443	443	455	458	455	445	438
Real effective exchange rate (annual average, percent change)	2.2	...	...	...	...	...	...

Sources: Lebanese authorities; IMF staff estimates.
1/ Does not include the bridge loan from the central bank.
2/ Defined as currency in circulation plus resident and nonresident deposits.
3/ Includes nonresident deposits.
4/ Excluding gold and encumbered assets.
5/ Short-term debt on a remaining maturity basis, including short-term nonresident deposits.

Table 2a. Lebanon: Central Government Overall Deficit and Financing, 2018–24
(In percent of GDP, unless otherwise indicated)

	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.
Revenue and Grants	20.5	21.5	22.9	22.8	22.2	21.2	21.1
Revenue	20.5	21.5	22.9	22.8	22.2	21.2	21.1
Tax revenue	15.0	15.7	16.9	16.9	16.4	15.3	15.2
Taxes on income and profits	5.3	6.2	7.1	7.2	6.7	6.0	6.0
Taxes on property	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Taxes on domestic goods and services	5.3	5.0	5.1	5.1	5.0	5.0	5.0
of which: VAT revenues	4.5	4.2	4.2	4.2	4.2	4.1	4.1
Taxes on international trade 1/	2.4	2.5	2.8	2.7	2.7	2.3	2.3
Other taxes	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Nontax revenue	4.0	4.3	4.5	4.4	4.4	4.4	4.4
Other Treasury Revenue	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Expenditure	31.5	31.2	34.4	34.9	34.7	36.0	36.4
Current primary expenditure	20.1	20.3	20.0	19.1	18.4	19.2	19.1
Personnel costs 2/	11.4	11.5	11.5	11.5	11.5	12.5	12.5
Transfers to EdL 3/	3.1	2.7	2.4	1.5	0.8	0.6	0.5
Other current 4/	5.5	6.1	6.1	6.1	6.1	6.1	6.1
Interest payments	9.6	9.4	11.8	12.3	12.9	13.5	14.1
Capital expenditure	1.5	1.6	2.6	3.5	3.4	3.3	3.2
Overall balance	-11.0	-9.8	-11.5	-12.1	-12.5	-14.8	-15.3
Primary balance	-1.4	-0.3	0.3	0.2	0.5	-1.3	-1.2
Net financing	11.0	9.8	11.5	12.1	12.5	14.8	15.3
Banking system	11.6	7.5	8.2	8.2	8.7	10.8	11.3
Government institutions	0.6	0.5	0.6	0.7	0.8	1.1	1.1
Other	-1.2	1.8	2.7	3.1	2.9	2.9	2.9
Memorandum items:							
Total government gross debt 5/	151.0	155.1	161.8	167.0	172.0	178.2	185.2
of which: foreign-currency denominated debt 5/	59.4	62.0	65.7	67.7	68.9	69.6	70.5
Nominal GDP (Bil. LL)	84,981	88,287	91,137	95,181	99,676	104,934	110,059

Sources: Lebanese authorities; and IMF staff estimates and calculations.

1/ Includes domestic excises, which are collected at customs and are classified as taxes on international trade.

2/ Includes wages, salaries, related benefits, and pensions.

3/ Excludes principal and interest payments paid on behalf of Électricité du Liban (EdL).

4/ Includes transfers to the National Social Security Fund, hospitals, municipalities, Higher Relief Committee, Displaced Fund, Council of the South, bread subsidy, and the interest subsidy.

5/ Does not include the bridge loan from the central bank.

Table 2b. Lebanon: Central Government Overall Deficit and Financing, 2018–24
(In billions of Lebanese pounds, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024
	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue and Grants	17,402	18,958	20,838	21,708	22,162	22,203	23,228
Revenue	17,402	18,958	20,838	21,708	22,162	22,203	23,228
Tax revenue	12,765	13,895	15,434	16,128	16,318	16,051	16,775
Taxes on income and profits	4,499	5,452	6,439	6,822	6,695	6,310	6,618
Taxes on property	1,139	1,184	1,155	1,207	1,264	1,330	1,395
Taxes on domestic goods and services	4,500	4,452	4,647	4,826	5,006	5,244	5,468
of which: VAT revenues	3,841	3,736	3,856	3,999	4,140	4,332	4,512
Taxes on international trade 1/	2,025	2,181	2,547	2,599	2,647	2,423	2,513
Other taxes	602	626	646	674	706	744	780
Nontax revenue	3,421	3,800	4,099	4,219	4,418	4,651	4,878
Other Treasury Revenue	1,216	1,263	1,304	1,362	1,426	1,502	1,575
Grants	0	0	0	0	0	0	0
Total Expenditure	26,754	27,575	31,354	33,217	34,583	37,734	40,086
Current primary expenditure	17,048	17,884	18,255	18,212	18,311	20,168	21,000
Personnel costs 2/	9,719	10,127	10,454	10,918	11,433	13,086	13,725
Transfers to EdL 3/	2,647	2,345	2,215	1,460	768	650	528
Other current 4/	4,682	5,412	5,587	5,835	6,110	6,432	6,747
Interest payments	8,156	8,309	10,768	11,706	12,902	14,114	15,555
Capital expenditure	1,315	1,382	2,331	3,299	3,369	3,452	3,532
Overall balance	-9,352	-8,617	-10,516	-11,508	-12,421	-15,531	-16,858
Primary balance	-1,196	-307	252	197	481	-1,416	-1,304
Net financing	9,352	8,617	10,516	11,508	12,421	15,531	16,858
Banking system	9,879	6,582	7,465	7,842	8,683	11,343	12,399
Government institutions	482	410	546	692	822	1,122	1,234
Other	-1,009	1,625	2,505	2,973	2,916	3,065	3,226
Memorandum items:							
Total government gross debt 5/	128,347	136,964	147,480	158,988	171,409	186,939	203,798
of which: foreign-currency denominated debt 5/	50,495	54,755	59,838	64,452	68,691	73,047	77,618
Nominal GDP (Bil. LL)	84,981	88,287	91,137	95,181	99,676	104,934	110,059

Sources: Lebanese authorities; and IMF staff estimates and calculations.

1/ Includes domestic excises, which are collected at customs and are classified as taxes on international trade.

2/ Includes wages, salaries, related benefits, and pensions.

3/ Excludes principal and interest payments paid on behalf of Électricité du Liban (EdL).

4/ Includes transfers to the National Social Security Fund, hospitals, municipalities, Higher Relief Committee, Displaced Fund, Council of the South, bread subsidy, and the interest subsidy.

5/ Does not include the bridge loan from the central bank.

Table 3. Lebanon: Balance of Payments, 2018–24

	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.
	(in millions of US Dollars)						
Current account (excl. official transfers)	-14,406	-15,452	-15,913	-16,191	-16,186	-16,654	-16,889
Goods (net)	-15,146	-14,711	-15,146	-15,294	-15,122	-15,429	-15,592
Exports, f.o.b.	3,847	4,228	4,549	4,847	5,210	5,559	5,954
Imports, f.o.b.	-18,993	-18,939	-19,695	-20,140	-20,332	-20,988	-21,546
Services (net)	1,438	1,928	2,324	2,589	2,838	3,087	3,386
Credit	15,749	16,796	17,544	18,335	19,173	20,188	21,237
Debit	-14,312	-14,867	-15,220	-15,746	-16,334	-17,101	-17,851
Memo: Tourism (net)	2,146	2,456	2,762	2,960	3,148	3,412	3,702
Income (net)	-2,275	-3,441	-3,949	-4,356	-4,763	-5,121	-5,463
Credit	3,169	3,198	3,149	3,300	3,391	3,427	3,437
Debit	-5,444	-6,639	-7,098	-7,656	-8,154	-8,548	-8,900
o/w: Interest of government debt	-680	-661	-945	-1,061	-1,178	-1,249	-1,308
Current transfers (net) 1/	1,578	772	858	869	860	809	781
Official (net)	27	0	0	0	0	0	0
Private (net)	1,551	772	858	869	860	809	781
Capital and financial account	5,155	10,696	14,366	15,097	14,160	13,013	12,726
Capital account (net)	1,551	1,551	1,551	1,551	1,551	1,551	1,551
Direct investment (net)	1,379	1,757	2,316	2,926	3,045	2,836	2,590
Portfolio investment, loans and other (net)	2,224	7,387	10,499	10,620	9,564	8,625	8,585
Government (net)	-1,284	464	2,169	2,665	2,076	1,674	1,392
BdL	-11	-102	0	0	0	0	0
Banks (net)	1,386	3,653	4,337	3,831	3,218	2,510	2,585
Foreign assets of banks 2/	-3,165	-340	-701	-584	-441	-277	-295
Nonresident deposits 3/	4,551	3,992	5,038	4,415	3,659	2,787	2,880
Nonbank private sector (net)	2,133	3,373	3,993	4,124	4,270	4,441	4,608
Errors and omissions	5,077	0	0	0	0	0	0
Overall balance	-4,175	-4,756	-1,547	-1,094	-2,025	-3,641	-4,162
Financing	4,175	4,756	1,547	1,094	2,025	3,641	4,162
Official reserves (- increase)	4,175	4,756	1,547	1,094	2,025	3,641	4,162
Use of Fund Resources	0	0	0	0	0	0	0
Memorandum items	2,224	7,387	10,499	10,620	9,564	8,625	8,585
Current account balance (in percent of GDP)	-25.6	-26.4	-26.3	-25.6	-24.5	-23.9	-23.1
Goods and services balance (in percent of GDP)	-24.3	-21.8	-21.2	-20.1	-18.6	-17.7	-16.7
Exports of goods (in percent of GDP)	6.8	7.2	7.5	7.7	7.9	8.0	8.2
Export value, percent change	-4.8	9.9	7.6	6.6	7.5	6.7	7.1
Export volume, percent change	-7.5	7.9	5.3	5.4	6.1	5.4	5.6
Imports of goods (in percent of GDP)	-33.7	-32.3	-32.6	-31.9	-30.8	-30.2	-29.5
Import value, percent change	3.0	-0.3	4.0	2.3	1.0	3.2	2.7
Import volume, percent change	-3.7	1.4	3.7	1.9	0.4	2.3	1.5
Services credit (in percent of GDP)	27.9	28.7	29.0	29.0	29.0	29.0	29.1
Services debit (in percent of GDP)	-25.4	-25.4	-25.2	-24.9	-24.7	-24.6	-24.5
Gross reserves (excl. gold, year-end, in millions of US$) 4/	36,467	31,711	30,164	29,070	27,045	23,404	19,241
External debt (in percent of GDP) 5/	191.1	195.7	207.0	214.7	218.7	219.0	219.4
Government external debt (in percent of GDP)	19.9	20.0	22.9	26.2	28.1	29.1	29.7
GDP (in millions of US$)	56,372	58,565	60,455	63,139	66,120	69,608	73,008

Sources: Lebanese authorities; BIS; and IMF staff estimates and projections.
1/ Excluding official budgetary transfers.
2/ Net of non-deposit foreign liabilities.
3/ Differs from banks' reported data, to include estimated deposit flows by Lebanese nationals living abroad but classified as residents.
4/ Excludes Lebanese Eurobonds and encumbered reserves.
5/ Includes all banking deposits held by nonresidents, including estimated deposits of Lebanese nationals living abroad but classified as residents.

