IMF's Crystal Ball

What it saw, didn't see, and when

Critical reading of Article IV Consultation Reports on Lebanon

2011-2019

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~~Six~~ Five IMF reports on Lebanon 2011-2019

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Since the flare up of the multiple crises, and even before that, a lot has been analyzed and written regarding the behavior, actions, and transgressions of actors in the fiscal and financial sectors. However, almost nothing has been mentioned on what the IMF had to say since 2011, the start of the economic decline.

The IMF has been keeping a watchful eye on the economy's regress, and the accompanying decay in trust, decline in the real value of the national currency, a shaky balance at the Central Bank, challenges to the banking system, the fiscal fiasco, and the totally irresponsible destructive governance at many levels of authority.

Following each mission, dubbed Article IV Consultation, the IMF issued a comprehensive report assessing areas of strengths and weaknesses, highlighting opportunities for reform, and warning of flaws in the system. The IMF conducted six missions since 2011 but published only five reports. One contentious report (2018) was hidden from the public, a collusion between the local authorities and the Fund. It is now public knowledge what the controversy was all about.

At a time when 'fair' distribution of financial losses is being debated, and 'fair' determination of responsibilities being called for, it should be pertinent to review what this institution has been saying all along, what it saw, didn't see, and when. This is especially true on the eve of the start of advanced discussions, and perhaps negotiations, between the government and the Fund.

Observers, who are not privy to scrutiny of government affairs as granted to the IMF, had long articulated the same misgivings on how the economy was being mismanaged. But the IMF did not go further. Like most observers, it did not foresee an imminent apocalypse, or what has been hidden in plain sight.

Shouldn't the IMF also share in shouldering part of the responsibilities? Before placing the IMF on a pedestal or demonizing it, an examination of the record of that organization in regards to Lebanon would also be useful, in order to evaluate its recommendations, and hopefully negotiate with it the best deal possible.

Content

Executive Summary

The International Monetary Fund (IMF) has published over the years, at the request of the Lebanese government, periodic reports on the economic, fiscal, and monetary conditions of the country, and also about the health of its financial sector. Typically, the IMF sends a mission to Lebanon which issues a fact finding and recommendation report called 'Article IV Consultation'. Usually, the published report reflects the findings of a mission conducted the previous year.

A review of the Article IV Consultation reports about Lebanon published by the IMF over the 2011-2019 period shows that the Fund's crystal ball was not functioning properly all the time. The IMF did not foresee the imminent collapse of the financial system. It had never uncovered that a large portion of the dollars at the Central Bank and the financial sector were in fact inexistent, and that they were instead a local artifact created by an internal mechanism not supported or covered by existing real funds. On the other hand, the IMF has been prescient on the damaging effects of the continuously growing debt as well as the budget deficit and negative balance in the Current Account. In each of its reports, it lamented the absence of serious reforms, especially in the fiscal and electricity sectors. It was early in detecting the havoc wrecked on the economy by the spillover of the Syrian crisis. The IMF also said that vision was blurred by the weak statistics available and called for strengthening the production of official data.

The Central Bank

In each report, and as late as its latest 2019 report, the IMF was commending BDL for maintaining financial stability while emphasizing its need to rebuild financial strength. The Fund has continuously lauded the ability of the Central Bank to attract deposit inflows, and was specific in noting that these funds will be channeled to finance the public deficit while at the same time it was calling for curtailing the government's dependence on BDL's lending and recommending the gradual phase out of exemptions from mandatory foreign currency reserves.

The IMF didn't foresee the huge losses at the Central bank and the financial sector although it had hinted that a fall in confidence and an economic and financial crisis could happen due to the high vulnerability of the economy and the financial system.

Peg and lira valuation

The IMF extolled the exchange rate peg as a lynchpin of stability and was constantly supportive of it although it knew that the real effective exchange rate was increasingly becoming overvalued over the years. It advised the authorities that monetary policy needs to remain geared to supporting the peg which must be backed by strengthening competitiveness and maintaining adequate foreign exchange reserves. The IMF saw that continued deposit inflows provided credibility to the peg.

Borrowing in FX

The Fund welcomed Parliament's approval of public borrowing in foreign currencies. It said that foreign currency borrowing reduces the government's reliance on BDL reserves and enables it to tap the banks' ample foreign exchange liquidity and benefit from low interest rates on the global market.

Interest rates

The IMF was encouraging higher interest rates and foreign currency borrowing despite the fact that the main funding sources were erratic deposit inflows. It supported increasing interest rates instead of resorting to financial engineering.

Financial Engineering

The Fund said that BDL has skillfully maintained financial stability in difficult circumstances, often with unconventional measures. It said that BDL's several financial engineering operations carried out starting in 2016 has successfully bolstered its foreign exchange reserves, supported the peg, strengthened bank capital, lowered the government's borrowing cost, and provided liquidity for domestic lending. It advised against the immediate cessation of these operations as this would increase risks. The IMF said that the financial engineering operations are not a sustainable solution but are unconventional stop-gap measures done out of necessity. In its 2019 report the IMF said that BDL should gradually revert to conventional monetary policy. These operations have added to BDL's foreign exchange liabilities and associated carry costs.

Banking resilience

The IMF has continuously assessed the banking system, except in its 2019 report where it gave it little attention. In no case, it foresaw a scenario that would lead to a collapse that would result in depriving depositors from accessing their money and in a more than 90 percent fall in the exchange rate of the local currency, nor did it forecast the inability of the Central Bank to function as a financier of last resort. The banking system is perceived by the IMF as a resilient sector that follows a conservative policy. It said that the banking system remains a critical pillar of Lebanese resilience.

Current Account deficit

Contrary to IMF's expectations reiterated in its various reports that the Current Account deficit would narrow over the medium term, the deficit kept on widening. The Fund was counting on a rebound in exports that would improve the Current Account balance.

Fiscal deficit

The IMF persistently advised the authorities to carry out fiscal consolidation (fiscal adjustment). It emphasized the importance of a credible and balanced fiscal adjustment strategy to prevent further fiscal deterioration, reestablish primary surpluses, and put public debt on a sustainable path. The Fund was not in favor of increasing public wages – especially without additional fiscal revenues. It advocated improving the fiscal deficit by increasing revenues, rather than cutting costs.

Rise in debt

The IMF continually stressed the need to address the escalating public debt. Early in 2011, it called for an ambitious fiscal strategy that could bring the debt ratio to below 100 percent of GDP by 2020 by achieving sizeable primary surpluses. It said that there was 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 the debt dynamics.

Electricity reforms

The IMF has recognized that vested interests and general lack of governance have prevented progress in the electricity sector. Increasing electricity supply would eliminate one of the biggest constraints to doing business in Lebanon, in addition to its positive effects on income distribution, the balance of payments, the environment and fiscal deficit. The Fund called for an immediate increase of the tariff and for eliminating electricity subsidies.

