INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/19

LEBANON

January 2017

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; 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 2016 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 December 12, 2016 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 December 12, 2016, following discussions that ended on November 2, 2016, 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 November 28, 2016.
- 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
Financial Stability System Assessment

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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January 24, 2017

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IMF Executive Board Concludes Article IV Consultation with Lebanon

On December 12, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Lebanon.

The protracted conflict in Syria continues to dominate Lebanon's outlook, with registered refugees now comprising over one-quarter of the population. The refugee presence is straining local communities, adding to poverty and unemployment, and placing further pressure on the economy's already-weak public finances and infrastructure.

Domestically, following a two-and-a-half-year impasse, Lebanon elected a president on October 31, 2016, and appointed a new prime minister soon thereafter. Consultations to form a new government are ongoing.

Growth remains subdued. Following a sharp drop in 2011, growth edged upward briefly to 2–3 percent, but has now slowed once again. IMF staff estimate that GDP increased by 1 percent in 2015 and project a similar growth rate in 2016. Lebanon's traditional growth drivers—tourism, real estate, and construction—have received a significant blow and a strong rebound is unlikely based on current trends. In the absence of a turnaround in confidence, or a resolution of the Syrian conflict, growth is unlikely to return to potential (4 percent) soon. Inflation also declined sharply in 2016 on the back of lower oil prices, but should return to trend (about 2 percent) by early-2017.

On the fiscal side, low oil prices have helped secure a primary surplus of 1.4 percent of GDP in 2015, and staff project a similar surplus (1.1 percent) in 2016. But public debt is high (138 percent of GDP in 2015) and without decisive corrective action, Lebanon's debt burden will increase further.

[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.

In the context of Lebanon's fixed exchange rate regime, foreign exchange inflows slowed in the first half of 2016, resulting in a drop in official international reserves. In response, during May–October the Banque du Liban (BdL) engaged in an unconventional financial operation which, among other objectives, helped boost reserves to above 2015 levels. At the same time, the operation also created sizable excess Lebanese pound liquidity and increased commercial banks' exposure to the sovereign.

Downside risks dominate the outlook, but there are also significant upside risks. If remaining political milestones are met quickly, the recent election of a president and appointment of a prime minister could pave the way for much needed reform and adjustment, boost the economy, and help correct macroeconomic imbalances. A resolution of the Syria conflict would also significantly boost Lebanon's economy. On the downside, however, foreign exchange inflows could decelerate, excess Lebanese pound liquidity and reduced banks' foreign exchange liquidity could put pressure on the foreign exchange reserves, growth might remain subdued, and fiscal imbalances could widen.

Executive Board Assessment[2]

Executive Directors commended the authorities for preserving macroeconomic stability and market confidence in very difficult circumstances, especially the significant spillovers from the conflict in Syria, including refugee inflows. These spillovers have affected growth and overwhelmed the country's already-strained public infrastructure and services. Directors recognized that, by hosting Syrian refugees, Lebanon is providing a global public good, and that the international community needs to be more supportive of Lebanon's efforts.

Directors observed that the recent election of a president and appointment of a new prime minister could set the stage for a revitalization of Lebanon's policymaking framework. In this context, they noted Lebanon's rising vulnerabilities and underscored the need for a change in policy direction, to anchor confidence and help secure improved economic performance.

Directors stressed that a sustained and balanced fiscal adjustment is essential. They welcomed Lebanon's primary surpluses, but observed that that, without further adjustment, Lebanon's public debt burden will continue to rise, adding to existing vulnerabilities and ultimately crowding out essential public investment and social spending.

In this regard, Directors urged passage of a budget for 2017. They also stressed the immediate need for reform in the electricity sector, which remains a large drain on the budget and a key bottleneck to improved competitiveness and equity.

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[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.

More broadly, Directors stated that it was critical to place public debt on a sustainable downward path. They observed that there is significant scope to increase revenue equitably, including by improving compliance and broadening the tax base, starting with fuel taxation.

Directors noted the challenges faced by monetary policy in the current environment of tighter international financial conditions and slowing inflows. They agreed that monetary policy should remain geared to supporting the peg, and commended the BdL for maintaining adequate international reserves. In this context, Directors underscored that, although the BdL's recent financial operation has successfully bolstered BdL's gross international reserves and banks' capital, it was not a sustainable solution to Lebanon's funding needs. They also called for a medium-term strategy to improve the BdL's balance sheet.

Directors stressed the critical role of Lebanon's banking system in securing sustained, broad-based economic growth. Taking note of the findings of the recent FSAP, they appreciated the authorities' close oversight of the financial system, but highlighted the need for continued vigilance. In particular, they stressed the benefits of measures that would introduce forward-looking capital planning; strengthen regulation and supervision by, among others, aligning loan classification rules and sovereign risk weights with international good practice; and support liquidity risk management. Directors noted that progress had been made since the last full assessment of Lebanon's AML/CFT framework, but observed that some gaps remain and that the framework needs to be enhanced further.

Directors urged the authorities to advance structural reforms. In addition to electricity reform, they stressed the need for legislation to reinvigorate private investment, including in the oil and gas sector; and for better service provision and stronger safety nets. In this context, Directors pointed out that increased growth was also important in supporting Lebanon's ability to cope with the recent refugee inflows.

Directors also urged the authorities to move decisively to improve Lebanon's statistical system, building on ongoing progress.

Lebanon: Selected Economic Indicators, 2014–18

	2014 Act.	2015 Act.	Projections		
			2016	2017	2018
Output and prices	(Annual percentage change)				
Real GDP (market prices)	2.0	1.0	1.0	2.0	2.5
GDP deflator	2.8	0.9	0.9	1.0	1.6
Consumer prices (period average)	1.9	-3.7	-0.7	2.0	2.0
Central government finances (cash basis)	(In percent of GDP)				
Revenue	21.8	18.8	19.0	19.0	19.2
Expenditure	27.8	26.2	26.9	27.5	28.3
Budget balance	-6.0	-7.3	-7.9	-8.4	-9.1
Primary balance	2.4	1.4	1.1	1.5	1.4
Total government debt	133	138	144	148	151
Monetary sector	(Annual percentage change, unless otherwise indicated)				
Credit to the private sector	9.3	5.9	1.9	3.0	4.2
Broad money 1/	6.0	4.8	5.5	4.0	4.0
Interest rates (period average, in percent)					
Three-year Treasury bill yield	6.6	6.6	...	...	...
Five-year Eurobond yield	5.3	5.7	...	...	...
External sector	(In percent of GDP, unless otherwise indicated)				
Exports of goods (in US$, percentage change)	-7.8	2.4	2.4	6.0	5.5
Imports of goods (in US$, percentage change)	-2.2	-6.4	4.0	7.0	3.8
Current account balance	-25.3	-18.2	-17.5	-17.4	-17.1
Foreign direct investment	-3.5	-3.4	-4.5	-4.4	-4.7
Total external debt 2/	170	175	179	180	179
Gross reserves (in billions of U.S. dollars) 3/	37.3	36.7	40.9	39.4	37.4
In percent of short-term external debt 4/	50.0	46.8	49.4	46.1	42.2
In percent of total banking system deposits	25.8	24.2	25.6	23.8	21.6
Exchange rate	1507.5	1507.5	...	...	...
Real effective exchange rate (annual average, percentage change)	1.2	10.0	...	...	...

Sources: Lebanese authorities; and IMF staff estimates.
1/ Defined as currency in circulation plus resident and nonresident deposits.
2/ Includes nonresident deposits.
3/ Excluding gold and encumbered assets.
4/ Short-term debt on a remaining maturity basis, including short-term nonresident deposits.

INTERNATIONAL MONETARY FUND

LEBANON

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

November 28, 2016

KEY ISSUES

Context. Following an extended impasse, Lebanon has a new president and a new prime minister, paving the way for a number of political changes. When formed, the new government will face a challenging policy environment. The Syrian crisis continues to dominate Lebanon's economic outlook, and the associated influx of refugees (about a quarter of the population) has few, if any, international parallels. GDP growth is still subdued and Lebanon's debt burden is rising, despite modest primary surpluses. Moreover, the economy remains vulnerable to shifts in deposit inflows, which have slowed notably since last year's Article IV consultation. Most recently, the Banque du Liban (BdL) engaged in a sizable financial operation that has (among other objectives) helped restore international reserves.

Policy Priorities. Policies need to aim at restoring fiscal sustainability, while preserving confidence in Lebanon's financial sector and laying the groundwork for lasting and inclusive growth. In addition, there is a pressing short-term need for investment and growth to help offset the impact of the regional conflicts. Lebanon cannot shoulder such a burden alone—sustained international support is both needed and warranted.

Key Recommendations. The new political landscape provides a unique opportunity to reestablish the credibility of Lebanon's policymaking framework. Three areas stand out for both relevance and urgency:

- The authorities need to articulate a plausible policy mix that halts the growth of public debt and places the economy on a more sustainable path. Front-loaded fiscal adjustment needs to be based on fair and broad-based revenue measures—starting from fuel taxation—and rebalanced spending, in particular a reduction of costly electricity transfers. Passage of a credible budget is a priority.
- Lebanon's exchange-rate peg remains the prime focus of monetary policy. The recent BdL financial operation has boosted official reserves; going forward the BdL needs to stand ready to increase interest rates if deposit inflows were to decelerate (while fiscal consolidation will help in ushering interest rate flexibility). More broadly, the banking system remains a critical pillar of Lebanese resilience, and the authorities need to continue to mitigate risks and anchor confidence, in line with the recommendations in the Financial Sector Stability Assessment report.
- Finally, the authorities need to promote sustainable growth by addressing the economy's most pressing bottlenecks, starting with electricity. The reform agenda is well known, but is now more urgent given Lebanon's difficult circumstances. In this context, significant and sustained support from the international community is vital.

Approved By
Adnan Mazarei (MCD) and Yan Sun (SPR)

Discussions took place in Beirut during October 20–November 2, 2016. The staff team comprised Mses. Fedelino (head) and Nakhle (local economist), Messrs. Agarwal and Tiffin (advance team's head, all MCD), Mr. Dybczak (FAD), and Ms. Sbrancia (SPR). Mr. Geadah (OED) joined some of the policy discussions. The team met with Minister of Finance Khalil, Governor of the Banque du Liban Salamé, various government officials and representatives of the private sector, civil society, and the international community. The team shared with the authorities its work on a range of analytical and policy issues. Greg Basile provided research assistance; Cecilia Pineda contributed to the preparation of this report.

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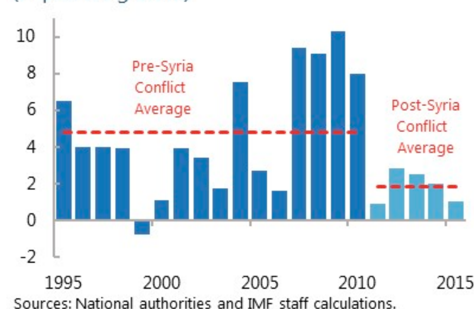
CONTEXT

1. This Article IV consultation took place at a time of major change. Following a 2½ year impasse, parliament elected a president on October 31; a few days later, a new prime minister was appointed, with a mandate to form a new cabinet. Consultations are still ongoing, but agreement is expected relatively swiftly, as solutions are needed quickly to address Lebanon's macroeconomic challenges.

2. Spillovers from the Syrian crisis have profoundly affected Lebanon. Now in its sixth year, the Syrian crisis continues to dominate Lebanon's outlook. The most immediate impact has been decelerating economic growth, coupled with an unparalleled inflow of refugees, now estimated at around one third of local population—the highest per capita count in the world.



Sources: National authorities and IMF staff calculations.

3. The economy's funding needs continue to grow. Historically, the economy has managed to sustain large imbalances and weather significant shocks, owing to its macro-financial structure—where banks channel deposit inflows from foreign investors and Lebanon's diaspora to cover Lebanon's sizable budget- and current-account deficits. But starting in mid-2015, inflows started to decelerate, prompting the Banque du Liban (BdL) to undertake a complex and sizable financial operation over the summer of 2016.

4. In the current uncertain environment, the priority is to reestablish the credibility of the policymaking framework, with particular focus on three key areas:

- **Restoring fiscal sustainability**. The growth of public debt (above 140 percent of GDP) needs to stop immediately. Fiscal discipline will underpin confidence and support financial stability (including by reducing Lebanon's reliance on inflows).

- **Anchoring financial stability**. The exchange rate peg is the appropriate nominal anchor and the BdL needs to stand ready to increase interest rates if necessary. There is also a need to continue to monitor and mitigate risks in the banking sector.

- **Promoting sustainable and inclusive growth.** Addressing Lebanon's infrastructure deficit—a result of protracted under-investment and exacerbated by the refugee presence—requires implementing reforms to address the economy's bottlenecks, such as electricity provision.

5. The international community must play a key role. Lebanon's response to the refugee crisis is a testament to both its generosity and resilience. Recent initiatives to match identified needs with donor funding need to proceed swiftly, as Lebanon requires and deserves significant support.

AN INCREASINGLY CHALLENGING ENVIRONMENT

6. **Despite regional tensions and the conflict in Syria, security conditions in Lebanon have held up well.** Such an achievement is all the more remarkable in light of the number of Syrian refugees within the country—estimates place them at around 1–1½ million (Box 1 and Selected Issues Paper on Refugee Issues).

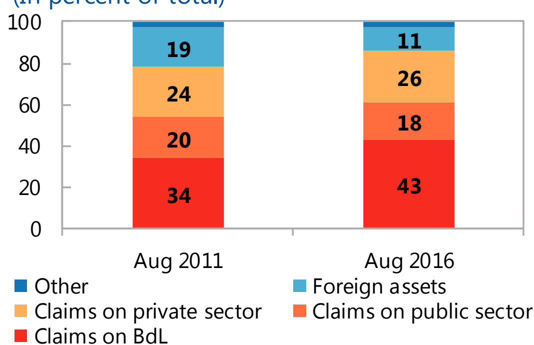
7. **There has been growing international recognition that the refugee crisis is a global problem, requiring a global response.** At the London Conference on "Supporting Syria and the Region" in February 2016, the authorities presented a new plan to address the costs of the crisis (see also Box 7 below). The plan calls for $11 billion over 2016–20, comprised of both grants ($5 billion) and loans ($6 billion). Its proposals are ambitious, and seek not only to offset the increasing toll of the refugee presence, but also to help restart job-rich growth that can benefit both host communities and refugees. To date, however, funding has remained short of estimated needs.

8. **Growth remains low.** Lebanon is in a protracted period of low growth of 1–2 percent, well short of potential. We estimate that growth was about 1 percent in 2015, and project a similar outcome in 2016 (below the authorities' estimate of 2 percent, though in line with most market forecasts).[1] Lebanon's traditional growth drivers—tourism, real estate, and construction—have all taken a blow, and a strong rebound is unlikely absent an improvement in political and security conditions. While lower oil prices have supported domestic demand and lowered fiscal costs, their overall impact is more mixed (Box 2 and Selected Issues Paper on Remittances). Inflation declined sharply in 2015, to an average of -3.7 percent, reflecting lower oil prices and a stronger U.S. dollar.

9. **The fiscal situation is increasingly challenging.** Tax revenues as a share of GDP continue to decline (see below), while interest payments have moved upward in line with public debt. A small primary surplus of 1.4 percent of GDP in 2015 was not sufficient to offset the impact of slowing nominal output growth and higher interest payments. As a result, public debt increased by 5 percentage points in 2015, to 138 percent of GDP.

10. **Banks remain the economy's chief source of funding**. With assets over 350 percent of GDP, banks hold over half of Lebanon's T-bills and Eurobonds (total sovereign exposures make up 61 percent of total bank assets). Banks, in turn, are funded primarily by deposits (including from non-residents), with generally a short-term maturity and high degree of concentration (Box 3). To further strengthen banking-sector resilience, the authorities requested a Financial Sector Assessment Program (FSAP) in the spring of 2016.

Composition of Commercial Banks' Assets
(In percent of total)



Source: BdL

[1] See Tiffin, Andrew, 2016, "Seeing in the Dark: A Machine Learning Approach to Nowcasting in Lebanon," IMF Working Paper 16/56 (Washington: International Monetary Fund).

Box 1. Dealing with the Impact of the Refugees

The Syrian crisis, now entering its sixth year, has been very costly. According to the United Nations High Commission for Refugees (UNHCR), the number of Syrian refugees in Lebanon is now more than 1.4 million. Accommodating such an outsize presence has come at a substantial cost. The authorities estimate direct budget costs at around $400 million per year. And estimates of indirect costs exceed $2½ billion in terms of the erosion of public services (World Bank, 2013).

The impact of refugees: From theory…

The discussion on how to address an inflow of refugees has parallels in a number of other host countries. According to standard economic theory, in the short run, new migrants with access to the labor market will tend to lower incumbents' wages, reflecting a lower capital labor ratio. The influx will also reduce the number of employed incumbents—some will be induced to exit the labor market. But there are also winners. Returns to capital actually increase, as the extra labor makes capital more productive (along with other complementary factors, such as skilled labor or land). Over the long run, however, these effects are unwound, as higher returns prompt higher investment and higher capital stock. Indeed, with constant returns to scale, the capital labor ratio will ultimately revert to the initial steady state, bringing back wages to their original level.

The key message from standard theory is that a modern economy is not a zero-sum game, as the number of jobs is not fixed. Instead, the economy will eventually respond to immigration by scaling up production in line with the new labor force. Market rigidities may shape the pace of adjustment, and flexible, investment-friendly economies will adjust more rapidly than economies with less flexible markets. But ultimately, economies are generally able to accommodate an addition of new workers.

…to the Lebanese reality

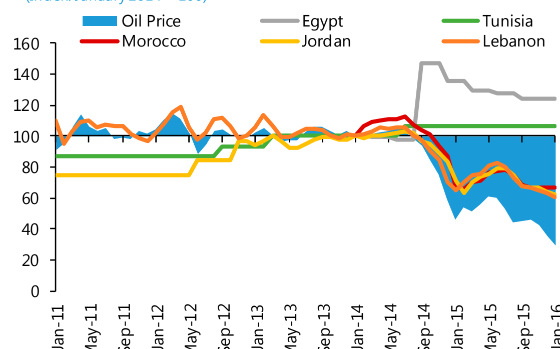
Key features of the Lebanese economy may confound the (benign) predictions of standard models.

- **Firstly, the length of adjustment will depend on the investment climate**—the easier it is to scale up the capital stock, the more quickly the economy will move to the new steady state. In advanced economies this scaling up generally takes place in a few years (Dadush, 2014). But Lebanon's investment climate has significant shortcomings, given poor infrastructure and low public investment.
- **Secondly, the nature of Lebanon's labor market may exacerbate the impact of Syrian refugees**. Studies from advanced economies tend to downplay the impact of unskilled immigration, noting that native wages generally remain unchanged, and finding that many incumbents often move to occupations where local knowledge and linguistic ability offer a comparative advantage (IMF, 2016). The Lebanese market is perhaps less accommodating. Data are scarce, but estimates suggest that almost half of the workforce is employed in the informal sector, and so is likely to compete directly with new refugees. Moreover, these workers are not covered by any social safety net, making them particularly vulnerable. Early estimates suggest that unskilled wages in some areas have fallen by as much as 50 percent (ILO, 2014), potentially tipping as many as 170,000 residents below the poverty line (World Bank, 2013)—although it is unclear how many of these represent *existing* Syrian migrants.
- **Thirdly, current studies may not be applicable to Lebanon given the scale of immigration in Lebanon over a short period**. Most empirical studies investigate relatively moderate increases in the labor force (and available jobs). Given the scale of the refugee presence, the size of Lebanon's labor shock may have outstripped some of its potentially beneficial impacts had the shock been smaller.
- **Finally, standard models are silent on the role of unpriced factors, such as public goods and infrastructure**. Implicitly, these are scaled up in line with the capital stock by the local authorities. But given Lebanon's political situation, and its limited fiscal space, this cannot be taken for granted. Furthermore, there may be negative externalities owing to an overburdening of existing public goods.

Sources: Uri Dadush, 2014, "The Effect of Low-Skilled Labor Migration on the Host Economy." KNOMAD Working Paper 1.
ILO, 2014, "Assessment of the Impact of Syrian refugees in Lebanon and their Employment Profile."
IMF, 2016, "The Refugee Surge in Europe: Economic Challenges" SDN/16/02
World Bank, 2013, "Lebanon: Economic and Social Assessment of the Syrian Conflict."

Box 2. Impact of the Oil Price Decline on Lebanon—A Mixed Picture

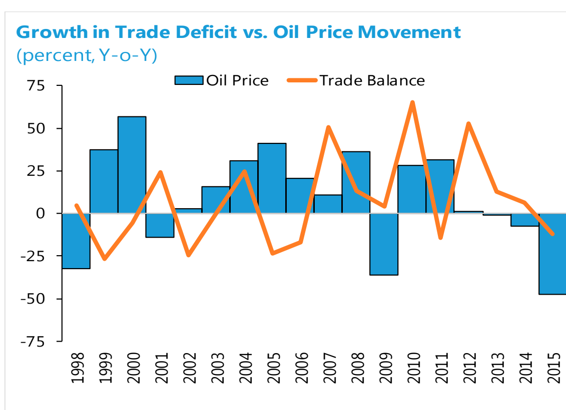
While a sharp decline in oil prices is seemingly a positive shock for an oil importer country like Lebanon, on balance its net effects are more mixed. The magnitude of positive and negative impacts is uncertain and critically depends on the pass-through of global prices into domestic retail prices. In that respect, Lebanon has one of the highest pass-through in the region—gasoline pump prices have declined by 49 percent since their peak in April 2012. Yet, Lebanon's strong ties with (now weaker) regional oil exporters—a key source of external demand and funding—make the assessment more nuanced and may offset some of the positive direct impacts of lower oil prices.[1]



Source: IMF Middle East and Central Asia REO

The oil price shock has affected the Lebanese economy through various channels.