Table 4. Lebanon: Monetary Survey, 2018–24

	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.
	(In trillions of Lebanese pounds)						
Net foreign assets	94.9	90.3	90.7	90.6	89.1	84.8	79.7
Banque du Liban	70.9	65.3	64.1	62.8	60.1	54.9	48.9
Commercial banks	24.0	25.0	26.5	27.9	29.0	29.9	30.8
Net domestic assets	176.3	191.7	208.3	223.2	237.4	251.5	266.6
Net claims on public sector	97.5	104.7	111.4	117.9	128.2	142.3	155.1
of which: Net claims on government	95.9	103.1	109.8	116.3	126.5	140.7	153.5
Banque du Liban	42.5	45.7	47.5	50.6	55.8	62.8	69.2
Commercial banks	53.3	57.3	62.3	65.6	70.8	77.8	84.2
Claims on private sector	78.5	78.5	81.0	84.6	88.6	93.2	97.8
Other items (net)	0.3	8.5	15.9	20.8	20.6	16.0	13.8
Broad money (M5) 1/	271.2	282.0	298.9	313.9	326.4	336.2	346.3
In Lebanese pounds	83.7	88.9	100.0	104.9	105.9	105.8	109.0
Currency in circulation	5.0	5.2	5.5	5.8	6.0	6.2	6.4
Deposits in Lebanese pounds	78.7	83.6	94.4	99.1	99.9	99.6	102.6
Deposits in foreign currency	187.4	193.2	199.0	209.0	220.5	230.4	237.3
	(Year-on-year percent change)						
Net foreign assets	-6.7	-4.9	0.4	0.0	-1.7	-4.8	-6.0
Net domestic assets	10.2	8.8	8.6	7.2	6.3	5.9	6.0
Net claims on public sector	10.5	7.4	6.4	5.8	8.7	11.0	9.0
Claims on private sector	-3.4	0.0	3.2	4.4	4.7	5.2	4.9
Broad money (M5) 1/	3.6	4.0	6.0	5.0	4.0	3.0	3.0
In Lebanese pounds	-2.1	6.1	12.5	5.0	1.0	-0.1	3.0
Deposits in foreign currency	6.4	3.1	3.0	5.0	5.5	4.5	3.0
Memorandum items	(In trillions of Lebanese pounds, unless otherwise indicated)						
Banque du Liban:							
Foreign assets	73.0	67.2	66.1	64.7	62.0	56.8	50.9
of which: foreign exchange	49.0	41.8	39.5	37.9	34.8	29.3	23.0
of which: gold	17.7	19.2	20.3	20.6	21.0	21.3	21.6
Claims on public sector (net)	44.2	47.4	49.1	52.3	57.4	64.5	70.9
Claims on commercial banks	26.8	26.8	26.8	26.8	26.8	26.8	26.8
Reserve money	62.2	55.3	56.0	53.6	50.2	48.0	47.1
Gross international reserves (including gold, billions of USD) 2/	48.2	44.4	43.7	42.8	41.0	37.5	33.6
Gross international reserves (excluding gold, billions of USD) 3/	36.5	31.7	30.2	29.1	27.0	23.4	19.2
in percent of banking system foreign currency deposits	29.6	25.0	23.1	21.2	18.6	15.4	12.3
in percent of total banking system deposits	20.9	17.5	15.7	14.4	12.9	10.8	8.6
Share of foreign currency private deposits in total (percent)	70.7	70.0	68.0	68.0	69.0	70.0	70.0

Sources: Banque du Liban; and Fund staff estimates and projections.

1/ Broad money (M5) is defined as M3 (currency + resident deposits) + nonresident deposits.

2/ Defined as all official foreign currency assets, less encumbered foreign assets.

3/ Defined as all official foreign currency assets, less encumbered foreign assets and gold.

Table 5. Lebanon: Financial Soundness Indicators for the Banking Sector, 2015–18
(In percent, end of period)

	2015	2016	2017	2018
Capital				
Regulatory capital to risk-weighted assets* (consolidated basis)	15.1	16.6	17.1	16.6
Regulatory Tier 1 capital to risk-weighted assets* (consolidated basis)	13.9	14.8	15.3	14.8
Total capital/Total assets (Individual Basis)	9.3	9.2	9.1	8.4
Asset quality				
Nonperforming loans net of provisions to capital 1/	6.8	8.7	11.6	13.1
Nonperforming loans to gross loans 1/	10.8	11.1	12.5	13.8
Asset concentration				
Claims on public sector (BdL excluded) to total assets	19.4	16.5	14.2	13.2
Placements with the BdL to total assets	36.4	42.1	45.4	50.8
Foreign assets to total assets	12.3	10.9	10.4	10.0
Profitability				
Efficiency ratio 2/	57.7	60.5	53.6	53.3
Return on assets (after tax)	1.0	0.9	1.2	0.9
Return on equity (after tax)	11.4	10.7	13.9	9.7
Liquidity 3/				
Deposits to total liabilities	88.9	87.9	85.4	76.2
Liquid assets to total assets	18.1	18.7	14.3	14.1
Liquid assets to short term liabilities	28.1	29.7	22.8	27.2
FX exposure 3/				
Foreign-currency-denominated loan to total loans	74.6	71.3	68.8	69.9
Foreign-currency-denominated liabilities to total liabilities	64.0	63.9	64.4	60.1
Net open FX position to regulatory capital	14.1	16.1	16.6	11.8

Sources: Lebanese authorities and Financial Soundness Indicators (FSI).
* As of September 2018
1/ Non performing loans definition covers loans to financial and non-financial sector. Figure related to the two banks under liquidation are included, thus materially affecting the gross NPL Ratio (around USD 1.9 bn exposure including interest is added to the gross exposure). The Non-performing loans to gross loans ratio is calclauted based on Banque du Liban Centrale Des Risques Data.
2/ It represents non-interest expense to sum of net interest income plus non-interest income. Profitability indicators have been revisited following banks' submission of annual audited financial statements
3/ These indicators are computed following FSI guide.

Annex I. Status of the Article IV 2018 Recommendations

Recommendations

1. **The 2018 consultation called for a fiscal consolidation plan with front-loaded fiscal adjustment, embedded in a credible budget.** Concretely, the consultation called for an adjustment package that combines both revenue and spending measures. It also called for strengthening the public investment management framework to improve Lebanon's public investment capacity before implementing large investment projects.

2. **The 2018 consultation called for more conventional interest rate policy instead of financial engineering operations.** It also noted that banks should continue strengthening buffers, align treatment of NPLs with international best practices, and enhance liquidity regulations. The consultation also advised the authorities to strengthen the crisis management and AML/CFT frameworks.

3. **The 2018 consultation stressed the importance of structural reforms—particularly electricity sector reform and eradicating corruption—to improve competitiveness and boost growth.** The consultation recommended that the authorities expand electricity capacity and fully eliminate subsidies. It also called for rendering the anti-corruption regulatory framework effective.

Progress

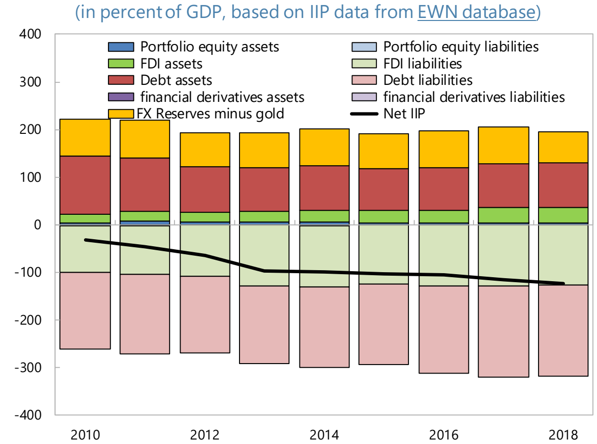
4. **In the fiscal sector**, the authorities passed the 2019 budget—which aims for a large fiscal adjustment. The budget includes various revenue and expenditure measures; however, the most important of which are for three years only. These measures include increasing the tax on interest income from 7 to 10 percent, a tax on imported goods, and a freeze of public sector hiring and early retirement. Other recommended much-needed fiscal measures including an increase in VAT and the reinstatement of gasoline excises and fuel taxes were not proposed by the government. **In the monetary sector**, the BdL continued to employ financial operations rather than more conventional interest rate policies but plans to phase them out as fiscal adjustment proceeds. It also remained active in the T-bills and Eurobonds primary markets, even though it only provided financing for the payment of wages and the debt service. There is still need for continued building up of capital buffers and fully aligning the risk weights placed on the banks' holdings of BdL foreign currency denominated instruments. **On structural reform**, the authorities approved the electricity sector plan but have yet to increase power supply and raise tariffs and simplify their structure. The authorities passed the Access to Information Law, initiated work on an anti-corruption strategy and prepared a draft of a modern public procurement law. Further steps are still needed to reduce corruption and improve governance.

Annex II. External Sector Assessment

The external position of Lebanon in 2018 is substantially weaker than the level consistent with medium-term fundamentals and desirable policy settings. External debt was unsustainable at 190 percent of GDP in 2018, while the current account deficit stood at over 25 percent of GDP. Gross international reserves were at 90 percent of the IMF's ARA reserve adequacy metric, falling short of 100 percent—the level considered to be adequate—for the first time in 10 years. Substantial fiscal and external sector adjustments are needed to strengthen the external position and reduce the need to attract non-resident deposit flows. Fundamental structural reforms are needed to improve Lebanon's external competitiveness and help further reduce the economy's savings-investment imbalance.

1. **In 2018, the net international investment position (IIP) continued to deteriorate and is estimated at about -128 percent of GDP in 2018.** Net external debt position stood at -98 percent of GDP, net FDI position at -97 percent of GDP, and gross FX reserves at 65 percent of GDP. About 40 percent of external gross liabilities (125 percent of GDP) was FDI-related and predominantly invested in real estate which has been stagnant over the past six years. The remainder (185 percent of GDP) comprised of debt liabilities which, for the first time in 10 years, saw a decline compared to the previous year. Government debt accounted for about 20 percent of the external debt liabilities, while the remaining majority comprised short-term non-resident deposits.[1] The trajectory of external debt and gross financing needs continue to rise, and external debt is assessed to be unsustainable (see Annex VI). On the asset side, debt securities held by the banking system, FDI assets, and gross reserves together account for 190 percent of GDP.

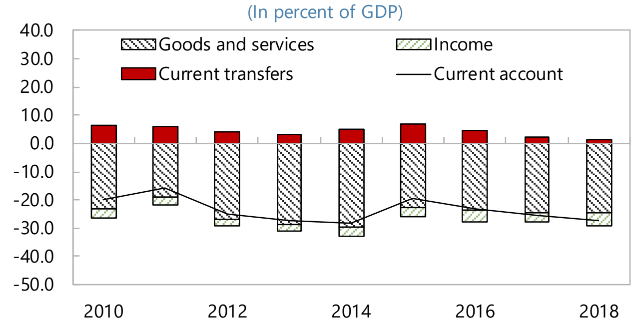
IIP Composition, by Instrument, 2010-18
(in percent of GDP, based on IIP data from EWN database)



Source: Lane and Milesi-Ferretti's External Wealth of Nations Dataset, IMF WEO.

2. **The current account deficit remained around 25 percent of GDP in 2018**, comprising of a trade deficit of 24 percent of GDP and interest payments of 4 percent of GDP, offset by 3 percent of GDP in net inflows in current transfers, the lowest level seen in more than a decade. This was primarily driven by a decline in inbound current transfers (14 percent of GDP in 2018 after peaking at 20 percent in 2014). Surplus

Components of Current Account, 2010–18
(In percent of GDP)



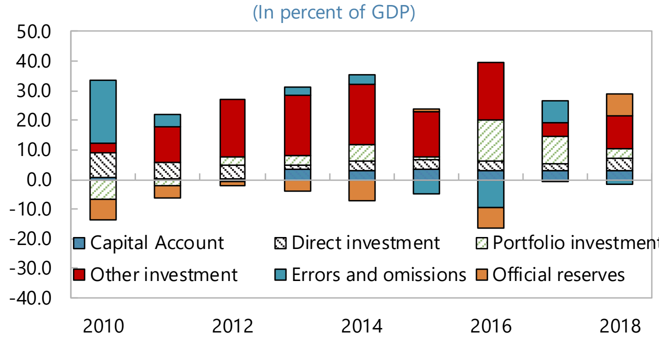
Source: Banque du Liban and Staff calculations.

[1] IMF estimates of non-resident deposits differs from banks' reported data and include estimated deposit flows by Lebanese nationals living abroad but classified as residents.

in service trade has also reached decade lows over the past two years and reached 2.6 percent of GDP, compared to a 10-year average of 7.4 percent of GDP. However, the lifting of travel bans of Gulf nationals is expected to restore inbound tourism in 2019 and beyond. Based on economic fundamentals, the current account approach to assessing the external sector balance suggests that the current account norm in 2018 was -5.6 percent of GDP, implying a current account gap of 20.3 percent of GDP. In turn, the external sustainability approach suggests a current account norm of -8.3 percent of GDP and a CA gap of 15.8 percent of GDP in 2024.

