LEBANON ECONOMIC MONITOR
DE-RISKING LEBANON

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PREFACE

The Lebanon Economic Monitor provides an update on key economic developments and policies over the past six months. It also presents findings from recent World Bank work on Lebanon. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy on the outlook for Lebanon. Its coverage ranges from the macro-economy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Lebanon.

The Lebanon Economic Monitor is a product of the World Bank’s Lebanon Macroeconomics, Trade and Investment (MTI) team. It was prepared by Wissam Harake (Country Economist) and Naji Abou Hamde (Economic Analyst), under the general guidance of Christos Kostopoulos (Lead Economist) and Kevin Carey (Global Practice Manager). Sameh Mobarek (Senior Energy Specialist) contributed on the energy sector. Mona Ziade (Communications Officer) is the lead on communications, outreach and publishing.

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To be included on an email distribution list for this Lebanon Economic Monitor series and related publications, please contact Nada Abou Rizk (nabourizk@worldbank.org). For questions and comments on the content of this publication, please contact Wissam Harake (wharake@worldbank.org) or Christos Kostopoulos (ckostopoulos@worldbank.org). Questions from the media can be addressed to Mona Ziade (mziade@worldbank.org).
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EXECUTIVE SUMMARY

I. Lebanon’s macro-financial conditions are currently under heavy scrutiny as the country faces increasing challenges. The risk profile for Lebanon is rising sharply in light of the convergence of a number of negative local and global factors, including global monetary conditions. Meanwhile, the utility of some of the tools used by the central bank is depleting following years of application. The central bank has responded by beefing up its stock of foreign exchange reserves, lengthening the maturity of deposits and limiting the liquidity available, thereby inhibiting speculation against the Lebanese Pound.

II. In this issue of the Lebanon Economic Monitor (LEM), we focus on Lebanon’s macro-financial conditions. We begin by explaining real economy and macro-fiscal features that underpin these conditions. We then present a synopsis on the intertwining monetary and financial sectors, followed by an elucidation on latest macro-financial dynamics. Naturally, the role and activity of the central bank is given particular attention.

III. WB projection for 2018 real GDP growth is revised downwards to 1 percent. The halt in central bank subsidized lending is having a significant impact on the real economy. Indeed, high frequency indicators—mostly based on the first half of 2018 (H1 2018)—point to a deceleration in economic activity thus far in 2018 across all but the external sector—where a 7.3 percent year-on-year (yoy) rise in merchandise exports over H1 2018 neutralized higher imports to leave the trade deficit minimally varied in absolute value (and lower as percentage of GDP). Indicators for the real estate sector, which has been the main beneficiary of these lending facilities, point to a contraction in the sector, with cement deliveries down by 3.4 percent (yoy) in H1 2018.

IV. A rise in current spending is expected to drive up the fiscal deficit from an exceptionally low 6.6 percent of GDP in 2017 to a projected 8.3 percent in 2018. Moreover, subdued GDP growth and high interest payments mean that the debt-to-GDP ratio is expected to persist in an unsustainable path toward 155 percent by end-2018. Meanwhile, inflationary pressures continue in 2018, driven in good part by the salary scale increases in 2017, a strong rebound in commodity prices, especially fuel products, and a low-threshold effects after 2 deflationary years.

V. Quick implementation of Government of the Lebanon’s commitments during CEDRE—Conférence Économique pour le Développement par le Réforme avec les Entreprises—is key in the short-term to help offset declining confidence. In this regard, fiscal and electricity reforms are highlighted as priorities.

VI. The government presented at the conference a Vision for Stabilization, Growth and Employment in which it pledged “a fiscal consolidation of 5 percentage points of GDP over the next five years (i.e. one percentage point a year). This is to be achieved through revenue measures, including improved collection and a reduction of loopholes, as well as a reduction in spending where possible, including through a reduction in the government’s transfers to EdL.”

VII. The government’s vision in CEDRE also articulated a strong reform and investment program for the electricity sector. This includes a more efficient power generation mix, expansion of power generation (both preceding steps are amenable to PPPs), reductions in technical and non-technical losses, institutional and capacity building reforms to modernize EdL, as well as tariff reforms - carefully sequenced and mitigated for the poor.
I. RISKIER LEBANON

1. Lebanon is once again in political inertia, unable to mobilize for impending challenges. Following a series of significant achievements—including the election of a president; passage of 2017 and 2018 budgets; a fruitful donors conference in Paris (CEDRE); liberation of areas along the border with Syria that were held by ISIS and Al Qaeda affiliates; and successful parliamentary elections based on a new election law—there was hope that a quick formation of government would usher in a new era of continued achievements. However, after over 100 days of political disagreements that have prevented formation of a new government, the positive confidence boost that was generated in the aftermath of a successful CEDRE conference has waned\(^1\). In its place, a familiar reality of political discord and serious macro-financial challenges have reassumed prominence.