- **Higher consumption:** Consumers react to the effective income boost of lower oil prices. However, absence of micro-data at the household level makes it difficult to estimate such impact.
- **Lower import costs**: Oil imports become cheaper, though according to staff estimates the price elasticity of oil demand is relatively low. Thus the import decline owing to lower oil prices is very modestly offset by increased consumption of oil volumes.

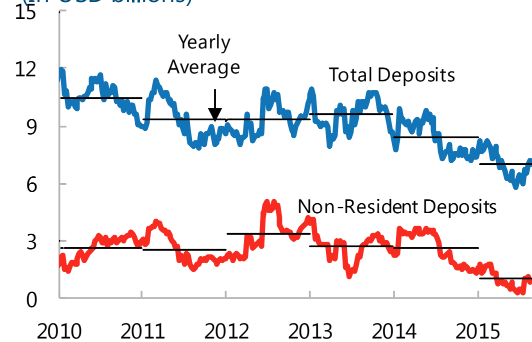


- **Better fiscal position:** The primary impact on the budget is on the spending side, as the sensitivity of public revenue to changes in oil prices is small (excises and VAT on gasoline—gasoil is fully not taxed—are the only taxes directly related to oil). However, the electricity company EdL has been producing electricity from fuel oil at a loss, requiring larger government transfers. These used to average about 4 percent of GDP (around $2 billion) prior to the oil shock in mid-2014. EdL transfers declined to 2.8 percent of GDP in 2015 (and projected at 1.5 percent of GDP in 2016).
- **Lower deposits/remittances and FDI to Lebanon**: A sizable share of the Lebanese diaspora lives in GCC countries and other oil producers in West Africa; remittance inflows from these countries have declined. More generally, less money is expected to come from these countries given their tighter liquidity conditions, either through property buying (FDI) or deposits from both Lebanese and foreign investors. There could thus be repercussions for the Lebanese real estate market as well as banks' liquidity—with possible spillover into the fiscal sector given the government's large funding needs.
- **Lower exports**: The GCC countries are Lebanon's key export market for goods (along with Iraq and Syria), accounting for over 40 percent of Lebanon's share of goods exports. Lower exports will partially offset lower oil imports. However, if the marginal propensity to consume out of savings from lower oil prices is high, higher non-oil imports may also offset some of the benefits from lower oil imports**.**
- **Lower tourism**: A large amount of (high-end) tourists have typically come from GCC countries, though their numbers have started to decline significantly with the onset of the Syria crisis. The oil price decline will likely not help their numbers to recover to pre-crisis levels.

[1] Our assessment is in line with previous findings (on the upsides of high oil prices for Lebanon) in Kyobe, A. and A. Sadikov, 2012, "The Price of Oil and the Lebanese Economy: A Blessing in Disguise?" IMF Country Report No. 12/40.

11. Deposit inflows have slowed. In the past, foreign-deposit inflows (between $8–12 billion per year) have been a key sign of confidence. Deposit growth has eased over the past couple of years, particularly since mid-2015. And notwithstanding a recovery over the summer (in part triggered by the BdL's actions, see below), by early-November 2016, year-to-date growth was $6 billion—or 4.7 percent growth on an annualized basis. The slowdown is likely explained by various factors including tighter liquidity conditions in GCC countries (a key source of deposits for Lebanon) and increased risk premia on Lebanese financial assets.

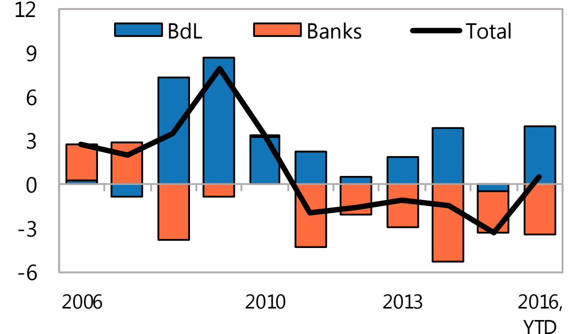
Y/Y Change in Commercial Bank Deposits
(In USD billions)



Source: Banque du Liban

12. Lebanon's external position remains challenging. The current account deficit is estimated to have narrowed by 7 percentage points to 18.2 percent of GDP in 2015 (though data are subject to frequent revisions). This decline is largely explained by lower oil prices, rather than by a contraction in non-oil imports. But goods-and-services exports continue to decline, owing to the impact of regional conflict on key trading partners and routes. Despite the improved current account, slowing financial inflows has prompted a contraction in Lebanon's Net Foreign Assets (NFA) position, at least through mid-2016.

Net Foreign Assets
(In USD billions, annual change)

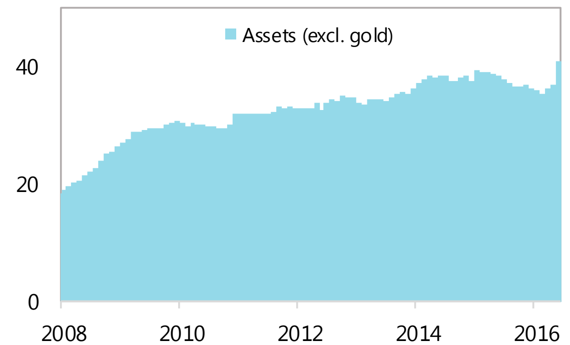


Sources: BdL and IMF staff calculations

13. As a result, the BdL has taken steps to shore up its reserves. With easing deposit inflows, gross reserves fell over 2015–16 to reach $35.1 billion in May 2016, a decline of 10.1 percent from a peak in May 2015. In response, in mid-2016 the BdL engaged in a sizable financial operation with a number of components and counterparts (Box 4).

14. The operation has had a number of implications. It has: (i) strengthened BdL's gross foreign exchange buffers, to $40.6 billion by end-October; (ii) reversed the cumulative decline in Lebanon's NFA position (to a cumulative $555 million by end-September, from -$1.4 billion through end-July); (iii) improved the capital buffers of banks; and (iv) reduced local-currency funding costs for the government and private sector. At the same time, the operation also created significant Lebanese pound liquidity (equivalent to one third of GDP); sizably reduced banks' FX liquidity held abroad; narrowed the spread between LL and USD deposit rates, adding to

BdL FX Assets, 2008-2016
(In USD billions)

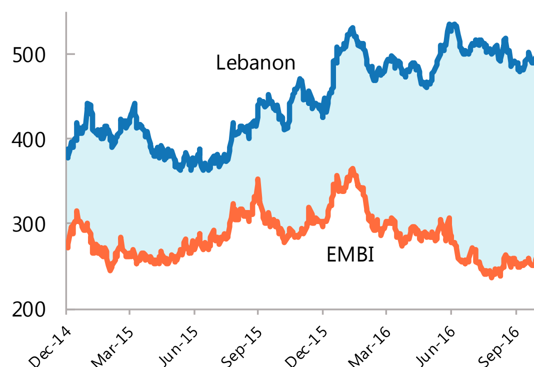


Sources: National authorities and IMF staff calculations.

dollarization risk; and increased the FX liabilities of the BdL (and related carry costs), thus affecting the BdL's balance sheet.

15. Appetite for Lebanese external debt has softened. Eurobond yields have increased by almost 70 bps over the past 12 months, compared to an average drop of around 70 bps for other emerging markets. Spreads have thus increased, to over 500 bps and 250 bps vis-à-vis U.S. Treasuries and emerging-market instruments, respectively.

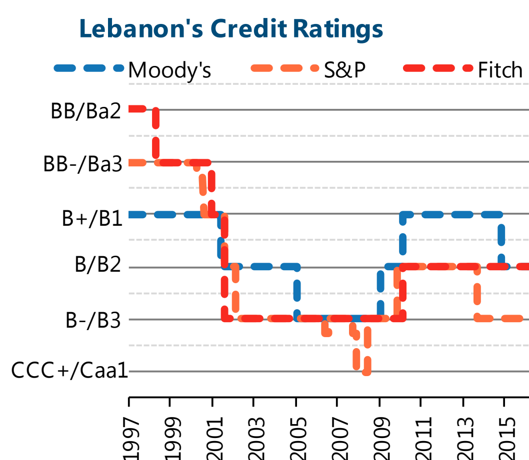
5-Year Spreads vs US Treasuries 1/
(In basis points)



1/ Lebanese series use BVAL values provided by Bloomberg.
Source: Bloomberg

16. The country's credit ratings reflect Lebanon's challenges. Moody's downgraded Lebanon from B1 to B2 in December 2014; and Fitch downgraded Lebanon to B- in July 2016. S&P, on the other hand, has kept its B- rating since November 2013, though it upgraded the outlook from negative to stable in 2016. Rating agencies' assessments continue to focus on the bank-sovereign nexus, slowing deposit growth and reserves, domestic political uncertainties, and rising fiscal difficulties.

Lebanon's Credit Ratings



17. There has been limited progress on structural reform.[2] Laws on anti-money laundering and combating the financing of terrorism (AML/CFT) were passed in November 2015; and more recently, legislation on tax transparency and exchange of information was also passed.[3] But over the past few years, parliament has met rarely and key legislative initiatives remain pending: legislation on developing Lebanon's offshore gas fields has yet to pass, along with similarly delayed electricity- and safety-net reforms.

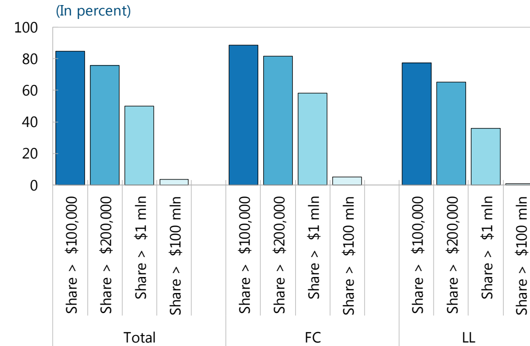
[2] Annex I covers the status of recommendations from the 2015 Article IV consultation.

[3] The OECD Global Forum will deliberate by June 2017 on whether the new legislation complies with its recommendations.

Box 3. Deposit Concentration and Deposit Growth

Deposits in Lebanese banks are highly concentrated. For the domestic banking system at end-2015, it is estimated that 16,000 accounts (less than 1 percent of all deposit accounts) held 50 percent of total deposits, while 1,600 accounts (less than 0.1 percent of all accounts) held 20 percent of total deposits. Classified by bucket sizes, 84.6 percent of total deposits are in accounts with balances greater than $100,000, 50.2 percent in accounts with balances greater than $1 million, and 3.7 percent of deposits in accounts with balances greater than $100 million. The concentration is higher in foreign currency than LL accounts.

Deposit Concentration
(In percent)



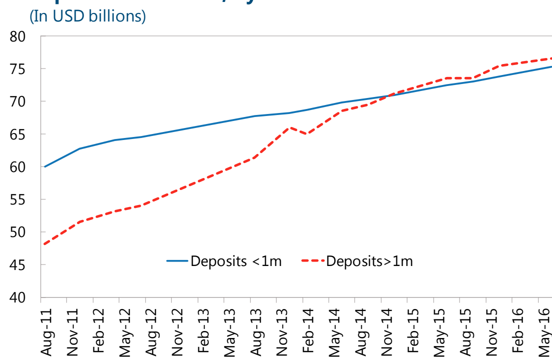
Sources: BCC and IMF staff calculations.

Large accounts have been a key driver of deposit growth.

- Between end-2008 and end-2015, deposits in "smaller accounts" (< $1 million) have grown by 55 percent, whereas deposits in "large accounts" (> $1 million) have grown by 185 percent.
- Much of the slowdown in deposit growth in 2015 can be attributed to large depositors. While, in recent years, accounts with balances greater than $1 million had grown by about 12–14 percent per year, in 2015, their growth rate declined to about 5.8 percent, driving much of the decline in deposit growth observed in 2015.

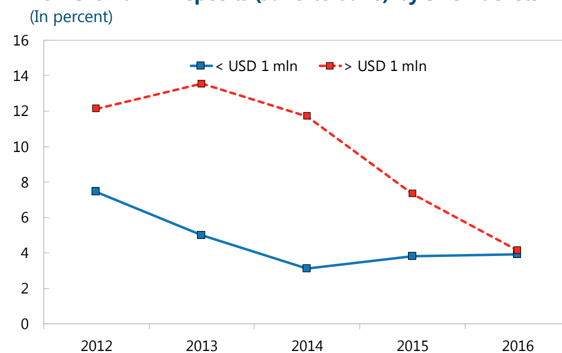
Given the size of the large deposits, the share of nonresident deposits may be larger than commonly believed.

Deposits in Accounts, by Balance Amount
(In USD billions)



Sources: BCC and IMF staff calculations.

YoY Growth in Deposits (June-to-June) by Size Buckets
(In percent)

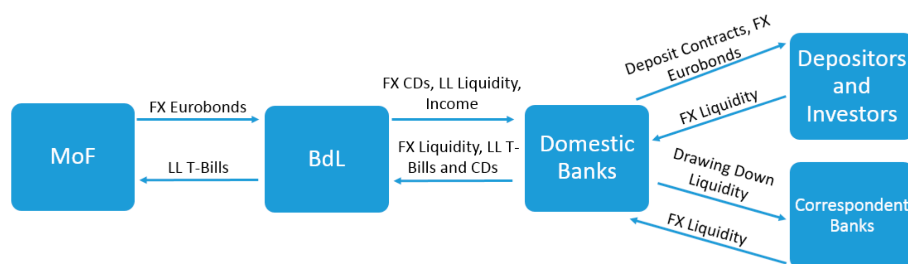


Sources: BCC and IMF staff calculations.

Box 4. The BdL's Financial Operation

In June 2016, the BdL engaged in a financial operation to strengthen its foreign exchange reserves, among other objectives. As of May 2016, the BdL gross reserves had declined y/y by 10.1 percent or $3.9 billion and stood at $35.1 billion, reflecting lower foreign exchange (FX) inflows and the economy's large FX funding needs. The operation consisted of various steps and targeted various objectives:

- **BdL's purchase of newly-issued Eurobonds from the Ministry of Finance ($2 billion)**. In the last week of May 2016, the BdL swapped Lebanese pound (LL) government debt for the new Eurobonds with the MoF. *This helped reduce public debt service costs and lengthen the public debt maturity structure.*
- **BdL's sale of Eurobonds and other FX securities to the banks ($13 billion according to staff estimates)**. Starting in June, the BdL invited banks to buy the newly-acquired Eurobonds and FX-denominated long-term CDs. *The BdL gross FX reserves increased to $40.6 billion by end-October; and the consolidated NFA position turned positive in September, to a cumulative $555 million.*
- **Banks' sales of LL instruments to the BdL and strengthening of banks' capital position**. Banks were offered sizable incentives to participate in the operation. For each purchase of FX securities, banks were eligible to discount an equivalent amount of LL T-Bills or CDs to the BdL at a zero percent, and split equally the income with the BdL.[1] The BdL instructed banks to retain all the income from the transaction as provisions in LL for a prospective implementation of IFRS 9 accounting rules in 2018 (by creating a 2 percent general provision against the loan book and a graduated increase in the Capital Adequacy Ratio from 12 percent to 15 percent by 2018). The discount of T-bills and CDs at zero percent is akin to a money-financed capital injection (without any equity stake in return; according to staff estimates, equivalent to 10 percent of GDP), *which helped strengthen banks' capital buffers*.



Banks used various approaches to attract foreign currency. They sold Eurobonds to foreign clients at prevailing rates and drew down their own FX liquidity—in part by repatriating funds from correspondent banks. A few banks also passed on part of their income to high net-worth depositors, by offering very attractive rates on sizable deposits. As a result, *annualized deposit growth rate increased from 3.5 percent at end-May to 4.7 percent by early-November.*

Banks are now facing sizable excess LL liquidity. As of mid-October, the operation had resulted in sizable liquidity (equivalent to a third of GDP, some of which is being mopped up and already been invested in newly-issued LL T-Bills). The BdL has taken various steps to reduce this liquidity further, and thus mitigate possible dollarization risks: (i) it is issuing long-maturity term deposits (of 5 years or more) at rates slightly below the prevailing LL rates, provided that participating banks subscribe 14 percent of any placement with the BdL in 5-year, 5-percent government bonds; and (ii) it has asked banks to extend additional LL lending (though in the current economic climate, asset quality may be affected in the future).

At the same time, the banks' internal FX liquidity position has weakened. Before the operation, banks' FX liquidity held abroad had declined from a peak of $18 billion in June 2011 to $10.4 billion by May 2016; by end-August, it was below $8.5 billion, increasing banks' reliance on the BdL for FX liquidity. Lower FX liquidity has led to increased FX deposit rates, narrowing the spread between LL and FX deposit rates and reducing the attractiveness of LL deposits. Moreover, since the incentives offered by banks to depositors focused on giving them one-off upfront income (instead of higher interest rates), prospects for keeping the new inflows in the system remain uncertain.

Finally, the operation also had an impact on BdL's balance sheet. It added to the foreign exchange liabilities of the BdL and the associated carry costs.

[1] For example, a bank discounting a security with face value of LL 100 with 8 percent coupon and remaining maturity of 10 years received upfront LL 140 (that is, LL 100 principal plus an immediate income of 40, equal to half of the LL 80 it would have ultimately received (over time) if the security had been held to maturity.

OUTLOOK AND RISKS

18. **Under the baseline, growth will likely remain subdued—too low to address Lebanon's macroeconomic imbalances and social challenges**. We assume that the impact of the Syrian conflict will remain broadly unchanged over the forecast horizon, depressing domestic confidence and leaving a (modest) global recovery as Lebanon's chief growth driver over the medium term.[4] Thus, Lebanon's output gap will remain open even toward the end of the projection period. As oil prices normalize, inflation is expected to return to trend (around 2 percent) by early 2017.

19. **And without a change in sentiment, the economy's funding base will remain soft.** Taking into account the BdL's financial operation, deposit inflows will likely total about $8 billion in 2016, up from about $7 billion in 2015. But with the operation now closed, and under an (unchanged-policy) baseline assumption no adjustment and reform, inflows are projected to return to the levels seen in the early half of the year—short of the levels needed to fund the economy over the medium term.[5]

20. **Upside potential is significant.** With the election of a president, Lebanon now has the opportunity to move beyond its recent political impasse. It is too early to project the likely impact of a new political settlement, as key milestones will likely require time to be met. But the prospect of a government able to tackle the country's long-pending reform agenda could have a material impact on confidence and growth, boosting inflows, supporting financial stability, and helping Lebanon's debt dynamics. Similarly, Lebanon's outlook is linked closely to developments in Syria. In the event of an early resolution, Lebanon would be uniquely placed to benefit from the reconstruction effort, as well as from the reestablishment of trade and an improvement in regional investor confidence.

21. **But sizable vulnerabilities and risks remain** (see Risk Assessment Matrix):

- *Deposit inflows could decelerate further*. The willingness and ability of depositors to fund Lebanon cannot be taken for granted, especially with the prospect of tighter regional and global financial conditions, and in light of shifting geopolitical tensions. The concentration of deposits, short-term maturity structure, and share of nonresident depositors in the Lebanese banking system all add to Lebanon's vulnerability (Box 3).
- *Growth could weaken further*. Lower growth would compound Lebanon's adverse debt dynamics and imbalances, and ultimately impair banks' asset quality.
- *Fiscal imbalances could widen*. Increased spending pressure, or continued inertia, would increase public debt, possibly leading to financing pressures and lower investor confidence. This could, in turn, spread into the macro-financial sphere—triggering lower deposits, higher financing costs, deteriorating bank finances, and falling reserves.

[4] This is a departure from previous Article IV consultations, where staff had assumed that resolution of the Syria crisis would start one year into the forecast horizon.

[5] According to staff estimates, an average deposit growth of about 6–7 percent is sufficient to maintain the economy's foreign currency buffers.

Lebanon: Risk Assessment Matrix[1]

Nature/Sources of Risk	*Relative Likelihood*	Expected Impact If Realized	Policies to Mitigate Risks
Deceleration of financial inflows, either due to increased domestic uncertainty, regional conflict and tensions, or increased competition for liquidity from GCC countries.	***High***	***High*** Could lead to significant funding pressure in Lebanon for both banks and the sovereign, increasing pressure on reserves, affecting confidence in the peg.	Maintain a high level of reserves as a buffer. Signal commitment to macro-financial stability through fiscal policy adjustment, passage of key legislation, and, if needed, by increasing interest rates. Further strengthen banks' capital and liquidity buffers and compliance with AML/CFT standards.
Intensification of the Syria crisis, fueling additional refugee flows and/or prompting a further worsening of Lebanon's political tensions.	***High***	***High*** Could further strain public service provision and labor/housing markets, destabilizing social structures and eroding law and order. An associated loss of confidence could also prompt the adverse cycle of consequences outlined above.	Improve service delivery, including with donor assistance, and build policy buffers to strengthen confidence and resilience.
Materialization of dollarization risk, owing to lower banks' FX liquidity held abroad and/or excess LL liquidity in the system.	***Medium***	***High*** Could put pressure on BdL's foreign exchange buffers and the exchange rate.	Encourage banks to rebuild their internal FX liquidity buffers, also by not resorting to financial engineering in the future. In addition, continue steps to absorb excess LL liquidity from the system, while remaining vigilant about the banks' use of excess LL liquidity.
Deterioration in the fiscal performance, due to weaker revenue or larger spending pressures.	***Medium***	***Medium*** Could lead to further deterioration of debt dynamics, leading to financing pressures and loss of investor confidence. It could also be associated with a reassessment of Lebanon's risk, leading to a sovereign rating downgrade. This could trigger the adverse cycle of consequences outlined above.	Formulate sustainable fiscal adjustment measures that place debt on a downward path over the medium term, focusing in particular on broadening tax bases and strengthening tax compliance.
Withdrawal of correspondent banking relationships.	***Medium***	***Medium*** Could hurt cross-border payments, trade finance, and remittances (a few foreign banks have ceased relations with a few smaller Lebanese banks owing to ML/TF concerns),	Continue to make progress to strengthen the AML/CTF regulatory environment 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.