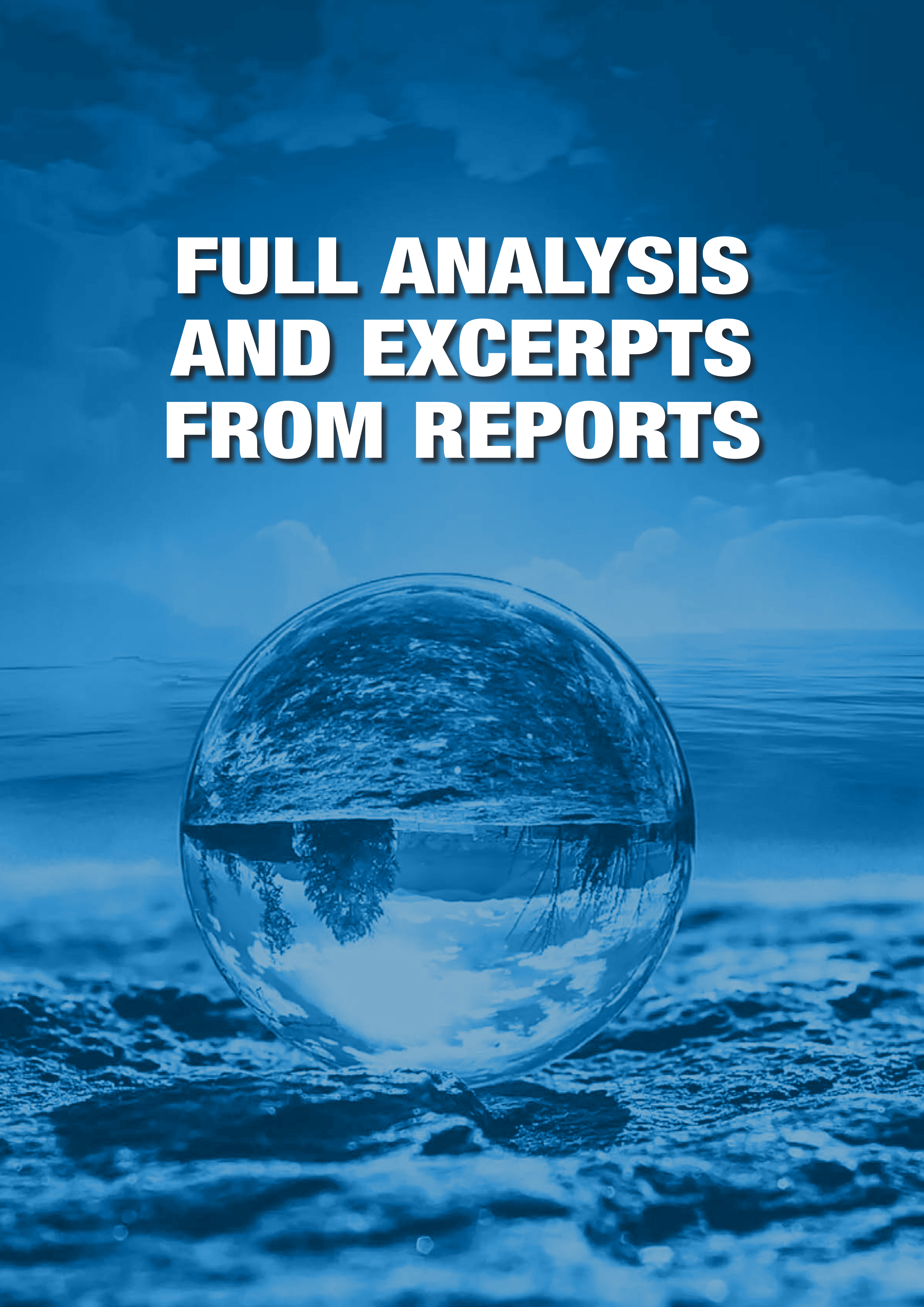
Spillovers of the Syrian crisis

Very early, the IMF sensed the huge risks that Lebanon would be exposed to because of the Syrian crisis. The spillover from the crisis presented the most serious risk to the economy. It said that the Syrian crisis had negatively affected investor confidence, disrupted tourism, increased costs of bilateral and transit trade, and forced local banks to reduce their exposure to Syria. The Fund lauded Lebanon for its efforts in hosting a number of refugees disproportional to its population and recommended international budget support to Lebanon.

Serious statistical flaws

The IMF was relentless in highlighting that data provision has serious shortcomings, especially national accounts and external sector statistics. The Fund said that there is an immediate need to develop regular and timely statistics. It warned that fiscal reporting was lagging and that irregular Treasury inflows and outflows were weakening data compilation. It has also noted that BDL does not publish externally-audited financial statements.

FULL ANALYSIS AND EXCERPTS FROM REPORTS



Almost a blind eye to losses in BDL Balance Sheet

Excerpts from Article IV Reports

2011

- There is a need for a medium-term plan for strengthening BDL's balance sheet.
- IMF believes that the trend deterioration in BDL's balance sheet should be arrested. BDL should weigh cost implications of replenishing reserves and develop a strategy to strengthen its income position. It should reduce the remuneration of banks' foreign currency deposits
- BDL's finances have been weakened by the sterilized accumulation of reserves. Though the pace of deterioration has slowed, BDL should formulate a medium-term plan to improve its income position
- The government resigned, BDL defended the pound, losing about half of its net foreign exchange holdings, but gross reserves remained unchanged which led to pressures on the pound because the Central Bank issued foreign currency CDs and banks placed excess reserves with BDL
- Market pressures subsided and deposit inflows resumed in March
- Foreign currency reserves are sufficient to withstand a shock of similar magnitude as the 2006 war with Israel and the 2005 assassination of Prime Minister Hariri, complemented by net foreign assets of commercial banks

2014

- IMF commended BDL for maintaining adequate international reserves
- The high level of gross international reserves remains an anchor for investors' confidence
- Foreign exchange reserves are adequate
- Foreign exchange deposits, gross reserves are… at a comfortable level
- Maintaining high reserves is warranted given large risks and vulnerabilities
- BDL should continue to maintain high foreign exchange reserves
- BDL has been increasingly providing foreign currency funding to the government with an impact on its net foreign exchange position
- BDL should gradually withdraw from T-bill auctions and adopt a strategy to improve its balance sheet over time
- The nexus between the sovereign and banks – whereby banks hold most of the government debt and support reserves – continues to provide stability but could amplify shocks
- BDL support operations to the government and private sector have weakened its balance sheet
- BDL's balance sheet needs to be strengthened

2015

- BDL has maintained an adequate level of gross foreign exchange reserves
- IMF Directors commended the central bank for supporting macroeconomic stability and maintaining adequate international reserves

The IMF has failed to recognize huge losses being incurred by the Central Bank, or point out that these losses are being booked as assets. Whilst discussing foreign currency reserves, it has always focused on their gross value. IMF reports just made passing remarks that BDL needs to strengthen its balance sheet and income position. It wasn't until its 2019 report that it has pointed out that net foreign reserves have fallen to negative value. Net reserves had already dropped into red territory since 2014. As late as 2017, it concluded that reserve buffers were adequate and that net reserves have declined – but did not mention their level. It called for a medium-term strategy to strengthen BDL's balance sheet. It did not elaborate on which parts of the balance sheet need to be strengthened, and on the mechanism that should be adopted to achieve that.

In June 2020 and only after the government published its own estimate of the Central Bank's accumulated losses that the IMF announces through its spokesperson Gerry Rice: "Our estimates are broadly consistent with those in the government's plan." In its 'Financial Recovery Plan' released a month and a half earlier, the government estimated the aggregated losses in BDL's balance sheet at LL177 trillion ($118 billion). The Financial Times magazine reported a week after Rice's statement that the Fund told the Minister of Finance and BDL's governor that it estimates BDL's accumulated losses at LL170 trillion. At the time of this publishing, government officials said that they agreed with BDL that losses in the Central Bank balance sheet were around $68-69 billion.

IMF's Crystal Ball

Almost a blind eye to losses in BDL Balance Sheet

- The authorities should continue to maintain a high level of reserves
- BDL has, appropriately, been building up Lebanon's foreign exchange (FX) reserve buffers
- BDL has been channeling FX resources from the banking system into international reserves… Some of these funds have also been used to meet the FX needs of the government
- There is a need to gradually strengthen BDL's balance sheet
- BDL does not publish externally-audited financial statements, and its reporting practices are not fully compliant with the International Financial Reporting Standards (IFRS)

2016

- Reserve buffers remain adequate
- BDL commended for maintaining adequate international reserves
- Reserve coverage is adequate according to the IMF's Assessing Reserves Adequacy (ARA) metric
- Increase in the FX liabilities of BDL (and related carry costs) affects BDL's balance sheet
- IMF calls for a medium-term strategy to improve BDL's balance sheet
- BDL has been providing foreign exchange to the government through an overdraft facility—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.
- 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.
- Deceleration of financial inflows, which is given a high probability by the IMF, could lead to significant funding pressure for both banks and the sovereign, increasing pressure on reserves, affecting confidence in the peg
- A large share of banks' foreign currency assets cannot be immediately pledged in the interbank market to raise liquidity, suggesting that large liquidity shocks might quickly involve BDL as lender of last resort

2019

- BDL has long protected the country's economy and maintained financial stability but now it must also start rebuilding its own financial strength
- High negative net foreign asset position
- BDL should strengthen its balance sheet
- High level of reserves should be maintained
- BDL has been the linchpin of financial stability… but at the cost of weighing down its balance sheet
- BDL's efforts to secure external financing have come under strain as… gross foreign exchange reserves have fallen
- BDL has skillfully maintained financial stability in difficult circumstances… but the cost of these operations has grown
- The reserves adequacy metrics now point to a reserve shortfall. Although gross reserves continued to be large at 65 percent of GDP at end-2018, they stand at 90 percent of the ARA metric and are projected to fall to 70 percent by the end of 2019

The IMF didn't give strong warnings about the huge risks of depleting BDL's foreign currency reserves leading to an even larger deficit in its net reserves. It considered high levels of gross FX reserves as an anchor for investors' confidence. It had just said in an incidental remark in 2014: "BDL has been increasingly providing foreign currency funding to the government with an impact on its net foreign exchange position." The Fund has acknowledged that BDL's foreign currency reserves have been pressured by the needs of financing the Treasury, imports, protecting the peg, and subsidizing retail and corporate loans and has been calling in recent years for strengthening the gross foreign currency reserves. It said in 2014: "BDL's balance sheet needs to be strengthened. Reserve accumulation, government financing and quasi-fiscal credit schemes to support the economy—and the associated sterilization costs—have all taken a toll on BDL's finances." The Fund continued to give the same advice until its final report in 2019. The recommendations reiterated over the years included the need for BDL to gradually withdraw from quasi-fiscal credit schemes which aim to support the economy and consist of subsidizing loans to the private sector. BDL was also urged to reduce its financing to the government. The Fund said in the 2019 report: "Given the limited interest by banks and the private sector, BDL financed most of the 2018 fiscal deficit." It advised BDL to step back from government bond purchases and place more importance on the strength of the financial system, both in terms of its balance sheet and requiring commercial banks to build up their own buffers.