3. Financing conditions are challenging. The government has not placed Eurobonds in the market since 2017. The May 2018 Eurobond issuances were underwritten by the BdL, some of which have been off-loaded in the secondary market at a discount. Maturing Eurobonds and all external interest payment obligations have been paid by the BdL on behalf of the government. The counterpart to these transactions has been a negative government FX cash balance (overdraft) at the BdL and a bridge loan at zero percent interest rate. The gross growth of official non-resident deposits increased in 2018 to almost 9 percent but should be compared to ever-increasing interest rates. In 2018, the BdL continued to engage in financial operations offering high yields to non-resident depositors, but nonetheless ended the year with a loss of about USD 4 billion in reserves. Non-resident deposit inflows slowed in 2019.

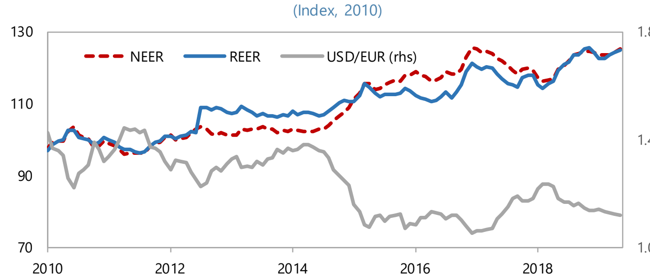
Financing of Current Account, 2010–18
(In percent of GDP)



Source: Banque du Liban and Staff calculations.

4. The IMF's EBA-light methodology suggests that the real effective exchange rate is significantly overvalued. The very high negative net foreign asset position, with high levels of short-term debt suggests that the external sustainability approach is the most relevant measure for Lebanon. It suggests a 50 percent overvaluation if net foreign assets were to be stabilized at the 2018 level of -128 percent of GDP. In turn, the exchange rate is overvalued by 66 percent if the net foreign assets were to be brought down to -100 percent of GDP by 2024. The current account approach suggests a real exchange rate gap of 63 percent in 2018 (compared to 45 percent estimated in 2017). As in previous years, the IREER approach suggests a much smaller REER gap of 9.1 percent.[2] The REER has appreciated over 30 percent since the lows in 2008. The appreciation trends are consistent with the higher domestic inflation rates in Lebanon in the past year and appreciation of the nominal effective exchange rate.

Real and Nominal Effective Exchange Rate, 2010-18
(Index, 2010)

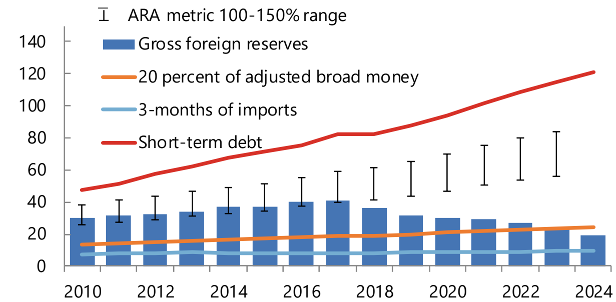


Sources: Information Notice System; and IMF staff calculations.

[2] These numeric results should be treated with caution in light of concerns regarding the quality of Lebanon's current account data (including very large positive errors and omissions in 2018 equivalent to about 10 percent of GDP) and the impact of the Syria conflict on Lebanon's balance of payments.

5. The reserves adequacy metrics now point to a reserve shortfall. Although gross reserves continued to be large at 65 percent of GDP at end-2018, they stand at 90 percent of the Fund's Assessing Reserves Adequacy (ARA) metric. In 2018, the BdL intervened in the foreign exchange market to support the fixed exchange rate peg while keeping the domestic liquidity tight in order to control speculative foreign exchange transactions. Together with challenges in attracting non-resident deposits, the BdL lost 7.4 percent of GDP in reserves in 2018, some of which is attributed to BdL's paying Eurobond principal and coupon on behalf of the government. The ARA metric is also projected to fall to 70 percent by end-2019.

Reserve Adequacy 2010-24
(USD billion)



Sources: National authorities; and IMF staff calculations

Annex III. Adjustment Scenario

1. Macroeconomic implications of staff recommendations across fiscal, structural as well as monetary and financial policies are integrated in an adjustment scenario. The table below presents selected economic indicators in this scenario.

2. In particular, the adjustment scenario incorporates additional fiscal adjustment over the medium term, delivering a primary balance of 4.6 percent of GDP by 2022 through a front-loaded fiscal adjustment. This in turn stabilizes the level of the debt-to-GDP ratio at 166 percent by 2022. The ratio then begins declining, reaching 163 percent in 2024. The additional fiscal adjustment combined with deeper structural reforms improves the current account deficit, which declines to about 20 percent of GDP by 2024. The government's continued reform drive also raises investor and depositor confidence over the medium term, which is reflected in higher growth of deposits and slightly lower interest rates. These developments in turn stabilize the BdL's foreign reserves, which begin substantially increasing by 2022. Growth in the adjustment scenario is lower than in the baseline through 2022 due to the contractionary impact of the additional fiscal tightening.[1] By 2024, however, growth reaches almost 4 percent, the long-term level it can then sustain as a result of higher investment and confidence as well as fundamental structural reforms, which boost it relative to the baseline forecast.

[1] The projections use a fiscal multiplier of 0.6 with 0.4 in the same year and 0.2 the following year.

Table 1. Lebanon: Selected Economic Indicators, 2018–24 (Adjustment Scenario)

	2018	2019	2020	2021	2022	2023	2024
	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Output and prices	(Annual percentage change)						
Real GDP (market prices)	0.3	0.2	0.3	1.4	2.2	3.3	3.8
GDP deflator	5.3	3.7	2.3	2.0	2.1	2.1	2.1
Consumer prices (end-of-period)	4.0	3.4	2.4	2.4	2.4	2.4	2.4
Consumer prices (period average)	6.1	3.1	2.6	2.4	2.4	2.4	2.4
Investment and saving	(In percent of GDP)						
Gross capital formation	22.0	21.5	22.5	23.5	23.4	23.3	23.2
Government	1.6	1.6	2.7	3.6	3.5	3.4	3.3
Nongovernment	20.4	19.9	19.9	19.9	19.9	19.9	19.9
Gross national savings	-3.3	-4.1	-3.0	-1.1	0.3	1.0	1.6
Government	-9.5	-8.2	-7.2	-5.3	-4.4	-4.2	-3.9
Nongovernment	6.1	4.0	4.2	4.2	4.7	5.3	5.6
Central government finances (cash basis)	(In percent of GDP)						
Revenue (including grants)	20.5	21.5	24.4	25.9	26.6	27.0	26.9
Expenditure	31.5	31.2	34.2	34.6	34.4	34.6	34.0
Overall balance (including grants)	-11.0	-9.6	-9.5	-8.7	-7.5	-7.4	-7.1
Primary balance (including grants)	-1.4	-0.1	2.0	3.2	4.6	4.6	4.7
Total government debt 1/	151	155	161	165	166	165	163
Monetary sector	(Annual percentage change, unless otherwise indicated)						
Broad money 2/	3.6	4.0	6.0	7.0	7.0	7.0	7.0
Deposit dollarization (level)	70.7	70.0	68.0	67.0	66.0	65.0	65.0
Interest rates (period average, in percent)							
Five-year Eurobond yield	9.0	10.2	9.0	7.6	6.9	7.0	7.0
Five-year treasury bill yield	6.8	8.0	8.0	8.0	7.5	7.5	7.5
External sector	(In percent of GDP, unless otherwise indicated)						
Exports of goods and services (in US$, percentage change)	2.3	7.1	5.1	5.3	5.9	6.9	7.2
Imports of goods and services (in US$, percentage change)	3.2	1.5	2.4	1.7	1.0	3.3	3.9
Balance of goods and services	-24.3	-21.9	-20.9	-19.3	-16.9	-15.2	-13.7
Current account	-25.6	-26.5	-26.1	-24.7	-22.7	-21.4	-20.3
Foreign direct investment	2.4	3.5	4.3	5.6	6.6	7.1	7.6
Total external debt 3/	191	197	212	226	237	246	253
Gross reserves (in billions of U.S. dollars) 4/	36.5	32.8	33.2	35.4	39.8	45.3	52.2
In months of next year imports of goods and services	12.9	11.4	11.3	12.0	13.0	14.2	15.9
In percent of short-term external debt 5/	44.2	37.4	35.4	34.6	35.7	37.3	39.7
In percent of banking system foreign currency deposits	29.6	25.9	25.4	25.7	27.3	29.5	31.8
In percent of total banking system deposits	20.9	18.1	17.3	17.2	18.0	19.2	20.6
Memorandum items							
Nominal GDP (in billions of U.S. dollars)	56.4	58.6	60.1	62.2	64.9	68.4	72.5
Non-resident deposits (staff estimate, percent change)	4.2	5.1	7.2	7.1	7.1	7.1	7.1
Commercial bank total assets (percent of GDP)	443	443	458	474	487	494	499
Real effective exchange rate (annual average, percent change)	2.2	...	...	...	...	...	...

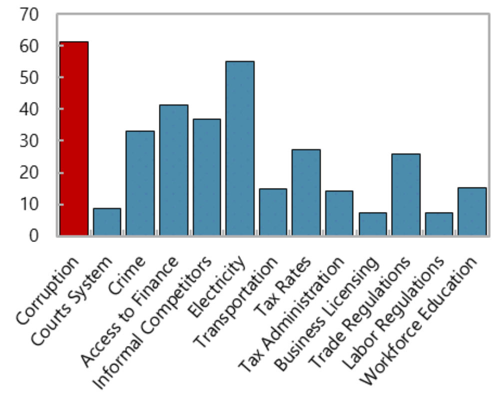
Sources: Lebanese authorities; IMF staff estimates.
Note: The adjustment scenario does not incorporate arrears clearance due to lack of information regarding the stock of arrears.
1/ Does not include the bridge loan from the central bank.
2/ Defined as currency in circulation plus resident and nonresident deposits.
3/ Includes nonresident deposits.
4/ Excluding gold and encumbered assets.
5/ Short-term debt on a remaining maturity basis, including short-term nonresident deposits.

Annex IV. Governance

1. There is evidence of governance weaknesses and a high level of corruption in Lebanon. According to the World Bank's Business Enterprise Survey (2013), 61.4 percent of firms identify corruption as a major constraint compared to 49.1 percent in the MENA region. Furthermore, corruption is identified as a major constraint by the highest number of firms in Lebanon, followed by electricity which is reported as a constraint by 55.1 percent of firms.

2. Over the years, Lebanon recorded modest progress in improving its governance framework, including in the fight against corruption. 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 have also been adopted.

Major Constraints to Businesses in Lebanon
(in percent of firms)



Source: Enterprise Survey, 2013.

3. The main areas for reducing corruption and improving governance are:

- **Anti-corruption framework.** Further concrete steps should also be urgently taken to reduce corruption. Existing 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 enactment and urgent implementation of the pending illicit enrichment and asset declaration legislation in line with best practices. 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 will also be important for the upcoming MENAFATF AML/CFT assessment (see below).

- **Fiscal governance** can be improved along several dimensions:

  (i). *Better monitoring of the use of public funds*, including in public employment (around 5,000 people were illegally hired after the hiring freeze of the 2017 salary scale law). Spending by the Council for Development and Reconstruction (CDR) should be included in the budget.

  (ii). *Passing a public procurement law* to ensure that public funds are appropriately disbursed in preparation for the CIP.

(iii). *Stronger management of core tax functions*, with reforms to the Tax Identification Number (TIN) system, compliance risk management and collection of tax arrears.

(iv). *Better oversight of tax administration* through establishment of an independent internal audit unit and improving transparency of external reporting.

- **Regulatory framework and the rule of law.** The doing business framework should be improved, beginning with decreasing delays with construction permits and contract enforcement. Border procedures can be streamlined to facilitate trade. At the same time, the authorities should solicit comments from the general public on proposed regulations.