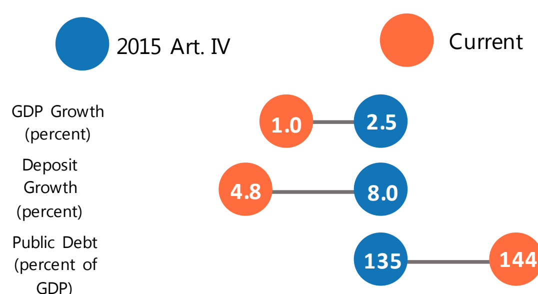
Authorities' Views

22. The authorities broadly agreed with staff's assessment of risks. They noted the significance of regional political developments in shaping Lebanon's outlook, highlighting in particular the impact of the Syrian conflict. They also shared staff's assessment regarding the importance of continued deposit inflows, underscoring that regional competition for funds had become more intense. But they noted that much of the recent slowdown in activity had resulted from the prolonged political impasse in Lebanon, and that the formation of a new government would likely result in a substantial turnaround in confidence, investment, and growth.

POLICY: ACTION NEEDED TO ANCHOR CONFIDENCE

23. With limited policy change, domestic and external vulnerabilities have deepened. Lower growth and a larger debt burden have increased the adjustment needed to stabilize Lebanon's debt dynamics; and if slow deposit inflows persist, Lebanon's external position might weaken. On this basis, our estimates and projections paint a less sanguine picture compared to just one year ago.

2016 Outlook: IMF Staff Projections



24. As Lebanon's outlook is growing less benign, only coordinated policy actions can anchor confidence. Lebanon's macrofinancial structure rests on the banking sector's ability to attract continued inflows, while maintaining confidence in the peg. As fiscal sustainability, depositor confidence, financial stability, and exchange rate credibility are all tightly interconnected, the policy response to address Lebanon's challenges must include various policy areas.

25. In this context, corrective measures are urgently needed.

- Over the short term, the key challenge will be to preserve the confidence of foreign investors, by articulating a credible policy mix that starts to address fiscal imbalances as a matter of urgency, while also strengthening the resilience of Lebanon's banking sector.
- Over the longer term, social stability and shared prosperity require job-rich, sustainable growth.

26. The 2016 consultation thus focused on three key themes: (i) starting the process of fiscal adjustment immediately; (ii) standing ready to increase interest rates to support financial inflows, if needed; while safeguarding financial stability; and (iii) laying the ground for higher-quality and more inclusive growth.

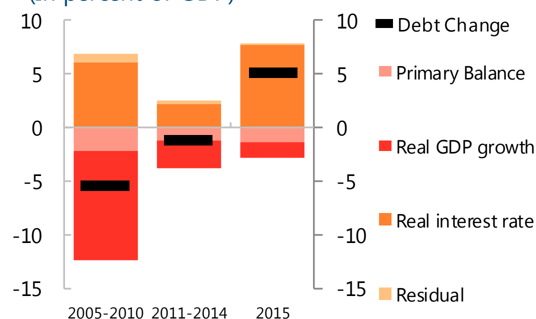
A. No Substitute for Fiscal Consolidation

27. Lebanon needs to make major progress in lowering the public debt burden. Over 2005–10, public debt dropped by 5 percentage points of GDP per year on average, owing to high growth and sustained primary surpluses. But as real growth decelerated in 2011, this impetus weakened; and by 2015, the debt ratio started to increase again.

28. Low growth is a primary driver of Lebanon's adverse debt dynamics, but not the only one. The drop in tax revenue of 4 percentage points of GDP in just four years suggests that other factors are at play, including tax policy changes (such as reductions in fuel taxation in 2011–12) and deteriorating compliance (see Selected Issues Paper on Revenue Mobilization). Meanwhile, wages, interest payments and transfers to Electricité du Liban (EdL) accounted for close to 70 percent of total expenditure in 2015. Capital spending has narrowed to about 1 percent of GDP, significantly below levels in comparator countries;[6] and social spending remains inadequate to address Lebanon's needs.

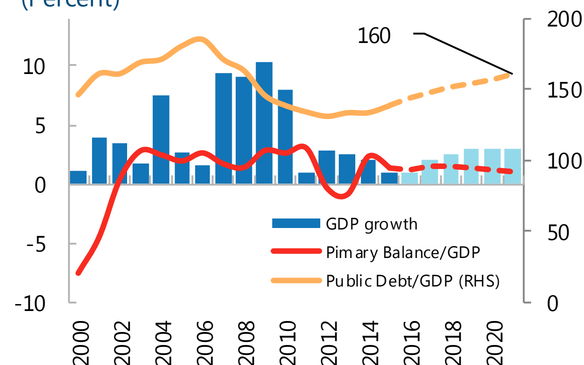
29. Under current policies, debt dynamics will deteriorate further. In the baseline scenario, low oil prices will help secure sustained primary surpluses of about 1½ percent of GDP. Nonetheless, higher interest rates and subdued nominal growth will push public debt to 160 percent of GDP by 2021—almost 20 percentage points higher than today (Annex II).[7] At the same time, spending rigidities will increase, with the interest bill projected to exceed 11 percent of GDP by 2021, or about 60 percent of total revenue. Fiscal risks may add further pressure, including sizable pension

Drivers of Debt Dynamics
(In percent of GDP)



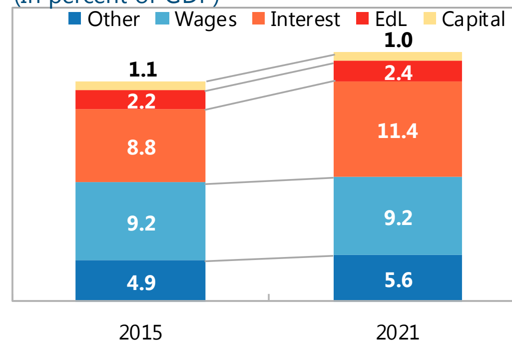
Source: IMF staff calculations.

Growth and Fiscal Indicators, 2000-2021
(Percent)



Sources: National authorities and IMF staff calculations

Composition of Spending
(In percent of GDP)



Sources: National authorities and IMF staff calculations

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[6] Capital investment figures exclude foreign-financed investments undertaken by the Council for Reconstruction and Development, which is small. For a more complete discussion on low investment and its impact on capital formation, see Selected Issues Paper on Lebanon's Capital Stocks.

[7] Given the lower growth profile in this year's baseline, the end-of-projection (2021) level is significantly higher than projected at the time of the 2015 Article IV (when public debt was projected to reach 143 percent of GDP by 2020).

liabilities,[8] demands to adjust public wages,[9] a potential increase in oil prices, and a possible softening in investor appetite for Lebanese debt.

30. Fiscal adjustment is essential. And while adjustment at a time of low growth makes policy trade-offs particularly acute, protracted inaction will prohibitively increase the size and cost of adjustment needed in the future (Box 5).

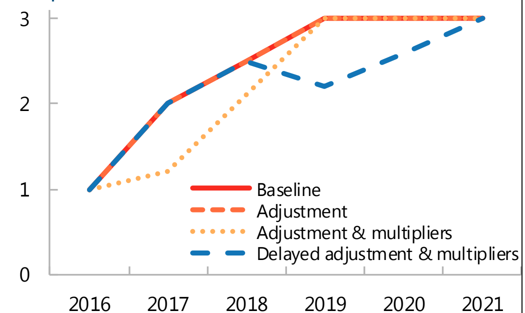
Box 5. Fiscal Adjustment and Growth Trade-Offs

Fiscal policy affects growth via many channels, mainly by tax and expenditure policies. However, there is only limited consensus in the literature on the size and durability of fiscal impact on growth. The empirical evidence suggests that the size of the impact may depend on the type of fiscal instrument used, the state of the business cycle, degree of trade openness, and type of the exchange rate regime, among other factors. While the empirical evidence is extensive for advanced economies, much less is known about the impact of fiscal policies in MENAP countries.

Assuming the composition and size of the proposed upfront adjustment, growth is expected to be temporarily reduced by 0.8 and 0.4 percentage points in 2017 and 2018. Based on the framework to quantify the size and persistence of fiscal multipliers by Cerisola and others (2015),[1] elimination of a transfer to EdL has only a temporary effect on growth, while the impact of the proposed tax measures is expected to last for two years.

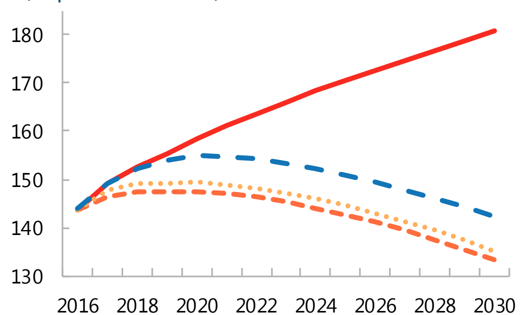
While the impact of lower growth on debt dynamics is negligible, postponing the adjustment by two years increases debt-to-GDP ratio by about 10 percentage points of GDP. These estimates are subject to large uncertainty. Nevertheless, assuming more lasting and negative impact of the proposed tax measures on growth, is unlikely to affect debt dynamics as negatively as its postponed implementation.

Real GDP Growth
(In percent)



Source: IMF staff calculations.

Public Debt
(In percent of GDP)



Sources: Ministry of Finance and IMF staff calculations.

[1] Cerisola M., A. Abdallah, V. Davies, and M. Fischer, 2015, "Assessing The Impact of Fiscal Shocks On Output in MENAP Countries", Technical Notes and Manuals, IMF.

31. The amount of adjustment needs to be sufficient to immediately halt further debt increases. A primary balance of 4 percent of GDP would be sufficient to stabilize debt, requiring an upfront adjustment of about 3 percent of GDP—if sustained, such an adjustment would place debt on a downward path within 5–6 years. Debt would then slowly decline to 133 percent of GDP by

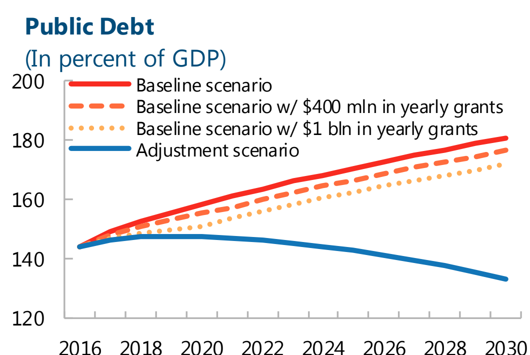
[8] See Jarmuzek M. and N. Nakhle, 2016, "Sustainability and Equity Challenges: Some Arithmetic on Lebanon's Pension System," IMF Working Paper No. 16/46 (Washington: International Monetary Fund).

[9] The government proposed a salary scale adjustment for the public sector in 2012, but this measure has not passed despite various attempts. Given uncertainties, our current projections exclude it.

2030. While such a surplus might seem large compared to the experience of other countries, in the case of Lebanon it needs to be viewed against high budget deficits and mounting funding needs and interest bills.

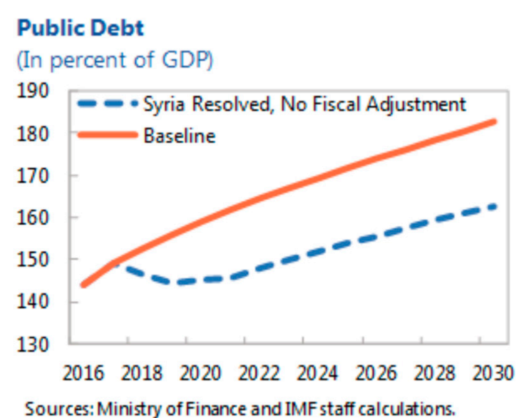
32. There is no substitute for upfront adjustment. Neither donor assistance, resolution of the Syrian conflict, nor any prospective revenue from oil and gas would, in itself, sustainably resolve Lebanon's debt dynamics.

- **Donor assistance**. Assuming grants increase over 2017–21, each year by between $400 million and $1 billion (about 0.5 to 1.9 percent of GDP, in line with the authorities' grant requests at the London conference), the impact on Lebanon's debt to GDP trajectory would be small.



Note: Grants would be dispersed between 2017 and 2020.
Sources: Ministry of Finance and IMF staff calculations.

- **Resolution of the Syrian conflict.** Lebanon stands to gain significantly from Syria's reconstruction effort when the conflict ends. But even under a favorable scenario—with the Syrian conflict ending by end-2017, Lebanon's output gap closing immediately, and economic output rising by the equivalent of 10 percent of Syrian GDP—the positive impact on growth will not be sufficient for debt sustainability.



Sources: Ministry of Finance and IMF staff calculations.

- **Oil and gas resources.** The size and income from Lebanon's off-shore resources are uncertain. And given that exploration has not yet started, it could take several years before the government would start receiving revenue.

Key recommendations

33. Our proposed adjustment package combines revenue and spending measures (see Table below). The package needs to be adopted in its entirety to achieve the targeted primary adjustment:

- **Passing a credible budget—the first in a more than decade—remains a critical priority.** In this context, the Minister of Finance's recent efforts to submit a 2017 budget to cabinet are praiseworthy, and passing a budget would provide a tangible sign of reform commitment.

Ongoing work to close accounts since 1993 needs to continue in parallel with the passing of a budget.[10]

- **Long-standing revenue measures need to be implemented.**[11] These include: (i) an increase in the corporate income tax rate (from 15 to 17 percent); (ii) the introduction of a capital gains tax on real estate; (iii) an increase in the rate on interest income tax (from 5 to 7 percent, though timing may depend on deposit behavior); (iv) an increase in the VAT rate from 10 to at least 11 percent; (v) an increase in tobacco excises; and (vi) new stamp duties and fees.

- **Increasing fuel taxation is overdue.** Low retail prices provide a unique opportunity. The VAT on diesel (suspended in 2011) needs to be restored and gasoline excises (significantly lowered in 2012) need to be increased to earlier levels, also to start containing negative externalities of high fuel consumption. The impact of such measures needs to be compensated by strengthening the social safety net (see below).

- **There is scope to increase tax compliance**. Tax collection is only 50 percent of estimated capacity (Box 6 and Selected Issues Paper on Revenue Mobilization). Ongoing efforts in this area to further promote electronic tax declaration, among others, need to be strengthened. Although the capacity of tax administration has increased by 120 staff in 2016, the needs are estimated to be five times higher.

Impact of Proposed Fiscal Measures on Budget Balance
(In percent of GDP)

	2016	2017	2018	2019	2020	2021
Increasing CIT rate from 15 to 17 percent	0.0	0.2	0.2	0.2	0.2	0.2
Increasing capital gain tax on real estate	0.0	0.2	0.2	0.2	0.2	0.2
Increasing interest income tax rate from 5 to 7 percent	0.0	0.5	0.5	0.5	0.5	0.5
Increasing VAT rate from 10 to 11 percent and improving compliance	0.0	0.9	1.0	1.1	1.2	1.3
Increase gasoline excises	0.0	0.4	0.2	0.2	0.2	0.2
Introduce new stamp duties and fees	0.0	0.2	0.2	0.2	0.2	0.2
Electricity production - Tariff restructuring	0.0	0.0	-0.2	-0.2	-0.2	-0.2
Overall impact on fiscal balance	**0.0**	**2.5**	**2.6**	**2.6**	**2.8**	**2.8**

- **Average electricity tariffs need to be increased to reduce (and eventually eliminate) transfers to Electricité du Liban.** Current proposals to link tariffs to new additional capacity, while protecting lower-end consumers, are welcome, as they should allow for an improvement in service without worsening the fiscal situation. But these are a first step only. Improved service from EdL will help reduce the average household energy bill, and so provide scope for further tariff increases in the future, with the goal of eliminating the EdL subsidy altogether.

[10] The ministry of finance has been preparing budgets, but the parliamentary Budget and Finance Committee has refrained from considering them as accounts since 1993 have not yet been closed, despite significant progress made on closing past accounts.

[11] These measures had been considered in the context of plans to adopt a salary scale adjustment for the public sector.

Box 6. VAT—A Good Candidate for Revenue Mobilization in Lebanon

There is need and scope to mobilize tax revenues in Lebanon, especially given the country's fiscal position. Tax revenue performance in Lebanon is weak and has been driving the drop in public revenues since 2010; and remains below the regional average.

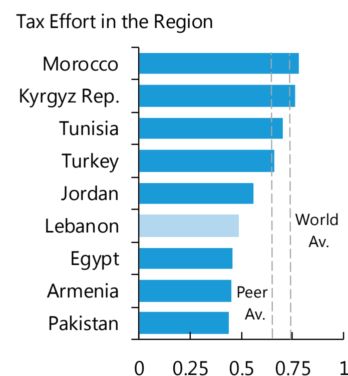
Central Government Revenue, 2010 -2015 (percent of GDP)

	2010	2011	2012	2013	2014	2015
Revenue	**22.1**	**22.8**	**21.8**	**19.8**	**21.8**	**18.8**
Tax revenue	17.4	16.4	15.3	14.1	13.8	13.5
Nontax revenue	3.6	5.2	5.4	4.6	5.8	4.3

Source: National authorities and IMF staff calculations.

Lebanon's tax effort (the ratio of actual tax revenue to capacity—the maximum tax revenue a country can ideally achieve) is lower than in similar MCD countries. Based on Fenochietto and Pessino (2013),[1] Lebanon's tax effort is only 50 percent, indicating, tax revenues might be doubled to around 30 percent of GDP at maximum effort. This compares to an average of 60 percent for similar MCD countries and a world average of about 70 percent.

Tax Effort in the Region



Source: IMF staff calculations

VAT is typically a good candidate for revenue mobilization. It is one of the least distortive taxes with generally the highest share in total tax revenue. As the structure of the Lebanese economy is oriented towards private consumption and a high share of imports, the potential gains from mobilizing VAT revenues are significant.

A VAT gap analysis points to significant VAT erosion over time.[2] This analysis measures the overall gap between actual VAT receipts and receipts under a perfectly enforced VAT levied on all consumption.[3] In turn, this gap can be disentangled into two components: (i) the compliance gap, which estimates the impact of imperfect compliance within the current tax system; and (ii) the policy gap, which calculates the deviation of current tax rules from the benchmark tax levied on all consumption. For Lebanon, the overall VAT gap was estimated at around 7.4 percent of GDP in 2013; up from 6.1 percent in 2009. The compliance gap of 3.3 percent of GDP has been stable over time. The policy gap is continuously rising to 4.0 percent of GDP—very close to actual VAT collected in 2013. The substantial part of the policy gap is a consequence of discretionary policy decisions—mainly the VAT exemption of gasoil in March 2012.

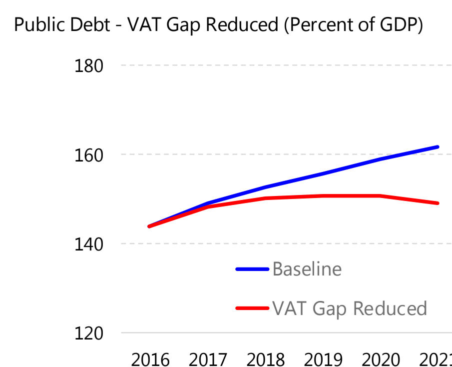
VAT Tax Gap (percent of GDP)

	2009	2010	2011	2012	2013
Overall gap	6.1	6.3	6.5	7.1	7.4
Compliance gap	3.1	3.0	3.0	3.1	3.3
Policy gap	3.1	3.3	3.5	4.0	4.0

Source: National authorities and IMF staff calculations.

Policy simulation suggest there is room to improve fiscal performance and debt dynamics over the medium term assuming only incomplete and gradual elimination of the VAT gap. Assuming a gradually elimination of a 50 percent of the compliance gap and a partial elimination of the policy gap—representing tax expenditure—that would happen over the next five years, the primary balance would increase from 1.1 percent to 5.2 percent of GDP, the overall balance would improve from -8.1 to -5.6 percent of GDP and the public debt would stabilize at about 150 percent of GDP in 2021. Therefore, this analysis suggests that even a partial elimination of the VAT gap can lead to a significant improvement in fiscal performance.

Public Debt - VAT Gap Reduced (Percent of GDP)



Source: National authorities and IMF staff calculations.

[1] Fenochietto, R. and C. Pessino, 2013, "Understanding Countries' Tax Effort," IMF Working Paper 13/244, (Washington: International Monetary Fund).

[2] Source: Revenue Administration Gap Analysis Program—The Value-Added Tax Gap (2016).

[3] Source: Current Challenges in Revenue Mobilization: Improving Tax Compliance (2015).

