LEBANON

Highlights

- **Lebanon has entered a deep economic crisis.** The pound is depreciating sharply, the government is struggling to manage the parallel foreign exchange market, inflation continues to spiral, and current economic trends point to hyperinflation and further economic decline.
- **A default on external debt occurred in March 2020, and all credit rating agencies downgraded Lebanon's sovereign ratings.** Major sources of external funding have dried up, including non-resident deposits, remittances and foreign direct investment, and all major ratings agencies have downgraded the sovereign rating.
- **Some reforms have advanced, but progress has been slow.** Several reforms requested by the International Monetary Fund (IMF), as part of their discussions with the government, have started, including auditing the central bank and embarking on subsidy reforms. Other reforms have stalled, notably the passage of a capital control law and the reform of the ailing electricity sector.

Key priorities for 2021

- **Agreeing on an IMF-supported stabilisation and structural reform programme is essential.** The priority should be to rebuild credibility though implementing concrete actions to reach an agreement with the IMF. This will need to include banking sector restructuring and restructuring of the government's debt obligations following its default on Eurobond payments in March. The reform programme should also involve other international financial institutions to ensure complementarity and coordination and help unlock around US$ 11 billion in commitments pledged during the CEDRE conference in 2018.
- **A social safety net needs to accompany the reform programme.** The sharp drop in economic activity, coupled with the exchange rate depreciation, record inflation and the Covid-19 crisis, have led to a surge in unemployment and poverty. There is a need to set-up a targeted social safety net to provide support for the most vulnerable segments during the painful reform process.
- **The campaign to combat corruption needs to take place, and a programme to recover stolen assets is essential.** Protests in October 2019 were triggered by discontent towards corruption in the ruling parties. Combating corruption needs to happen at all levels, starting from tax and revenue collection and procurement.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	1.5	0.9	-1.9	-6.7	-22.0
Inflation (average)	-0.8	4.5	4.6	2.9	80.0
Government balance/GDP	-8.9	-8.6	-11.3	-10.5	-16.5
Current account balance/GDP	-23.5	-26.3	-28.2	-27.4	-16.3
Net FDI/GDP [neg. sign = inflows]	-3.1	-2.3	-3.7	-3.6	0.5
External debt/GDP	182.1	190.3	192.8	197.8	n.a.
Gross reserves/GDP	78.6	76.5	66.4	45.7	n.a.
Credit to private sector/GDP	103.8	107.4	100.3	89.4	n.a.

CONTINUES

Covid-19: macroeconomic implications

Lebanon is embroiled in multi-dimensional economic crises. The economy is estimated to have fallen into a recession of -6.7 per cent in 2019, reflecting regional and domestic political uncertainties, social unrest, slow implementation of reforms and lower capital inflows. Expectations for 2020 are even worse, as a deeper recession is exacerbating unemployment and poverty. The unemployment rate is estimated to be above 40 per cent, and 75 per cent of the population could be living below the poverty line by the end of 2020. The pound has continued to depreciate and the central bank is struggling to manage the parallel foreign exchange market. The official pegged exchange rate (of 1,507.5 Lebanese pounds per US dollar) is being used only for vital imports, while the rest of the economy is subject to multiple exchange rates in the parallel market, often reaching 9,000 Lebanese pounds per US dollar.

Inflation continues to spiral. Annual inflation reached record levels of 120 per cent in August 2020 year-on-year, as the pound continued to depreciate. Given Lebanon's import dependence, the depreciation, coupled with dollar shortages, is making imports more expensive and difficult to get. Food and non-alcoholic beverages were the main drivers of inflation, in addition to rising prices of clothing and footwear, furniture, household equipment and transport. Following the August 2020 explosion, imported building materials are in high demand requiring fresh dollars thus putting pressure on those imports. At the same time, purchasing power is quickly evaporating, notably for the many Lebanese earning in local currency and spending in US dollars on imported goods.

Lebanon has ceased servicing all of its external debt. This decision in March 2020, together with the ongoing political, economic and social crisis, contributed to a narrowing in the fiscal deficit. Revenues declined, with both non-tax and tax revenues dropping significantly due to a worsening economic crisis. Expenditures also fell, mainly owing to lower debt service costs, traditionally the main expenditure component; and to a decline in transfers to Electricité du Liban (EdL), usually around 4 per cent of GDP. The debt-to-GDP ratio reached 175 per cent at the end of 2019, and is rising further as the economy is collapsing. Meanwhile, Lebanon is struggling to access capital markets and is opting for domestic borrowing, with domestic debt accounting for approximately two-thirds of total debt (evaluated using the official exchange rate).

External imbalances remain wide. The current account deficit was over 20 per cent of GDP in 2019, one of the highest in the world. This was due to the continued appreciation of the real effective exchange rate (5.5 per cent year-on-year in December 2019) and a large import bill (59.3 per cent of GDP), which was only partially compensated for by exports of services (25.5 per cent of GDP) – mainly tourism and financial services. The external situation deteriorated further in the first half of 2020, with an additional 77 per cent appreciation in the real effective exchange rate and a 13 per cent decline in non-resident deposits compared with the end of 2019. The foreign currency reserves of Banque du Liban (BdL) dropped by 26 per cent year-on-year in August 2020 to US$ 22.8 billion, as the foreign currency was used to subsidise a basket of essential imports. The actual net assets of the BdL are estimated to be negative.