The Fund was also advising BDL to strike a balance between accumulating sufficient reserves and avoiding high sterilization costs. Sterilization costs are incurred by central banks when they buy or sell financial assets to offset the effect of their interventions on the foreign exchange market. According to the IMF, BDL needs to maintain high foreign exchange reserves, but reserve accumulation and the associated sterilization costs have weakened its balance sheet.

Dollar peg a lynchpin of stability

Excerpts from Article IV Reports

2011

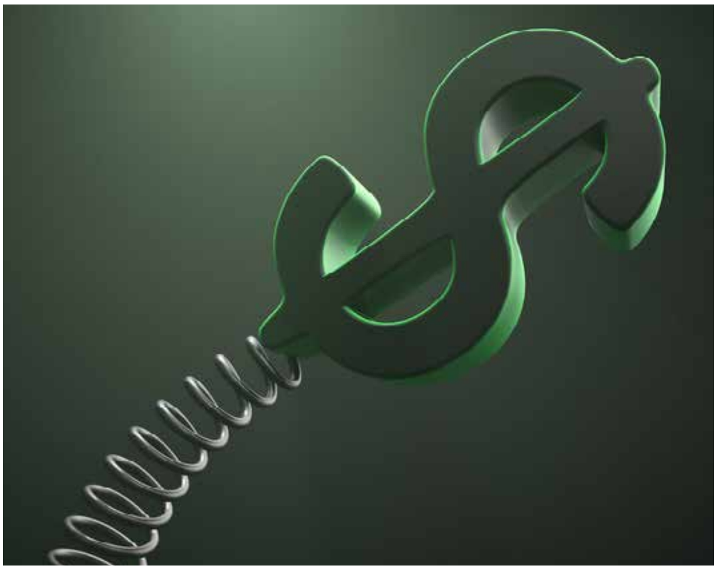
- The currency peg remains the cornerstone of financial stability
- The exchange rate peg provides a firm anchor for financial stability
- The peg has served Lebanon well and remains the linchpin for financial stability in a highly dollarized economy
- It continues to serve Lebanon well in view of the government's high foreign-currency debt and currency mismatch on the balance sheets of nonbanks and households
- Strengthening competitiveness would support the currency peg
- Lebanon might have lost some competitiveness, which it should regain through productivity-enhancing reforms to ensure that the peg and current account are sustainable
- There is a need to gradually phase out exemptions from reserve requirements (introduced to stimulate lending in Lebanese pounds) once recovery takes hold

2014

- The exchange rate peg is the nominal anchor for Lebanon
- The peg has been playing as lynchpin of macro-financial stability, given the government's high debt and debt service in foreign currency, and substantial household and corporate currency mismatches from the large credit dollarization. Strong and supportive policies are needed to underpin the continued viability of the peg
- Monetary policy helped maintain confidence in the Lebanese financial system, with the exchange rate peg providing a firm anchor for financial stability
- Monetary policy should remain geared to supporting the peg

2015

- Monetary policy should remain geared to supporting the U.S. dollar peg, which has served Lebanon well
- Deposit inflows continue to fund the economy and sizeable buffers support the credibility of the exchange rate peg
- A temporary deposit inflow slowdown would be manageable, but a more protracted slowdown would require sharp fiscal adjustment and could threaten the peg



The IMF has not forecasted the total collapse of the exchange rate that has started in the summer of 2019 and is still ongoing.

It was constantly supportive of pegging the lira exchange rate to the US dollar. The Fund continued to hail the dollar peg as essential for stability. "The exchange rate to the dollar peg is a linchpin of macroeconomic and financial stability in a highly dollarized economy," it said. It advised the authorities that monetary policy needs must remain geared to supporting the peg which must be backed by strengthening competitiveness and maintaining adequate foreign exchange reserves.

The IMF saw that continued deposit inflows provided credibility to the peg.

It had also been pointing to the overvaluation of the real effective exchange rate (REER) which had escalated further over the 2011-2019 period. Despite the fact that the REER's overvaluation indicates that the country is losing its trade competitiveness with exports becoming more expensive and imports cheaper.

The IMF said that the sensitivity of the debt dynamics to exchange rate depreciation shocks underscores the importance of the peg to maintain financial stability. The Fund showed its support for the peg despite the cost the Central Bank incurs to maintain it. It said in 2019 that BDL has been protecting the peg "at the cost of intensifying sovereign-bank linkages, which pose risks to banking sector stability, and weighing down its balance sheet while protecting banks' profitability."

IMF's Crystal Ball

Dollar peg a lynchpin of stability

2016

- Monetary policy should remain geared to supporting the peg
- The peg remains the prime focus of monetary policy
- The exchange rate peg is the appropriate nominal anchor
- IMF commended the central bank for supporting macroeconomic stability and maintaining adequate international reserves and agreed that monetary policy should remain geared to supporting the peg

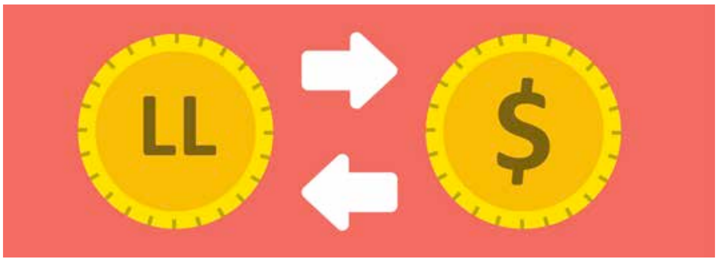
2019

- Rebalancing the economy in the current framework of an exchange rate peg requires the steadfast implementation of a large and credible fiscal adjustment and ambitious structural reforms
- BDL has been the linchpin of financial stability and protecting the peg, but at the cost of intensifying sovereign-bank linkages, which pose risks to banking sector stability, and weighing down its balance sheet while protecting banks' profitability
- The difficult fiscal situation has influenced Central Bank policies. Within the constraints of maintaining high confidence in the currency peg – including through an appropriate level of foreign exchange reserves – BDL has aimed at a level and structure of interest rates that are sufficiently attractive for nonresident inflows… without unduly increasing the interest cost for the government and discouraging bank lending to the economy

BDL holds large international reserves by accumulating deposits from the banks in order to intervene on the market to maintain the exchange rate peg and incurs additional carry costs doing so. According to the IMF 2015 report, a prolonged slowdown of financial inflows could threaten the peg and would require sharp fiscal adjustment. It said in 2019 that remittance and deposit inflows and tourism income could fall if security risks in the region escalate. This could increase exchange-rate pressures, hurt confidence, and would lead to higher financing costs and falling reserves.

Throughout the years, the IMF has utilized several methodologies to assess the level of over and under valuation of the exchange rate. It has also revised these numbers in subsequent reports. The numbers in the table below are reported as they were published in each year's report. The graph shows the numbers as published in the 2019 report.

According to IMF calculations, the exchange rate was properly valued until after 2012. Since then, it was steadily going into overvaluation territory.

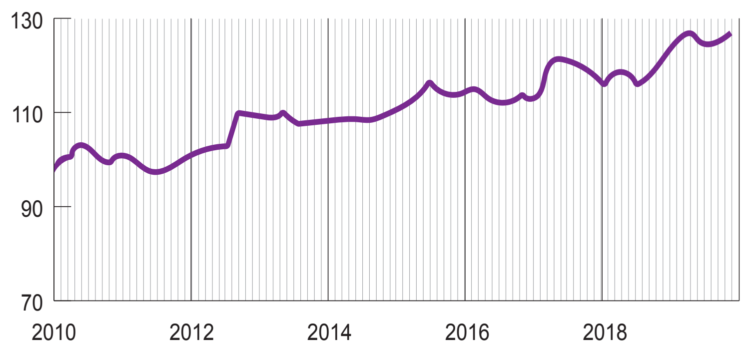


REAL EFFECTIVE EXCHANGE RATE

	REER	CA
2012	11-17%	
2014	2-10%	
2015	2-10%	
2017	0	23%*
2019	63%	50%

* In the 2019 report, the 2017 CA approach was revised at 45%

- REER Real Effective Exchange Rate
- CA Current Account approach



Source: Information Notice System; and IMF staff calculations

Kudos for foreign currency borrowing

Excerpts from Article IV Reports

2011

- Steps to tap the Eurobond market are appropriate
- Support the authorities' intention to seek parliamentary approval for new foreign currency borrowing to take advantage of banks' ample foreign exchange liquidity and globally low interest rates, and to reduce reliance on BDL reserves
- Financing government spending through additional foreign currency borrowing could increase banks' pound liquidity, which could then be channeled to the local currency T-bill market

2014

- On the foreign currency side, BDL has been increasingly providing funding to the government, with an impact on its net foreign exchange position
- The gap between foreign currency payments and receipts has been widening
- The government has been increasingly borrowing in foreign currency from BDL in overdraft
- Welcomed the authorities' effort to seek parliamentary approval to raise the cap on new foreign currency borrowing to reduce the government's reliance on BDL