- **A long-standing salary scale adjustment for the public sector poses challenges.** If passed, its budgetary costs need to be fully offset to preserve the targeted fiscal adjustment (for example by considering broadening the VAT tax base and increasing VAT rates); at a minimum, salary increases should be phased in without retroactive payments; and should ideally be linked to measures to strengthen productivity and rationalize public sector employment growth.

- **The National Poverty Targeting Program (NPTP) needs to be strengthened.** The NPTP is an essential part of Lebanon's (nascent) social safety net, and provides support to households living in extreme poverty. The program is funded in part by grants from the World Bank and UNDP, but a proposal for additional government funding is currently waiting for the ministry of finance's approval, which should be granted as a matter of priority.

34. Over time, as adjustment takes hold and as growth recovers, public investment and social spending need to be increased. Rebalancing spending was a key focus of last year's consultation, and bears repeating.

35. An appropriate oil and gas framework is needed. Legislation on an exploration and fiscal regime for the oil and gas sector needs to be passed. A formal engagement with the Extractive Industries Transparency Initiative (EITI) would signal a commitment to transparency and accountability.

Authorities' Views

36. The authorities are aware of the importance of front-loaded fiscal adjustment and the costs of delay. They acknowledged that debt-service costs pose a problem for sustainability, while also crowding out needed spending. Although a number of measures—including stricter implementation of spending ceilings as well as tax proposals—were presented in the draft 2016 budget, a number of additional measures are expected to be approved and implemented once a new government is formed. At the same time, the authorities noted that, in the post-electoral environment, spending pressures might intensify, especially if additional hiring in the public sector continues.

37. The proposed salary scale adjustment remains a sensitive issue. The authorities are aware of the need to combine salary increases with reforms in the public sector employment, especially to eliminate distortions in the wage structure across different public administration sectors. They noted that public sector employees are entitled to the (long-delayed) salary increases, also to secure a more decent living for public servants and to mitigate corruption in the public sector.

38. There was broad agreement on the design and implementation of the adjustment proposed by staff. While agreeing on the tax measures, the authorities were of the view that improvements in tax compliance and collections should precede increases in tax rates. They also agreed that EdL transfers should be reduced and eventually eliminated, though they noted some disappointment at the lack of progress on proposals to change the tariff structure.

39. The authorities reiterated that the international community needs to provide additional assistance, especially direct budget support. They stressed the global public good afforded by Lebanon's hosting such a large refugee presence. And they requested that the international community provide additional funding, not only as humanitarian aid, but also in the form of budget support. They also noted that, while funding in some areas had increased, the lack of longer-term commitments makes the provision and scaling up of critical services particularly challenging, as effective interventions will span over a number of years—in the case of education, for example, the authorities noted that they cannot educate children for one year and suspend their education the next for lack of funding.

B. Preserving Confidence in Lebanon's Financial System

Using Interest Rates to Secure Buffers

40. The BdL is bearing much of the burden of economic policy. It has effectively operated as a policy maker of last resort—playing a critical role in preserving stability and supporting Lebanon's exchange rate peg (Lebanon's key nominal anchor). In this context, while the BdL's recent financial operation has helped offset a decline in reserves, it cannot offer a sustainable solution to Lebanon's funding needs. Absent an improvement in depositor sentiment, the BdL will need to attract fresh inflows, which may require higher interest rates. To date, the BdL has not yet raised rates owing to concerns about public debt dynamics and growth. But a policy change will be unavoidable if deposit growth does not improve.

41. The timing and extent of any potential change in interest rates will depend on Lebanon's fiscal stance.

- Fiscal adjustment would help reduce the government's financing requirements, especially in foreign exchange. The BdL has been providing foreign exchange to the government through an overdraft facility[12]—allowing the government to draw foreign exchange resources beyond the ceiling set by law on its (non BdL) foreign currency borrowing. In the context of softening deposit inflows, funding the government's foreign currency needs might place added strain on reserves.

- Fiscal adjustment would also pave the way for more market-determined interest rates. The BdL has sometimes helped finance the government by offering long-term instruments to banks and channeling the proceeds to cover shortfalls in both the T-bill market and the Eurobonds market. As a result, T-Bill yields have remained largely unchanged since 2012, muting their role as a key market signal. Finally, the BdL also has adopted a range of quasi-fiscal initiatives to channel subsidized credit to support the economy, particularly to the real estate sector ($4.4 billion over 2013–16).

[12] At the same time, the government maintains positive net balances with the BdL in domestic currency (equivalent to $4.3 billion at end-September 2016).

Key recommendations

- **Monetary policy needs to remain geared to supporting the exchange rate peg.**
  - If deposit growth were to soften, rather than relying on a repeat of its recent operation, the BdL would instead need to use interest rates as a more direct and easily communicated policy tool to secure foreign exchange inflows. In this regard, the BdL also needs to communicate the size and scope of its recent operation to reduce market uncertainty.[13]
  - While an interest rate increase would have an impact on debt service for both the private and public sector and increase banks' cost of funding, such costs should be cast against the implications of the recent BdL operation.
  - Given the size of their reserve buffers (which remain adequate, Annex III), the authorities have some freedom to choose the pace and timing of any interest rate move.
- **Steps to absorb excess liquidity need to be accompanied by efforts to encourage banks to improve their net foreign asset position.** The BdL needs to continue to sterilize the excess Lebanese pound liquidity created by the financial operation, while remaining vigilant to ensure that new lending does not undermine asset quality. Going forward, as financing needs are reduced, banks need to be encouraged to rebuild their foreign exchange liquidity buffers abroad—taking into account rollover and dollarization risks.
- **As fiscal adjustment takes hold over time, the BdL would need to withdraw from T-Bill and Eurobond auctions and encourage banks to participate directly**. As an incentive, it would gradually reduce the attractiveness of placements with the BdL, paving the way for more flexible and market-based yields on government instruments. Overall, this will encourage greater fiscal discipline.
- **As conditions normalize, the BdL also needs to withdraw from quasi-fiscal schemes.** It would need to allow old subsidized credit schemes to expire, while refraining from adding new ones. Looking forward, there is a need to strengthen the BdL's balance sheet, as its income position has been impacted by repeated policy interventions.

Authorities' views

42. In the authorities' view, the financial operation has met several objectives and has helped preserve financial stability. The BdL emphasized the following seven objectives: strengthening BdL's foreign currency assets, enhancing the capital base of banks, increasing liquidity in local currency, improving the government debt profile by reducing the cost of borrowing, improving the balance of payments, targeting positive inflation rate, and improving the country's rating and outlook. They pointed to steps being taken to sterilize the excess (local-currency) liquidity created by the operation, and underscored that the operation had boosted confidence. In

[13] The BdL recently issued a note on the operation, available at http://www.bdl.gov.lb/publications.html.

their view, staff's assessment of the operation was rather negative, and the market needed time to absorb the operation's implications. The authorities continued to view interest rate tools as excessively costly to the economy, and felt that the financial operation was the best option at hand given the various constraints and pressures faced at the time it was undertaken.

Preserving Confidence in the Banking System

43. Lebanon's resilience hinges on the continued health of its macro-financial structure. The FSAP findings (see Financial Sector Stability Assessment (FSSA) report) suggest that the country's challenging economic environment and the government's growing funding needs are having an impact on banks. Moreover, while regulatory capital requirements exceed the minimum levels set under the Third Basel Accord, banks' capital buffers are modest in light of their significant exposure to local-currency sovereign debt and foreign-currency BdL instruments.

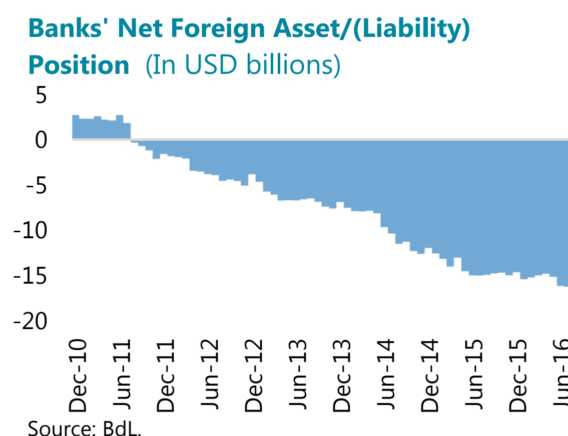
- *Sovereign exposure.* Risk weights are not in line with international standards.[14] In the event of a sovereign downgrade to a rating below "B-" and a corresponding increase in risk-weights for all FX-denominated instruments to 150 percent—as per Basel's standardized approach—the impact would be a reduction of regulatory capital by an estimated 6 percentage points.

- *Interest rate risk.* Banks are primarily funded via short-term deposits and have a large portion of their investments in long-term sovereign instruments, pointing to interest rate risk.

- *Asset quality.* Despite a slowdown in the real economy, reported nonperforming loans (NPLs) have remained relatively stable over past five years, at 10.4 percent by end-June 2016.[15] Banks are also significantly exposed to Lebanon's softening real estate sector—either directly in the form of housing loans and loans to developers, or indirectly in the form of loans to corporates, in turn collateralized by real estate.

- *Foreign currency liquidity needs.* A large share of banks' foreign currency assets (e.g., long-term deposits with the BdL) cannot be immediately pledged in the interbank market to raise liquidity, suggesting that large liquidity shocks might quickly involve the BdL as lender of last resort. And net foreign assets of banks have declined. At present, 1 percent of deposits (or $1.6 billion) represents 4 percent of BdL's gross reserves, highlighting the systemic importance of sufficient liquidity buffers.

Banks' Net Foreign Asset/(Liability) Position (In USD billions)



Source: BdL.

[14] Currently, banks are allowed to apply a risk-weight of 50 percent for FX-denominated BdL exposure (instead of 100 percent, as applied to FX government debt and as per Basel standards in case of sovereign ratings of B or B- equivalent).

[15] The official definition excludes accrued interest, off-balance sheet assets, and restructured loans.

44. Assessment of compliance with the Basel Core Principles (BCP) found that the supervisor is well respected, though continued progress is needed in a number of areas. The Banking Control Commission's (BCC) deserves credit for raising supervisory standards; at the same time, the supervisory approach does not yet support a clear view on the risk profile and systemic relevance of individual banks. In addition, the ongoing BCC supervisory review of capital needs to reflect banks' risk profile. The FSAP also found that the loan classification rules currently are not aligned with international best practice.

Key recommendations

45. The authorities have put in place a number of actions in line with the FSSA's main recommendations. The recent announcement by BCC to implement a graduated increase of the capital adequacy ratio to 15 percent (from 12 percent) by 2018 is welcome. In addition:

- **There is a need for forward-looking capital planning.** Over the longer run, banks will need to engage in forward-looking capital planning reflecting their risk profile and linked to a multi-factor stress testing. In this context, the supervisory review of capital planning is welcome. In addition, the risk weight on BdL foreign-currency exposure needs to be aligned with the Basel Accord, allowing for a reduction in sovereign exposure over the medium term, and incentivizing banks to diversify their liquidity holdings as they strengthen their net foreign asset position.

- **Continued efforts to strengthen banking regulation and supervision are needed.** As per the BCP assessment, there is a need to align the regulatory treatment of restructured loans with international good practice and to stay vigilant on asset quality, including by monitoring loan-loss migrations at the bank level. The authorities also need to put in place a systematic reporting system on the funding structure and liquidity risk profile.

- **The Anti Money Laundering (AML)/Combating Financing of Terrorism (CFT) framework needs to be strengthened further.** While progress has been made since the last full assessment of Lebanon's AML/CFT framework in 2009—including through legislative steps taken in November 2015—some gaps remain. In line with the FSSA recommendations, the authorities need to better align AML/CFT supervision with current ML/TF risks; and need to continue to keep a close focus on the risk of withdrawal of correspondent banking relationships.

Authorities' views

46. The authorities provided several clarifications on capital adequacy. First, they noted that the BdL places banks' foreign currency deposits with foreign central banks and prime banks whose credit assessment is BBB and above. Hence, the risk weight of banks' exposure to the BdL with regard to placements in foreign currency (50 percent) should be considered in the context of their exposure to foreign central banks and prime banks. Second, the BCC regularly conducts scenario analyses, including to analyze the potential impact of a downgrade of Lebanon's sovereign rating to a level below B-. Such analyses indicate that a downgrade to CCC+ would not cause all banks to breach minimum required capital ratios. Lastly, the new regime of a graduated increase in the capital adequacy ratio to 15 percent from 12 percent will protect against risks mentioned above.

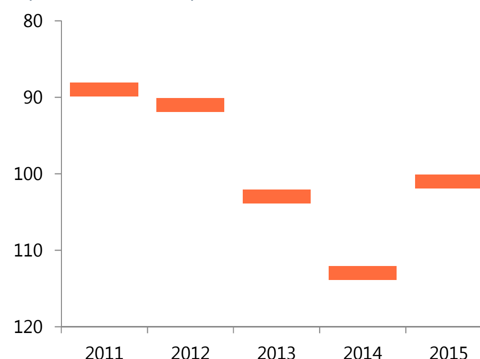
47. The authorities disagreed with the BCP assessment of problem assets and the provisioning and quality of banks' loan portfolios, and the assessment of the AML/CFT framework. They stated that the applicable regulatory framework prescribes the criteria for supervisory loan classification and sets the framework for following up on all loans, with special care taken for loans classified as Class 3 or worse, noting that the BCC reviews a large sample of credit portfolios, covering at least 50 percent of the total banks' loan portfolios, through its missions. Finally, they underscored that they are fully compliant with AML/CFT rules according to Financial Action Task Force (FATF) and MENA FATF.

C. Lebanon's Only Enduring Solution: Investment, Jobs, and Growth

48. There cannot be enduring and inclusive growth without structural reform. The traditional drivers of growth have not provided the high-quality, job-rich growth needed. Indeed, Lebanon's employment growth elasticity is one of the lowest in the region (at least for Lebanese nationals), and job creation has not kept up with the economy's growing labor force–now expanded by the refugee influx.[16]

49. Lebanon's current account deficit suggests an underlying competitiveness problem, even factoring in the Syria crisis. The sharp increase in the deficit is attributable, in part, to the disruption of trade relationships and elevated regional uncertainty. Nonetheless, even abstracting from the impact of Syria, the external balance is weaker than suggested by fundamentals, pointing to an underlying problem with productivity and competitiveness (see Annex III).[17] If Lebanon is to transition to a stronger, more sustainable growth path, action is needed to boost productivity, fight corruption, and address the cost of doing business.[18]

Lebanon. Competitiveness Rank, 2011-15
(Rank out of 144)



Source: World Economic Forum,

[16] According to ILO estimates, the national unemployment rate is estimated at around 9 percent, but rises to 12 percent including refugees.

[17] The EBA methodology results suggest that Lebanon's real exchange rate may be overvalued by anywhere between 0–23 percent. However, in light of concerns regarding the quality of Lebanon's current account data, and given the particular nature of the Syrian conflict, such results should be treated with caution.

[18] *Lebanon Systematic Country Diagnostic,* World Bank (2015).

50. The need for electricity reform is a long-standing priority. The electricity sector has not only been widely identified as Lebanon's most pressing bottleneck, but it also remains a major drain on the budget. Indeed, over 2006–14 the government transferred an average of 4½ percent of GDP each year to EdL, representing over 40 percent of the current debt stock. The World Bank has long been active in promoting electricity reform. But progress has been hindered by, political disagreements within the government.

51. Lebanon's stock of human capital remains a key untapped resource. Lebanon enjoys a steady stream of well-educated labor market entrants (see Selected Issues Paper on Human Capital and the Knowledge Economy), but has typically had difficulty matching these entrants with suitable job opportunities. The net result has been an ongoing "brain drain"—adding to the strength of Lebanon's diaspora, but limiting the scope for domestic development. The BdL has launched a new financing program (under BdL Circular 331) to help boost startup investment in the knowledge economy, aimed at stemming the drain of Lebanon's talented youth, and jumpstarting the development of a local high-tech sector.

52. The knowledge economy is a promising source of growth, but challenges remain. Access to cheaper financing has helped kick-start the sector, though there are limits to what the BdL can do on its own. For Lebanon to realize the full potential of its human capital, various stakeholders need to work together to create a conducive institutional and business climate, starting from strengthening infrastructure—frequent electricity outages and slow internet speeds are a major hindrance for firms.

53. Lebanon's capital markets have the potential for development. The Capital Markets Authority (CMA) is now operational and a new trading platform is paving the way for market initiatives. But successful development will require a further strengthening of Lebanon's regulatory and institutional framework. And as markets grow, the CMA needs to strike a balance between innovation and investor protection, shifting the nature of its oversight towards monitoring, risk-based supervision of intermediaries, and market surveillance.

54. But investment and growth are not just long-term needs. Lebanon's refugee presence has added to Lebanon's infrastructure gap and has intensified the need for reform. As a matter of policy, Lebanon has long affirmed that it is not a country of asylum or resettlement, and that the Syrian refugees cannot expect to stay in Lebanon permanently. Nonetheless, as a large number of refugees is likely to remain in Lebanon over the medium term, there is a need to shift them away from a protracted cycle of short-term humanitarian aid. In this context, there is an immediate need for increased investment (especially in infrastructure) and job-rich growth.[19] But this requires sustained and forward-looking support from the international community, starting with the authorities' proposal at the 2016 London conference (Box 7).

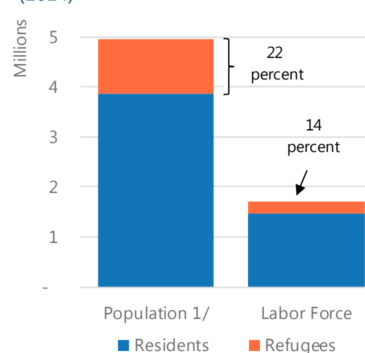
[19] Regulatory requirements, including a substantial residency fee and additional documentary requirements have restricted refugees' access to the labor market, and have come at a substantial humanitarian cost. At the London Conference, the authorities committed to review these regulations. See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/498026/Supporting_Syria__the_Region_London_2016_-_Lebanon_Statement.pdf. Most recently, the authorities have replaced the pledge not to work with a pledge to abide by Lebanese Law, which allows for legal employment in a number of specified sectors.

Box 7. The 2016 London Conference

At the London Conference in February 2016, the authorities presented a new plan to address the costs of the refugee crisis. Noting that Lebanon is, by necessity, providing a critical universal public good, the plan calls for substantial international assistance—$11 billion over 2016–20, including both grants ($5 billion) and loans ($6 billion). The plan's proposals are wide-ranging and ambitious, covering budget support, concessional financing, and direct assistance to local municipalities and the school system.

The key thrust of the proposal is an effort to stimulate growth and employment through a targeted series of investment initiatives. It focuses not only on high-priority infrastructure needs, but also on the maintenance of key public services (education, municipal services, etc.). In essence, it targets some of Lebanon's investment bottlenecks directly, helping the economy scale up to meet its new employment needs. The authorities project that these interventions could create 300,000–350,000 jobs, of which 60 percent would accrue to Syrian refugees. Also, the authorities would encourage job creation in labor-intensive sectors through the *Subsidized Temporary Employment Programme* (STEP), which provides incentives for small- and medium-sized enterprises to invest and expand their workforce. It is estimated that this would generate a further 100,000 jobs, again shared between local residents and Syrian refugees.

Syrian Refugees in the Labor Force
(2014)



1/ UN Department of Economic and Social Affairs (UNDESA)
Source: ILO and IMF staff calculations

But despite the potential benefits of the authorities' plan, incorporating Syrian refugees into the labor market is potentially controversial. As a matter of policy, Lebanon has long maintained that it is not a country of asylum, a final destination for refugees, or a country of resettlement. The permanent integration of Syrian refugees, therefore, is not viewed as a viable solution; and any measure that discourages the ultimate repatriation of the refugees is arguably problematic. In this context, according to Decree 197 (December 2014) Syrians can only work legally in the agricultural, construction, and domestic service sectors. And even for these sectors, the financial and administrative requirements for establishing legal residency are often prohibitive for a large portion of vulnerable Syrian households. Many refugees enter the labor market illegally, but the insecurity and inefficiencies associated with the informal sector represent a significant burden—not only in humanitarian terms, but also in terms of the labor market's ability to adjust quickly and flexibly. Expanding refugee access to stable sources of livelihood has clear humanitarian and security benefits; but it also allows the refugee community to contribute to local growth and development. Moreover, the impact on repatriation incentives is unclear. International experience suggests that self-reliant refugees, who have been able to enhance their skills while in exile, are often able to return to their origin country more rapidly (World Bank, 2015).[1]

[1] World Bank, 2015, "Sustainable Refugee Return." GPFD Issues Note August 2015.

Key recommendations

55. While the adoption of a far-reaching reform agenda will depend on political consensus, small steps in a few select areas could have a significant impact on confidence. In staff's view, the following measures are perhaps the most pressing:

- **Electricity reforms.** Lower oil prices are not a reliable source of sustained budget savings, and, ultimately, electricity transfers need to be reduced to zero. In this context, low oil prices present an opportunity to start the process of bringing tariffs up to cost-recovery levels—though in a

way that protects more vulnerable consumers. Recent proposals to link the tariff structure to the expansion of capacity are promising and need to be adopted quickly, as they allow for increased production (and lower production costs) without increasing transfers from the budget.

- **Fostering the knowledge economy**. In terms of funding, revisiting the scale of incentives to avoid too much money chasing too few ideas could be beneficial. Finalizing and implementing capital market regulation, and the preparation and adoption of a capital market development plan could also help. But more fundamentally, there is a need to put in place a supporting ecosystem for the knowledge economy, starting from reliable and robust internet connectivity and electricity.