- **Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT).** The high-level awareness among the authorities and private sector of ML/FT-related risks, such as from domestic proceeds of corruption and non-resident deposits, is encouraging. Over the past years, the authorities have strengthened the AML/CFT legislative framework, and report to have undertaken two national risk assessments (NRA). The Special Investigative Committee's (SIC) focus on supervision and its leadership in improving the Lebanese AML/CFT system are also important positives.

  - **Continued legislative improvements and effective implementation of AML/CFT measures are needed to mitigate intrinsic ML/TF risks and ensure a positive future MENAFATF AML/CFT assessment.** A negative assessment could adversely affect investment and banks' continued access to correspondent banks. To this end, the authorities are urged to continue improving the AML/CFT system, including by i) sharing the outcomes of the national risk assessments with private and public sector stakeholders; ii) 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; iii) ensuring the timely availability of accurate beneficial ownership information; iv) improving targeted financial sanctions requirement;, and v) increasing the numbers of prosecutions and convictions for ML, commensurate with risks.

  - **Plans by the BdL, supported by the Association of Banks in Lebanon, to fully abolish numbered/secret accounts are commendable and should be implemented without delay.** Authorities have committed to abolishing numbered or secret accounts, notably because their continued use reflects negatively on the Lebanese banking sector. Likewise, it is crucial that the authorities modernize banking secrecy provisions to allow timely and direct access to financial information held by financial institutions by law enforcement and judicial bodies. This would help support investigations and prosecutions against money laundering, corruption and other financial crimes.[1]

[1] Note that some of the banking information, which cannot be shared domestically, is shared with foreign authorities as a result of the implementation of FATCA/CRS and FATF's cross border wire transfer transparency requirements.

Annex V. Public Debt Sustainability Analysis

With public debt already above 150 percent of GDP and gross financing needs of over 30 percent of GDP, Lebanon's public debt is unsustainable under the baseline scenario. Debt and gross financing needs will continue to rise as a share of GDP, reaching 180 percent and 37 percent, respectively, by 2024. In addition, debt dynamics and financing needs are highly vulnerable to a range of shocks. Decisive policy actions to bring the debt path on a downward trend are thus urgently required.

1. Baseline scenario projection assumes the following:

- *Real GDP growth* is projected to pick up slowly assuming the government implements the planned reforms which would unlock funding for its Capital Investment Plan (CIP). Starting at 0.2 percent in 2019, growth is projected to pick up in 2021 and peak at 3.7 percent in 2023.

- *Inflation* (measured by the GDP deflator) is projected to ease from 5.3 percent in 2018 to 2.1 percent in 2021.

- The *primary deficit* is estimated at 1.4 percent of GDP in 2018; it is projected to narrow in 2019 before turning into a small surplus in 2020, thanks to corrective fiscal measures. However, these measures are expected to be temporary and their reversal is projected to lead to a primary deficit again by 2023.

2. The baseline assumptions are plausible in historical and cross-country context. Lebanon's forecast track record is not systematically biased. The median forecast errors for growth, inflation, and the primary balance during 2008–16 are broadly in line with those observed in other countries.

3. The deteriorating debt outlook is mainly driven by the projected positive interest rate-growth differential. The public debt-to-GDP ratio is forecast to increase from over 150 percent in 2018 to 180 percent in 2024. Over the forecast horizon, economic growth is not expected to reach levels high enough to offset adverse dynamics from real interest rates, even considering the concessional loans expected from the CIP. Although the gross financing needs-to-GDP ratio is forecast to fall through 2022, it is projected to rise again to 37 percent of GDP in 2024. The increase in financing needs in 2022 and beyond is primarily driven by the debt maturity profile of around five and seven years, for domestic and foreign debt, respectively.

4. The debt and financing needs projections are highly sensitive to a range of shocks:

- *Growth shock*. Slower growth remains one of the principal risks to debt sustainability. If growth were to decline by one standard deviation in 2020 and 2021, the debt-to-GDP ratio would reach almost 200 percent and financing needs would exceed 40 percent of GDP in 2024.

- *Real exchange rate shock*. A 50-percent real exchange rate shock, based on the standard MAC DSA inflation pass-through coefficient of 0.25, would affect the debt-to-GDP ratio to a similar extent as a growth shock, because, under these standard assumptions, the effects of higher foreign currency debt would be largely offset by the impact of inflation in eroding domestic debt.

- *Interest rate shock*. Higher interest rates also pose a significant risk to debt sustainability. A shock to the interest rate would result in financing needs reaching almost 40 percent of GDP in 2024. Interest rates on domestic and foreign bonds have recently been rising and may continue doing so, and the potential rate increase could be even higher than assumed in this scenario if investor confidence evaporates.[1]

- *Macro-fiscal shock*. If shocks to growth, the interest rate, and the primary balance occurred simultaneously, the debt-to-GDP ratio would exceed 250 percent at the end of the projection horizon. Financing needs would rise to close to 50 percent of GDP.

- *Contingent liability shock*. In the absence of concrete estimates of contingent liabilities, a standardized shock of 10 percent of financial sector assets is used to reflect the significant size of Lebanon's banking sector relative to the size of its economy and to represent a hypothetical realization of such contingent liabilities. In this scenario, the debt-to-GDP and financing needs-to-GDP ratios would reach 218 and 43 percent by 2024, respectively. This does not assume any feedback on GDP growth and interest rates due to the contingent liability shock.

5. The fan figures show significant uncertainty around the baseline. The width of the symmetric fan figure, estimated at around 60 percent of GDP, illustrates the degree of uncertainty for equal-probability upside and downside shocks.

6. Lebanon's debt profile reveals substantial weaknesses. Despite the relatively long average maturity of government debt, projected public GFNs are very high and generate significant rollover risks, reflecting the level of debt and large fiscal deficits. External financing needs are almost 12 times the upper risk-assessment benchmark, bond spreads have been rising and now exceed the upper risk-assessment benchmark by 242 basis points, and public debt in foreign currency is about halfway between the lower and upper risk-assessment benchmarks.

7. There are additional risks from public sector liabilities that not currently captured in the DSA. The coverage of debt in the DSA is limited to the central government and does not capture the stock of government expenditure arrears, the exact magnitude of which is uncertain. Beyond the central government, the liabilities of public enterprises and the BdL also pose risks to public debt sustainability, with the latter having accumulated foreign currency liabilities over the last decade.

[1] The Interest Rate Shock scenario—as defined in the public DSA—assumes that the interest rate increases by difference between average real interest rate level over projection and maximum real historical level, or by 200bp, whichever is larger.

Figure 1. Lebanon: Public DSA Risk Assessment

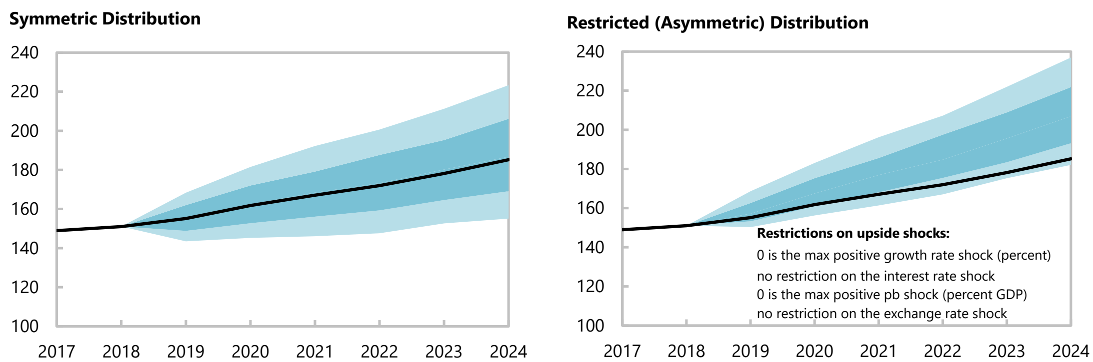
Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

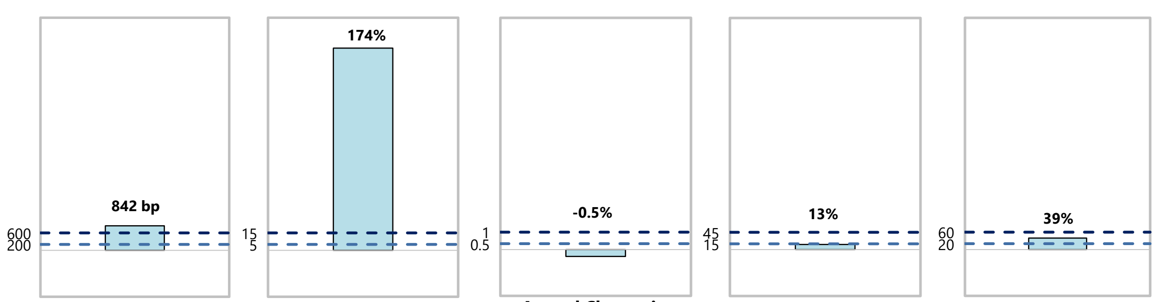
Baseline Percentiles: 10th-25th 25th-75th 75th-90th



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)

Lebanon Lower early warning Upper early warning



EMBIG (in basis points) 4/

External Financing Requirement (in percent of GDP) 5/

Annual Change in Short-Term Public Debt (in percent of total)

Public Debt Held by Non-Residents (in percent of total)

Public Debt in Foreign Currency (in percent of total)

Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

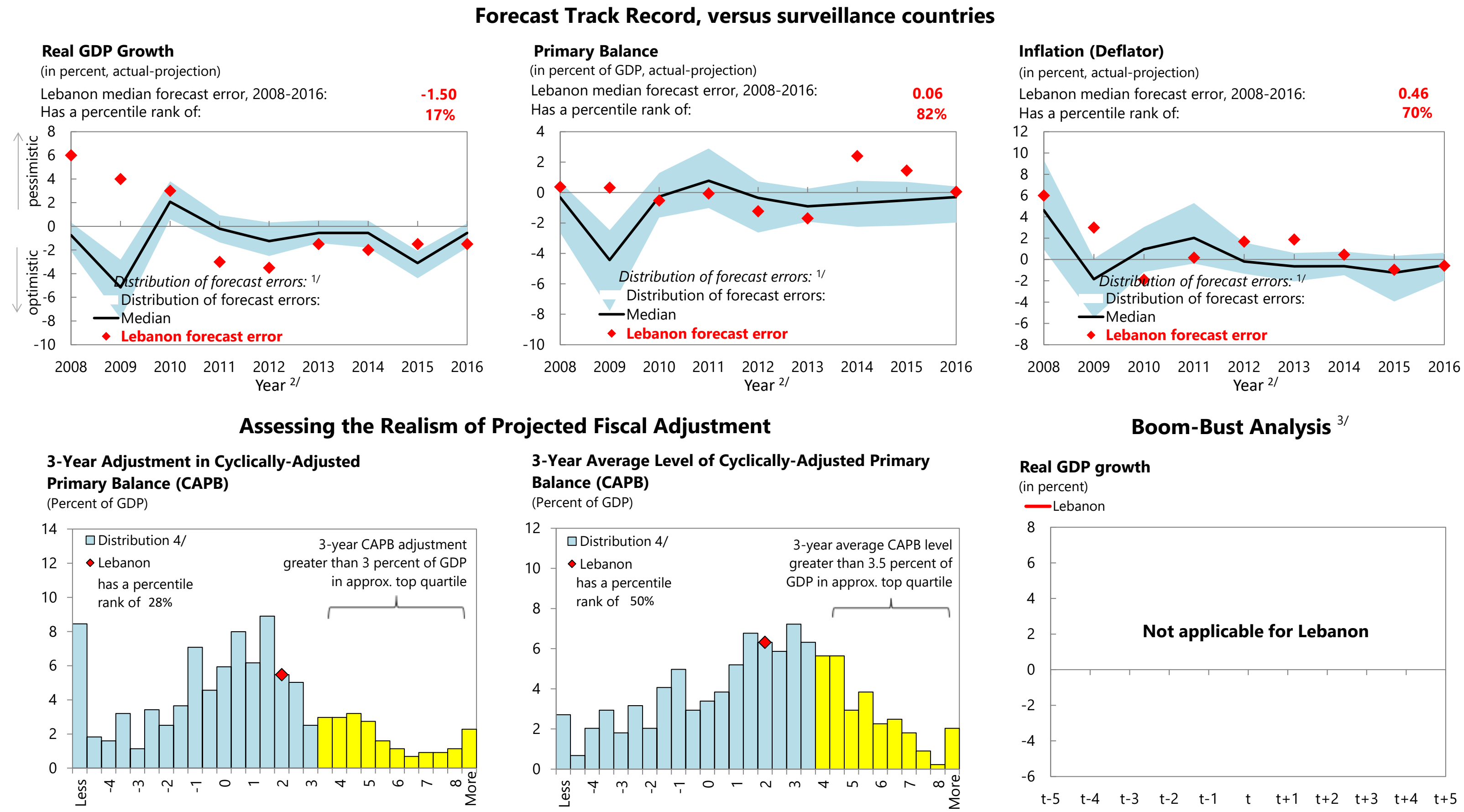
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 01-May-19 through 30-Jul-19.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Lebanon: Public DSA—Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Lebanon, as it meets neither the positive output qap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Lebanon: Public Sector Debt Sustainability (DSA) Analysis—Baseline Scenario