2. The potential for Lebanon to regain the confidence of its people and investors is evident from recent parliamentary accomplishments. In the absence of a new government, parliament held its first legislative session on 24 September 2018, passing a bundle of important bills, in the first legislative session since parliamentary elections in May 2018. During the session, bills on e-transaction and personal data, judicial mediation, waste management were passed as well as some anti-corruption draft laws on whistleblowers protection and transparency in the oil and gas sector. Additionally, parliament also endorsed two World Bank projects, namely, Health Resilience, Roads and Employment, and a project preparation advance for Strengthening Fiscal Governance. In addition, Lebanon is likely to benefit from the recent re-opening of Syria-Jordan Nassib border crossing, which was a main gateway for Lebanese exports into the GCC and Iraqi markets.

3. In the absence of a government, commitments made by Lebanon in CEDRE, which include reforming the electricity sector and lowering the fiscal deficit, are not able to progress.

4. More urgently, a confluence of factors, local and global, are weighing down on already fragile macro-financial conditions. Increased local discord over governance issues are interacting with heightened geopolitical tensions, re-enforcing internal schisms; the Syrian war and its spillovers into Lebanon, albeit progressively more containable, continue with no end in sight; the persistently sluggish economy is taking a toll on private and public balance sheets, further slowing economic activity; rising risk premia for Lebanon is generated from increased exposure to emerging market volatility that is driven by global monetary conditions.

5. Macro-financial fragility stems from a frail macro-fiscal framework underpinned by unsustainable debt ratios and persistent and sizable fiscal and current account deficits (Figure 1), exposing the country to significant refinancing risks. Attracting sufficient capital, and in particular deposits, to finance significantly larger budgetary and current account deficits is proving challenging in light of slower deposit growth. This is especially so in light of rising U.S. interest rates. Meanwhile, there is a near-complete void of government initiative to address macroeconomic imbalances and other structural bottlenecks such as power generation in Lebanon. Instead, progressively potent interventions by the central bank, the Banque du Liban (BdL), to actively manage economic and financial challenges facing the country, even when successful, offer only temporary reprieve, and are not without additional macro-financial risks.

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\(^1\) Government had yet to form by the time this publication went to print.

6 | Riskier Lebanon
6. In this note, we focus on Lebanon’s macro-financial conditions. We begin by explaining real economy and macro-fiscal features that underpin these conditions. We then present a synopsis on the intertwining monetary and financial sectors, followed by an elucidation on latest macro-financial dynamics. Naturally, the role and activity of BdL is given particular attention.

![Current Account Deficit, Fiscal Deficit, and Public Debt (% of GDP)](image1)

**FIGURE 1.** Large twin deficits have been a long-term vulnerability for Lebanon

**Sources:** BdL and WB staff calculations.

![Real GDP Growth (%)](image2)

**FIGURE 2.** Volatile GDP growth makes way to consistently sluggish output

**Sources:** CAS and WB staff calculations.
II. THE FUNDAMENTALS

A. A Defective Growth Model

7. Over the past few decades, highly volatile and uneven growth has characterized Lebanon’s economy, partially as a result of frequent political and security shocks, but also due to structural problems. Real GDP grew on average by an estimated 5.6 percent annually from 1993 to 2010, but these figures mask the impact of the many shocks (domestic, international, political) Lebanon faced over this period (Figure 2). Since 2011, traditional drivers—real estate, construction, finance and tourism—have suffered greatly from the regional turmoil. This combined with significant interruptions in governance and near-complete absence of economic reforms in the face of large shocks led to persistently sluggish real GDP growth that averaged 1.7 percent annually. Additionally, it is likely that the informal economy has expanded in the wake of the Syria war in a manner that might not be accounted for in the National Accounts statistics.

8. Lebanon’s real GDP growth has decelerated sharply since 2010, but its main drivers have remained services characterized by low productivity and low employability potential for high-skill labor. The service sector constituted 72.4 percent of real GDP over the 2004-2016 period, while industry and agriculture made up a much less 14 percent and 4.3 percent of GDP, respectively (Figure 3). Real estate is the largest service sector, averaging 13.7 percent of GDP over the same period (Figure 4), and increasing to 17.3 percent if combined with construction. Wholesale and retail trade is also a principal output for the economy, making up 13.4 percent of GDP. This is followed by public administration at 9.4 percent of GDP and financial services at 7.3 percent of GDP. All but financial services are low value-added sectors and do not generate high skill employment opportunities. Additionally, all but wholesale and trade of the aforementioned sectors, lend themselves to rent-seeking.