- **Facilitating donor support**. The framework for channeling funds through the government needs to be improved. As short-term measures:

  - There is need to expedite the disbursement of donor money from budgetary transit accounts, as currently procedures remain slow.[20]

  - The coordination framework launched after the London Conference, to better coordinate with the international community, needs to be elevated to a high-level forum to discuss strategic issues.

- **Pending legislation**. The framework law for Public Private Partnerships—awaiting parliamentary approval for three years—could help mobilize private sector resources for infrastructure investment, though with due attention to possible fiscal risks. Similarly, an agreement with the European Union regarding simplified rules-of-origin for Lebanese exports has been negotiated but is yet to be ratified.

Authorities' Views

56. The authorities agreed broadly with staff's diagnosis and priorities, but stressed that the slow pace of reform in the past had been a symptom of Lebanon's protracted political impasse. The election of a president was an encouraging first step, and following the formation of a new government, action on the reform agenda could potentially proceed very swiftly. The authorities agreed in particular with the pressing need for electricity reform, and noted that a tariff structure that allowed an expansion of generating capacity would be key in bringing down overall production costs.

57. The authorities also underscored that Lebanon's reform agenda was closely linked to the refugee presence, and that additional donor funding would be critical. Lebanon's infrastructure deficit has widened sharply owing to the added demands of the refugee community. So far, most donor support had come in the form of short-term humanitarian assistance but even this was short of actual needs. Longer-term funding—either in the form of budget support to

[20] For example, the authorities are currently at risk of losing a £90 million grant for the education sector, as timely delivery from the transit account to the education sector cannot be guaranteed.

reduce the government's cost of borrowing, or concessional finance for infrastructure spending—has not yet materialized. While grateful for the support received so far, they urged the international community to step up their support as a matter of urgency.

D. Data Issues

58. Data quality remains weak. There has been a general deterioration in the provision of data. Fiscal data are reported with long and increasing lags; national accounts compilation suffers from serious shortcomings; and balance of payments statistics are subject to frequent and sizable revisions. The Central Administration of Statistics (CAS) and the External Sector Section of the BdL are aware of existing problems and are working to improve data quality. But progress has been slow and uneven.

Key recommendation

- **The authorities need to address data gaps.** At a minimum, the timeliness of fiscal data need to be improved; IIP data need to be finalized and published; and collaboration between CAS and other institutions needs to be strengthened.

STAFF APPRAISAL

59. Lebanon finds itself at a critical juncture. The recent presidential election and the appointment of a new prime minister with a mandate to form a new government bode well for a revamping of Lebanon's policymaking framework. Lack of adjustment and reform in the past has reflected internal and regional political fissures, rather than a lack of capacity.

60. The Syria shock has been both profound and long-lasting. The costs of regional conflicts have been significant; growth has stalled; and Lebanon's already-strained infrastructure and services have struggled to cope with refugee inflows. Despite all this, Lebanon has endured and its response to the crisis is a testament to both its generosity and resilience.

61. Yet, the need for adjustment and reform pre-dates the Syrian crisis. Lebanon entered it with a long-standing need for reform and with large infrastructure gaps—chief among all, in the electricity sector. The budget was also burdened with significant spending rigidities, mainly related to salaries, debt service and transfers to EdL. High growth rates masked all these factors prior to the crisis, but once growth dissipated, they have come to weigh heavily on fiscal performance.

62. The economy faces rising vulnerabilities. Staff estimates and projections are less benign compared to last year's Article IV consultation, especially on public debt dynamics. And a new development—the slowdown in financial inflows—has come at a time when the economy's funding needs remain sizeable, and when liquidity conditions have tightened in many of Lebanon's traditional sources of funding, namely regional oil exporters. As a result, Lebanon's foreign exchange reserves dropped for the first time in eleven years in 2015, and the decline continued into mid-2016, prompting the BdL to take action.

63. The BdL's recent financial operation has been a stop-gap measure, but cannot sustainably resolve Lebanon's funding needs. The BdL has continued its efforts to support financial stability and the exchange rate peg, which remains the appropriate nominal anchor. As in previous episodes, the BdL has deployed unconventional measures. While the operation bolstered BdL's gross international reserves and banks' capital, it has also resulted in a large injection of local currency liquidity and erosion of banks' foreign currency buffers, which now need to be addressed; and has affected the BdL's balance sheet. In addition, as in other countries, it is important for the BdL to communicate the size and scope of its unconventional measures in a timely manner.

64. Going forward, the policy agenda needs to decisively address Lebanon's pressure points. Fiscal adjustment is essential—large enough to halt Lebanon's adverse debt dynamics, and with a composition that broadens the tax burden (starting from fuel taxation) while seeking to rebalance the spending mix toward more efficient programs and better social safety nets. Neither large donor funding, temporarily higher growth, nor prospective gas revenue can permanently substitute for fiscal adjustment. Passing a credible budget remains a critical priority and would signal a strong commitment to discipline. Fiscal adjustment would also reduce the government's reliance on bank funding and would, in turn, reduce the need for ongoing financial inflows—ultimately relieving pressure on the BdL and allowing it to use interest rate policy more flexibly going forward.

65. Financial stability has been a pillar of sustained confidence. The banking system is renowned for its resilience—though the system now faces a more challenging macroeconomic environment, growing exposure to the sovereign, lower foreign currency liquidity buffers abroad, significant interest-rate risk, and greater international scrutiny. The Banking Control Commission is proactively vigilant. Its efforts need to be complemented by measures to introduce forward-looking capital planning; strengthen regulation and supervision by, among others, aligning loan classification rules and sovereign risk weights with international good practice; and support liquidity risk management. Finally, the AML/CFT frameworks need to be strengthened further.

66. Higher, more sustainable, and more inclusive growth can provide a lasting solution. Current growth rates are insufficient to address Lebanon's employment or social needs, and even in the past, higher growth rates have often failed to generate sufficient job opportunities. But Lebanon has a wide range of resources at its disposal, including an innovative and resilient business sector, and an enviable pool of high-quality human talent. Unlocking this potential will require reinvigorating Lebanon's structural reform agenda to address key infrastructure bottlenecks, also to improve competitiveness. But beyond the longer-term need for a more balanced growth path, job-rich investment is urgently needed now, particularly in light of large-scale refugee presence. The authorities' ambitious proposal at the London Conference to boost employment and growth deserves attention and international support.

67. In this context, the international community needs to play a stronger role. Lebanon has received significant assistance, but largely for humanitarian purposes and below estimated needs. Funding volatility also undermines the effectiveness of spending programs. Larger and more stable support to help Lebanon address the costs of the Syrian crisis is both needed and warranted.

68. Data gaps need to be addressed. Progress continues to be made in many areas; stronger cooperation among agencies and high-level support for the Central Administration of Statistics would help strengthen data compilation and dissemination. The Fund stands ready to assist, including through our Middle East Technical Assistance Center.

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

Table 1. Lebanon: Selected Economic Indicators, 2013–21

(Population: est. 4.5 million; 2014)
(Per capita GDP: est. US$11,112; 2014)
(Quota: SDR 266 million, 0.11 percent of total)
(Poverty rate: 28 percent; 2004-05)
(Unemployment: 11.0 percent; 2011) 1/
(Main products and exports: services, jewelry)
(Key export markets: UAE, Saudi Arabia, Switzerland)

	2013	2014	2015	Proj.					
	Est.	Est.	Est.	2016	2017	2018	2019	2020	2021
Output and prices	(Annual percentage change)								
Real GDP (market prices)	2.5	2.0	1.0	1.0	2.0	2.5	3.0	3.0	3.0
GDP deflator	5.3	2.8	0.9	0.9	1.0	1.6	1.8	1.7	1.9
Consumer prices (end-of-period)	1.1	-0.7	-3.4	2.0	2.0	2.0	2.0	2.0	2.0
Consumer prices (period average)	4.8	1.9	-3.7	-0.7	2.0	2.0	2.0	2.0	2.0
Investment and saving	(In percent of GDP)								
Gross capital formation	24.2	23.9	22.0	22.4	22.6	22.7	22.8	23.1	23.1
Government	1.7	1.3	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Nongovernment	22.5	22.6	21.0	21.3	21.5	21.6	21.8	22.0	22.0
Gross national savings	-1.7	-1.5	3.8	4.9	5.2	5.6	6.2	7.2	8.0
Government	-7.0	-4.7	-6.3	-6.9	-7.4	-8.1	-8.6	-9.1	-9.5
Nongovernment	5.3	3.2	10.1	11.7	12.5	13.7	14.8	16.3	17.4
Central government finances (cash basis)	(In percent of GDP)								
Revenue (including grants)	19.8	21.8	18.8	19.0	19.0	19.2	19.2	19.2	19.2
Expenditure	28.5	27.8	26.2	26.9	27.5	28.3	28.9	29.4	29.8
Budget balance (including grants)	-8.7	-6.0	-7.3	-7.9	-8.4	-9.1	-9.7	-10.2	-10.5
Primary balance (including grants)	-0.8	2.4	1.4	1.1	1.5	1.4	1.4	1.2	1.0
Total government debt	133	133	138	144	148	151	154	157	160
Monetary sector	(Annual percentage change, unless otherwise indicated)								
Credit to the private sector	9.6	9.3	5.9	1.9	3.0	4.2	4.9	4.7	4.9
Reserve money	3.5	9.4	5.9	13.3	11.0	11.8	11.3	2.2	2.1
Broad money 2/	9.0	6.0	4.8	5.5	4.0	4.0	4.0	4.0	4.0
Deposit dollarization (level)	66.2	65.8	64.9	64.5	64.5	64.0	63.5	63.0	62.5
Interest rates (period average, in percent)									
Three-month treasury bill yield	4.4	4.4	4.4	...	...	...	...	...	...
Five-year treasury bill yield	6.8	6.8	6.8	...	...	...	...	...	...
External sector	(In percent of GDP, unless otherwise indicated)								
Exports of goods and services(in US$, percentage change)	1.3	-7.8	2.4	2.4	6.0	5.5	6.8	6.5	6.0
Imports of goods and services (in US$, percentage change)	5.2	-2.2	-6.4	4.0	7.0	3.8	4.5	4.6	4.4
Balance of goods and services	114.1	104.2	99.0	100.5	104.0	104.3	104.8	105.4	105.5
Current account	-25.9	-25.3	-18.2	-17.5	-17.4	-17.1	-16.7	-15.9	-15.1
Foreign direct investment	-1.6	-3.5	-3.4	-4.5	-4.4	-4.7	-4.8	-4.9	-4.6
Total external debt 3/	167	170	175	179	180	179	177	176	175
Gross reserves (in billions of U.S. dollars) 4/	33.9	37.3	36.7	40.9	39.4	37.4	34.9	32.3	28.9
In months of next year imports of goods and services	12.4	14.6	13.8	14.4	13.4	12.1	10.8	9.6	9.2
In percent of short-term external debt 5/	48.8	50.0	46.8	49.4	46.1	42.2	38.0	33.7	29.0
In percent of banking system foreign currency deposits	37.6	39.3	37.3	39.8	36.9	33.8	30.6	27.5	23.8
In percent of total banking system deposits	24.9	25.8	24.2	25.6	23.8	21.6	19.4	17.3	14.9
Memorandum items:									
Nominal GDP (in billions of U.S. dollars)	47.6	49.9	50.9	51.8	53.4	55.6	58.3	61.1	64.1
Foreign-exchange-denominated bank deposits (percent change)	11.1	5.3	3.7	4.6	4.0	3.2	3.2	3.2	3.2
Commercial bank total assets (percent of GDP)	346	352	366	378	382	381	378	375	372
Net imports of petroleum products (in millions of U.S. dollars)	-5,000	-4,747	-3,320	-4,254	-4,604	-4,947	-5,225	-5,564	-5,869
Local currency per U.S. dollar (period average)	1507.5	1507.5	1507.5	...	...	...	...	...	...
Real effective exchange rate (annual average, percent change)	4.0	1.2	10.0	-1.3	-0.1	0.2	0.0	-0.2	0.6

Sources: Lebanese authorities; and IMF staff estimates.
1/ According to a labor force survey conducted by the World Bank in April 2011. The latest official unemployment rate is 9.7 percent in 2007.
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: 2013–21

(In percent of GDP, unless otherwise indicated)

	2013 Act.	2014 Act.	2015 Act.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.
Revenue and Grants	19.8	21.8	18.8	19.0	19.0	19.2	19.2	19.2	19.2
Revenue	19.8	21.8	18.8	19.0	19.0	19.2	19.2	19.2	19.2
Tax revenue	14.1	13.8	13.5	13.8	13.9	14.1	14.1	14.1	14.1
Taxes on income and profits	3.5	3.7	3.8	3.9	4.0	4.1	4.2	4.2	4.2
Taxes on property	1.7	1.7	1.5	1.6	1.6	1.6	1.6	1.6	1.6
Taxes on domestic goods and services	5.3	5.1	4.8	4.8	4.9	4.9	4.9	4.8	4.8
of which: VAT revenues	4.6	4.4	4.1	4.1	4.2	4.1	4.1	4.1	4.1
Taxes on international trade 1/	3.0	2.7	2.7	2.8	2.8	2.9	2.9	2.9	2.9
Other taxes	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Nontax revenue	4.6	5.8	4.3	4.1	4.1	4.1	4.1	4.1	4.1
Other Treasury Revenue	1.1	2.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Expenditure	28.6	27.8	26.2	26.9	27.5	28.3	28.9	29.4	29.8
Current primary expenditure	18.9	18.1	16.3	16.8	16.5	16.7	16.8	16.9	17.1
Personal costs 2/	9.0	8.9	9.2	9.3	9.3	9.3	9.3	9.3	9.3
Transfer to EdL 3/	4.2	4.2	2.2	1.9	2.3	2.5	2.6	2.8	3.0
Other current 4/	5.7	5.0	4.9	5.6	4.9	4.9	4.9	4.9	4.9
Interest payments	8.0	8.4	8.8	9.1	9.9	10.6	11.1	11.4	11.6
Capital expenditure	1.7	1.3	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Overall balance	-8.8	-6.0	-7.3	-7.9	-8.4	-9.1	-9.7	-10.2	-10.5
Primary balance	-0.8	2.4	1.4	1.1	1.5	1.4	1.4	1.2	1.0
Net financing	8.7	6.0	7.3	7.9	8.4	9.1	9.7	10.2	10.5
Banking system	8.3	2.9	6.5	6.2	6.5	7.0	7.4	7.6	8.0
Government institutions	0.9	1.1	0.5	0.6	0.6	0.6	0.6	0.6	0.7
Other	-0.3	2.2	0.4	1.2	1.4	1.5	1.7	1.9	1.9
Memorandum items:									
Total government gross debt	133	133	138	144	148	151	154	157	160
of which: foreign currency denominated debt	41	38	38	38	39	39	40	41	41
Nominal GDP (Bil. LL)	71,755	75,230	76,666	78,113	80,461	83,828	87,923	92,106	96,642

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.

Table 2b. Lebanon: Central Government Overall Deficit and Financing: 2013–21

(In billions of Lebanese pounds, unless otherwise indicated)

	2013 Act.	2014 Act.	2015 Act.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.
Revenue and Grants	14,199	16,398	14,433	14,832	15,327	16,070	16,888	17,725	18,558
Revenue	14,199	16,398	14,433	14,832	15,327	16,070	16,888	17,725	18,558
Tax revenue	10,115	10,387	10,329	10,818	11,201	11,786	12,410	13,004	13,623
Taxes on income and profits	2,501	2,795	2,887	3,067	3,218	3,420	3,657	3,858	4,044
Taxes on property	1,201	1,245	1,179	1,250	1,287	1,341	1,407	1,474	1,546
Taxes on domestic goods and services	3,782	3,811	3,717	3,784	3,935	4,086	4,273	4,464	4,669
of which: VAT revenues	3,296	3,302	3,159	3,216	3,350	3,476	3,633	3,794	3,966
Taxes on international trade 1/	2,158	2,042	2,064	2,225	2,254	2,411	2,519	2,628	2,755
Other taxes	473	495	483	492	507	528	554	580	609
Nontax revenue	3,268	4,353	3,303	3,205	3,302	3,440	3,608	3,779	3,966
Other Treasury Revenue	816	1,658	800	808	824	845	870	941	969
Grants	0	0	0	0	0	0	0	0	0
Total Expenditure	20,512	20,939	20,066	21,029	22,099	23,736	25,419	27,079	28,753
Current primary expenditure	13,576	13,621	12,526	13,102	13,262	13,967	14,729	15,607	16,531
Personal costs 2/	6,473	6,727	7,081	7,276	7,504	7,809	8,144	8,545	8,970
Transfer to EdL 3/	3,021	3,157	1,682	1,458	1,841	2,077	2,304	2,576	2,853
Other current 4/	4,082	3,737	3,763	4,368	3,917	4,081	4,281	4,486	4,708
Interest payments	5,720	6,314	6,722	7,094	7,980	8,877	9,755	10,495	11,197
Capital expenditure	1,216	1,004	818	833	857	892	935	978	1,025
Overall balance	-6,313	-4,541	-5,633	-6,197	-6,772	-7,665	-8,531	-9,354	-10,195
Primary balance	-593	1,773	1,089	897	1,208	1,211	1,224	1,140	1,002
Net financing	6,235	4,541	5,633	6,197	6,772	7,665	8,531	9,354	10,195
Banking system	5,939	2,161	4,969	4,830	5,212	5,896	6,464	7,036	7,711
Government institutions	638	844	372	486	468	508	545	588	629
Other	-210	1,648	322	934	1,093	1,262	1,523	1,731	1,856
Memorandum items:									
Total government gross debt	100,345	106,008	112,258	119,031	126,696	135,227	144,581	154,777	166,058
of which: foreign currency denominated debt	38,593	40,813	43,110	46,214	49,896	54,157	58,904	64,168	69,941
Nominal GDP (Bil. LL)	71,755	75,230	76,666	78,113	80,461	83,828	87,923	92,106	96,642

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.

Table 3. Lebanon: Balance of Payments, 2013–21

	2013	2014	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.
				(in millions of US Dollars)					
Current account (excl. official transfers)	-12,305	-12,649	-9,258	-9,052	-9,292	-9,489	-9,715	-9,732	-9,709
Goods (net)	-15,328	-15,023	-13,096	-14,506	-16,337	-16,861	-17,423	-18,025	-18,635
Exports, f.o.b.	5,182	4,557	3,987	3,734	3,891	4,284	4,723	5,214	5,649
Imports, f.o.b.	-20,510	-19,580	-17,083	-18,241	-20,228	-21,145	-22,146	-23,238	-24,284
Services (net)	2,777	1,568	2,187	2,838	3,667	4,089	4,577	5,042	5,494
Credit	15,708	14,706	15,744	16,474	17,537	18,321	19,412	20,488	21,601
Debit	-12,931	-13,137	-13,556	-13,636	-13,870	-14,232	-14,835	-15,446	-16,107
Memo: Tourism (net)	2,104	1,529	2,116	2,227	2,518	2,673	2,806	2,968	3,107
Income (net)	-1,356	-1,562	-1,735	-1,628	-1,231	-1,502	-1,825	-1,913	-1,952
Credit	1,967	2,483	2,342	2,259	3,026	3,435	3,947	4,277	4,499
Debit	-3,323	-4,046	-4,077	-3,887	-4,258	-4,937	-5,772	-6,190	-6,452
o/w: Interest of government debt	-475	-470	-544	-526	-587	-631	-686	-685	-729
Current transfers (net) 1/	1,601	2,368	3,385	4,245	4,609	4,785	4,957	5,163	5,385
Official (net)	-44	7	69	0	0	0	0	0	0
Private (net)	1,645	2,361	3,317	4,245	4,609	4,785	4,957	5,163	5,385
Capital and financial account	10,717	10,919	9,646	13,229	7,838	7,409	7,253	7,143	6,340
Capital account (net)	1593	1402	1833	1453	1453	1453	1453	1453	1453
Direct investment (net) 2/	9,125	9,518	7,813	11,776	6,385	5,956	5,800	5,690	4,887
Portfolio investment, loans and other (C&D) (net)	13,113	11,911	10,697	17,075	5,902	4,361	3,496	2,778	1,147
Government (net)	723	422	263	178	247	330	465	520	593
BdL	-198	-223	-216	-100	0	0	0	0	0
Banks (net)	5,027	6,870	4,286	3,966	2,163	2,249	2,339	2,433	2,530
Foreign assets of banks 3/	-1,539	2,915	822	127	-962	-990	-1,018	-1,047	-1,078
Nonresident deposits 4/	5,989	2,440	4,499	4,874	4,161	4,274	4,393	4,515	4,643
Nonbank private sector (net)	2,833	710	1,818	9,018	1,445	-308	-1,433	-2,339	-4,165
Errors and omissions	3,322	5,161	-948	0	0	0	0	0	0
Overall balance	1,734	3,431	-560	4,177	-1,454	-2,080	-2,462	-2,589	-3,369
Financing	-1,734	-3,431	560	-4,177	1,454	2,080	2,462	2,589	3,369
Official reserves (- increase)	-1,715	-3,412	580	-4,177	1,454	2,080	2,462	2,589	3,369
Use of Fund Resources	-19	-19	-19	0	0	0	0	0	0
Memorandum items (in percent of GDP)									
Current account balance	-25.9	-25.3	-18.2	-17.5	-17.4	-17.1	-16.7	-15.9	-15.1
Goods and services balance	-26.4	-27.0	-21.5	-22.5	-23.7	-23.0	-22.0	-21.2	-20.5
Exports of goods	10.9	9.1	7.8	7.2	7.3	7.7	8.1	8.5	8.8
Export value, percent change	1.3	-7.8	2.4	2.4	6.0	5.5	6.8	6.5	6.0
Export volume, percent change	3.3	-5.9	14.8	5.5	3.7	4.5	5.8	5.4	5.4
Imports of goods	-43.1	-39.2	-33.6	-35.2	-37.9	-38.0	-38.0	-38.0	-37.9
Import value, percent change	-7.9	-12.1	-12.5	-6.3	4.2	10.1	10.2	10.4	8.3
Import volume, percent change	1.2	-2.4	3.5	11.6	7.6	3.1	3.5	3.4	3.6
Services credit	33.0	29.5	31.0	31.8	32.9	32.9	33.3	33.5	33.7
Services debit	-27.2	-26.3	-26.7	-26.3	-26.0	-25.6	-25.4	-25.3	-25.1
Gross reserves (excl. gold, year-end) 5/	33,892	37,304	36,724	40,902	39,448	37,368	34,906	32,316	28,947
External debt 6/	167.1	170.0	174.6	179.0	180.1	179.3	177.5	176.4	174.7
Government external debt	19.2	19.2	19.3	19.3	19.2	19.0	18.9	19.3	19.3
GDP	47,598	49,904	50,856	51,816	53,374	55,607	58,323	61,098	64,108

Sources: Lebanese authorities, BIS, and IMF staff estimates and projections.