(In percent of GDP, unless otherwise indicated)

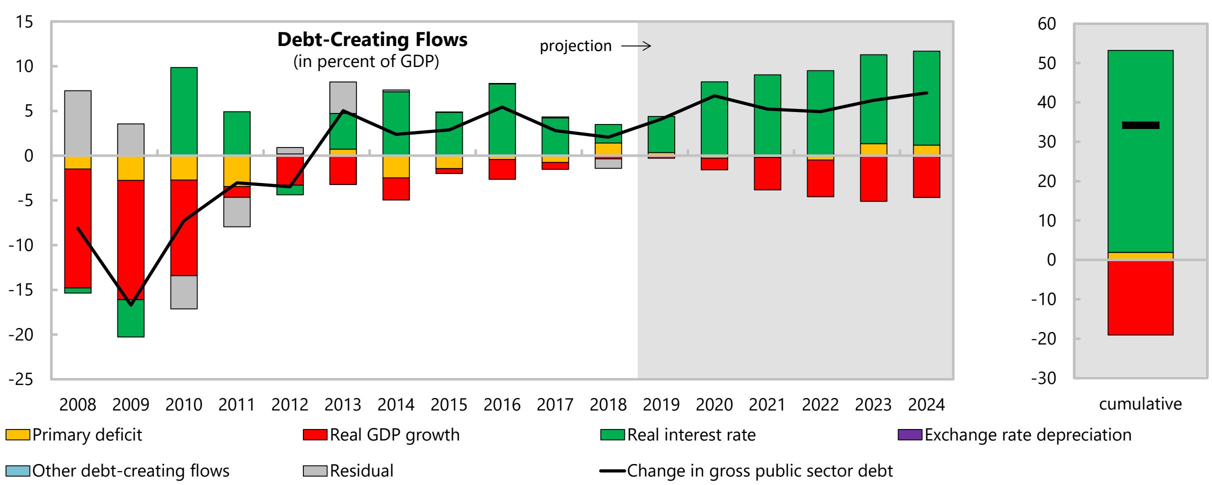
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	140.7	149.0	151.0	155.1	161.8	167.0	172.0	178.2	185.2
Public gross financing needs	37.0	40.8	35.2	29.3	28.1	24.7	24.4	26.0	37.9
Real GDP growth (in percent)	4.2	0.6	0.2	0.2	0.9	2.3	2.6	3.1	2.7
Inflation (GDP deflator, in percent)	4.1	3.6	5.3	3.7	2.3	2.1	2.1	2.1	2.1
Nominal GDP growth (in percent)	8.5	4.2	5.6	3.9	3.2	4.4	4.7	5.3	4.9
Effective interest rate (in percent) [4/]	7.1	6.7	6.8	6.5	7.9	7.9	8.1	8.2	8.3

As of July 30, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		874
5Y CDS (bp)		923
Ratings	Foreign	Local
Moody's	Caa1	Caa1
S&Ps	B-	B-
Fitch	B-	B-

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.5	2.8	2.1	4.1	6.7	5.2	4.9	6.2	7.0	34.1	
Identified debt-creating flows	-3.5	2.7	3.1	4.1	6.7	5.2	4.9	6.2	7.0	34.1	
Primary deficit	-1.5	-0.8	1.4	0.3	-0.3	-0.2	-0.5	1.3	1.2	1.9	5.8
Primary (noninterest) revenue and grants	21.7	21.8	20.5	21.5	22.9	22.8	22.2	21.2	21.1	131.6	
Primary (noninterest) expenditure	20.2	21.0	21.9	21.8	22.6	22.6	21.8	22.5	22.3	133.6	
Automatic debt dynamics [5/]	-1.9	3.4	1.7	3.8	7.0	5.4	5.4	4.8	5.8	32.2	
Interest rate/growth differential [6/]	-1.9	3.4	1.7	3.8	7.0	5.4	5.4	4.8	5.8	32.2	
Of which: real interest rate	3.7	4.2	2.1	4.0	8.3	9.0	9.5	9.9	10.5	51.3	
Of which: real GDP growth	-5.6	-0.8	-0.4	-0.3	-1.3	-3.6	-4.1	-5.1	-4.7	-19.1	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.9	0.1	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

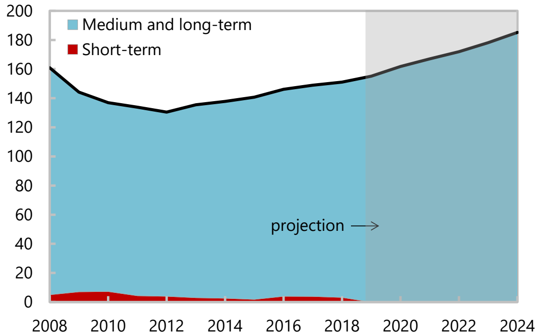
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

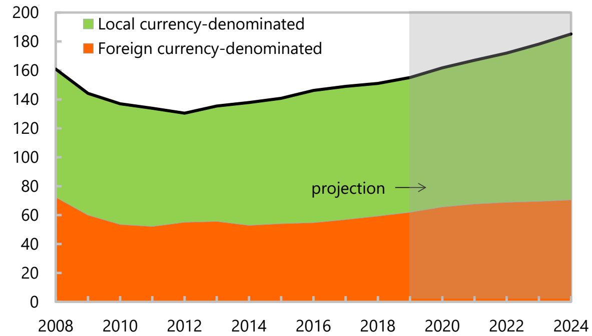
Figure 4. Lebanon: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



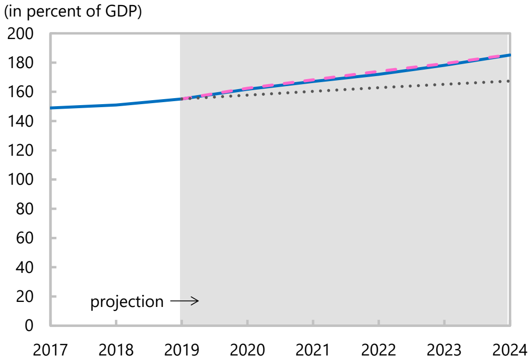
By Currency
(in percent of GDP)



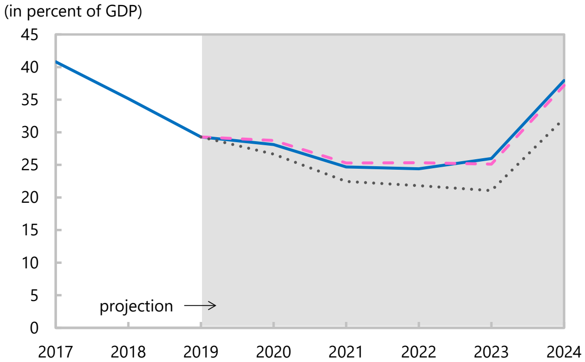
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

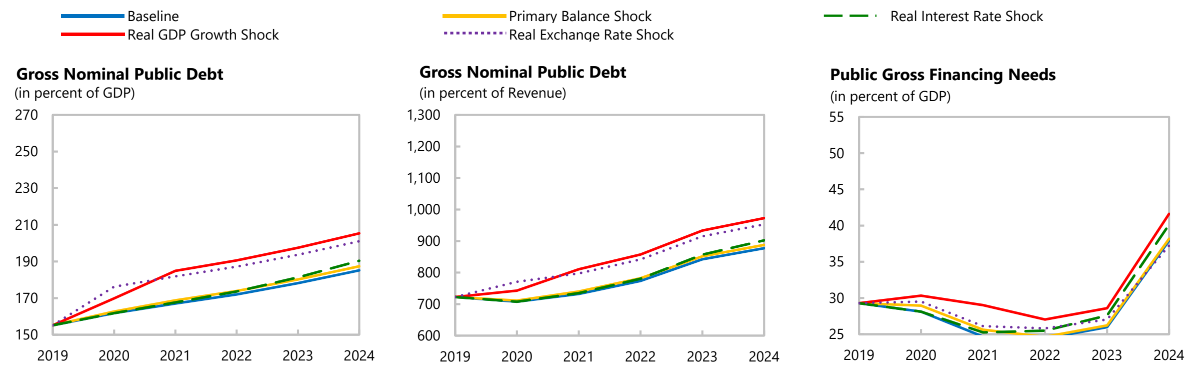
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.2	0.9	2.3	2.6	3.1	2.7
Inflation	3.7	2.3	2.1	2.1	2.1	2.1
Primary Balance	-0.3	0.3	0.2	0.5	-1.3	-1.2
Effective interest rate	6.5	7.9	7.9	8.1	8.2	8.3
Constant Primary Balance Scenario						
Real GDP growth	0.2	0.9	2.3	2.6	3.1	2.7
Inflation	3.7	2.3	2.1	2.1	2.1	2.1
Primary Balance	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	6.5	7.9	7.9	8.1	8.2	8.3

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.2	2.9	2.9	2.9	2.9	2.9
Inflation	3.7	2.3	2.1	2.1	2.1	2.1
Primary Balance	-0.3	1.2	1.2	1.2	1.2	1.2
Effective interest rate	6.5	7.9	7.6	7.5	7.3	7.2

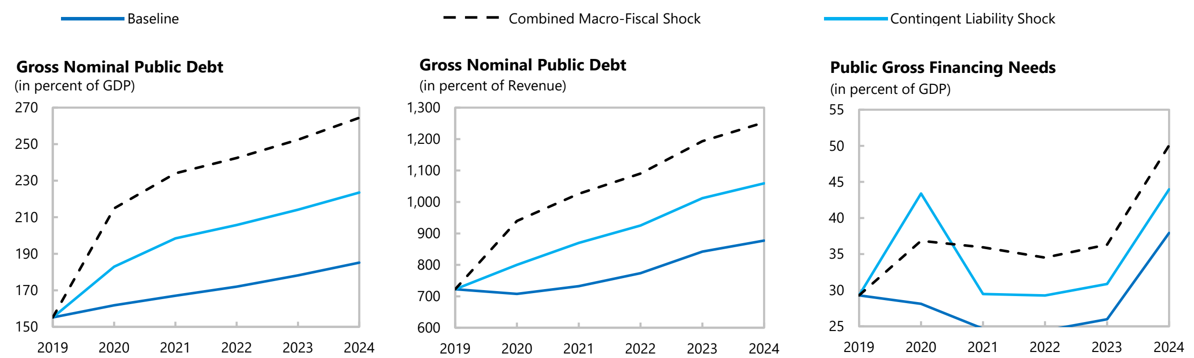
Source: IMF staff.