9. On the demand side, the economy is strongly biased towards a large structural external deficit position. Lebanon’s economy is heavily consumption based, with private consumption averaging 88.4 percent of GDP over the 2004-2016 period (Figure 5). The main supply-side sectors identified above—real estate, trade, public administration etc. — do not produce the consumption goods in demand, which are instead largely imported. This renders the external sector a large net negative on output, averaging -24.4 percent of GDP over the 2004-2016 period. Meanwhile, total investments at 23 percent of GDP has mostly been focused on a non-productive, rent-seeking, real estate sector.

10. Lebanon ranks as one of the least competitive economies, both globally and regionally. The Global Competitiveness Index (GCI) by the World Economic Forum ranks Lebanon 105th of 137 countries, ahead of only Yemen in the region (Figure 6). Moreover, Lebanon’s backslide in competitiveness has been the most marked in the region over the past decade. The leading drags on Lebanon’s competitiveness have been its macro-economic environment, a dilapidated infrastructure and weak institutions and governance.

11. As a result, the economy has struggled to reduce widespread poverty and to generate inclusive growth, as job creation has been weak and poorly distributed. The long-run, employment-growth elasticity is estimated
to be 0.2 (World Bank, 2012), much lower than an estimated MENA average of 0.5 (IMF, 2014). Meanwhile, the employment that has been generated has been concentrated in low productivity activities as those involving higher productivity have not grown proportionally. Over the past decade or so, domestic trade accounted for about 47.3 percent of all new employment, public and private services for 34.7 percent and construction for nearly 10 percent (ILO, 2015).

Thus, and in mirroring the structure of the economy, relatively low productivity activities dominated employment growth, while growth in productive activities such as communications, agriculture and manufacturing was marginal. Moreover, since foreign labor dominated low skilled (less productive) activities, high GDP growth rates have not translated into significant job creation for the Lebanese.

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3 IMF (2014), Article IV Consultation and Selected Issues, July 2011, Washington DC.

B. The Shrinking Fiscal Space

12. Lebanon’s public finances in the post-war period have been structurally weak, with high overall fiscal deficits the norm. This has been driven by below potential growth, an inability to rein in waste and corruption and an exorbitant and inefficient power generation sector. The decade prior to the Syrian conflict, the overall fiscal deficit ranged from 17.8 percent of GDP in 2001 to 7.5 percent in 2010, averaging 11.7 percent of GDP over that period (Figure 7). As a result of these high and sustained deficits, Lebanon’s public debt peaked at nearly 180 percent of GDP in 2006 (Figure 8). Between 2006 and 2010, above potential GDP growth significantly improved Lebanon’s fiscal balances and pushed debt-to-GDP down by about 40 percentage points (pp) of GDP. The Syrian crisis, however, reversed this progress pushing the public debt to 148.5 percent of GDP by end-2017.

13. Lebanon’s expenditures are characterized by large budget rigidities which limit fiscal space and flexibility to react to shocks. These expenditures are concentrated on wages, pensions, debt servicing and transfers to Electricité du Liban (EdL), the combination of which accounted for an average of 76 percent of total spending over the past decade. The wage bill (as a share of GDP) for public sector employees in Lebanon is not excessive when compared to a group of comparator countries (Le Borgne and Jacobs, 2016). Pensions, however, stand out as particularly costly, heterogeneous and highly insufficient, covering a very small minority; retirement and end of services compensation have averaged 2.6 percent of GDP over the past decade, while hardly 2 percent of the entire population receives a pension (including survivorship, invalidity and old-age pensions).


14. Low public capital expenditures have reduced potential growth. The absence of fiscal space combined with a lack of official budgets between 2005-2016 have resulted in a sharp fall in public spending on capital projects—these have averaged around 1.6 percent of GDP over the past decade, which is significantly below comparator countries. As a result, the country’s infrastructure network and quality have deteriorated, particularly transportation, water supply and electricity—services important for the population’s well-being. Further, low public investment in these sectors has caused capacity to lag behind demand, leading to a reduction in potential economic growth and an overall deterioration in living conditions.
C. The Need to be $-Attractive