1/ Excluding official budgetary transfers.

2/ From 2009: includes new data source for real estate investment.

3/ Excluding budgetary loan disbursements.

3/ Net of non-deposit foreign liabilities.

4/ Differs from banks' reported data, to include estimated deposit flows by Lebanese nationals living abroad but classified as residents.

5/ Excludes Lebanese Eurobonds and encumbered reserves.

6/ Includes all banking deposits held by nonresidents, including estimated deposits of Lebanese nationals living abroad but classified as residents.

Table 4. Lebanon: Monetary Survey, 2013–21

	2013	2014	2015	2016	2017	2018	2019	2020	2021
	Act.	Act.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In trillions of Lebanese pounds)								
Net foreign assets	98.5	98.6	94.7	102.1	101.9	100.1	97.7	95.1	91.5
Banque du Liban	65.9	70.9	68.7	76.7	75.5	72.6	69.1	65.4	60.6
Commercial banks	32.6	27.7	26.0	25.4	26.4	27.5	28.6	29.7	30.9
Net domestic assets	112.1	124.6	139.1	144.6	154.7	166.8	179.9	193.5	208.7
Net claims on public sector	62.0	64.5	72.3	77.1	82.3	88.2	94.6	101.7	109.4
of which: Net claims on government	68.0	70.6	78.6	85.4	90.6	96.5	103.0	110.0	117.7
Banque du Liban	11.2	14.3	21.6	30.0	29.4	28.7	28.0	27.3	26.5
Commercial banks	56.8	56.3	57.0	55.5	61.3	67.8	74.9	82.7	91.2
Claims on private sector	63.0	68.8	72.9	74.2	76.5	79.6	83.5	87.5	91.8
Other items (net)	-12.8	-8.7	-6.0	-6.7	-4.1	-1.0	1.7	4.4	7.6
Broad money (M5) 1/	210.6	223.3	233.9	246.7	256.6	266.9	277.5	288.6	300.2
In Lebanese pounds	73.8	79.3	84.6	90.7	94.3	99.3	104.7	110.2	116.1
Currency in circulation	3.4	3.6	3.5	4.2	4.4	4.6	4.8	5.0	5.2
Deposits in Lebanese pounds	70.4	75.7	81.1	86.4	89.9	94.8	99.9	105.3	111.0
Deposits in foreign currency	136.8	143.9	149.2	156.1	162.3	167.5	172.9	178.4	184.1
	(Year-on-year percent change)								
Net foreign assets	-1.4	0.2	-3.9	7.8	-0.2	-1.8	-2.4	-2.6	-3.8
Net domestic assets	20.1	11.2	11.6	3.9	7.0	7.8	7.8	7.6	7.8
Net claims on public sector	10.9	4.2	12.0	6.7	6.7	7.2	7.3	7.4	7.6
Claims on private sector	9.6	9.3	5.9	1.9	3.0	4.2	4.9	4.7	4.9
Broad money (M5) 1/	9.0	6.0	4.8	5.5	4.0	4.0	4.0	4.0	4.0
In Lebanese pounds	5.3	7.5	6.7	7.1	4.0	5.4	5.4	5.3	5.3
Deposits in foreign currency	11.1	5.2	3.7	4.6	4.0	3.2	3.2	3.2	3.2
Memorandum items:	(In trillions of Lebanese pounds, except where otherwise indicated)								
Banque du Liban:									
Foreign assets	68.2	73.0	70.4	78.3	77.1	74.1	70.6	66.9	62.1
of which: foreign exchange	47.8	48.8	46.2	56.5	54.3	51.2	47.4	43.5	38.5
of which: gold	16.7	16.5	14.8	16.4	17.4	17.6	17.8	18.0	18.3
Claims on public sector (net)	9.6	13.1	20.4	26.7	26.1	25.5	24.8	24.0	23.2
Claims on commercial banks	-19.6	-19.9	-24.1	-33.7	-31.0	-28.5	-25.5	-25.3	-25.1
Reserve money	20.5	22.4	23.7	26.9	29.8	33.3	37.1	38.0	38.8
Gross international reserves (including gold), in billions of U.S. dollars 2/	45.0	48.3	46.6	51.8	51.0	49.0	46.7	44.2	41.1
Gross international reserves (excluding gold), in billions of U.S. dollars 3/	33.9	37.3	36.7	40.9	39.4	37.4	34.9	32.3	28.9
in percent of banking system foreign currency deposits	37.6	39.3	37.3	39.8	36.9	33.8	30.6	27.5	23.8
in percent of total banking system deposits	24.9	25.8	24.2	25.6	23.8	21.6	19.4	17.3	14.9
Share of foreign currency deposits in total private sector deposits (in percent)	66.2	65.8	64.9	64.5	64.5	64.0	63.5	63.0	62.5

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, 2011–16

	2011	2012	2013	2014	2015	2016 (*)
Capital						
Regulatory capital to risk-weighted assets**	11.6	13.0	14.5	14.9	15.1	15.1
Regulatory Tier 1 capital to risk-weighted assets**	11.0	12.1	13.5	13.8	13.9	13.9
Total capital/Total assets	8.0	8.7	8.9	9.2	9.3	9.3
Asset quality						
Non performing loans net of provisions to capital 1/	5.2	5.2	6.1	6.3	6.8	7.7
Non performing loans to gross loans 1/	9.6	9.7	10.2	10.2	10.8	10.4
Asset concentration						
Claims on public sector (BdL excluded) to total assets	20.8	20.5	22.9	21.3	20.3	19.7
Placements with the BdL to total assets	33.6	34.6	33.0	36.1	37.9	39.5
Foreign assets to total assets	18.1	17.2	16.2	13.8	12.8	11.7
Profitability						
Efficiency ratio 2/	52.1	57.0	56.6	57.6	57.3	59.2
Return on assets (after tax)	1.1	1.0	1.0	1.0	1.0	1.0
Return on equity (after tax)	14.5	12.8	11.7	11.3	11.4	10.9
Liquidity						
Deposits to total liabilities	87.9	87.9	87.5	87.3	86.8	86.4
Liquid assets to total assets	22.7	23.2	22.7	20.0	18.1	16.9
Liquid assets to short term liabilities	32.5	33.9	33.8	30.0	28.1	26.3
FX exposure						
Foreign-currency-denominated loan to total loans	78.4	77.4	76.5	75.8	74.6	73.8
Foreign-currency-denominated liabilities to total liabilitie	66.2	65.1	65.5	64.8	64.0	63.7
Net open FX position to regulatory capital	16.9	13.9	11.8	13.9	14.1	14.4

(*) As of June 2016.

(**) As of December 2015.

1/ Non performing loans include unrealised interest.

2/ non-interest expense to sum of net interest income plus non-interest income.

Sources: Lebanese authorities and Financial Soundness Indicators (FSI).

Annex I. Status of the Article IV 2015 Recommendations

Recommendations

The 2015 consultation called for fiscal discipline. Concretely, the consultation called for a restored primary surplus to place debt on a more sustainable path, including through: increased fuel taxation, increasing the VAT from 10 to 11 percent; increasing the tax rate on interest income from 5 to 7 percent; introducing a capital gains tax on real estate transactions; introducing new stamp duties and fees; and regularizing telecom transfers. The consultation also urged the authorities to pass a budget.

T**he 2015 consultation also stressed the importance of preserving financial stability**. In this context, it was suggested that the authorities needed to: strengthen bank supervision; increase capital buffers; improve loan classification and restructuring rules; and enhance the AML/CFT framework. To promote capital market development, the consultation also recommended that the authorities privatize the Beirut Stock Exchange.

The 2015 consultation highlighted the need for structural reform to help secure more inclusive growth and greater resilience. It was recommended that the authorities renew their efforts to reform the electricity sector, including through a gradual increase in tariffs toward cost recovery levels. The consultation also suggested that the authorities needed to: reform the pension system; encourage employment opportunities for high-skill workers; and pass long-delayed legislation (e.g., on Public Private Partnerships, or on the use of gas resources) to provide a signal to potential investors. It also underscored the need for the authorities to improve the provision and quality of statistical information.

Progress

In the fiscal sector, the authorities managed a small primary surplus in 2015, which is likely to be repeated in 2016. Telecom transfers over 2015–16 were also substantially more regular than in 2014. The minister of finance presented the 2017 budget to cabinet within the deadlines established under the constitution, but no action has been taken so far by cabinet or parliament. **In the monetary sector**, parliament passed legislation related to the AML/CFT framework. **And on structural reform**, parliament convened two emergency sessions to pass a series of long delayed legislation, including measures to comply with international tax transparency norms, and to help unlock funding from the World Bank. Delays in the dissemination of statistical information have increased.

Annex II. Public Debt Sustainability Analysis[1]

With public debt already above 140 percent of GDP and gross financing needs close to 30 percent of GDP, risks to public debt sustainability are increasingly significant. Under the baseline scenario, debt and financing needs will continue to rise as a share of GDP, reaching 160 percent and 33 percent, respectively, by 2021. In addition, debt dynamics and financing needs are subject to significant macro-economic shocks, especially to growth and contingent liability shocks. The level of foreign exchange reserves and a captive investor base remain important mitigating factors.

1. **The baseline scenario does not assume any improvement in the conflict in Syria within the projection horizon**. This is also underpinned by the following assumptions:

- *Real GDP growth* is projected to pick up slowly. From 2 percent in 2017, itis projected to increase gradually, to 3 percent in 2019 and for the rest of the projection horizon.
- *Inflation* (measured by the GDP deflator) is estimated to remain at 1 percent in 2016 and 2017. Between 2018 and 2021 it is projected to increase marginally and settle slightly below 2 percent.
- The *primary balance* is projected to stay in a surplus of about 1–1½ percent of GDP from 2016 onwards. Low oil prices are the main exogenous factor driving surpluses. The projections also assume that no corrective measure will be introduced on the revenue and expenditure side.

2. **The baseline assumptions are broadly plausible.** Lebanon's forecast track record is not systematically biased, as reflected in projection errors generally not being consistently on one side or the other. The median forecast errors for growth, inflation and primary balance during 2010–15 are broadly in line with those observed in other countries.

3. **The deteriorating debt outlook is mainly shaped by the projected path of the positive interest rate-growth differential.** The public debt-to-GDP ratio is forecast to increase from 138 percent in 2015 to 160 percent in 2021. Economic growth is not expected to reach levels large enough to offset adverse dynamics from real interest rates. Although the gross financing needs are projected to increase by only 3 percentage points of GDP, to 33 percent of GDP in 2021, they would reach levels of about 40 percent of GDP beyond 2021. Their trajectory is primarily driven by large fiscal deficits and the debt maturity profile—an average of around 5 and 7 years, for domestic and foreign debt, respectively.

[1] Prepared by Kamil Dybczak (FAD).

4. The debt and financing needs projections are particularly sensitive to growth and contingent liability shocks:

- *Growth shock*. Slower growth remains the principal risk to debt sustainability. Assuming a decline in growth by one standard deviation in 2017 and 2018, the debt-to-GDP ratio is forecast to reach above 180 percent of GDP in 2021. Financing needs are projected to reach 37 percent of GDP in 2021 and remain at high levels until the end of the projection horizon.

- *Interest rate shock*. Higher interest rates also pose a significant risk to debt sustainability. A shock to the interest rate results in the debt-to-GDP ratio reaching above 165 percent at the end of the projection horizon. Financing needs are projected to reach 35 percent of GDP in 2021.

- *Macro-fiscal shock*. If shocks to growth, interest rate, and primary balance occurred simultaneously, the debt-to-GDP ratio would exceed 190 percent at the end of the projection horizon. Financing needs would reach 40 percent of GDP and continue growing.

- *Contingent liability shock*. In the absence of contingent liabilities estimates, a standardized shock of 10 percent of financial sector assets is used to represent a hypothetical realization of such contingent liabilities. In such a scenario, the debt-to-GDP ratio would reach 200 percent at the end of the projection horizon. Financing needs would reach 40 percent of GDP in 2021. The large effect reflects the significant size of Lebanon's banking sector. This scenario does not assume any feedback on GDP growth and interest rates due to the contingent liability shock.

5. The fan charts show significant uncertainty around the baseline. The width of the symmetric fan chart, estimated at around 60 percent of GDP, illustrates the degree of uncertainty for equal-probability upside and downside shocks. But in light of the downside risks associated with the Syria crisis, an upside shock to growth is constrained to zero in the asymmetric fan chart, resulting in a more upward-sloping debt path. This reflects a balance of risks skewed to the downside.

6. Lebanon's debt profile reveals weaknesses. External financing needs are well above the upper risk-assessment benchmark and public debt in foreign currency above the lower risk-assessment benchmark. While bond spreads are above the lower risk assessment benchmark, they have been relatively stable in past episodes of stress. Public debt held by nonresidents is estimated to be only slightly above the lower risk assessment benchmark, while the level of, and the change in, short-term debt are below the lower risk assessment benchmarks.

7. Risks to debt sustainability need to be weighed against a number of mitigating factors.

- *Investor base*. Debt is held largely by domestic financial institutions that are tightly regulated in terms of their net open positions and investment strategies. This factor, coupled with relatively low demand for private sector credit and limited regional investment opportunities, has resulted in a captive investor base (although to participate in the recent financial operation domestic banks sold part of their Eurobond holdings to foreign clients). In turn, domestic financial institutions fund their positions from deposits largely held by nonresidents, though recently these have started to decelerate. In addition, a significant share of domestic debt is held by the BdL.

- *Debt financing profile*. The large external financing needs—amounting to almost 170 percent of GDP—reflect payments related to debt but also, to a significant extent, large nonresident short-term deposits. Although debt denominated in foreign currency accounts for about 40 percent of total public debt, it is held mostly by domestic financial institutions.

- *Buffers*. The high level of gross international reserves remains an anchor for investors' confidence. In addition, ample LL liquidity in the economy would point to an excess demand for government papers denominated in LL.

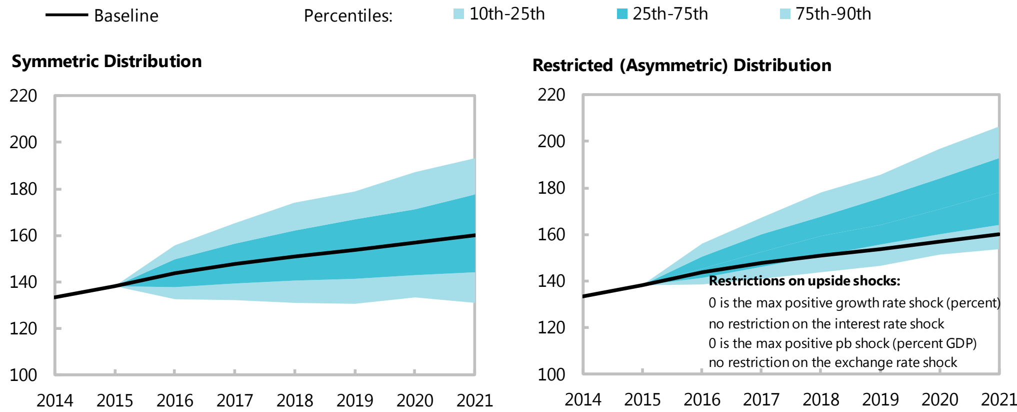
Lebanon Public DSA Risk Assessment

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

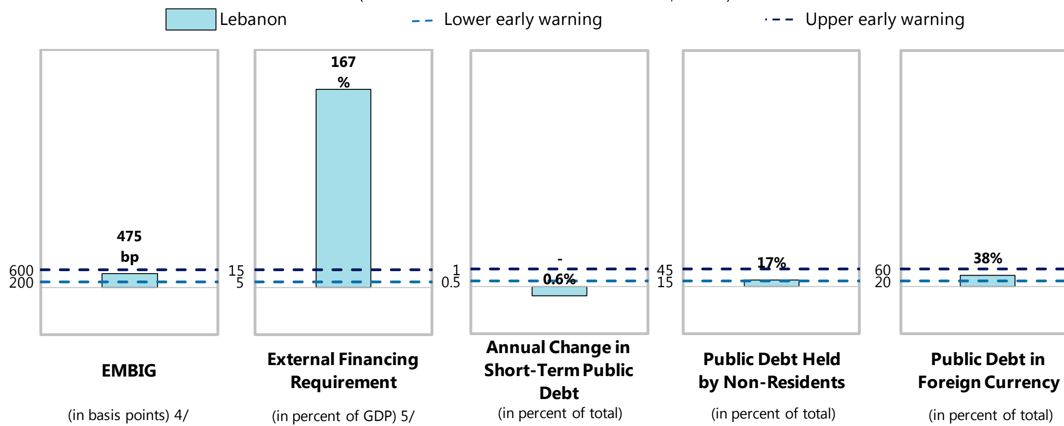
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



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:

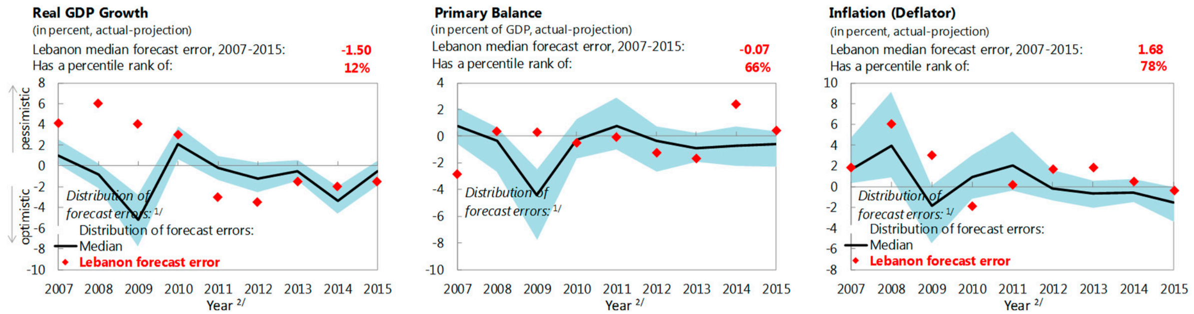
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 8-Jan-16 through 8-Apr-16.

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.

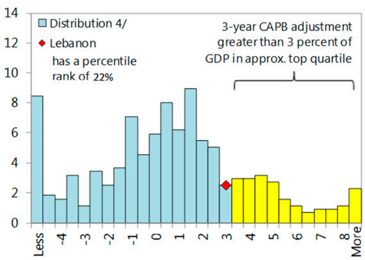
Lebanon Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

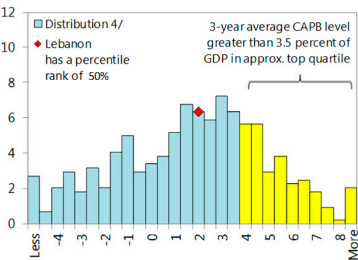


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

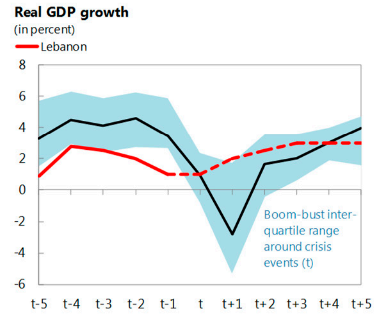


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



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/ Lebanon has had a positive output gap for 3 consecutive years, 2013-2015. For Lebanon, t corresponds to 2016; for the distribution, t corresponds to the first year of the crisis.
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.