Figure 5. Lebanon: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	0.2	0.9	2.3	2.6	3.1	2.7
Inflation	3.7	2.3	2.1	2.1	2.1	2.1
Primary balance	-0.3	-0.6	-0.6	0.5	-1.3	-1.2
Effective interest rate	6.5	7.9	8.0	8.2	8.3	8.4
Real Interest Rate Shock						
Real GDP growth	0.2	0.9	2.3	2.6	3.1	2.7
Inflation	3.7	2.3	2.1	2.1	2.1	2.1
Primary balance	-0.3	0.3	0.2	0.5	-1.3	-1.2
Effective interest rate	6.5	7.9	8.3	8.8	9.1	9.5
Combined Shock						
Real GDP growth	0.2	-2.5	-1.0	2.6	3.1	2.7
Inflation	3.7	1.5	1.2	2.1	2.1	2.1
Primary balance	-0.3	-0.7	-1.8	0.5	-1.3	-1.2
Effective interest rate	6.5	9.9	8.2	8.7	9.0	9.4

	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	0.2	-2.5	-1.0	2.6	3.1	2.7
Inflation	3.7	1.5	1.2	2.1	2.1	2.1
Primary balance	-0.3	-0.7	-1.8	0.5	-1.3	-1.2
Effective interest rate	6.5	7.9	8.0	8.2	8.3	8.4
Real Exchange Rate Shock						
Real GDP growth	0.2	0.9	2.3	2.6	3.1	2.7
Inflation	3.7	19.0	2.1	2.1	2.1	2.1
Primary balance	-0.3	0.3	0.2	0.5	-1.3	-1.2
Effective interest rate	6.5	9.9	7.9	8.1	8.2	8.3
Contingent Liability Shock						
Real GDP growth	0.2	-2.5	-1.0	2.6	3.1	2.7
Inflation	3.7	1.5	1.2	2.1	2.1	2.1
Primary balance	-0.3	-13.4	0.2	0.5	-1.3	-1.2
Effective interest rate	6.5	8.1	8.7	8.8	8.9	8.9

Source: IMF staff.

Annex VI. External Debt Sustainability Analysis

1. Lebanon's external debt is unsustainable. External debt is estimated at about 190 percent of GDP in 2018. The current account deficit excluding interest payments is high at 20 percent of GDP, and although this is projected to decline over the projection period, the interest-growth differential on account of high and growing external debt will continue to weigh against the positive developments in the non-interest current account deficit. The increase in external debt is somewhat dampened by the draining of foreign exchange reserves. All else equal, the non-interest current account deficit will have to reach 5.9 percent to stabilize external debt over the long term at the 2024 level (214 percent of GDP).

2. External debt mainly comprises of non-resident deposits. 77 percent of the external debt is non-resident deposits, most of which are short-term with maturities less than one year.[1] Government debt only accounts for about 10 percent 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.

3. Gross external financing need stood at 174 percent of GDP in 2018 and financing it is becoming increasingly difficult. Non-resident deposits have proved more difficult to attract to Lebanon in 2018 compared to past years. The political impasse in 2018 and fiscal slippages have heightened the risk aversion of non-resident depositors and increased the risk premium required to attract them. In 2018, the government did not issue any Eurobonds in the market. Instead, they were issued to the BdL, which then re-sold part of them to the market at a discount to attract foreign exchange.

4. The scenario analysis demonstrates Lebanon's sensitivity to an exchange rate shock. A real depreciation shock of 30 percent would increase external debt to over 300 percent of GDP. The sensitivity to of the debt dynamics to this shock highlights the importance of reducing external imbalances and relying on external financing. Growth shock, non-interest current account shock, and combined shock lead to an external debt that exceeds 220 percent of GDP by 2024.

5. To restore external sustainability, a decisive external adjustment is needed. 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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[1] IMF estimates of non-resident deposits differs from banks' reported data and include estimated deposit flows by Lebanese nationals living abroad but classified as residents.

Table 1. Lebanon: External Debt Sustainability Framework, 2014–24
(In percent of GDP, unless otherwise indicated)

			Actual									Projections			
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024		Debt-stabilizing non-interest current account 6/
Baseline: External debt	166.6	166.6	182.0	189.4	191.1			**195.7**	**207.0**	**214.7**	**218.7**	**219.0**	**219.4**		**-5.3**
Change in external debt	5.4	0.0	15.4	7.5	1.6			4.6	11.3	7.7	4.1	0.3	0.4	0.0	
Identified external debt-creating flows (4+8+9)	20.1	10.9	16.0	17.1	12.8			22.7	20.5	16.1	14.3	13.1	13.6	0.0	
Current account deficit, excluding interest payments	24.7	15.5	18.3	20.4	19.4			18.6	18.1	17.1	15.7	15.2	14.4	5.3	
Deficit in balance of goods and services	25.2	23.9	28.0	25.4	19.6			18.5	19.9	19.3	19.1	18.6	18.1		
Exports	39.9	39.7	37.3	35.9	34.8			35.9	36.5	36.7	36.9	37.0	37.2		
Imports	65.1	63.6	65.3	61.3	54.4			54.4	56.4	56.0	55.9	55.6	55.3		
Net non-debt creating capital inflows (negative)	-3.3	-2.7	-3.0	-1.4	-2.8			-3.3	-4.2	-4.9	-4.9	-4.4	-3.8	-3.8	
Automatic debt dynamics 1/	-1.3	-1.9	0.7	-1.8	-3.8			7.4	6.6	3.9	3.5	2.2	2.9	-1.5	
Contribution from nominal interest rate	3.5	3.7	4.8	5.5	6.2			7.8	8.2	8.6	8.8	8.7	8.7	8.7	
Contribution from real GDP growth	-2.9	-0.7	-2.6	-1.0	-0.4			-0.4	-1.6	-4.6	-5.3	-6.5	-5.7	-5.7	
Contribution from price and exchange rate changes 2/	-1.8	-4.9	-1.5	-6.4	-9.6			...	...	...	...	...	...	-4.5	
Residual, incl. change in gross foreign assets (2-3) 3/	-14.7	-11.0	-0.6	-9.7	-11.1			-18.1	-9.2	-8.4	-10.3	-12.8	-13.2	0.0	
External debt-to-exports ratio (in percent)	417.8	419.9	488.3	528.0	549.7			545.1	566.4	584.7	593.1	592.1	589.1		
Gross external financing need (in billions of US dollars) 4/	76.4	77.6	84.1	89.7	98.0			99.0	104.8	111.0	118.7	126.2	132.8		
in percent of GDP	158.1	155.3	164.1	168.0	173.9	10-Year	10-Year	169.1	173.3	175.8	179.5	181.3	181.9		
Scenario with key variables at their historical averages 5/								**195.7**	**197.9**	**200.7**	**201.9**	**200.9**	**199.7**		**-12.4**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							For debt stabilization	
Real GDP growth (in percent)	1.9	0.4	1.6	0.6	0.2	2.9	3.4	0.2	0.9	2.3	2.6	3.1	2.7	2.7	
GDP deflator in US dollars (change in percent)	1.1	3.0	0.9	3.6	5.3	3.9	3.1	3.7	2.3	2.1	2.1	2.1	2.1	2.1	
Nominal external interest rate (in percent)	2.2	2.3	3.0	3.2	3.4	2.6	0.5	4.2	4.3	4.3	4.3	4.2	4.2	4.2	
Growth of exports (US dollar terms, in percent)	-7.8	2.9	-3.7	0.3	2.3	-1.2	8.4	7.3	5.1	4.9	5.2	5.6	5.6		
Growth of imports (US dollar terms, in percent)	7.6	1.1	5.2	-2.2	-6.4	8.1	12.9	4.0	7.0	3.8	4.5	4.6	4.4		
Current account balance, excluding interest payments	-24.7	-15.5	-18.3	-20.4	-19.4	-19.1	3.9	-18.6	-18.1	-17.1	-15.7	-15.2	-14.4		
Net non-debt creating capital inflows	3.3	2.7	3.0	1.4	2.8	4.4	3.4	3.3	4.2	4.9	4.9	4.4	3.8		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

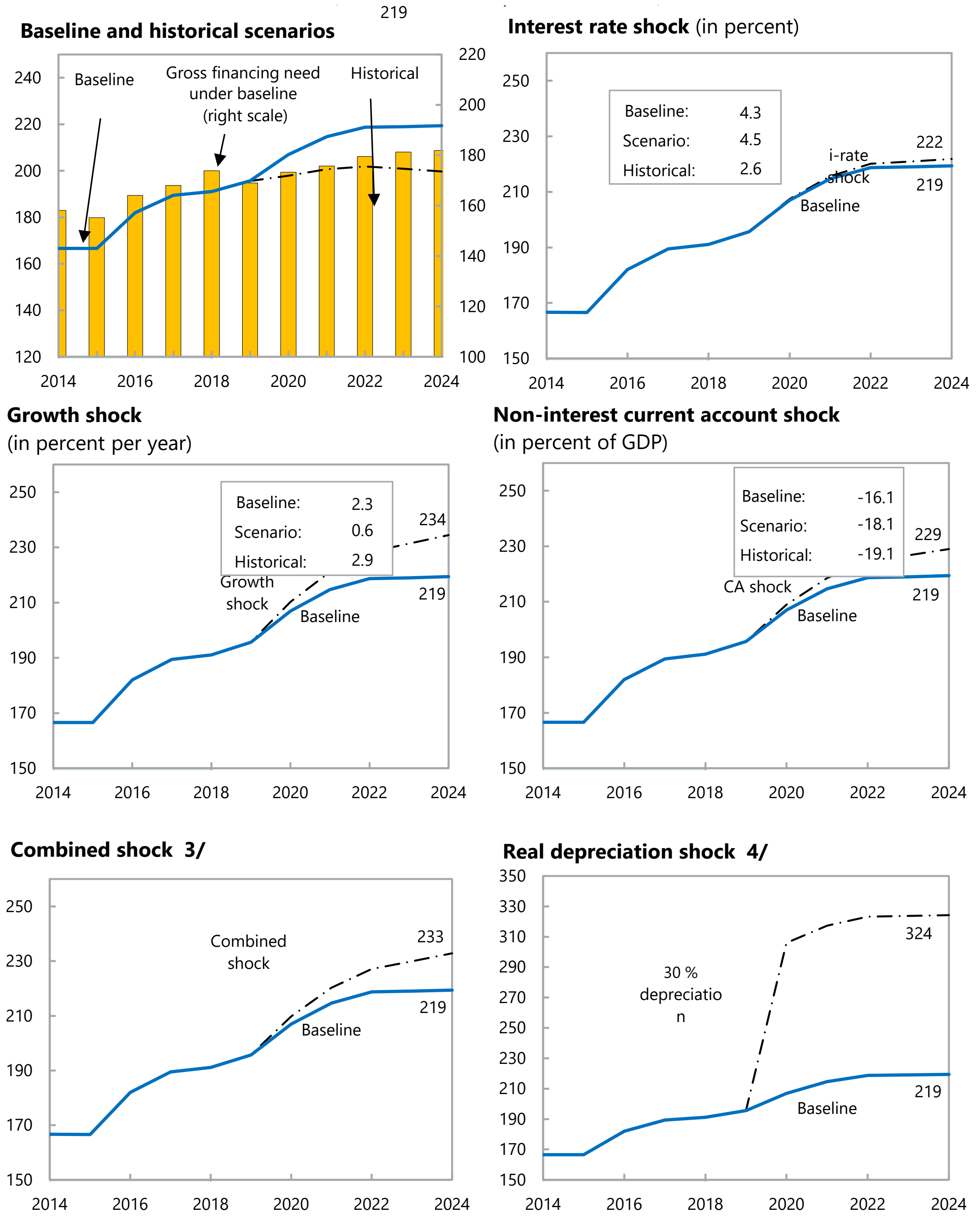
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

Figure 1. Lebanon: External Debt Sustainability—Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2020.

INTERNATIONAL MONETARY FUND

LEBANON

August 21, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Middle East and Central Asia Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of July 31, 2019)

Membership Status

Joined: April 14, 1947; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	633.50	100.00
IMF's Holdings of Currency (Holdings Rate)	507.04	80.04
Reserve Tranche Position	126.46	19.96

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	193.29	100.00
Holdings	193.12	99.91

Use of Fund Resources

Lebanon has no outstanding credit from/obligations to the IMF.