15. While structurally in a sizable deficit since the end of the civil war, Lebanon’s trade balance further deteriorated with the eruption of regional turmoil. Lebanon’s exports (of goods and services) have been severely afflicted by the regional turmoil, although a decline in their share of GDP has been in effect since 2008, when they reached a high of 78.1 percent of GDP (Figure 9). By 2017, exports regressed to a low of 36 percent of GDP, registering a bottom since 2002, with both merchandise goods and services sharing this dynamic. Exports of merchandise goods have been specifically damaged by the closure of the last remaining Syrian route in May 2015, through which exporters were able to access the GCC and Iraqi markets. Exports of services have equally regressed since 2010, dragged by travel and financial services, with the former reflecting a contraction in the tourism sector and the latter a regression in banks’ strategy of regional expansion. Imports of goods and services underwent a similar dramatic shift, falling from a high of 102 percent of GDP in 2008 to a low of 60 percent in 2017. While exports and imports have imposed offsetting effects on the trade balance, the regional turmoil’s overall impact is a clear worsening of this balance; the trade deficit in the crisis period (2011-2017) averaged 24.3 percent of GDP, compared to a pre-crisis (2002-2010) average of 20 percent.

16. As with the trade balance, the regional turmoil helped exacerbate an already sizable current account deficit from a pre-crisis (2002-2010) average of 16.3 percent of GDP to an average of 20.1 percent of GDP over the 2011-2017 crisis period (Figure 10). Nonetheless, the current account retained its fundamental structure over the two periods; a surplus in net exports of services, driven by travel services, has historically partially offset the massive trade-in-goods deficit. Thus, the deterioration in the current account balance from pre-crisis to crisis periods can be attributed to a decline in the average net exports of travel services from 9.9 percent of GDP to 4.8 percent of GDP, respectively.

17. The economy is structurally and heavily dependent on capital and financial inflows to finance its current account deficit. This dependence has become more acute as the current account deficit expanded in recent years. In addition, there have been structural shifts in the capital and financial accounts since the period prior to the regional crisis, reflecting a diminished range of resources available for Lebanon. In the pre-crisis period (2002-2010), the main inflows were sourced from net foreign direct investments.

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6 While the drop in the GDP share of exports from 2008 to 2010 can be attributed to a denominator-led effect of exceptionally high GDP growth rates, the proceeding years experienced a decline in the absolute value of exports.
(FDI) and net other investments (loans, currency and deposits), averaging 9.8 percent of GDP and 17 percent of GDP respectively, that partially offset an accumulation in reserves asset at an annual average of 9.3 percent of GDP. The crisis period (2011-2017) witnessed a sharp decline in net FDI and other investments, averaging instead 3.4 percent of GDP and 13.8 percent of GDP, respectively. These, however, were mitigated by a slower accumulation of reserves assets, which fell to 4 percent of GDP.

18. **Lebanon’s net foreign asset (NFA) position has been in a general decline since 2011.** Within the context of a fixed exchange rate regime and long-term internal and external deficits, Lebanon necessitates a surplus accumulation in its NFA position on an annual basis. This was generally achieved in the pre-2011 period, with some exceptions (Figure 12). Nevertheless, a rise in the current account deficit, along with a sharp fall in FDI and other sources of inflows have resulted in a negative change in the NFA position of the economy for every year from 2011 to 2015. In order to safeguard its stock of foreign exchange reserves, and boost the NFA position, the Central Bank, Banque du Liban (BdL), initiated the first in a series of large financial engineering/SWAP operations (see section III.B). This successfully increased NFA in 2016 by US$ 1.2 billion. In 2017, however, and despite continued financial engineering operations by BdL, there was again a decline in the NFA position, albeit by only US$ 156 million. The decline has continued into 2018, falling in H1 by US$ 190 million.

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7 Interestingly, an important resource in managing this transition has been a better identification of the balance of payments, as errors and omissions fell from an average outflow of 4.5 percent of GDP in the pre-crisis period to an inflow of 0.1 percent in the crisis period.

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12 | The Fundamentals
III. A MACRO-FINANCIAL ECONOMY

19. Throughout Lebanon’s modern history, and increasingly so since the end of civil war in 1990, the banking system has been a primary lure for capital inflows, and its sole conduit into the economy. It led the financing of the post-civil war reconstruction efforts in the nineties and has been funding persistent and sizable internal and external deficits ever since. Moreover, in light of regressed tourism and FDIs into the country since 2011, banks have become the main vehicle for capital inflows. Overseeing the banks has been an active and strong central bank, whose interventions have been at times controversial. To understand the mechanics behind Lebanon’s macro-financial system, we first begin by considering the structural set up, and then proceed to elucidate more on recent dynamics.