2015

- Eurobond spreads have generally moved in line with regional peers.
- February, a $2.2 billion Eurobond issue by the Treasury – the largest so far – was significantly oversubscribed
- Parliament's agreement to pass a law allowing for new Eurobond issuances was also a positive step

2016

- To mitigate deceleration of financial inflows that could lead to significant funding pressure for both banks and the sovereign, increasing pressure on reserves, and affecting confidence in the peg, BDL should maintain a high level of reserves as a buffer and, if needed, increase interest rates
- BDL would need to withdraw from T-Bill and Eurobond auctions and encourage banks to participate directly
- Although debt denominated in foreign currency accounts for about 40 percent of total public debt, it is held mostly by domestic financial institutions

2019

- The fiscal adjustment in the budget will not suffice to bend down the public debt-to-GDP ratio and public debt will remain unsustainable
- The highest priority is the implementation of a sustainable fiscal adjustment that will bend down the path of the public debt-to-GDP ratio through a combination of revenue and expenditure measures. This needs to be complemented by structural reforms and concessionally financed investment

In March 2020, Lebanon failed to pay maturing foreign currency debt (Eurobonds). It was the first time in its history that the country defaults on its debt. Nine years earlier, the IMF was encouraging the authorities' to resort to new foreign currency borrowing. It said: "Steps to tap the Eurobond market are appropriate." In 2011 and 2014, the Fund welcomed the authorities' effort to seek Parliament's approval for additional foreign currency borrowing. It said in 2011 that foreign currency borrowing reduces the government's reliance on BDL reserves and enables it to tap the banks' ample foreign exchange liquidity and benefit from low interest rates on the global market.

Actually, BDL lost foreign exchange reserves worth 7.4 percent of GDP in 2018 partly for paying Eurobond principal and coupon on behalf of the government. That year, instead of offering a new Eurobond issue on the market, the government asked the Central Bank to subscribe to the Eurobonds. Afterwards, BDL had to resell part of the bonds on the market at a discount in order to attract foreign exchange. According to the IMF, financing public spending through additional foreign currency borrowing could increase the banks' lira liquidity which would then be channeled to the T-bill market.

In 2015, the IMF described a Parliament's decision to pass a law allowing for new Eurobond issuances as a 'positive' step. The Fund also downplayed the risk involved in the size of the foreign debt. It said that year: "Although debt denominated in foreign currency accounts for more than 40 percent of total public debt, it is held mostly by domestic financial institutions and is underpinned by sizable external buffers in the form of international reserves. The level of, and the change in, short-term debt are very low, substantially reducing refinancing risk." Despite these reassurances, the IMF considered the spiraling overall debt as a real challenge that must be addressed mainly through fiscal adjustment.

In its 2016 report, the IMF started seeing over exposure to the risk weight on BDL foreign-currency exposure. It called for the exposure to be aligned with the Basel Accord, allowing for a reduction in sovereign exposure over the medium term.

Pressing for higher interest rates

Excerpts from Article IV Reports

2011

- Pound interest rates should be allowed to rise
- Letting interest rates rise would make government T-bills more attractive to banks and thus allow the Treasury to reduce reliance on BDL
- BDL was subscribing to T-bills with shorter maturities because banks were not interested in them because they didn't consider the interest rates attractive
- Pursuing interest rate stability under the currency peg over an extended period has been costly for BDL's balance sheet and foreign reserves. IMF argued that letting interest rates on T-bills… would compensate for higher risks and make them attractive to banks, allowing the treasury to reduce its reliance on BDL. This could also lower the average cost of borrowing and allow targeting a smoother maturity profile of government debt
- IMF supported a gradual move

2014

- The government raised interest rates on T-bills with maturities shorter than 7 years in March 2012, by 50 basis points, in line with Fund advice

The IMF has been pressing the authorities to raise interest rates to encourage banks to subscribe to Treasury bills and to attract deposit inflows which finance the twin deficits. This is despite the fact that high interest rates increase debt service for the private and public sectors and are detrimental to economic growth. Moreover, relying on steady deposit inflows is undependable and risky.

The Fund had a different attitude in former years. In 2009-2010 the authorities had to cut interest rates, upon IMF's advice, in order to slow deposit inflows and limit reserve accumulation. The Fund said in 2011 regarding this recommendation: "Starting in late 2010, domestic and external shocks affected Lebanon's economic performance, and the context for [IMF] staff advice on near-term policies changed significantly."

According to the IMF, absent an improvement in depositor sentiment with potential slowdown in inflows, BDL would need to stand ready to increase interest rates in order to attract fresh deposit inflows. In 2012, the authorities followed the Fund's advice and increased interest rates on T-bills with maturities of less than seven years to make them attractive to banks and reduce reliance on BDL although some IMF directors had previously cautioned about the fiscal and economic impact of higher interest rates. The IMF said in 2016: "To date, BDL has not yet raised rates owing to concerns about public debt dynamics and growth. But a policy change will be unavoidable

IMF's Crystal Ball

Pressing for higher interest rates

2016

- BDL needs to stand ready to increase interest rates if deposit inflows were to decelerate
- BDL will need to attract fresh inflows, which may require higher interest rates. 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
- The timing and extent of any potential change in interest rates will depend on Lebanon's fiscal stance
- Fiscal adjustment would also pave the way for more market-determined interest rates
- T-Bill yields have remained largely unchanged since 2012, muting their role as a key market signal
- If deposit growth were to soften, rather than relying on a repeat of its recent [financial engineering] operation, BDL would instead need to use interest rates as a more direct and easily communicated policy tool to secure foreign exchange inflows
- While an interest rate increase would have an impact on debt service for both the private and public sectors and increase banks' cost of funding, such costs should be cast against the implications of the recent BDL [financial engineering] operation

2019

- BDL is commended for not buying the T-bills with 1 percent interest rate whose issuance had been proposed by the government
- BDL should step back from government bond purchases and providing other financing facilities including a zero-interest overdraft facility and bridge financing and let the market determine yields on government debt
- IMF calls for a conventional interest rate policy

if deposit growth does not improve." The Central Bank increased interest rates the following year to face the impact of the resignation of Prime Minister Saad Hariri.

Fiscal adjustment and reforms, however, remain on top of the Fund's priority list. It said in 2016: "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 BDL and allowing it to use interest rate policy more flexibly going forward."

Under an 'Adjustment Scenario' over the medium term included in the IMF 2019 report, the government's reform drive would raise investor and depositor confidence which would be reflected in higher growth of deposits and slightly lower interest rates. According to the Fund, keeping interest rates stable under the currency peg over an extended period of time has been costly for BDL's balance sheet and foreign reserves. The IMF considers that fiscal adjustment and reforms could be a good alternative to alleviate public finance burdens and pave the way for flexible market-determined interest rates.

The Fund prefers that BDL uses the conventional interest rate policy instead of financial engineering operations because it is a more direct and easily communicated tool to attract foreign exchange inflows. It said in 2016: "Since the incentives offered by banks to depositors [under the financial engineering operations] focused on giving them one-off upfront income (instead of higher interest rates), prospects for keeping the new inflows in the system remain uncertain." These operations have contributed to the tightening of monetary conditions since the high interest rates the banks can earn on dollar deposits at BDL have affected rates on dollar loans to bank customers. This subsequently led to higher rates on lira loans as well.

Bittersweet financial engineering

Excerpts from Article IV Reports

2016

- BDL 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
- Starting in mid-2015, inflows started to decelerate, prompting BDL to undertake a complex and sizable financial operation over the summer of 2016
- BDL has taken steps to shore up its reserves. With easing deposit inflows, gross reserves declined 10 percent from a peak in May 2015. In response, in mid-2016 BDL engaged in a sizable financial operation
- BDL engaged in a sizable financial operation that has (among other objectives) helped restore international reserves
- The operation has: (i) strengthened BDL's gross foreign exchange buffers (ii) reversed the cumulative decline in Lebanon's Net Foreign Assets (NFA) position (iii) improved the capital buffers of banks (iv) reduced local-currency funding costs for the government and private sector
- The operation also created significant Lebanese pound liquidity; sizably reduced banks' FX liquidity held abroad; narrowed the spread between LL and USD deposit rates, adding to dollarization risk; and increased the FX liabilities of BDL (and related carry costs), thus affecting BDL's balance sheet
- IMF commended BDL for maintaining adequate international reserves. In this context, IMF 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
- Encourage banks to rebuild their internal FX liquidity buffers, also by not resorting to financial engineering in the future
- BDL needs to continue to sterilize the excess Lebanese pound liquidity created by the financial operation
- BDL's recent financial operation has been a stop-gap measure, but cannot sustainably resolve Lebanon's funding needs
- As in previous episodes, 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
- It has affected BDL's balance sheet
- It is important for BDL to communicate the size and scope of its unconventional measures in a timely manner
- To participate in the recent financial operation domestic banks sold part of their Eurobond holdings to foreign clients

The IMF said that BDL's financial engineering operation carried out in 2016 "has successfully bolstered its foreign exchange reserves, strengthened bank capital, lowered the government's borrowing cost, and provided liquidity for domestic lending." It advised against the immediate cessation of these operations, which continued until 2018, as this would increase risks. "BDL may need to continue its financial operations for a while even if the underlying economic situation improves," the Fund said. It also said: "BDL has skillfully maintained financial stability in difficult circumstances, often with unconventional measures."