Lebanon Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

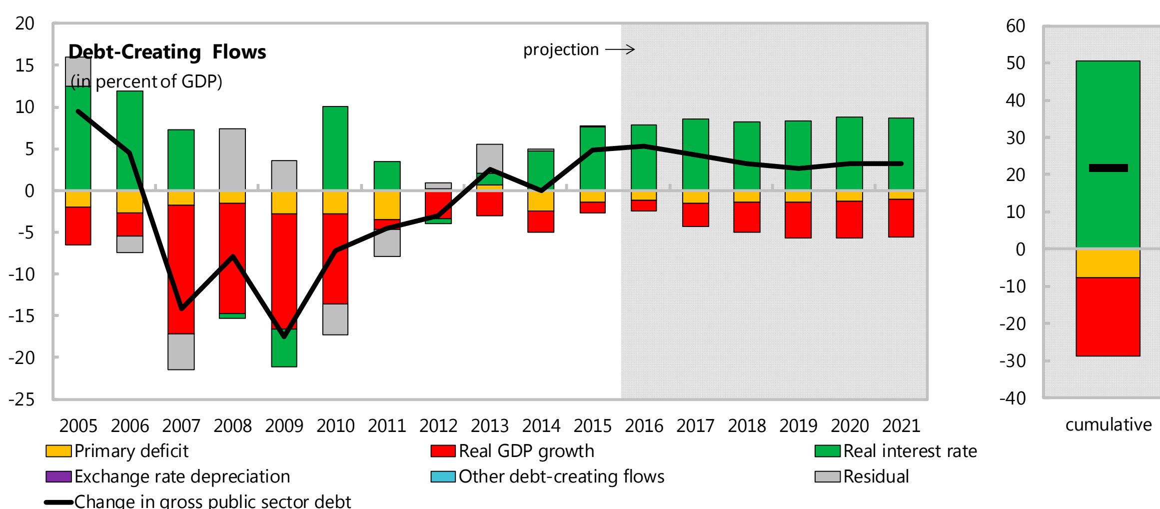
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	153.6	133.4	138.3	143.6	147.9	151.1	153.7	156.9	160.1
Public gross financing needs	46.8	24.2	26.2	29.2	36.7	27.7	21.0	21.8	33.1
Real GDP growth (in percent)	5.3	2.0	1.0	1.0	2.0	2.5	3.0	3.0	3.0
Inflation (GDP deflator, in percent)	4.2	2.8	0.9	0.9	1.0	1.6	1.8	1.7	1.9
Nominal GDP growth (in percent)	9.7	4.8	1.9	1.9	3.0	4.2	4.9	4.8	4.9
Effective interest rate (in percent) [4]	7.3	6.6	6.7	6.7	7.1	7.5	7.7	7.8	7.7

As of February 06, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		442
5Y CDS (bp)		458
Ratings	Foreign	Local
Moody's	B2	B2
S&Ps	B-	B-
Fitch	B	B

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-4.2	0.0	4.9	5.4	4.2	3.2	2.7	3.2	3.2	21.8	
Identified debt-creating flows	-4.8	-0.2	4.9	5.4	4.2	3.2	2.7	3.2	3.2	21.8	
Primary deficit	-1.8	-2.4	-1.4	-1.1	-1.5	-1.4	-1.4	-1.2	-1.0	-7.8	4.2
Primary (noninterest) revenue and gra	23.2	21.8	18.8	19.0	19.0	19.2	19.2	19.2	19.2	114.9	
Primary (noninterest) expenditure	21.4	19.4	17.4	17.8	17.5	17.7	17.8	18.0	18.2	107.1	
Automatic debt dynamics [5]	-3.0	2.2	6.3	6.5	5.7	4.6	4.1	4.4	4.2	29.6	
Interest rate/growth differential [6]	-3.0	2.2	6.3	6.5	5.7	4.6	4.1	4.4	4.2	29.6	
Of which: real interest rate	4.6	4.8	7.6	7.9	8.5	8.2	8.4	8.8	8.7	50.5	
Of which: real GDP growth	-7.6	-2.5	-1.3	-1.4	-2.8	-3.5	-4.3	-4.4	-4.5	-20.9	
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	
Please specify (1) (e.g., drawdown of	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	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]	0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general 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).

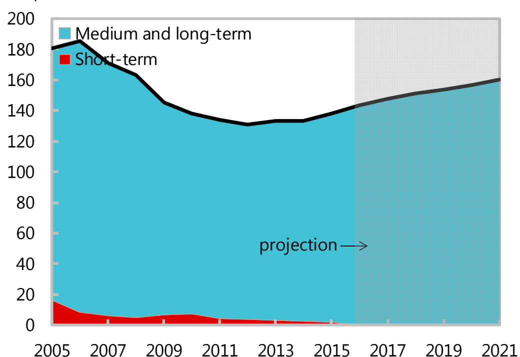
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

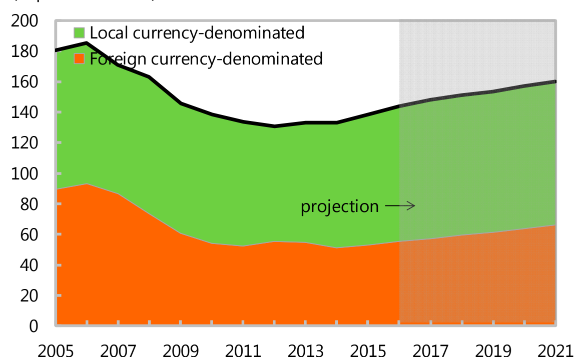
Lebanon Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



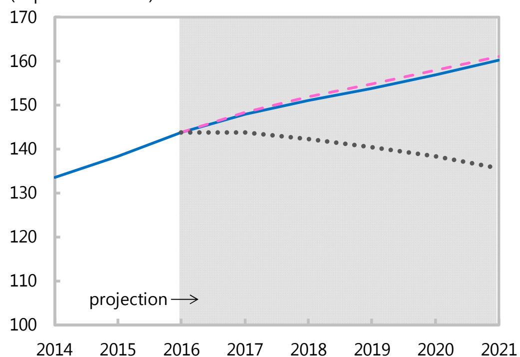
By Currency
(in percent of GDP)



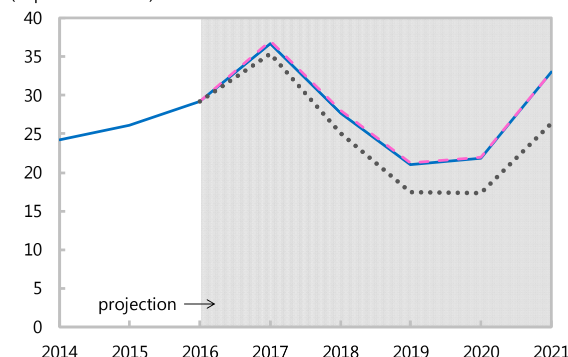
Alternative Scenarios

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)

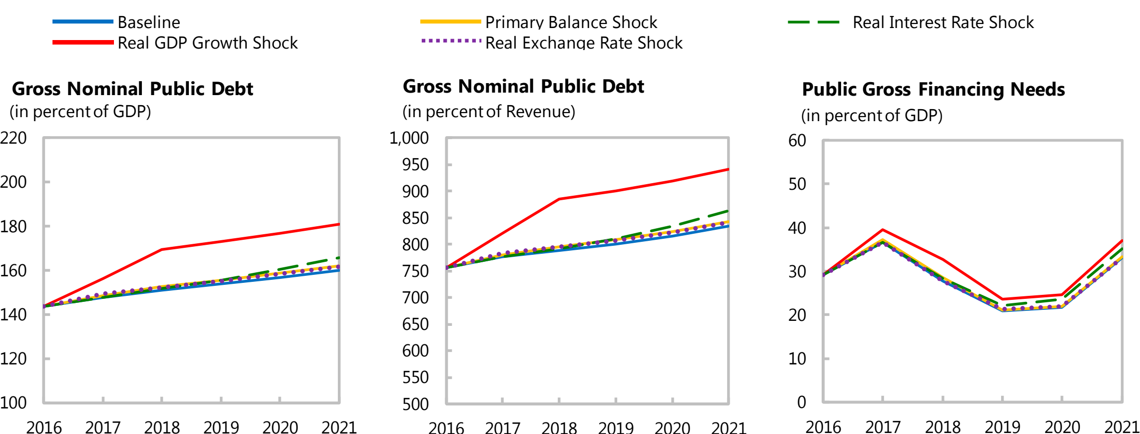
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.0	2.0	2.5	3.0	3.0	3.0
Inflation	0.9	1.0	1.6	1.8	1.7	1.9
Primary Balance	1.1	1.5	1.4	1.4	1.2	1.0
Effective interest rate	6.7	7.1	7.5	7.7	7.8	7.7
Constant Primary Balance Scenario						
Real GDP growth	1.0	2.0	2.5	3.0	3.0	3.0
Inflation	0.9	1.0	1.6	1.8	1.7	1.9
Primary Balance	1.1	1.1	1.1	1.1	1.1	1.1
Effective interest rate	6.7	7.1	7.5	7.7	7.8	7.7

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.0	4.8	4.8	4.8	4.8	4.8
Inflation	0.9	1.0	1.6	1.8	1.7	1.9
Primary Balance	1.1	1.8	1.8	1.8	1.8	1.8
Effective interest rate	6.7	7.1	6.8	6.5	6.3	6.0

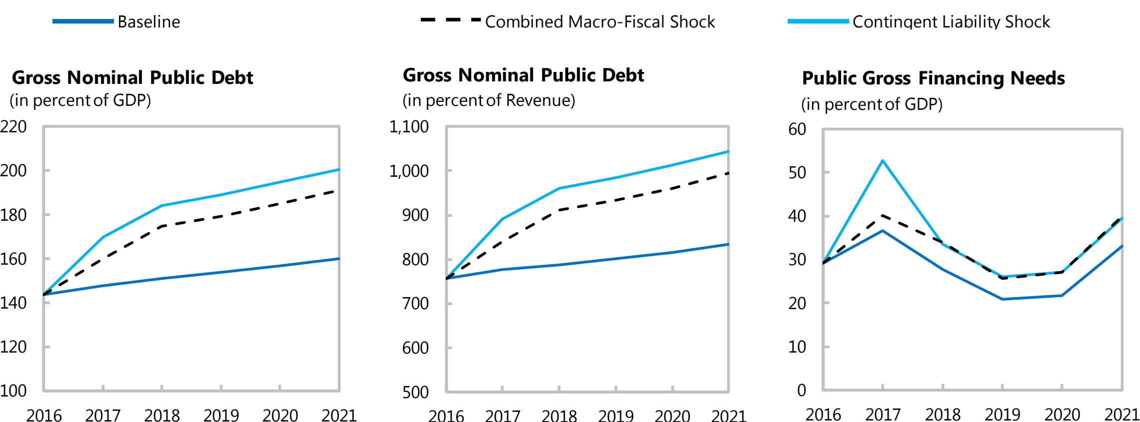
Source: IMF staff.

Lebanon Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

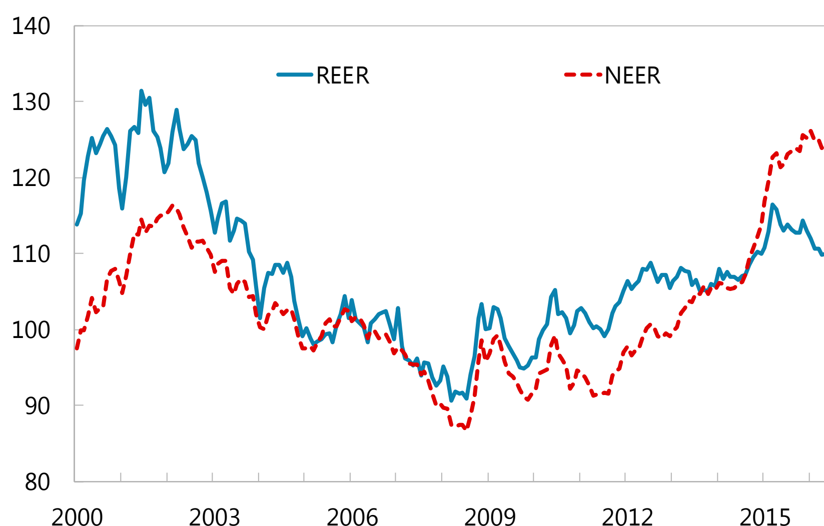
Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.0	2.0	2.5	3.0	3.0	3.0
Inflation	0.9	1.0	1.6	1.8	1.7	1.9
Primary balance	1.1	0.8	0.8	1.4	1.2	1.0
Effective interest rate	6.7	7.1	7.5	7.8	7.8	7.8
Real Interest Rate Shock						
Real GDP growth	1.0	2.0	2.5	3.0	3.0	3.0
Inflation	0.9	1.0	1.6	1.8	1.7	1.9
Primary balance	1.1	1.5	1.4	1.4	1.2	1.0
Effective interest rate	6.7	7.1	8.0	8.5	8.8	9.0
Combined Shock						
Real GDP growth	1.0	-1.9	-1.4	3.0	3.0	3.0
Inflation	0.9	0.0	0.7	1.8	1.7	1.9
Primary balance	1.1	0.6	-0.4	1.4	1.2	1.0
Effective interest rate	6.7	7.3	7.9	8.5	8.8	9.0

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.0	-1.9	-1.4	3.0	3.0	3.0
Inflation	0.9	0.0	0.7	1.8	1.7	1.9
Primary balance	1.1	0.6	-0.4	1.4	1.2	1.0
Effective interest rate	6.7	7.1	7.5	7.8	7.9	7.8
Real Exchange Rate Shock						
Real GDP growth	1.0	2.0	2.5	3.0	3.0	3.0
Inflation	0.9	2.7	1.6	1.8	1.7	1.9
Primary balance	1.1	1.5	1.4	1.4	1.2	1.0
Effective interest rate	6.7	7.3	7.4	7.7	7.8	7.7
Contingent Liability Shock						
Real GDP growth	1.0	-1.9	-1.4	3.0	3.0	3.0
Inflation	0.9	0.0	0.7	1.8	1.7	1.9
Primary balance	1.1	-12.4	1.4	1.4	1.2	1.0
Effective interest rate	6.7	7.4	8.5	8.6	8.6	8.5

Source: IMF staff.

Annex III. External Sector Assessment

1. In a continuation of last year's trend, the nominal effective exchange rate (NEER) has appreciated while the real effective exchange rate (REER) has depreciated marginally and returned to its end-2014 level. The appreciation of the NEER reflects largely the appreciation of the U.S. dollar vis-à-vis the euro. In contrast, the CPI inflation differential has declined as the drop in oil price has passed through to domestic prices, leading to a more muted behavior of the REER.



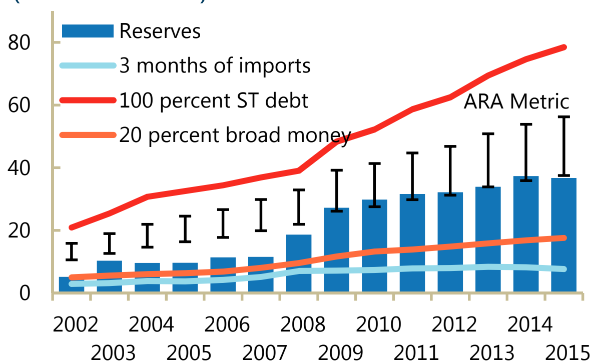
2. The current account deficit has decreased but remains large, while data quality remains problematic. Lebanon has sustained large current account deficits by international standards for almost a decade; the deficit widened notably in the wake of the Syrian crisis (by an average of 10 percent of GDP). However, errors and omissions also increased substantially during the same period (by an average of 9 percent of GDP) pointing to the presence of the large unrecorded inflows (overstated outflows). Moreover, data revisions in the last few years have been frequent and large in magnitude. As presented in the 2015 Article IV report, the current account deficit for 2012 was revised from 11.7 percent to 24.6 percent within a year. At the moment, revisions from 2014 onwards are likely, though their magnitude and sign remain uncertain. Preliminary data has led to sharp revision of some series, such as errors and omission, but has not been confirmed yet. We estimate current account deficit to be 17.5 percent of GDP in 2016.

3. The improvement in the goods trade balance reflects the substantial decline in oil prices. Oil imports account for approximately 20 percent of Lebanon total imports. In 2015, the import bill decreased by about $1.9bn or about 4 percent of GDP. As a result, the current account balance deficit also narrowed, and is expected to continue to do so in the medium term, as external demand increases at a faster pace than the gradual increase in oil prices. This forecast assumes that Lebanon would be able to finance its large external deficit, have a gradual adjustment, and avoid a drastic current account reversal through import compression.

4. The EBA-lite methodology[1] shows mixed results. According to the current account (CA) approach, the exchange rate is overvalued by 23 percent, reflecting a CA norm[2] of 13.2 percent of GDP. On the other hand, the REER is at equilibrium according to the REER approach. Given the large uncertainty about the actual size of the CA deficit, it is possible that the actual misalignment is lower than the one reflected by the CA approach. The EBA-lite methodology suggests some overvaluation of the exchange rate. Yet, the ability of this methodology to capture deviations from equilibrium could be compromised in an environment facing a temporary but protracted shock as the Syrian crisis.

5. Reserve coverage is adequate according to the ARA metric.[3] The metric is constructed to capture the reserve coverage against potential sources of drain on reserves. Based on historical and cross-country experience, a coverage in the range of 100–150 of the metric is considered adequate. In the case of Lebanon, reserve coverage has been within this range since 2009—with a small deviation by end-2015. Most of short-term debt, weighted at 30 percent, is in the form of short-term deposits of non-residents.

Reserve Adequacy 2002-15
(In USD billions)



Sources: National authorities, and IMF staff calculations.

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[1] See http://www.imf.org/external/np/pp/eng/2016/020516.pdf.

[2] The CA norm is the level of current account that is in line with fundamentals and desirable policy levels. See reference in previous footnote for more details.

[3] For details on the ARA metric, please refer to: http://www.imf.org/external/np/pp/eng/2011/021411b.pdf,

Annex IV. External Debt Sustainability Analysis

1. Lebanon's external debt remained elevated at 175 percent of GDP as of end-2015, and is projected to keep increasing before declining in 2021. The high debt level reflects the sizable current account deficit and the large stock of non-resident deposits (largely with short-term maturity). Under the baseline, external debt is projected to pick at 180 percent of GDP in 2017 and decline slightly to 175 percent of GDP in 2021. The slight decline is explained by the reduction in the current account deficit and in the growth rate of non-resident deposits, while GDP growth is forecast to increase.

2. The scenarios reflect Lebanon's sensitivity to exchange rate movements. Out of all the scenarios, a real depreciation of 30 percent represents the most severe one, leading to an increase of external debt to 253 percent of GDP. The sensitivity of the debt dynamics to this shock highlights the importance of the exchange rate peg to maintain macroeconomic and financial stability in Lebanon. Debt dynamics are also sensitive to other shocks, though depending on their size, the impact would be less severe.[1] For instance, by 2021 debt would increase to 180 percent of GDP under a permanent shock to the interest rate, to 190 percent of GDP under a growth shock, and to 198 percent of GDP under a shock to the non-interest current account balance.

[1] The bound tests are based on ½ standard deviation shocks calculated on 10-year historical data (see charts).

Table 1. Country: External Debt Sustainability Framework, 2011-2021

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2011	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	169.2	163.9	167.1	170.0	174.7			**179.0**	**180**	**179.2**	**177.5**	**176.4**	**174.8**	**-1.6**
2 Change in external debt	6.1	-5.3	3.3	2.8	4.8			4.3	1.1	-0.9	-1.7	-1.1	-1.7	
3 Identified external debt-creating flows (4+8+9)	5.0	7.1	11.1	14.4	13.2			13.7	11.9	11.0	10.2	9.6	8.9	
4 Current account deficit, excluding interest payments	10.2	19.3	21.4	19.6	12.3			12.1	11.5	10.3	8.9	7.9	7.2	
5 Deficit in balance of goods and services	18.7	25.3	26.4	27.0	21.5			22.5	23.7	23.0	22.0	21.3	20.5	
6 Exports	59.7	46.8	43.9	38.6	38.8			39.0	40.2	40.6	41.4	42.1	42.5	
7 Imports	78.5	72.1	70.3	65.5	60.3			61.5	63.9	63.6	63.4	63.3	63.0	
8 Net non-debt creating capital inflows (negative)	-1.8	-1.3	-2.7	-3.2	-2.0			-2.1	-2.1	-1.7	-1.4	-1.3	-1.2	
9 Automatic debt dynamics 1/	-3.4	-10.9	-7.6	-2.0	2.9			3.7	2.4	2.5	2.7	2.9	2.9	
10 Contribution from nominal interest rate	5.0	4.6	4.5	5.7	5.9			5.4	5.9	6.8	7.8	8.0	8.0	
11 Contribution from real GDP growth	-1.4	-4.3	-3.8	-3.2	-1.7			-1.7	-3.5	-4.3	-5.1	-5.1	-5.0	
12 Contribution from price and exchange rate changes 2/	-7.0	-11.1	-8.2	-4.6	-1.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	1.2	-12.4	-7.8	-11.6	-8.4			-9.4	-10.8	-11.9	-11.9	-10.6	-10.5	
External debt-to-exports ratio (in percent)	283.3	350.4	380.8	440.4	449.9			459.0	448.5	441.0	428.9	419.3	411.1	
Gross external financing need (in billions of US dollars) 4/	59.5	70.0	75.5	82.9	84.6			88.4	91.6	94.3	98.0	101.5	104.8	
in percent of GDP	148.5	158.7	158.7	166.1	166.5	10-Year	10-Year	170.6	171.6	169.5	168.0	166.2	163.5	
Scenario with key variables at their historical averages 5/								**179.0**	**168.5**	**159.1**	**150.6**	**143.7**	**137.6**	**-10.0**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	0.9	2.8	2.5	2.0	1.0	4.8	3.9	1.0	2.0	2.5	3.0	3.0	3.0	
GDP deflator in US dollars (change in percent)	4.5	7.0	5.3	2.8	0.8	4.2	3.4	1.0	1.0	1.7	1.8	1.7	1.9	
Nominal external interest rate (in percent)	3.2	3.0	3.0	3.6	3.5	4.0	1.1	3.2	3.4	3.9	4.6	4.7	4.7	
Growth of exports (US dollar terms, in percent)	17.7	-13.8	1.3	-7.8	2.4	7.0	17.8	2.4	6.0	5.5	6.8	6.5	6.0	
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	-10.2	-19.3	-21.4	-19.6	-12.3	-10.0	9.3	-12.1	-11.5	-10.3	-8.9	-7.9	-7.2	
Net non-debt creating capital inflows	1.8	1.3	2.7	3.2	2.0	3.4	1.5	2.1	2.1	1.7	1.4	1.3	1.2	

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).