A. Staggered Incentives

20. The Lebanese financial system is dominated by commercial banks, with the non-bank financial sector marginal and relatively inconsequential.8 In fact, banks’ assets constituted 97 percent of financial system assets in Lebanon at end-2015 (WB-IMF, 2017).9 By June 2018, the balance sheet of the banking sector reached US$ 234 billion, equivalent to over 4 times GDP, of which private sector deposits made up US$ 173 billion. Moreover, Lebanese firms depend significantly on the banking sector for their financing, as 53 percent of all firms—50 percent of small firms and 63 percent of medium-size firms—reported having received a bank loan (Le Borgne and Jacobs, 2016, pg. 43).

21. Lebanese banks attract depositors, primarily the large and wealthy Lebanese diaspora, who appreciate BdL’s tight regulatory environment that ensured a focus on traditional commercial banking and minimum exposure to toxic assets. For example, a BdL-imposed prohibition on investments in mortgage-backed securities, which were at the heart of the global financial crisis in 2007-08, helped identify Lebanon as a safe haven for regional capital that was fleeing western financial institutions during the crisis. Similarly, the stability of the system during the banking crisis in neighboring Cyprus was salutary. Additionally, Lebanon’s strict bank secrecy is a significant factor for some depositors (Le Borgne and Jacobs, 2016, pg. 25).

22. Lebanon’s banking sector enjoys a comfortable capital cushion. Banks are well capitalized and resilient owing to prudent investments and conservative regulation by BdL and the Banking Control Commission. The Capital Adequacy Ratio (as per Basel III requirements) was at 16.5 percent by end-2016 (BankData, 2017)10, while commercial banks’ consolidated capital account11 has held steadily between 7 to 9 percent of the total balance sheet since 2011.

23. The main monetary policy objective for BdL has been sustaining the fixed exchange rate regime at US$ 1 to LBP 1507.5, and a primary monetary tool used to achieve this objective has been a staggered structure of interest rates. This interest rate structure primarily involves three staggered clusters of rates, namely, and in increasing order of magnitude: (i) global rates—proxied by the LIBOR; (ii) the rate paid on dollar deposits in Lebanon; and (iii) the interest rate paid on LBP deposits in Lebanon (Figure 13). Since 2011, the margin paid on dollar deposits

8 By end-2016, there were 67 operating banks in Lebanon, 50 of which were commercial and the rest investment banks (Association of Banks in Lebanon, Annual Report 2016).
11 The capital account is the sum of Tier 1 and Tier 2 capital.
in Lebanon vis-à-vis the LIBOR has averaged 256 basis points (bps), while that paid on LBP deposits vis-à-vis dollar deposits in Lebanon averaged 244 bps. The former margin helps attract dollars to the economy, while the latter bolsters demand and utility of the local currency. This staggered structure is underpinned by term deposits (TDs) and certificate of deposits (CDs) offered by BdL in both LBP and US$, and bought by commercial banks.

24. The significance of this monetary policy is amplified by the fact that deposits are by far the main funding resource for banks, themselves being the sole financing channel for the economy. In fact, by June 2018, the deposit-to-total liabilities ratio\(^{12}\) stood at 76 percent. A priority for the banking sector has been to attract private non-resident deposits, which constituted 21 percent of total private deposits by June 2018. Predictably, private non-resident deposits have also been the most volatile, fleeing during times of upheaval (i.e. 2002 fiscal crisis, Hariri Assassination in 2005, 2006 Lebanon-Israel war), and flowing in briskly during periods of optimism, reconstruction (post 2006 war) and in search of a safe haven in the 2008-09 global financial crisis (Figure 14). Moreover, Lebanon’s economy is highly dollarized, with the deposit dollarization rate having remained comfortably above 60 percent since the beginning of the millennium, registering 68.4 percent by June 2018.

25. The interest rate structure and other incentives have increasingly bound banks to the public sector and ensured the inability of other business models to compete. To operate profitably, banks’ chief business model increasingly depended on attracting deposits to fund onward lending to the sovereign using various conventional and non-conventional instruments, with key intermediation by BdL. High interest rates, a sovereign guarantee on public debt—along with a government record of never having defaulted on public debt—and the simple business of lending to the sovereign, all helped render the state the dominant client for banks. In fact, over half of commercial banks’ assets have consistently been sovereign assets (Figure 15), primarily consisting of Treasury Bonds (TBs) in LBP, Eurobonds in US$ and various BdL instruments (Figure 16). Indeed, interest income amounted to 66 percent of total consolidated banks’ income in 2015 (BankData, 2017).\(^{13}\) Over the years, BdL instruments have increasingly become the main investment of choice for commercial banks. As a result, large international retail banks, even ones with a historical presence in Lebanon, have all together

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\(^{12}\) This is the ratio of total private and public-sector deposits at commercial banks to commercial banks’ balance sheet.