2019

- BDL has continued its financial operations to facilitate banks offering high returns on USD deposits, with the aim of attracting USD deposits to the banking sector and maintaining a high level of foreign reserves
- BDL may need to continue its financial operations for a while even if the underlying economic situation improves
- While immediate cessation of financial operations would increase risks, BDL should gradually phase them out as fiscal adjustment and the subsequent decline in yields demanded by investors allow it to do so
- The financial operations contributed to very tight monetary conditions, in which private credit declined and non-performing loans increased
- The operations have provided high marginal returns in LL and in USD on new bank USD deposits at BDL
- These operations have boosted BDL's dollar holdings without affecting rates on older deposits at the BDL or on government debt
- The volume of these financial operations has been large in recent years: the operations since fall of 2017 have attracted over $24 billion through February 2019
- The financial operations raised the banks' combined exposure to BDL and government

According to the IMF, the financial engineering operations are not a sustainable solution but unconventional stop-gap measures done out of necessity. It said in its 2019 report that the Central Bank should gradually revert to conventional monetary policy. These operations, which have added to BDL's foreign exchange liabilities and the associated carry costs, mainly aim to attract dollar deposits to the banking sector, maintain a high level of foreign exchange reserves, and support the foreign exchange peg.

BDL offered generous incentives to the banks to encourage them to participate in these deals. A few banks in their turn, offered very attractive rates on large deposits from large depositors. Customer deposit inflows slowed down despite these costly operations. Gross international reserves decreased by $7.5 billion between their previous peak at the end of February 2018 and May 2019.

These developments reduced the authorities' room for maneuver, according to the IMF. It said in 2019: "BDL has long protected the country's economy and maintained financial stability but now it must also start rebuilding its own financial strength. The years of bearing the brunt of responsibility for the country's economic stability have left its mark on BDL's balance sheet and have intensified sovereign-bank links."

Resilient and conservative banks

Excerpts from Article IV Reports

2011

- Thanks to prudent management and conservative regulation, banks report capital above the regulatory minimum and high liquidity buffers with low nonperforming loans (NPLs) and stable profits
- Effective banking regulation and supervision, coupled with conservative bank funding, asset structures, and management, have allowed the banking sector to build buffers
- The banking sector (with assets of 350 percent of GDP) funds itself from short-term deposits, about a quarter of which it intermediates to deposits at the BDL and another quarter to long-term government debt, thus exposing itself to the sovereign and a maturity mismatch

2014

- Banks have so far been resilient, but the environment is increasingly challenging
- Banks' profitability has deteriorated, with an average return on assets of about 1 percent
- Liquidity buffers, including large deposits with BDL, are strong
- Banks' already high exposure to the sovereign has continued to increase
- Capital buffers should be strengthened given banks' large exposure to the sovereign
- Encourage banks to reconsider their business model revolving around channeling deposits to the public sector

The alarm was never sounded by the IMF on a possible total collapse of the banking system. The IMF had periodically undertaken stress tests in its various reports, including in an extensive study (FSAP) of the financial sector published in 2016.

The banking system is resilient and follows a conservative policy that had protected it from the fallout of the global financial crisis in 2007-2008 and attracted foreign deposits. This oft-repeated refrain that was prevalent before the crisis is no longer heard these days. The IMF used to share this opinion. It said in 2016: "The banking system remains a critical pillar of Lebanese resilience."

According to the Fund's 2011 report, the banks were enjoying capital above the regulatory minimum, high liquidity buffers, low nonperforming loans (NPLs), and stable profits thanks to their prudent management and conservative regulation. The claim about stable profits contradicts the government's 'Recovery Plan' which estimates the direct aggregated losses in the banks' balance sheets at LL64 trillion ($40 billion).

In 2015, the Fund was lauding the authorities' ability in preserving trust in the banking system which it described as robust. The IMF said: "Deposit inflows remain strong, foreign exchange reserves at a comfortable level, and the banking system robust. This attests to the authorities' capacity to maintain confidence, particularly the confidence of non-resident depositors, which is the core strength of Lebanon's financial system, despite the difficult environment." The following year, it continued to highlight the resilience of the banking system, but noticed that the banks were facing "more

IMF's Crystal Ball

Resilient and conservative banks

2015

- The banking system played a critical role in securing sustained, broad-based economic growth.
- Authorities are commended for their close oversight of the financial system
- The IMF highlighted the importance of increasing capital buffers
- Based on traditional financial-soundness indicators, there is little evidence of a build-up of risks to financial stability
- Private sector leverage appears contained. Leverage is not a pressing worry

2016

- The banking system is renowned for its resilience
- The Banking Control Commission is proactively vigilant
- Regulatory capital requirements exceed the minimum levels set under Basel III
- Banks' capital buffers are modest in light of their significant exposure to local-currency sovereign debt and foreign-currency BDL instruments
- A large share of banks' foreign currency assets (e.g., long-term deposits with BDL) cannot be immediately pledged in the interbank market to raise liquidity, suggesting that large liquidity shocks might quickly involve BDL as lender of last resort
- 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

2019

- The financial system remains well capitalized, liquid, and profitable. Bank capitalization exceeds Basel III requirements
- Action should be taken to continue building up banks' capital buffers
- Deposit insurance should be strengthened
- In line with the 2016 Financial Sector Assessment Program (FSAP) advice, the authorities should also increase deposit insurance coverage levels and provide for insured depositors' preference under the creditor hierarchy rules applicable in resolution and liquidation of failed banks.

challenging macroeconomic environment, growing exposure to the sovereign, lower foreign currency liquidity buffers abroad, significant interest-rate risk, and greater international scrutiny."

The Fund had warned as early as 2011 that the banking sector was exposing itself to a maturity mismatch because it was financing itself from short-term deposits to roll over its large exposure to the sovereign. Besides their short-term maturity structure, the banks' increasing vulnerability was also driven by deposit concentration and the relatively large size of their nonresident deposits, according to the IMF's 2016 report. Deposit concentration occurs when few depositors hold a disproportionally large share of the total value of deposits in the banking system. At the end of 2015, half of total deposits were held by less than one percent of all deposit accounts. The IMF said: "Much of the slowdown in deposit growth in 2015 can be attributed to large depositors." The same is likely to have happened since the outbreak of anti-government protests when billions of dollars were transferred abroad despite de facto capital controls imposed by the banks. Those carrying out the transfers were apparently large depositors close to the banks, some of them politically connected.

Even by 2019, the financial system was still considered liquid, profitable, and well capitalized with capitalization exceeding Basel III requirements. But the IMF said that year: "While financial stability has been maintained, deposit inflows, critical to finance the budget and external deficits, slowed down during the past year, reducing the authorities' room for maneuver." It said that banks must strengthen their capital and liquidity buffers further when financial inflows slow down. The Fund regularly stressed the importance of additional bolstering of buffers in the reports it released all over the 2011-2019 period. Only in the 2019 Article IV Consultation, it also called for the strengthening of deposit insurance. The IMF said: "In line with the 2016 Financial Sector Assessment Program (FSAP) advice, the authorities should also increase deposit insurance coverage levels and provide for insured depositors' preference under the creditor hierarchy rules applicable in resolution and liquidation of failed banks."

Excerpts from FSAP 2016

Financial System Stability Assessment undertaken by IMF

- **Lebanon has maintained financial stability for the last quarter century during repeated shocks and challenges**
  …adroit crisis management have helped preserve confidence through regional and domestic economic and political shocks
- **Macroeconomic and financial vulnerabilities have accumulated**
  …Financing needs require a continued inflow of remittances and nonresident deposits
- **Central Bank policies have helped to maintain confidence**
  …and have helped to contain systemic risks, they result in the creation of new reserve money
- **The banking system has thus far proven resilient to domestic shocks and regional turmoil, but the materialization of severe shocks could expose vulnerabilities**
  …Confidence in the banking sector has been sustained. Capital restoration following shocks could take significant resources. Liquidity stress in banks could quickly lead to a need for the BDL to provide funding
- **Effective oversight and crisis management have contributed to stability**
  …Effective banking supervision
- **Progress has been made to strengthen financial integrity framework, with some scope for improvement remaining**
  …Banking secrecy does not appear to be a significant immediate source of risk for financial stability
- **Some global banks are reducing the provision of financial services to Lebanese banks and remittance companies**

Twin deficits

Excerpts from Article IV Reports

2011

- Vulnerabilities remain large. Persistently high Current Account deficit, while Debt-to-GDP ratio is one of the highest in the world, giving rise to large recurrent financing needs which depend on domestic political stability and a favorable regional environment
- Continued nonresident deposit inflows are needed to finance persistent and large Current Account deficits
- Lebanon might have lost some competitiveness, which it should regain through productivity-enhancing reforms to ensure that the peg and Current Account are sustainable