Latest Financial Arrangements

None.

Implementation of HIPC Initiative and Multilateral Debt Relief Initiative (MDRI)

Not applicable.

Safeguards Assessment

Pursuant to Fund policy, the Banque du Liban (BdL) was subject to a full safeguards assessment in conjunction with the first Emergency Post-Conflict Assistance (EPCA) in April 2007. The 2008 safeguards assessment report proposed several specific measures for enhancing the BdL financial reporting, audit and control procedures, and recommended an update of the central bank law. An update safeguards assessment was completed in August 2009 in the context of the second EPCA. The update noted progress achieved in enhancing procedures for reserve management and external audit, but recommended further actions to strengthen internal audit, financial reporting transparency, oversight, and central bank legislation.

Nonfinancial Relations

Exchange Arrangement

Lebanon has accepted the obligations of Article VIII, Sections 2, 3, and 4 in 1993, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. The de jure exchange rate arrangement is free floating, and the de facto exchange rate arrangement is classified as stabilized. Since October 1999, the BdL has been intervening to keep the pound around a mid-point parity of LL 1,507.5 per $1, with a bid-ask spread of LL+/-6.5.

Last Article IV Consultation

The 2018 Article IV consultation was concluded by the Executive Board on May 11, 2018. At the time, Directors noted that the economic situation in Lebanon continued to be difficult with high public debt, twin deficits, and tightening financial conditions. They acknowledged that the Syrian crisis and the large number of refugees are exacerbating the situation, commended the authorities for their generous efforts in hosting refugees and agreed that Lebanon needs continued international support. In their view, recent political developments—the election of the president and appointment of the prime minister—and the financial pledges secured at the CEDRE investment conference should pave the way for ambitious reforms to tackle internal and external imbalances, improve investor confidence, and achieve sustainable and inclusive growth. Directors emphasized the need for immediate and substantial fiscal adjustment to improve debt sustainability, including by increasing VAT rates, broadening the base, and eliminating electricity subsidies. They also recommended to strengthen public investment management to ensure successful implementation of the authorities' Capital Investment Plan (CIP). They commended the central bank for its critical role but emphasized that the BdL should gradually revert to conventional monetary policy and stressed the need to reduce financial sector vulnerabilities by strengthening buffers, ensuring that an adequate crisis management framework is in place, and continuing to strengthen the AML/CFT framework. They encouraged the authorities to implement the necessary structural reforms to boost competitiveness and productivity, incentivize investment, and address the external imbalances. They recommended to continue to improve governance and reduce corruption and called for further improvements to the statistical system.

Financial Sector Assessment Program

Lebanon participated in the Financial Sector Assessment Program in 2016, and the related report was presented to the Executive Board at the time of the 2016 Article IV consultation.

Resident Representative Office

The IMF Resident Representative Office in Lebanon was opened in January 2008 and closed in August 2011. The Fund maintains a local office.

Technical Assistance (TA)

Fiscal area—METAC provided TA on International Public Sector Accounting Standards and Fiscal Reporting (IPSAS), public accounting, tax and PFM reform, capacity building for the macro fiscal unit, enhanced fiscal risk statement (FRS), supported capacity development on PPPs fiscal costs and risks, and hosted a workshop on Gender Responsive Budgeting (GRB). METAC also conducted a revenue administration assessment, using the Tax Administration Diagnostic Tool (TADAT), which was followed by an expert visit to assist the tax administration on the development of a compliance improvement plan. A Public Investment Management Assessment (PIMA) mission came to assist the authorities in strengthening the management of public investment. METAC will continue providing TA on International Public Sector Accounting Standards and improvements to fiscal reporting and management of fiscal risks. It will also follow up on the TADAT recommendations and assist the tax administration in mitigating identified risks with a compliance plan and developing strategies for reducing and preventing the accumulation of tax arrears.

Financial area—METAC trained the Banking Control Commission of Lebanon (BCCL) on (i) understanding the concepts and practices of stress-testing implemented by banks, and their role in the Internal Capital Adequacy Assessment Process (ICAAP); (ii) integrating the review of ICAAP stress-testing in their supervisory review and evaluation exercises; and (iii) setting up and administering a bottom-up stress testing process, and collating and evaluating results. METAC will continue to assist the BCCL in developing a more customized model for multi-factor capital and liquidity stress-testing.

Statistical area—METAC assisted the Central Administration of Statistics (CAS) to reconcile data used in the Balance of Payments (BoP) and in the national accounts. The Statistics Department and METAC provided TA on the Residential Property Price Index to BdL. METAC also helped the CAS improve the Consumer Price Index (CPI) and discussions are ongoing to develop a Producer Price Index (PPI). TA will continue to help improve the CPI and develop the PPI while future assistance will be provided to improve the annual national accounts methodology and to assess options to develop a compilation system for quarterly GDP.

WORLD BANK–IMF COLLABORATION

1. The Lebanon teams of the Fund and the World Bank met to discuss macrocritical structural reforms and coordinate their work in 2019. The teams agreed that the approval of the electricity reform plan and the discussion on the 2019 budget are important first steps in the process of fiscal adjustment that would stabilize and then put public debt as a share of GDP on a downward path. The government has an opportunity to implement reforms to preserve stability and strengthen confidence. Such reforms, both on the fiscal and structural fronts, would encourage donors to disburse the concessional funds committed during the CEDRE investment conference in April 2018. The underlying economic situation in Lebanon remains challenging, with low growth, high public debt, twin deficits, and funding needs which are exacerbated by the large number of Syrian refugees. Lebanon needs urgent action to preserve confidence in the system and take advantage of international support that could help finance the Capital Investment Plan (CIP), which is aimed at upgrading infrastructure while providing employment opportunities to both host communities and 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 process. The authorities should approve and implement legislation of key growth-enhancing reforms identified in its CEDRE vision.

2. Based on this shared assessment, the teams identified the following structural reform areas as macrocritical to preserve confidence in the system and to establish a policy framework that supports macroeconomic stability:

- **Implementation of 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**. The plan would include reforms to the value-added tax (VAT) as well as eliminating exemptions and improving compliance. This would be accompanied by an assessment of the socio-economic distributional impact.

- **Increasing gasoline excise and fuel taxes.** These measures are straight-forward and easy to implement as they would only require approvals from the ministers of energy and finance without having to pass by Cabinet or Parliament.

- **Gradually eliminating the electricity subsidy.** The WB offered the authorities technical advice on the new electricity reform plan that has been approved by both Cabinet and Parliament. The plan aims to reduce technical and non-technical losses, 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.

- **Implementing the recommendations of the Public Investment Management Assessment.** It is crucial that the most important improvements to the country's public investment management framework are implemented before the execution of most of the CIP. Key reforms include incorporating Council for Development and Reconstruction (CDR) spending in the budget and passing a public procurement law—which was drafted with assistance from the WB.

- **Scaling up and out the National Poverty Targeting Program (NPTP).** This would help protect the most vulnerable from the impact of the needed fiscal adjustment.

3. The teams agreed to the following division of labor:

- **Fiscal reform.** The Fund is providing capacity building on International Public Sector Accounting Standards and Fiscal Reporting (IPSAS), public accounting, gender sensitive budgeting, PPPs fiscal costs and risks, tax and PFM reform and capacity building for the macro fiscal unit.

- **Electricity sector reform.** The Bank is providing technical assistance to follow-up on the implementation of the electricity reform plan, which was approved by Cabinet on April 9, 2019 and by Parliament on April 17, 2019.

- **Public Investment Management Assessment.** The Fund is assisting the authorities in implementing the recommendations from the joint IMF/WB/METAC public investment management assessment (PIMA) conducted in the June–July 2018 mission.

- **The National Poverty Targeting Program.** The Bank is helping the authorities build on the successes and lessons learned over the past seven years to scale up and out the NPTP and move it in the direction of a productive safety net program that links safety nets to employability.

- **Reform of the statistical system:** The Fund is providing TA on the consumer price index, producer price index and national accounts.

4. The teams have the following requests for information from their counterparts:

- The teams request to be kept informed of progress on the other institution's agenda. Timing: when milestones are reached (and at least semi-annually).

- The table below lists the teams' separate and joint work programs in 2020.

Lebanon—Bank and Fund Planned Activities in Macrocritical Structural Reform Areas			
Title	**Products**	**Provisional Timing of Missions**	**Expected Delivery Date**
1. Fund Work Program	Article IV Consultation Staff Report	2020	2020
	TA on:		
	• Continuing the support for the implementation of the International Public Sector Accounting Standards and improvements to fiscal reporting, with a special focus on financial instruments, including debt.	Ongoing	2020
	• Supporting fiscal risk identification, disclosure and mitigation of identified risks. Developing strategies for reducing and preventing the accumulation of tax arrears.	Ongoing	2020
	• Improving the annual national accounts methodology and assessing options to develop a compilation system for quarterly GDP. Continuing the establishment of a PPI and continuing to improve the CPI methodology.	Ongoing	2020
	• Developing a stress-test model to assess banking sector vulnerabilities.	Ongoing	2020
2. Bank Work Program	Supporting Innovation in SMEs Project	Ongoing	06/30/2020
	Greater Beirut Water Supply	Ongoing	11/30/2020
	Roads and Employment Project	Ongoing	06/30/2022
	Greater Beirut Public Transport Project	Ongoing	12/31/2023
	PCB Management in the Power Sector	Ongoing	06/30/2020
	Emergency National Poverty Targeting Project	Ongoing	12/31/2019
	Lebanon Power Sector Reforms Program	Ongoing	06/14/ 2021
	Lebanon financial sector monitoring and policy dialogue	Ongoing	06/30/2020
3. Joint Work Program	CIP assessment/Follow-up on the CEDRE process	Ongoing	2020

STATISTICAL ISSUES

Lebanon—Statistical Issues Appendix As of July 31, 2019
I. Assessment of Data Adequacy for Surveillance
General: Data provision has serious shortcomings that significantly hamper surveillance, particularly in national accounts and external sector statistics. Lack of timely, comprehensive and reliable national accounts data and social and labor market indicators undermine accountability and economic analysis. Fiscal reporting is lagging, and irregular treasury inflows and outflows undermine data compilation.
National accounts: National accounts data are weak. Only annual data are compiled and disseminated at this time. Data are available through 2017 and 2018 national accounts are expected to be published in the fourth quarter of 2019. Work is ongoing to start publishing quarterly national accounts data. The responsibility of producing national accounts statistics was transferred to the Central Administration of Statistics (CAS) in 2012 for the publication of 2011 accounts. Data sources are limited to mainly administrative data. Access to comprehensive business financial records maintained by the Ministry of Finance would greatly improve annual national accounts estimates and support the release of quarterly data. This is expected to improve with the ongoing efforts at the ministry to promote electronic tax declarations and e-service portals. BdL is yet to publish the updated Coincident Indicator—the one still used to date includes a set of high frequency indicators selected and weighed in 1993.
Price statistics: A Consumer Price Index (CPI) was released in March 2014 by the CAS with Fund assistance. Notable improvements introduced with the new CPI include the dissemination of more detailed national level index data on the CAS website; the publication of regional indexes; monthly collection of rent prices; and improved index calculation methods. The CPI covers all areas in Lebanon and is disseminated within three weeks after the end of the reference month. The weights of the CPI are expected to be updated based on the results of the 2020 household budget survey. There is an immediate need to develop regular and timely statistics on producer prices, while medium- to long-term needs include data on labor markets, wages and real estate prices.
Government finance statistics: Significant delays are still ongoing in the release of fiscal data. While the dissemination of central government finance statistics (GFS) has improved in recent years, the coverage of government finance statistics is not comprehensive. Published monthly data on the central government budgetary accounts do not cover items such as certain transfers, financing data, foreign-financed capital expenditure, and arrears; they include dues that should eventually be transferred to third parties (Telecom revenue due to municipalities). Some (treasury) spending is only identified ex post and presented in an economic classification with a lag. Some of these items are nonetheless provided to the Lebanon team in the context of surveillance activities. Government finance statistics are on a modified cash basis for revenue (transfers from the Telecom) and for budgetary expenditure data (issuance of payment orders). GFS data for budgetary central government based on 2001 *Government Finance Statistics (GFS) Manual* are published on a yearly basis in the IMF publication the *Government Finance Statistics Yearbook;* however, these data cover only transactions and no balance sheet data are reported. In 2018, data was reported based on GFS 2014 for the year 2017.