\(^{13}\) Banks’ income figures for 2016 have been highly distorted by profits reaped from the large financial engineering operation.
abandoned the Lebanese market. The last such bank, HSBC, sold off its assets in Lebanon to BLOM bank in August 2016.

26. In light of crowding out effects to the private sector from the high interest rates, BdL advanced incentive schemes to entice banks to lend to specific sectors. The 2007-2009 period witnessed a surge in banks’ investments in high-yielding BdL certificates of deposits and Treasury papers leading to insufficient lending in Lebanese Pounds to the private sector (IMF, 2012). In response, BdL allowed for larger reductions in the effective reserve requirements of commercial banks, conditioned on extension of loans to specific sectors. The success of these incentive schemes led BdL to increase the deduction ceiling on reserve requirements to 90 percent in January 2011.

B. Facing Post 2011

27. Since 2011, there has been a discernable slowdown in deposit growth, the bulwark for financing internal and external imbalances. World Bank staff estimate that new private sector deposits at commercial banks since 1994 have averaged around 12 percent of GDP annually, of which new non-resident private deposits averaged 3.3 percent of GDP. This, however, conceals a decidedly decelerating trend. In fact, between 2003 and 2010 new total (resident plus non-resident) private deposits (D) averaged 19.2 percent of GDP, while new non-resident private deposits (NRD) averaged 4.3 percent. These ratios have declined sharply since, due primarily to the regional turmoil, and secondarily to the unsustainability of such high levels. During the crisis period of 2011-2017, D and NRD shares of GDP fell to 7.5 percent and 3.2 percent, respectively (Figure 17).

28. In light of slowing deposit growth, reflecting decelerating capital inflows, BdL has embarked on successive financial engineering operations in order to reinforce the economy’s net foreign assets (NFA) position. From 2011, the economy suffered 5 consecutive years of hemorrhaging of its NFA position (Figure 16).
18), a unique condition and an appreciable vulnerability for the post-war economy in Lebanon. In response, BdL initiated its first large financial engineering operation in 2016 in the form of a SWAP, with the intention of attracting inflows into the country and boosting its own stock of foreign exchange reserves as well as banks’ capital base. This was followed by other SWAPs with differentiated terms but similar objectives of reinforcing the economy’s NFA position, and more specifically, increasing BdL’s stock of foreign exchange reserves. Common to all operations is a type of premium offered by BdL to incentivize banks to engage in these SWAP operations. These operations have so far achieved the primary objective of boosting the NFA position, or at the very least mitigating its decline. However, this has been achieved at high and increasing costs carried on BdL’s balance sheet, and higher exposure to macro-financial risks for the economy. Moreover, in light of slowing deposit growth, a main funding source for banks to engage in these activities has been their holdings in foreign banks, as illustrated by a declining trend in banks’ deposits with BIS banks (Figure 15). Essentially, the sovereign’s foreign currency-denominated buffers have been reinforced at the expense of banks’ foreign currency-denominated buffers.

29. To offset the sharp slowdown in economic activity that ensued post 2011, BdL introduced successive and sizeable stimulus packages, in the form of subsidized loans. These were in effect from 2014 to 2017. According to BdL (2015), the principal goal from launching the stimulus packages was “to create new job opportunities for the Lebanese youth and stimulate the Lebanese economy through ensuring the necessary financing for small and medium enterprises”. The funds from the stimulus packages were provided as soft loans to commercial banks who on-lend the funds at a subsidized rate of interest (World Bank, 2016). According to BdL, as of August 2018, BdL extended a total of LBP 9,141 billion (US$ 6.1 billion), based on this scheme, to banks, which subsequently lent out LBP 12,162 billion (US$ 8.1 billion) to the private sector. Around 59 percent of these loans were directed toward the housing sector. Preliminary evidence also suggests that economic activity would have been more sluggish in the absence of BdL’s

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19 For more in-depth discussion of BdL’s 2016 financial engineering operations, refer to: World Bank (2016), The Big Swap: Dollars for Trust, the Lebanon Economic Monitor, Fall 2016 Issue.

20 This likely also involved an improvement in the risk profile as BdL assets are invested in instruments rated BBB and above.


22 World Bank (2016), The Big Swap: Dollars for Trust, the Lebanon Economic Monitor, Fall 2016 issue.
subsidized lending, considering the political paralysis, the volatile security environment and spillovers from the Syrian conflict that Lebanon was exposed to over this period (World Bank, 2016).

30. BdL subsidized lending to the real economy via the banking sector ensured strong flow of credit to the private sector, especially since 2012. By June 2018, the stock of outstanding credit to the resident private sector reached 99 percent of GDP (and that to resident and non-resident private sector reached 130 percent of GDP), which is by no means low. The real estate sector has been the primary beneficiaries of these loans.