2014

- The external Current Account deficit has remained large, at about 13 percent of GDP in both 2012 and 2013. It is expected to narrow to about 10.5 percent of GDP over the medium term as a rebound in exports will be to a large extent offset by higher imports
- Financing needs would remain high, reflecting large fiscal and Current Account deficits
- While growth is projected to pick up and the non-interest Current Account deficit to shrink, a projected rise of nonresident deposit inflows, together with increases in nominal interest rates, will contribute to the increase in external debt

2015

- The sharp increase in the Current Account deficit is attributable, in part, to the disruption of traditional trade relationships and elevated regional uncertainty
- The deficit is expected to improve (slowly) over the medium term. 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
- The Current Account deficit is projected to narrow over the medium term but will remain sizable15 percent of GDP by 2020
- Following recent data revisions, the Current Account deficit is estimated at around 25 percent of GDP in 2014. This is a clear source of vulnerability, particularly in light of the peg to the dollar. Nonetheless, foreign inflows continue to grow
- External debt will remain elevated. The external debt was 165 percent of GDP at end-2014, up from its most recent trough of 163 percent at end-2010. The increase reflects the sizable Current Account deficit, financed in large part by non-resident deposits into the banking sector (short-term deposits account for 77 percent of the economy's external debt)

The fund has urged the authorities in all its reports to address the chronic deficit in the Current Account and Public Finance (Budget) – a.k.a Twin Deficit, an expression used only in the 2019 report. The twin deficit is mainly financed by deposit inflows. The Fund said: "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." Reliance on deposit inflows is, however, a risky gamble. The IMF warned in its 2011 report that steady inflows of deposits depend on political stability in Lebanon and a favorable environment in the region. In fact, starting from 2015, inflows began to slow down, which prompted BDL to embark on its financial engineering operations to attract hard currencies from abroad. The situation worsened further in recent years with increasing political instability locally which has shaken investor confidence and unfavorable regional conditions, especially escalating political tensions with Gulf countries. The IMF said in its 2019 report that deposit inflows have largely dried up and that "the large budget and Current Account deficits are exacerbating the already-serious vulnerabilities."

2016

- If slow deposit inflows persist, the external position might weaken
- The sharp increase in the Current Account 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
- The Current Account balance deficit is expected to continue to narrow 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
- 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 sizable budget and Current Account deficits. But starting in mid-2015, inflows started to decelerate, prompting BDL to undertake a complex and sizable financial operation over the summer of 2016
- 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. 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

2019

- The external position remains substantially weaker than the level consistent with medium-term fundamentals and desirable policy settings
- Years of low growth and large Current Account deficits, both of which reflect a significant erosion of external competitiveness as well as the adverse effects of regional developments
- Current Account deficit excluding interest payments is high at 20 percent of GDP, and although this is projected to decline over the projection period, the interest-growth differential on account of high and growing external debt will continue to weigh against the positive developments in the non-interest Current Account deficit
- Growth shock, non-interest Current Account shock, and combined shock lead to an external debt that exceeds 220 percent of GDP by 2024
- Large Current Account deficits that have brought external debt close to 190 percent of GDP
- Current Account deficit remained largely unchanged at over 25 percent of GDP in 2018, accentuating external financing pressures
- A fiscal effort coupled with structural reforms will gradually improve the Current Account and allow a reduction of the economy's reliance on deposit inflows
- Bank deposits inflows that used to finance deficits have largely dried up

Current Account deficit

Contrary to IMF's expectations reiterated in its various reports that the Current Account deficit will narrow over the medium term, it kept on widening and reached over 25 percent of GDP in 2018 and 26.4 of GDP in 2019. Even in the 2019 report, the Fund forecasted a decline in the Current Account deficit to 23.1 percent of GDP by 2024. The IMF was counting on a rebound in exports to improve the Current Account balance as its staff assumed in the 2014 report that the Syrian conflict would be resolved by 2016.

The Current Account balance, which is a component of the balance of payments, is composed of the balance of trade in goods and services, the balance of income (such as dividends and salaries), and the balance of current transfers (such as remittances and international aid). The IMF attributed the large Current Account deficit to weak competitiveness and low productivity of the economy in addition to the disruption of export routes due to the war in Syria. It said that many years of low growth and large Current Account deficits reflect a significant erosion of external competitiveness as well as the adverse effects of regional developments. The Fund advocated structural reforms coupled with a multiyear effort to achieve primary surpluses to gradually improve the Current Account and reduce reliance on deposit inflows. The Primary Balance consists of the fiscal balance before deducting debt service (interest payments on public debt and repayments of the foreign debt principal).

Bringing the Current Account deficit down further to its norm would require the realization of events that remain upside risks over the medium term, including development of gas fields and a resolution to the Syria conflict, or further structural reforms with an equivalent impact.

Fiscal deficit

Excerpts from Article IV Reports

2011

- Implementing the 2012 budget would interrupt a decade-long record of primary surpluses and a reduction in the Debt-to-GDP ratio since 2006. This would send a negative signal to markets
- A small primary surplus could be achieved by implementing the proposed increases in the VAT rate and the withholding tax on interest, rescinding the February cut in the fuel excise, and limiting the public sector wage increase while allowing some increase in social and capital spending compared to 2011
- Fiscal consolidation strategy should further cut the debt ratio. This could be achieved by a combination of equitable and efficient tax measures, expenditure rationalization, most importantly by reducing the transfers to the electricity company, as well as improvements in tax administration and public financial management (PFM)
- Fiscal policy should be anchored in a sizeable reduction in the Debt-to-GDP ratio (one of the highest in the world)
- Revenue measures and electricity sector reform would create fiscal space to reduce the Debt to-GDP ratio while increasing social and capital spending
- Medium-term fiscal strategy should target a significant reduction in the Debt-to-GDP ratio, while creating space for higher social and capital spending and making fiscal policy more equitable

Notwithstanding its pertinent recommendations regarding the fiscal deficit, the Fund commended the executive authorities in its 2016 report for maintaining fiscal discipline despite the absence of a public budget. Parliament has not approved budgets for 12 years. The country remained without budget since 2005 and until the 2017 budget was approved.

The IMF persistently advised the authorities to carry out fiscal consolidation (fiscal adjustment). It emphasized the importance of a credible and balanced fiscal adjustment strategy to prevent further fiscal deterioration, reestablish primary surpluses, and put public debt on a sustainable path. In the 2019 report, the IMF warned that Lebanon has no fiscal space but a narrow window to reverse the current unsustainable trends and the scale of the debt burden and financing needs are putting the country's fiscal position under severe stress. The Fund advised the authorities to achieve primary surpluses for many years in order to regain fiscal and external sustainability.

The IMF predicted that the effects of the ambitious fiscal adjustment goals of the 2019 budget will be limited.

The IMF was not in favor of increasing public wages – especially without additional fiscal revenues. It had warned the government from the negative impact of a potential increase. Before the approval of the salary adjustment, the IMF reiterated that the adjustment must be part of a package that includes credible revenue measures and should be phased in gradually and without retroactive payments. The implementation of the pay rise and new public sector hiring despite a declared employment freeze contributed to a widening of the fiscal deficit in 2018 to 11 percent of GDP from 8.6 percent in the previous year.

The IMF advocated to improving the fiscal deficit by increasing revenues, rather than cutting cost. It looked particularly at increasing VAT rates, fuel tax, and tax on earned interest, while at the same time keeping expenses stable as a percentage of GDP. It also recommended reshuffling expenses to become more equitable, as well as earmarking a higher level for infrastructure.

2014

- There have been no approved budgets since 2005 and accounts have not been officially closed since 1993
- Recommended a fiscal adjustment strategy that is credible, balanced, and anchored in a multi-year framework
- The bulk of the adjustment would come from revenue – and particularly from the still under-tapped VAT potential – while spending would remain broadly unchanged as a share of GDP, though with a composition rebalanced in favor of higher capital and social spending
- Significant spending pressures are building up. The main increase will stem from a much debated salary scale adjustment for the public sector, with an estimated cost (excluding pensions) of 1.3 percent of the 2014 GDP on a permanent basis
- If implemented, the salary scale adjustment would further exacerbate budget rigidities
- Recommended factoring in all costs of the scale adjustment, including on pensions
- The consolidation strategy should minimize the impact of a planned salary increase
- Financing needs would remain high, reflecting large fiscal and Current Account deficits
- Fiscal policy has been lacking a medium-term perspective, with spending conducted largely through treasury advances and ad-hoc measures in times of pressures
- Despite progress on fiscal reforms, policymaking continues to fare low in terms of transparency
- Large budget rigidities persist. Over 70 percent of current spending comprises of transfers to the loss-making Electricité du Liban (EDL), public sector wages, and interest payments
- Capital spending – already compressed – has been often cut to curb deficits, further exacerbating Lebanon's infrastructure deficit
- The revenue measures approved so far will be insufficient to offset higher spending
- Hosting the large refugee population is adding to fiscal strains
- Windfalls from prospective gas resources are no substitute for adjustment