Lebanon—Statistical Issues Appendix (concluded)
Monetary and financial statistics: The sectorization of institutional units and classification of financial instruments in the data reported to STA fall short of what is needed for the compilation of Standardized Report Forms. Reflecting in part restrictions imposed by domestic legislation, the Banque du Liban (BdL) does not publish externally-audited financial statements. In February 2018, the BdL adopted the International Financial Reporting Standards (IFRS) reporting standards. The BdL does not submit SDDS-compliant numbers. The lack of a reliable classification of deposits by residency (also due to bank secrecy) and the large net errors and omissions complicate the balance of payments analysis.
Financial sector surveillance: Lebanon is a regular reporter of Financial Soundness Indicators (FSIs). All core and eight encouraged FSIs are reported on regular quarterly basis, except for the two indicators on capital adequacy that are reported on semi-annual basis. Compilation of FSIs for other sectors (other financial corporations, non-financial corporations, households, real estate markets) is needed to expand the list of FSIs compiled by Lebanon for macro prudential analysis.
Balance of payments: There have been efforts to improve Balance of Payments (BoP) statistics, including the quality of surveys through better compliance. However, there remain significant challenges to compiling reliable BoP data. In particular, there are data issues in the current account (unrecorded exports and imports, uncertainty with respect to the estimates of private sector services, workers' remittances, and investment income), the capital account (grants), and the financial account (foreign direct investment, equity investment in the nonbank private sector, and corporate borrowing abroad). METAC has assisted CAS to re-establish the rest of the world (ROW) account to reduce the discrepancy in reporting between the National Accounts and BoP statistics. Data is subject to frequent and very large revisions that hamper accurate assessment of the external sector position of Lebanon. An IIP statement was compiled with technical assistance though not yet ready for publication. The forms and the reporting requirements for banks and non-banks were amended in January 2010 and May 2013 to include more comprehensive and detailed breakdown of BoP components. The lack of effective inter-agency cooperation and data sharing between the BdL, CAS, customs and the Ministry of Finance are among the main factors impeding progress and there is a noted increase in the lack of cooperation and coordination among various agencies on data sharing.
II. Data Standards and Quality
Lebanon joined the General Data Dissemination System in January 2003. Metadata and plans for improvement need to be updated. No Report on the Observance of Standards and Codes (ROSC) for data dissemination is available for Lebanon.
III. Reporting to STA
Lebanon currently reports annual data based on *GFSM 2001* to be published in the *Government Finance Statistics Yearbook (GFSY)*, but the data suffer from weaknesses, mainly limited coverage. CAS does not currently report any data to STA. Lebanon reports monetary statistics on a regular monthly basis, covering the Central Bank and commercial banks only. The monetary data are reported with a timeliness of approximately three months. In September 2011, the BdL started regular submission of core *Financial Soundness Indicators* data and metadata, and data for Q1-2019 were posted on the IMF website.

Lebanon—Table of Common Indicators Required for Surveillance

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	07/12/19	07/12/19	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/31/19	07/02/19	M	M	M
Reserve/Base Money	05/31/19	07/01/19	M	M	M
Broad Money	05/31/19	07/01/19	W/M	W/M	M
Central Bank Balance Sheet	05/31/19	07/01/19	M	M	M
Consolidated Balance Sheet of the Banking System	05/31/19	07/01/19	M	M	M
Interest Rates[2]	05/31/19	07/01/19	W/M	W/M	W/M
Consumer Price Index	05/31/19	06/21/19	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	12/31/18	06/18/19	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	05/31/19	07/08/19	M	M	M
External Current Account Balance	05/31/19	07/09/19	Q	Q	Q
Exports and Imports of Goods and Services	05/31/19	05/31/19	Q	Q	Q
GDP/GNP	12/31/17	12/04/18	A	A	A
Gross External Debt	05/31/19	06/25/19	M	M	M
International Investment Position[6]	N/A	N/A	N/A	N/A	N/A

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means. These are reported to the country team with a lag.

[2] Both market-based and officially-determined policy interest rates (including discount rates, rates on treasury bills, notes and bonds).

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security fund) and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); and not available (NA).

Statement by Mr. Hazem Beblawi, Executive Director for Lebanon and Mr. Sami Geadah, Alternate Executive Director September 11, 2019

1. The long-standing resilience of the Lebanese economy faced increased challenges over the past year. Growth—which averaged about 8 percent before the Syrian civil war—plummeted to very low rates. The stagnation in growth, together with the deterioration in the fiscal position, increased an already high public debt to GDP ratio. Low growth, combined with a massive influx of refugees, also contributed to significant increases in poverty and unemployment. Moreover, the growth in private deposit inflows—important for financing the budget and the external current account—started to soften this year. While the challenges of dealing with refugees are likely to persist, as are the adverse spillovers of geopolitical tensions, growth is expected to benefit in the coming years from structural reforms, gas exploration, infrastructure spending, and a revival of tourism following lifting the ban on travelers from Gulf countries.

2. The international community has pledged substantial concessional financing for Lebanon, most notably to upgrade infrastructure in the context of CEDRE[1] in April 2018 to support stabilization, growth and employment. More than US$11 billion in pledges for concessional loans and grants were made for infrastructure projects. Lebanon's infrastructure suffered from years of underinvestment and stresses caused by a large refugee population. At the conference, the Lebanese government presented a comprehensive vision aimed at jumpstarting growth through revamping physical infrastructure, restructuring the public sector, modernizing legislation and procedures, enhancing governance including fiscal governance and improving transparency, updating procurement laws and procedures, and promoting the productive sectors. These reforms were formulated in the context of continued macroeconomic stability, which would be facilitated through a significant fiscal adjustment.

3. The authorities are addressing the country's economic challenges with seriousness and determination. Fiscal policy was significantly tightened soon after the government took office in early 2019 and work was expedited on structural reforms. The importance with which the authorities are dealing with economic issues is reflected in the direct involvement of the President and political parties. Following a meeting in August in which the President brought together the main political actors to set aside differences and focus on economic reforms, an economic summit was held in early September for economic policy makers and political parties. The President declared an economic emergency and formed an economic committee headed by the Prime Minister to follow-up on the meeting. The authorities confirmed the commitment to a fixed exchange rate; a significant fiscal adjustment; a plan to start US$3.3 billion of projects approved by

[1] *Conférence Economique pour le Développement, par les Réformes et avec les Enterprises.*

Parliament, full implementation of the power sector reform agenda; and laws to fight tax evasion, modernize customs and public procurement legislation.

Fiscal Policies

4. A significant fiscal adjustment is being undertaken in the context of a medium-term fiscal framework. Following the public spending cuts in early 2019, Parliament approved a budget that aimed at reducing the deficit by about 2 percentage points of GDP in 2019. Budget measures included increasing the tax on interest earnings, introducing a tax on imports, raising fees, freezing public sector hiring, and raising the minimum years of service for retirement from government (including military) employment by 5 years. While there are differences between the staff and authorities on the yield of these measures, the authorities are prepared to take additional measures to achieve a meaningful reduction in the fiscal deficit this year. As was conveyed to staff, there were some delays in processing payment orders that were submitted at the end of 2018, which amounted to about 0.6 percent of GDP.

5. The draft budget for 2020 aims at a primary surplus of 3 percent of GDP. The authorities plan to increase the primary surplus by 1 percentage point of GDP in each of 2021 and 2022. The draft budget proposes to lower significantly electricity subsidies (to US$1 billion), freeze public sector wages and hiring, raise the VAT rate on luxury goods to 15 percent, liquidate or sell state-owned enterprises, and include fiscal reforms needed to utilize the foreign assistance that was pledged at CEDRE. The authorities are reluctant to raise the VAT rate on necessities because of the effect of this measure on the vulnerable parts of the population. Preparations for the 2020 budget are advanced. A draft budget was prepared, which the authorities plan to present to Parliament in October so that it can be adopted before the end of this year in line with constitutional deadlines.

Structural Reforms

6. The reform of the electricity sector is important for public finances, economic growth, and the environment, and the government is fully committed to implementing it in a timely manner. In July 2019, Parliament adopted a plan to reform the sector which would provide 24-hour electricity by 2022**,** a welcome change for Lebanese who for decades relied on private generator providers to fill the supply gap. Reforms to the sector will eliminate significant budget subsidies. As for the staff's revenue recommendations, there is a difference in views on the timing of the electricity tariff increase. The staff recommends that tariffs be increased immediately. The authorities prefer to raise tariffs in conjunction with an increase in electricity supply that allows consumers to reduce the use of more expensive electricity from private generators. The authorities expect financial savings from the reforms to stem largely from reducing costs, lowering technical and nontechnical losses, increasing efficiency, and improving collections, rather than tariff increases.

7. The authorities recognize that fighting corruption, strengthening governance and accountability, including public financial management, modernizing procurement rules, reforming customs, and improving public investment management are of utmost importance. They have worked with the EU and UN agencies to strengthen the role and capacities of anti-corruption bodies, and intend to join the Open Government Partnership. The legislative infrastructure for fighting corruption is in place. Parliament passed the access to information and whistleblower protection laws, a law establishing a national anti-corruption commission, and a law on transparency in oil and gas. Parliament also passed the e-transaction law and updated the code of commerce. The implementation decrees pertaining to these laws are currently being completed. Work is ongoing on strengthening governance in the revenue and customs administrations, and making the procurement system more transparent.

Financial Sector Policies

8. The difficult fiscal situation has influenced central bank policies. Within the constraints of maintaining high confidence in the currency peg—including through an appropriate level of foreign exchange reserves—the BdL has aimed at a level and structure of interest rates that are sufficiently attractive for nonresident inflows—which are an important funding source for bank purchases of government securities—without unduly increasing the interest cost for the government and discouraging bank lending to the economy. At the same time, in the absence of Parliamentary approval of budgets in past years, the BdL undertook quasi-fiscal activities aimed at supporting growth. The central bank had to resort to unconventional monetary policies out of necessity, like many other central banks in the aftermath of the Global Financial Crisis. The authorities expect that the ongoing fiscal adjustment and structural reforms will alleviate the burden on central bank policies to maintain macroeconomic stability and support growth.

9. The financial system remains well capitalized, liquid, and profitable. Bank capitalization exceed Basel III requirements, and complies with the International Financial Reporting Standards (IFRS9). The downgrade of Lebanon’s sovereign credit rating by Fitch in late August—which the authorities and markets were prepared for—may necessitate that banks raise the weights on their holdings of Lebanese government debt from 100 percent to 150 percent; Standard and Poors did not change its rating. The rating downgrade could be expected to reduce the capital adequacy ratio of the banking system from 17.9 percent to 11.7 percent if the 150 percent weight were to be also applied on bank holdings of BdL certificates of deposit, and to 15.7 percent if the weight on BdL certificates of deposit were to be 50 percent. It is expected that any required increase in provisioning would be accommodated smoothly. Staff has recommended that the banking system increase its buffers by applying the weights used for sovereign exposures to placements with the central bank. The authorities question the merit of this recommendation as the central bank keeps these placements in high quality liquid assets abroad.

The Syrian Crisis

10. There is still no end in sight to the Syrian crisis. Lebanon hosts about 1½ million displaced Syrians—about one-third of the Lebanese population—for a ninth year causing economic, social and political stresses. The capacities of the host communities and government infrastructure and services have been long overstretched and exhausted, including education and medical services. The massive number of displaced—both in number and relative to Lebanon's population—has few, if any, international parallels. There was little reduction in the number of displaced Syrians in Lebanon despite the cessation of fighting in many parts of Syria. Most of them are reluctant to return now because of the lack of security, infrastructure, services, and opportunities. Lebanon has been increasingly stressed with the seemingly open-ended continuation of the crisis, which has brought comparisons with Palestinian refugees that were driven into Lebanon about seventy years ago.