C. Emerging Lebanon?

31. Current emerging market volatility have centered around economies which have traditionally been dependent on capital inflows to finance external deficits, exposing them to sudden stop scenarios. This dynamic is especially relevant during times of monetary policy transition for the US FED from expansionary to contractionary policy, as is the case now. Indeed, a group of emerging economies, which includes Turkey, South Africa, Argentina and Brazil, benefited from the search for yield in periods of low global interest rates. These same economies are now facing refinancing pressures as global interest rates pick up and international investors deleverage risk. The depreciation of the Turkish Lira (TRY), and indeed other emerging market assets, are manifestations of such conditions.23

32. For an economy to be exposed to the above dynamic, it needs to be subject to two main criteria: (i) foreign exchange refinancing risk (in the private or public sector)24 and (ii) global market integration. Hence, contagion is not so much a result of direct economic linkages between affected countries. In the case of Lebanon, while direct economic linkages between Lebanon and Turkey are not insignificant (see Box 1), Turkey might only act as a regional gateway for a wider more classical emerging market reaction to rising global interest rates.

33. Large internal and external foreign exchange financing needs subject Lebanon to acute refinancing risk. As illustrated earlier, the Lebanese economy is strongly a deficit economy that depends on short-term capital inflows to finance long-term, sizable (twin) deficits. Gross public debt reached around 148 percent of GDP by end-2017, registering one of the highest ratios in the world. Over 40 percent of gross public debt is denominated in foreign currency. As a result, debt service for the government amounts to approximately 10 percent of GDP annually, consuming about half of domestic revenues and driving a large overall fiscal deficit that has averaged close to 8 percent of GDP over the past decade. Externally, a large trade deficit leads to a sizable structural current account deficit, which has averaged close to 20 percent of GDP since 2011. In 2016, gross financing needs for the public sector were 30 percent of GDP, while that for the external sector (gross external financing needs) were 171 percent of GDP (IMF, 2017). This is all under the context of a fixed exchange rate regime that has been in effect for a couple of decades and which has become a main pillar of the Lebanese macroeconomic policy.

34. While the above has been a long-term structural vulnerability for Lebanon, a principal buffer has traditionally been the economy’s relative segmentation from global financial markets. This is due to the dominion of domestic investors—domestic commercial banks, central bank and public institutions—in the Lebanese foreign debt market. While statistics

23 The Turkish currency, which has been gradually softening against major currencies for a few years now, depreciated by over 60 percent vis-à-vis the US dollar since the beginning of 2018 (as of August 27, 2018, the exchange rate is 6.2 TRY to the US$).

24 Experience, such as the 2008 Great Financial Crisis, suggests that the public sector can be forced to assume private sector liabilities in order to prevent from systemic financial collapse.
on foreign holders of Lebanese Eurobonds—the only sovereign debt instrument readily accessible to foreign investors—are not available, we can deduce relevant information residually from other data. In March 2016, domestic commercial banks held US$ 18.5 billion worth of Lebanese sovereign Eurobonds, equivalent to 73.9 percent of Lebanon’s outstanding stock of Eurobonds. The rest was split between the central bank and foreign investors. As a result, returns on Lebanese Eurobonds were relatively uncorrelated with those for other emerging markets’ debt instruments; the correlation coefficient between Lebanon’s EMBIG and a more general emerging market composite EMBIG26 using monthly observations for the period January 2012 to December 2015 was a low 0.078.

35. Increased dependence on foreign portfolio investors to raise foreign exchange over the past couple of years, has rendered the financial sector more exposed to global financial markets. By June 2018, domestic commercial banks still held US$ 16.1 billion in Lebanese Eurobonds, with the proportion of the total outstanding declining sharply to 48.9 percent. While the central bank also holds a stock, anecdotal evidence suggests that a principal driver of this decline is a significant rise in the proportion held by foreign investors. Furthermore, the Lebanon EMBIG-composite EMBIG correlation coefficient rises to 0.28 over the period January 2016 to August 2018.

36. As a result, global market conditions have become a more important determinant of Lebanese Eurobonds’ risk/return profile. Consequently, the recent normalization of global interest rates has had an impact on Lebanese Eurobonds as indicated by a sharp rise in Lebanon’s Credit-default Swap (CDS) spread (Figure 20).

37. If this confidence shock should materialize into systemic malfunctions, the stabilizing tools available to Lebanon are limited. Lebanon’s fixed exchange rate regime is a central pillar for its macro-financial structure and cannot be abandoned without a significant risk of systemic financial failures. Moreover, due to Lebanon’s relatively less diversified export base (small merchandise exports, non-WTO member, weak trade agreements), say compared to Turkey, it lacks the routes to an export-led adjustment.