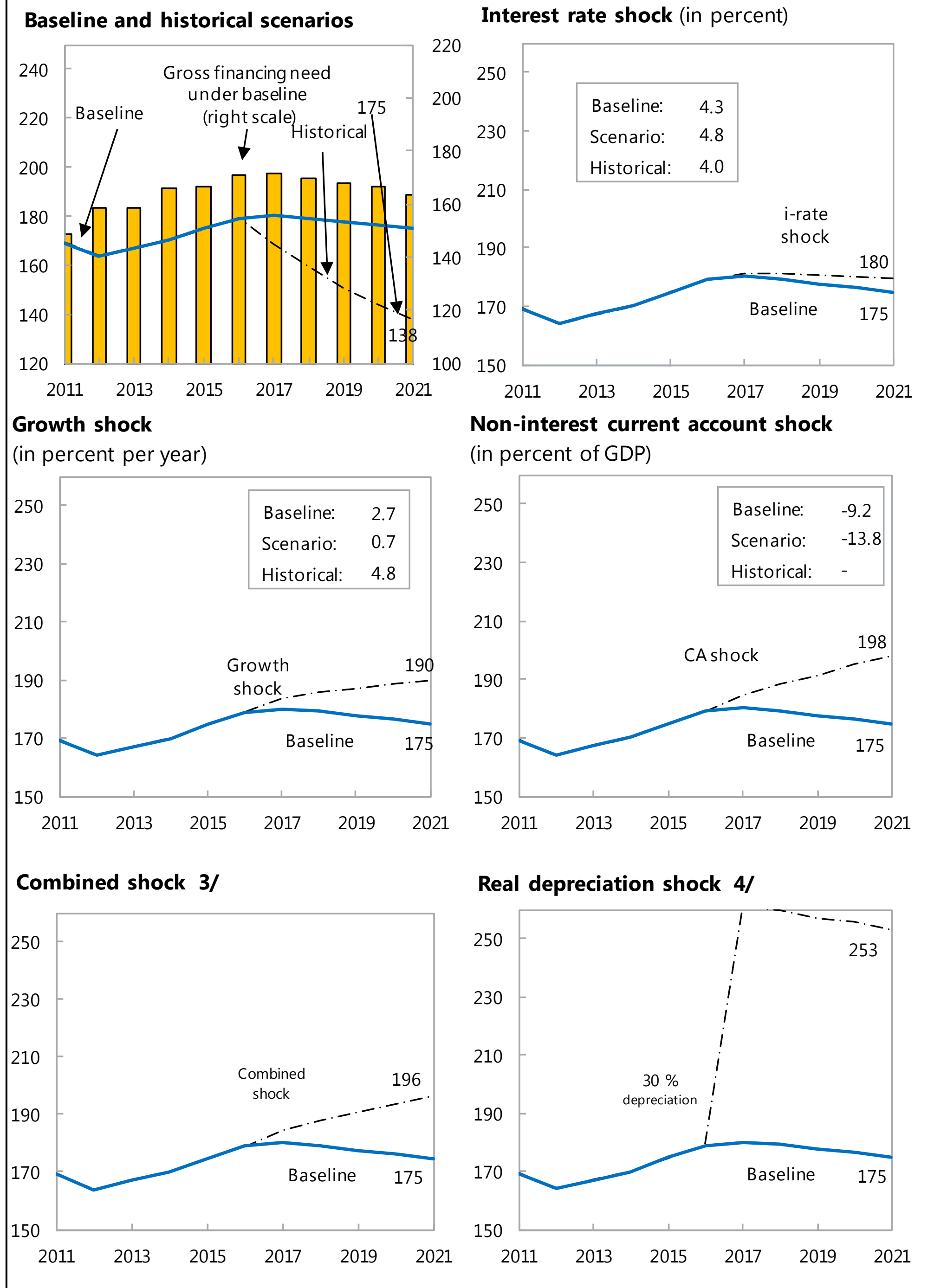
3/ For projection, line includes the impact of price and exchange rate changes.

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. Country: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. 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 2010.

INTERNATIONAL MONETARY FUND

LEBANON

November 28, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | The Middle East and Central Asia Department (In consultation with other departments)

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FUND RELATIONS

(As of October 31, 2016)

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	192.34	99.51

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 exchange arrangement, which maintains a *de-facto* peg to the U.S. dollar, 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 2015 Article IV Consultation was concluded by the Executive Board on June 26, 2015. At the time, Directors commended the authorities for preserving macroeconomic stability and market confidence despite the unprecedented humanitarian and economic spillovers from the conflict in Syria, including a daunting inflow of refugees which has taken a toll on public finances, infrastructures, and the social fabric. They called on the international community to provide greater humanitarian and development assistance to Lebanon and encouraged the authorities to further strengthen confidence and secure more inclusive growth by implementing priority fiscal and structural reforms promptly. Directors stressed that a sustained fiscal adjustment is essential without which the public debt ratio will continue to rise and add to existing vulnerabilities. They also stressed the urgent need to reform the electricity sector to remove a large drain on the public finances. They commended the central bank for supporting macroeconomic stability and maintaining adequate international reserves and agreed that monetary policy should remain geared to supporting the U.S. dollar peg. They commended the authorities' close oversight of the financial system, and stressed the need for continued vigilance and efforts to strengthen the regulatory framework. Directors welcomed the authorities' recent request for an update assessment under the Financial Sector Assessment Program. They underscored the need to advance structural reforms to promote job creation and improve competitiveness and encouraged the authorities to improve Lebanon's statistical system, building on ongoing progress.

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 (to be issued).

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—In recent years, the Fiscal Affairs Department (FAD) has provided assistance on the tax regime and revenue administration of oil and gas resources, tax gap analysis for the Value Added Tax (VAT), strengthening the performance of the Large Taxpayers' Office (LTO) and VAT Directorate, PFM reform, the budget system law, public accounting; while METAC continued to provide TA on capacity building for the macro fiscal unit, public accounting, tax and PFM reform. In 2016, METAC carried out a TA mission on major fiscal risks and their potential impact on the budget.

Financial area—The Monetary and Capital Markets Department (MCM) has provided TA mainly on the techniques of stress testing in a forward-looking perspective, the implementation of a risk-based supervision (RBS) manual and enhancement of on-site examination procedures.

Statistical area—The Statistics Department has provided TA in national accounts, price statistics compilation and balance of payments. Several missions on the consumer price index (CPI) were undertaken, and workshops on price compilation issues and a national accounts statistics mission were conducted in 2016. METAC has been providing assistance on national accounts.

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 2017.**[1] The teams agreed that Lebanon is in the midst of a protracted period of low growth. There is no substitute to fiscal consolidation as only decisive fiscal action can put the debt on a sustained downward path and reduce Lebanon's reliance on external funding—particularly in light of easing deposit growth in the past couple of years. Given the constrained and uncertain environment, Lebanon should adopt a number of immediate measures to anchor confidence. These include restoring fiscal sustainability, anchoring financial stability and promoting sustainable and inclusive growth. Finally, pending fiscal laws need to be swiftly passed.

2. **Based on this shared assessment, the teams identified the following structural reform areas as macrocritical,** in view of their central role in achieving fiscal consolidation in the short run and job-rich and sustained growth over the medium term:

- **Implementation of long-standing revenue measures.** These include: (i) an increase in the corporate income tax rate (from 15 to 17 percent); (ii) introduction of a capital gains tax on real estate; (iii) an increase in the rate on interest income tax (from 5 to 7 percent, though timing may depend on deposit behavior); (iv) an increase in the VAT rate from 10 to at least 11 percent, while broadening its base and strengthening compliance; (v) an increase in tobacco excises; and (vi) new stamp duties and fees.

- **Increase of fuel taxation.** Low retail prices provide a unique opportunity to do so. At a minimum, the VAT on diesel should be restored and gasoline excises should be increased to earlier levels and shifted to ad valorem rates to preserve collections over time, also to start containing negative externalities of high fuel consumption.

- **Recalibrating of electricity tariffs.** Current proposals to link higher tariffs to the addition of new capacity are welcome, as they should allow for an improvement in service without worsening the fiscal situation even further. But these should be considered as a first step only. Improved service from EdL should help reduce the average household energy bill, and so provide scope for further increases in the future, with the ultimate goal of eliminating the EdL subsidy altogether. At the same time, lower-end consumers should be protected.

- **Strengthening of the National Poverty Targeting Program**. This is an essential part of Lebanon's nascent social safety net, and provides support to households living in extreme poverty. The program is funded in part by grants from the World Bank and UNDP, but a proposal for additional funding is currently waiting for ministry of finance's approval. This funding should be approved as a matter of priority.

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[1] The IMF team was led by Ms. Annalisa Fedelino (mission chief) and the World Bank team by Mr. Ferid Belhaj (Country Director).

- **Tapping into the knowledge economy as a promising source of growth.** All stakeholders need to work together to create a conducive institutional and business climate and strengthen the country's infrastructure. On the financing side, more focus is needed on the seed financing stage. In this context, finalizing and implementing capital market regulation, and preparation and adoption of a capital market development plan will also help.

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

- **Fiscal reform.** The Fund is providing capacity building on fiscal regimes and revenue administration for the oil and gas sector. It is also providing analytical advice and TA on (i) capacity building for the macro-fiscal department, in collaboration with the World Bank; (ii) improving the transparency and accountability of public accounts; (iii) modeling compliance in income tax; and (iv) promoting the use of indirect audit techniques.

- **Electricity sector reform.** There has been little progress in implementing electricity sector plans over the past 5 years, owing to ongoing political disagreements. Consequently, the Bank has suspended its engagement in this area, pending a renewed consensus to move forward. Indeed, the Bank's current Country Partnership Framework (2017-20) has no has no significant financing plans in the electricity sector.

- **The National Poverty Targeting Program:** The Bank will continue to strengthen the National Poverty Targeting Program. The Bank and donors scaled-up the successful e-card food voucher program after the Syrian crisis. In addition, a pilot graduation program will be introduced for selected beneficiaries to improve their employability.

- **The knowledge economy:** The Fund met various stakeholders in the knowledge economy ecosystem and prepared analytical work with cross country comparisons on the topic. The Bank is moving forward with its TA on the development of the capital market.

- **Reform of the statistical system:** The Fund will continue to provide 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 2016–17.

Lebanon—Bank and Fund Planned Activities in Macrocritical Structural Reform Areas			
Title	**Products**	**Provisional Timing of Missions**	**Expected Delivery Date**
1. Bank Work Program			
IBRD Lending Program	Education Development Project II ($40 m)	Ongoing	12/31/2017
	Greater Beirut Water Supply ($200 m)	Ongoing	06/30/2019
	Supporting Innovation in SMEs ($30 m)	Ongoing	06/30/2018
	RACE Support Project ($100 m IDA + $4 m Grant)	Pending Effectiveness	02/28/2023
Grants/Trust Funds	Second Emergency Social Protection Imp. Support 2 ($6.6m – Special Funding)	Ongoing	12/31/2016
	Emergency National Poverty Targeting Project ($8.2 m / Lebanon Trust Fund/LTF + $10 m /Lebanon Syrian Crisis Trust Fund/LSCTF)	Ongoing	12/31/2017
	Emergency Education System Stabilization ($32 m – LSCTF)	Ongoing	11/30/2018
	Emergency Primary Healthcare Restoration ($15 m – LSCTF)	Ongoing	12/30/2018
Technical Assistance/ Economic & Sector Work	Lebanon Capital Markets Regulation & Development	Ongoing	03/31/2017
	MSME TA - Lebanon MSME TA Facility	Ongoing	03/31/2017
	Hydropower development in Lebanon	Ongoing	05/31/2017
	Financial Sector Assessment Program (FSAP) Update	Ongoing	11/30/2016
	Financial Sector Assessment Program (FSAP) follow up	Ongoing	06/30/2017
	PPP Diagnostic and SEZ Advisory Technical Assistance	Ongoing	08/25/2017
	Subsidized Temporary Employment Program	Ongoing	06/17/2019

Lebanon—Bank and Fund Planned Activities in Macrocritical Structural Reform Areas (concluded)			
Title	**Products**	**Provisional Timing of Missions**	**Expected Delivery Date**
2. Fund Work Program	**Article IV Consultation Staff Report**	**2016**	**2016**
	TA on:		
	➢ Public Accounting	Ongoing	2017
	➢ Public Financial Management Reform	Ongoing	2017
	➢ Budget System Law	Ongoing	2017
	➢ Statistics (National Accounts, CPI, IIP)	Ongoing	2017
	➢ Further enhance the supervisory framework and implement Risk Based Supervision	Ongoing	2017
	➢ Build the capacity of the BCCL supervisors to efficiently supervise and assess banking risks	Ongoing	2017
	➢ Oil and Gas Taxation and Revenue Administration	Ongoing	2016
	➢ VAT Gap Analysis	Completed	2016
	FSAP Update	Completed	
3. Joint Work Program	FSAP	Completed	

STATISTICAL ISSUES

Lebanon—Statistical Issues Appendix As of November 2016
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 2013, with significant delays in the publication of 2014 national accounts. There are plans to start publishing quarterly data; however, the priority should be to improve the annual estimates before developing quarterly ones. 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, 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.
Price statistics: A new 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 January 2016 CPI was adversely impacted after the prime minister's office refused to approve the contractual data collectors and the CAS was required to rely only on the permanent data collection staff for the collection of prices. While data collection activities have returned to normal, the use of the permanent data collection staff has increased costs significantly. 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. 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 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 2016, data was reported based on GFS 2014.

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, and its reporting practices are not fully compliant with the International Financial Reporting Standards (IFRS). The lack of a reliable classification of deposits by residency (also due to bank secrecy) complicates 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). Data is subject to frequent and very large revisions that hamper accurate assessment of the external sector position of Lebanon. A Foreign Direct Investment (FDI) survey is currently in progress. 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 2015 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	11/3/16	11/3/16	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	9/30/16	11/1/16	M	M	M
Reserve/Base Money	9/30/16	11/1/16	M	M	M
Broad Money	9/30/16	11/1/16	W/M	W/M	M
Central Bank Balance Sheet	9/30/16	11/1/16	M	M	M
Consolidated Balance Sheet of the Banking System	9/30/16	11/1/16	M	M	M
Interest Rates[2]	10/28/16	10/31/16	W/M	W/M	W/M
Consumer Price Index	9/30/16	10/21/16	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	6/30/16	31/10/16	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	9/30/2016	11/2/2016	M	M	M
External Current Account Balance	3/31/16	10/6/2016	Q	Q	Q
Exports and Imports of Goods and Services	3/31/16	10/6/2016	Q	Q	Q
GDP/GNP	12/31/13	12/11/14	A	A	A
Gross External Debt	9/30/2016	11/2/2016	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 Hazem Beblawi, Executive Director for Lebanon and Sami Geadah, Alternate Executive Director
December 12, 2016

Lebanon has been facing a number of major challenges associated with the crisis in neighboring Syria. There has been a massive influx of refugees which are now estimated at about one third of the population, trade routes have been disrupted, and the crisis has exacerbated domestic political frictions and left Lebanon without a president for 2½ years. These developments have undermined consumer and business confidence and led to a significant decline in trade, tourism, and construction.

The economy has performed remarkably well in view of these challenges. Macroeconomic stability has been maintained, which was underpinned by responsible economic and financial policies and by keeping security conditions from deteriorating. While growth has been adversely affected by the Syrian crisis (the World Bank estimated that it lowered Lebanon's annual GDP growth by an average of 2.9 percentage points), growth remained positive and is estimated in the range of 1-2 percent in 2016. The World Bank's latest estimate for growth is 1.5-2 percent in 2016.

There are a few additional indicators that have come available since the publication of the staff report: inflation was 1.1 percent in the year ending in October 2016; and deposit inflows increased by 6 percent in the year ending in September 2016, and remain more than sufficient to fund the economy. Real estate prices have been resilient, and the stock market rose sharply with the renewed sense of optimism immediately following the presidential election. This rise came after S&P revised Lebanon's outlook from negative to stable in September 2016 despite the political deadlock at the time.

The authorities agree with the need for fiscal consolidation, the importance of maintaining financial stability, and with the necessity of structural reforms. While the central bank has deftly implemented policies that preserved financial stability and supported growth, and the government has been successful in keeping the fiscal position from deteriorating further, the recent election of a president and the forthcoming formation of a government bode well for an economic recovery and for the implementation of fiscal and structural reforms.
As the authorities are in broad agreement with the findings and conclusions of the Article IV staff report and the FSSA, we will provide some additional perspective on a few issues.

The Syrian crisis

The Syrian crisis has had a profound impact on Lebanon. The massive number of refugees—both in number and relative to Lebanon's population—has few, if any, international parallels as noted in the Selected Issues Paper on the Syrian refugee crisis. As also noted, Lebanon's

response so far is a testament to its generosity and resilience, but the country cannot be expected to bear this burden on its own. The influx of refugees has drained public resources, strained infrastructure, lowered the quality of public services, worsened poverty and unemployment, and led to political and social tensions.

The international community has recognized that Lebanon is providing a global public good in hosting the Syrian refugees. Several conferences have pledged to help Lebanon support refugees and host communities. The conference that was held in London in February 2016 raised over US$11 billion in pledges for the region, in addition to announcements of up to US$41 billion in new loans from multilateral development banks and donors. Notwithstanding public announcements of support from the international community, few of these pledges have materialized and the donor response has so far been described as uncertain.

The Fund has also recognized the need to support countries facing large refugee inflows. The IMFC Communiqué of October 2016 calls on the Fund to "strengthen analysis and support for countries managing spillovers from non-economic sources, such as large refugee flows and global epidemics." We look forward to initiatives in this regard, which do not seem to have been reflected in the Fund's Work Program.

Macroeconomic policies

The authorities recognize the need for fiscal consolidation. After successfully lowering the ratio of public debt to GDP by over 50 percentage points from a peak of 185 percent in 2006, this ratio started to increase again. The main contributor to this turnaround has been the slowdown in growth that is associated with the Syrian crisis. The crisis has also had a direct effect on public finances, estimated by the World Bank at 1¾ of GDP per annum over 2012-2014. This estimate—which may have increased since then—roughly corresponds to the rise in public debt. The authorities accordingly keep reiterating the need for the international community to provide additional assistance, including direct budget support.

The authorities are hopeful that the formation of a new government following the recent election of a president will facilitate the adoption of fiscal reforms, which have been hampered by political impasse in recent years. Nevertheless, the authorities have managed to undertake measures to strengthen public finances, notably through efforts to improve tax collections. It should be noted that the lack of parliamentary approval of the budget has not undermined fiscal discipline. The Ministry of Finance issues spending limits to line ministries that cannot be exceeded, and budgets have to be approved by the Cabinet. Any additional spending initiatives need to be matched by new revenue measures. This process has helped the government achieve fiscal primary surpluses.

With the scope for fiscal manoeuver compromised by political impasse (which has started to ease with the election of a President and appointment of a Prime Minister), the central bank has played an important role in maintaining macroeconomic and financial stability and in supporting growth. In late 2016, it resorted to nonconventional policies in a financial operation that bolstered its foreign exchange reserves, strengthened bank capital, lowered the government's borrowing cost, and provided liquidity for domestic lending.

The Financial system

Lebanon has maintained financial stability despite a series of extreme events. Financial stability was preserved throughout the civil war (1975-1990), foreign occupation (1980-1992), political assassinations (including Prime Minister Hariri in 2005), a war that destroyed considerable infrastructure (2006), the failure to elect a President (2014-2016), and protracted political disagreements. Many of these events could be considered as tail events in stress tests. Lebanon had only one financial crisis in its modern history, in 1966, which provided the authorities with important lessons and heightened their awareness to the dangers of financial instability. The importance that all political parties attach to the stability and resilience of the financial system was reflected in their readiness to hold an extraordinary parliamentary session to adoption of key legislative initiatives related to the financial system in 2015, at a time when parliament was not convening because of disagreements related to the election of a President.

The authorities' interest in preserving this stability—and their confidence in the resilience of the system and its supervision—is also reflected in the request for an FSAP during a very challenging period. As noted in the staff report and in the FSSA, besides the massive influx of refugees, low growth, domestic political impasse, there was also a slowdown in capital inflows and an increasing threat of a disruption in correspondent bank relationships.

The authorities welcome the FSAP findings, which confirmed the resilience of the financial system and its effective supervision. While they also welcomed the staff recommendations for further strengthening and developing the system, the authorities were surprised by the suggestion to remove bank secrecy, especially as the staff recognize that bank secrecy has not impeded supervision, nor has it prevented the authorities from lifting secrecy on AML/CFT grounds. Moreover, the central bank and the Special Investigative Commission have proven agile in dealing with suspicious accounts, have complied with TF related targeted financial sanctions, and have not hesitated from requiring banks to close accounts with suspicious activities. Lebanon was assessed as fully compliant with AML/CFT rules in the latest assessment by the Financial Action Task Force (FATF) and MENA FATF. The authorities are keenly aware of the importance of the integrity of the banking system and of the need to maintain confidence in it.