2015

- The need for a sustained fiscal adjustment is essential and inescapable
- Continued fiscal deterioration is expected due to political stalemate and entrenched social tensions
- Tax capacity remains largely under-utilized
- With more than half of the cumulative fiscal deficit in the past resulting from fuel-related subsidies to the electricity sector, higher oil prices would have a direct impact on fiscal sustainability
- Reducing the debt ratio is the main priority
- Lack of fiscal adjustment is costly and inequitable. Without it and with ever more debt, interest payments will soar to some 12 percent of GDP, or about 40 percent of total spending, crowding out essential social programs and infrastructure projects and largely benefitting public debt holders at the expense of the less-privileged
- Revenue measures should be broad-based, starting from increases in fuel taxation; while spending composition should move away from transfers to the electricity company toward capital projects and social programs

2016

- 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
- The authorities have managed to undertake measures to strengthen public finances, notably through efforts to improve tax collections
- 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
- Tax revenue performance is weak
- A long-standing salary scale adjustment for the public sector poses challenges
- Passage of a credible budget is a priority
- Start the process of fiscal adjustment immediately
- A sustained and balanced fiscal adjustment is essential —large enough to halt Lebanon's adverse debt dynamics
- Broadening the tax burden starting from fuel taxation
- Rebalance the spending mix toward efficient programs and better social safety nets
- Reduction of costly electricity transfers

2019

- The fiscal deficit increased significantly, reaching 11 percent of GDP in 2018, up from 8.6 percent of GDP in 2017, partly due to an increase in the public sector salary scale and new hiring despite the hiring freeze
- The salary scale increase was more expensive than anticipated
- Lebanon has no fiscal space
- The scale of the debt burden and financing needs are putting the overall fiscal position under severe stress
- Large budget and Current Account deficits are exacerbating the already-serious vulnerabilities
- The new government has a narrow window to reverse the current unsustainable trends
- The 2019 budget has ambitious fiscal adjustment goals, but it is based on optimistic projections, and IMF estimates that its effects will be more limited
- Multi-year fiscal adjustment is a key element of the necessary reforms
- Revenue measures should include raising VAT and increasing fuel excises as well as efforts to increase tax compliance
- Eliminating electricity subsidies is the most significant potential expenditure saving
- Fiscal tightening should be complemented with scaled-up targeted transfers to the poor and vulnerable
- The highest priority is the implementation of a sustainable fiscal adjustment. This needs to be complemented by structural reforms and concessional finance

Rise in debt needs to stop immediately

Excerpts from Article IV Reports

2011

- An ambitious fiscal strategy could bring the debt ratio to below 100 percent of GDP by 2020
- A future reduction in the Debt-to-GDP ratio will have to come from sizeable primary surpluses

2014

- Lebanon's debt profile reveals weaknesses
- Vulnerabilities have increased. Fiscal performance has worsened, and public debt has been on an upward trajectory
- Slower growth remains the principal risk to debt sustainability. Higher interest rates also pose a significant risk
- Putting the public debt on a sustainable downward path can only be achieved through strong fiscal consolidation

2015

- Debt dynamics are sensitive to macroeconomic shocks, particularly to the exchange rate
- Without further adjustment, the public debt ratio will continue to rise and add to existing vulnerabilities, crowding out essential public investment and social spending

2016

- Need to make major progress in lowering the public debt burden
- The growth of public debt (above 140 percent of GDP) needs to stop immediately
- 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

2019

- The highest priority is the implementation of a sustainable fiscal adjustment that will bend down the path of the public Debt-to-GDP ratio through a combination of revenue and expenditure measures.
- This needs to be complemented by structural reforms and concessional financing

The IMF was continually stressing the need to address escalating public debt. The main medium-term macroeconomic challenges include, among other things, reducing the very high government Debt-to-GDP ratio. This didn't prevent the IMF from saying in the 2011 report: "An ambitious fiscal strategy could bring the debt ratio to below 100 percent of GDP by 2020." But the report included a caveat: "A future reduction in the ratio will have to come from sizeable primary surpluses." In the 2014 report, the Fund pointed to increasing vulnerabilities and worsening fiscal performance with public debt remaining on an upward trajectory since 2012. IMF directors said in the 2015 report: "Without further adjustment, the public debt ratio will continue to rise and add to existing vulnerabilities, crowding out essential public investment and social spending." In the 2016 report, the IMF underscored that the adjustment needed to stabilize the debt dynamics have increased due to lower growth and a larger debt burden and that the rise in public debt "needs to stop immediately." It said: "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." The IMF criticized the authorities' debt policies saying: "Under current policies, debt dynamics will deteriorate further." Its disapproval of debt policies continued through 2019. It said: "The fiscal adjustment in the budget will not suffice to bend down the public Debt-to-GDP ratio and public debt will remain unsustainable." According to the 2019 report, reducing the Debt-to-GDP ratio requires achieving primary surpluses of four to five percent of GDP for several years.

Structural reforms

Excerpts from Article IV Reports

2011

- The reform scenario builds on structural reforms to increase medium-term growth and fiscal consolidation to reduce government debt, which in turn would boost confidence and lead to lower spreads
- A combination of revenue and expenditure measures would increase the primary surplus, while creating fiscal space for higher investment and targeted social spending
- Additional gains could come from the ongoing modernization of revenue administration and reforms in public financial management (PFM)
- Need to implement long-delayed structural reforms, achieve fiscal consolidation over a number of years, reform the tax system by making it more equitable, strengthen the delivery of social services and the social safety net, and continue to protect the financial sector from excessive risks

The IMF identified a set of macro-critical structural reforms that constantly included reforms of the electricity sector, taxes, and social services. The reforms identified in 2019 were: increasing gasoline excise and fuel taxes, gradually eliminating the electricity subsidy, scaling up and out the National Poverty Targeting Program, implementing the recommendations of the Public Investment Management Assessment (PIMA) before the execution of most of the Capital Investment Plan (CIP), and the implementation of a medium-term fiscal plan to achieve a substantial and sustained primary surplus that would reduce the Debt-to-GDP ratio over time. PIMA was jointly conducted in 2018 by the IMF, the World Bank, and the IMF's Middle East Regional Technical Assistance Center (METAC). According to the 2019 report, the country needs urgent action to preserve confidence in the system and tap international support to finance the CIP and reforms would encourage donors to disburse $11 billion in concessional funds committed during the CEDRE investment conference. The Fund was also critical of the government reform plans. It said in 2019: "Structural reforms proposed thus far will not substantially reduce the Current Account deficit or lift growth to levels sufficient to reduce unemployment. Many of the benefits of government reforms are temporary in the medium-term projections."

IMF's Crystal Ball

Structural reforms

2014

- Advancing structural reforms is key to raising growth potential and improving labor market and social conditions
- Social safety nets should be strengthened and unemployment reduced

2015

- Structural reforms likely to remain stalled
- Urgent need to jump-start the legislative agenda, including on the new Petroleum Tax Law, the Exploration and Production Agreement for the oil and gas sector, and the Public Private Partnership framework law to attract private investment. Labor reforms that help create formal-sector employment opportunities for lower-skilled workers are needed
- The authorities are encouraged to further strengthen confidence and secure more inclusive growth by implementing priority fiscal and structural reforms promptly
- Authorities should embark on structural reform, starting immediately with the electricity sector, to achieve social stability and a job-rich, sustainable growth
- Strengthening the safety nets and reforming the pension system could improve equity and fiscal sustainability
- The pension system is fiscally unsustainable and suffers from striking equity shortcomings

2016

- There has been limited progress on structural reform
- 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
- 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
- The international community is called upon to provide greater humanitarian and development assistance to Lebanon

2019

- The authorities understand that the room for maneuver has narrowed significantly and have embarked on fiscal and structural reforms to correct the course of the economy
- Structural reforms proposed thus far will not substantially reduce the Current Account deficit or lift growth to levels sufficient to reduce unemployment
- Concrete steps must be urgently taken to reduce corruption

Electricity reforms

Excerpts from Article IV Reports

2011

- Investment in the electricity sector is welcome but should go in parallel with reforms to improve its efficiency

2014

- Vested interests and general lack of governance in the electricity sector have prevented progress
- Electricity sector reform could yield immediate benefits. Plans to strengthen generation capacity, switch to natural gas, and increase average electricity tariffs toward cost recovery levels – while protecting more vulnerable consumers – should be implemented without further delay
- Shift spending composition away from EDL subsidies into capital and social spending
- Increase electricity production efficiency through electricity sector reform

2015

- In the medium term the authorities should embark on structural reform, starting immediately with the electricity sector, to achieve social stability and a job-rich, sustainable growth
- The authorities should increase electricity production efficiency and reduce the burden on public resources, through electricity-sector reform
- EDL should urgently be placed on a sound financial footing to reduce the need for government transfers
- Cabinet should urgently implement electricity improvements, a game-changer for productivity, competitiveness, growth, and equity
- The authorities should shift spending composition away from transfers to the electricity company into capital spending, and increase electricity production through electricity sector reform

2016

- There is an urgent need to reform the electricity sector to remove a large drain on public finances

2019

- The electricity sector plan should be advanced without delay. Increasing electricity supply by the EDL to 24/7 would eliminate one of the biggest constraints to doing business in Lebanon, in addition to its positive effects on income distribution, the balance of payments, the environment and the fiscal deficit
- The reform of the electricity sector is important for public finances, economic growth, and the environment, and the government is fully committed to implementing it in a timely manner
- In July 2019, Parliament adopted a plan to reform the sector which would provide 24-hour electricity by 2022
- The authorities should both increase tariffs and simplify the tariff structure. Consumers should pay electricity tariffs high enough for EDL's budget to be balanced in the medium-term

IMF recognized that vested interests and general lack of governance in the electricity sector have prevented progress.