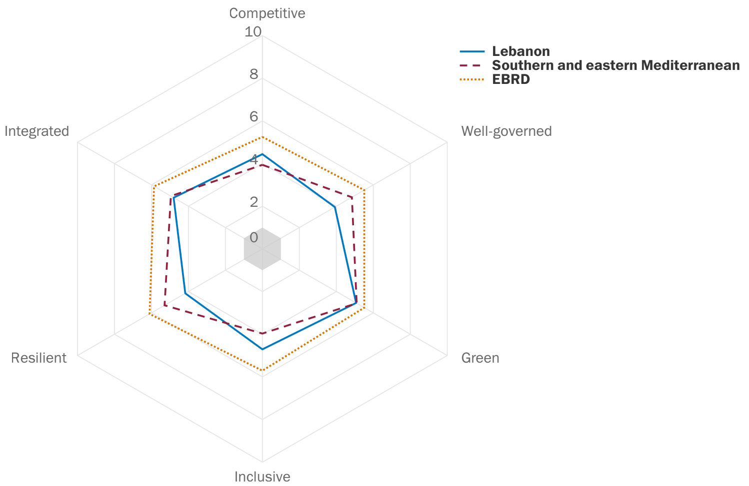
The outlook remains uncertain and the recovery depends on the speed of implementation of reforms. A further contraction of 22 per cent is expected in 2020 - the result of the ongoing economic crisis, the default on debt repayments, the Covid-19 crisis and the associated containment measures, in addition to the August 2020 warehouse explosion, which caused enormous damage. A recovery in 2021 is contingent on the government embarking on a comprehensive economic reform programme in collaboration with the IMF and in the context of an IMF programme, including debt restructuring, which would lead to increased international support and follow-up on the CEDRE commitments. However, any delay in the implementation of reforms will lead to a fourth successive year of deep GDP contraction.

CONTINUES

Policy response to Covid-19

In response to the Covid-19 crisis, the authorities undertook a variety of measures. In March 2020, the government established a national solidarity fund, accepting in-kind and monetary donations. It also allocated LBP 1.2 trillion (US$ 796 million at the official rate) for social support, extended all deadlines related to payment of taxes and fees, and provided a solidarity basket of food, sanitisers and financial assistance of LBP 400,000 (US$ 265 at the current official rate) to families most in need. Some of the announced measures were likely not implemented, attracting criticism. A BdL circular in March 2020 allowed banks and financial institutions to extend exceptional five-year zero per cent interest rate loans in Lebanese pounds or US dollars to customers that already have credit facilities but were unable to meet their obligations, operating expenses, or pay salaries to their employees during March, April and May 2020. The BdL also reduced the Beirut Reference Rate in April 2020 to 5.75 per cent for US dollars and 7.75 per cent for Lebanese pounds, and suspended US dollar withdrawals until the airport reopens.

Assessment of transition qualities (1-10)



Structural reform developments

Lebanon has entered discussions for an IMF-supported programme. The discussions began in April 2020. However, progress has been slow and did not progress to negotiations, with almost none of the reforms requested by the IMF fully implemented. The discussions were placed on hold subsequently in July 2020 and the IMF has made it clear it is ready to resume discussions once the government agrees on a common approach towards – and starts implementing – reforms in key sectors. Without the IMF's backing, Lebanon will likely be unable to gain access to external financing, as creditors will want to see a firm commitment to reforms.

The authorities have made progress on some of the reforms urged by the IMF in advance of a programme and major international counterparts. Audits of BdL have been launched, while a capital control law was drafted awaiting parliamentary approval. In July 2020, the cabinet chose a US-based company for the forensic audit of BdL, while two other companies were selected to carry out the accounting audits. In early July 2020, a capital control draft law was introduced in parliament after taking into account comments from various parties. Formal capital controls could help Lebanon curb currency depreciation and rapidly decreasing foreign reserves which follows *de facto* capital controls by the banking sector starting in late 2019. Given the fiscal constraints, the government needs to reform the electricity sector. Some progress was recently made with the appointment of a new board of directors of EdL,

CONTINUES

the state-owned utility, but the appointments were criticised by several groups who viewed these as still reflective of sectarian affiliations. Subsidy reforms continued, with the increase in the price of subsidised bread in June 2020. For the first time since October 2019, bread prices increased by 33 per cent, after previous weeks saw long lines in front of bakeries as some owners had decreased production due to the rising costs of imports. Meanwhile, reforming the electricity sector and subsidies will require a concerted effort by the government.

A new trade finance fund has been launched. Cedar Oxygen, a US$ 175 million independent Trade Finance Impact Fund supported by BdL, was launched in July 2020 to provide trade finance solutions to manufacturing companies. The support of the industrial sector through Cedar Oxygen aims to stabilise the economy and the banking sector, and ultimately attract foreign capital investments to Lebanon. Cedar Oxygen will be working in partnership with selected Lebanese banks, which will identify those eligible for financing.