The Fund welcomed a plan approved by Parliament in 2019 to provide 24-hour electricity by 2022. It said: "Increasing electricity supply by Electricité du Liban (EDL) to 24/7 would eliminate one of the biggest constraints to doing business in Lebanon, in addition to its positive effects on income distribution, the balance of payments, the environment and the fiscal deficit."

According to the IMF, reforming the electricity sector must include an immediate increase of the tariff and eliminating electricity subsidies which could be "the most significant potential expenditure saving." It said: "The authorities should both increase tariffs and simplify the tariff structure. Consumers should pay electricity tariffs high enough for EDL's budget to be balanced in the medium-term." According to the 2019 report, reforming the electricity sector is a major part of the government's pledge at the CEDRE conference to cut the fiscal deficit.

Spillovers of the Syrian crisis

Excerpts from Article IV Reports

2011

- The uprising in Syria, particularly if protracted, presents the most serious risk to the economy
- Downside risks are high, mainly from the uprising in Syria, further escalation of which could have serious political and economic repercussions on Lebanon
- The uprising in Syria keeps Lebanon on edge given their close political and economic ties
- It has already affected investor confidence in Lebanon, disrupted tourism, increased costs of bilateral and transit trade, and prompted banks to reduce their exposure to Syria
- The largest exposure [of commercial banks] in terms of assets and loans is to Syria, with $7.5 billion assets in seven subsidiaries and $1.5 billion in direct loans from Lebanon

2014

- Spillovers from the Syria crisis have weighed on the economy
- Macroeconomic conditions have suffered a broad-based deterioration largely driven by the Syria crisis
- More spillovers could further destabilize social structures and increase economic costs
- IMF commended the authorities' efforts for receiving an unprecedented inflow of Syrian refugees
- Lebanon cannot shoulder the costs of the massive inflow of Syrian refugees alone, and international budget support is needed
- Economic growth has remained significantly below pre-Syria crisis levels
- The influx of refugees has deeply impacted the labor market, potentially increasing unemployment to about 20 percent
- Official food inflation has not increased, as Syria-related disruptions to transit routes have diverted to domestic markets food previously exported to regional markets, thus relieving demand pressures
- Net current transfers have picked up, reflecting significant humanitarian assistance, as well as lower outflows due to Syrian workers likely supporting relatives that moved to Lebanon

Very early, the IMF sensed the huge risks that Lebanon would be exposed to because of the Syrian crisis. It said in the 2011 report: "The uprising in Syria, particularly if protracted, presents the most serious risk to the economy." The uprising had already negatively affected investor confidence, disrupted tourism, increased costs of bilateral and transit trade, and forced local banks to reduce their exposure to Syria, according to the report.

IMF lauded Lebanon for its efforts in hosting a number of refugees disproportional to its population and recommended international budget support to Lebanon because the country is unable to bear the costs of massive refugee inflows without help. It recognized that Lebanon does not have the fiscal space to address the impact of the Syrian refugee.

The banks' largest exposure in terms of assets and loans is to Syria, with $7.5 billion assets in seven subsidiaries and $1.5 billion in direct loans from Lebanon. Starting from the 2014 report, the Fund began to assess the impact of Syrian refugees on the economy. It said: "The influx of refugees has

2015

- The conflict in Syria dominates Lebanon's outlook
- Downside risks associated with the Syrian crisis are exceptionally high
- The fiscal impact of the Syrian crisis is extensive
- Lebanon does not have the fiscal space to address the impact of the Syrian refugee crisis alone; dealing with it requires strong international support
- The refugee crisis is straining local communities, adding to poverty and unemployment, and placing further pressure on the economy
- Daunting inflow of refugees has taken a toll on public finances, infrastructures, and the social fabric
- Lebanon's main trading partner for services is Syria, and the widening Current Account deficit has emerged at a time when the Syrian conflict has worsened. So, it is likely that the larger deficit has been driven in large part by the disruption of Syrian demand for travel and business services
- If the crisis in Syria were to be resolved, Lebanon would be in a unique position to assist in its reconstruction, with significant and positive implications for local incomes and growth

2016

- The protracted conflict in Syria continues to dominate Lebanon's outlook
- Lebanon's outlook is linked closely to developments in Syria
- 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
- Larger and more stable support to help Lebanon address the costs of the Syrian crisis is both needed and warranted
- The most immediate impact [of the Syrian crisis] has been decelerating economic growth, coupled with an unparalleled inflow of refugees
- improvement in regional investor confidence
- 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
- 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

2019

- Funding needs are exacerbated by the large number of Syrian refugees
- Low growth, combined with a massive influx of refugees, has contributed to significant increases in poverty and unemployment
- There is still no end in sight to the Syrian crisis. Lebanon hosts displaced Syrians for a ninth year causing economic, social and political stresses
- The capacities of the host communities and government infrastructure and services have been long overstretched and exhausted, including education and medical services

deeply impacted the labor market, potentially increasing unemployment to about 20 percent." Refugee inflows were also fueling poverty, straining local communities and public services, increasing spending pressures, and exacerbating political uncertainties.

The IMF pointed to some positive byproducts of the Syrian crisis. Food inflation didn't increase because disruptions to transit routes have diverted to the local market food previously destined for export to regional markets. Net currency transfers have increased driven by significant humanitarian assistance and lower outflows as Syrian workers were likely supporting relatives that had moved to Lebanon. Despite the improvement in net current transfers, the Current Account, which includes these transfers, recorded a widening in its deficit mainly due to the disruption of Syrian demand for Lebanese travel and business services especially that Syria is Lebanon's main trading partner for services.

Economic growth has been subdued by spillovers from the conflict in Syria, but "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," according to the 2016 report.

The IMF said that as there is still no end in sight to the Syrian crisis, the capacities of the host communities and government infrastructure and services have been long overstretched and exhausted, including education and medical services.

Serious statistical flaws

Excerpts from Article IV Reports

2011

- Data provision has serious shortcomings
- There are weaknesses in the compilation of data on national accounts, the labor market, general government and the other nonfinancial public sector, and balance of payments
- There are no national data on wages and real estate activity and prices
- Data on poverty and income distribution are patchy, impairing social policy formulation
- Raising the statistical capacity in Lebanon to those of other upper middle income countries requires a firm commitment and high-level support from the government, including the allocation of sufficient resources and provision of a clear legal mandate to the Central Administration of Statistics (CAS)

The IMF was relentless in highlighting that data provision has serious shortcomings, especially national accounts and external sector statistics. The Fund said that 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. It also noted that BDL does not publish externally-audited financial statements.

The IMF reiterated that there was a lack of timely, comprehensive and reliable national accounts data and social and labor market indicators, and that this undermines accountability and economic analysis. The Fund has warned that fiscal reporting was lagging and that irregular Treasury inflows and outflows were weakening data compilation. It said in the 2019 report: "Significant delays are still ongoing in the release of fiscal data. The coverage of government finance statistics is not comprehensive. The IMF viewed the reported annual data suffer from weaknesses, mainly limited coverage. It said in the 2019 report: "The lack of a reliable classification of deposits by residency (also due to bank secrecy) and the large net errors and omissions complicate the Balance of Payments (BoP) analysis." Despite efforts to improve BoP statistics, there remain significant challenges to compiling reliable data, such as unrecorded exports and imports, uncertainty regarding estimates of private sector services, remittances, and investment income, grants, foreign direct investment, equity investment in the nonbank private sector, and corporate borrowing abroad.

2014

- 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 economic analysis

2015

- 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 has recently been lagging and irregular treasury inflows and outflows undermine data compilation

2016

- 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

2019

- 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
- Significant delays are still ongoing in the release of fiscal data
- The coverage of government finance statistics is not comprehensive
- The data suffer from weaknesses, mainly limited coverage
- 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
- Reflecting in part restrictions imposed by domestic legislation, BDL does not publish externally-audited financial statements
- The lack of a reliable classification of deposits by residency (also due to bank secrecy) and the large net errors and omissions complicate the balance of payments analysis
- There have been efforts to improve Balance of Payments (BoP) statistics, including the quality of surveys, but significant challenges remain to compiling reliable BoP data
- Metadata and plans for improvement need to be updated

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