38. Nonetheless, domestic investors remain an important, albeit weakened, buffer for Lebanese debt instruments, requiring a reasonably high threshold intensity for the confidence shock to threaten the macro-financial structure. Even if foreign investors of Lebanese Eurobonds hold up to 45 percent of the outstanding sovereign Eurobond portfolio, this would constitute less than 20 percent of Lebanon’s gross public debt.

39. Other mitigating factors include a captive/home-biased depositor base, credibility of the central bank and potential monetary policy discretionary space. In comparison with emerging market risk/return profile, Lebanon’s risk premium has been consistently higher, but interest rates more around the average. As illustrated in Figure 19, risk premium paid on Lebanon’s Eurobonds has been significantly higher than that paid on emerging market debt. However, this has not been compensated for by correspondingly high interest rates (Figure 20). A number of factors work in Lebanon’s favor. To begin with, the depositor base is relatively captured as both resident and non-resident depositors28 exhibit strong resiliency toward political and security shocks in Lebanon. In addition, there is extraordinary confidence by depositors in the central bank, which has become renowned for its crisis management successes (2005 Hariri assassination, 2006 war etc.). More recently, the financial engineering operations have helped reinforce the net foreign

26 The J.P.Morgan Emerging Markets Bond Index Global (“EMBI Global”) tracks total returns for traded external debt instruments in the emerging markets. For Lebanon, this would primarily be sovereign Eurobonds.
28 Lebanese expatriates are the main constituency for non-resident depositors.
asset position of the economy, without the necessity of raising interest rates at a time when the risk premium was surging higher (Figure 19) and global interest rates rising. This leaves some discretionary space in the form of interest rate increases. In fact, this seems to be the latest mitigating measures adopted by BdL, especially since November 2017.

D. Recent BdL Responses

40. The Saudi-based temporary resignation of PM Hariri on November 4, 2017, constituted a significant negative shock on confidence for Lebanon’s financial markets, leading to substantial exchange market pressures. A spike in dollarization of deposits ensued in the first few days of the crisis; people’s rush for dollarizing their accounts saw the deposit dollarization rate increase by 145 basis points (bps) in November and December 2017, but has since fallen by 30 bps to reach 68.42 percent by June 2018. Reflecting the rush to dollarization, private sector deposits (resident and non-resident) in LBP decreased by US$ 2.9 billion in the crisis month of November 2017.

41. BdL stepped in very rapidly with counter measures that proved critical in preventing outright outflows. In the face of the surge in demand for dollars, BdL adopted the following measures: (i) it prohibited withdrawal of fixed-term deposits prior to maturity, when prior to the crisis such withdrawals could be done anytime at a cost of foregoing an interest rate margin; (ii) it closed off the discount window such that commercial banks could no longer exchange Treasury bonds they held for LBP liquidity; and (iii) it made it compulsory to spot deliver LBP when exchanging into dollars, when previously, trans-actors were given 24 hours to meet the LBP cost. This led to an LBP liquidity crunch which sent the overnight interbank rate souring temporarily, reaching 150 percent, before settling back to more normal single digit rates. Anecdotal evidence suggests that this liquidity crunch was a deliberate policy...
intended to deny speculators the resources with which they can attack the Lebanese Pound.

42. **The central bank also encouraged banks to offer enticing rates for longer maturity deposits.** Worried depositors who inquired with banks about their holdings, or who went to banks with intentions of dollarization or even withdrawal, were offered very enticing interest rates for longer maturity, LBP- and US$-term deposits. In fact, weighted average deposit rates in LBP and US$ rose by 85 bps and 17 bps, respectively, from October 2017 to December 2017, the largest increases since the Hariri assassination in February 2005. In total, from the onset of the crisis, the weighted average deposit rate in LBP and US$ rose by 116 bps and 37 bps, respectively, to register 6.72 percent and 4.09 percent, by June 2018. Looking at the relative margins within the staggered interest rate structure can also be telling. The LBP-US$ deposit rate margin rose by 79 bps over the period October 2017 to June 2018, whereas, that for US$ deposit-LIBOR declined by 59 bps (October 2017 to May 2018). Hence, tightening global monetary conditions have led to a 98 bps rise in the LIBOR, more than offsetting the increases in the weighted average deposit rate in US$. This can further expose Lebanon to emerging market stresses, possibly driving further increases on interest rates on US$ deposits in Lebanon.

43. **Key achievements by BdL have been a sharp rise in the maturity profile of deposits at commercial banks and tighter liquidity in LBP.** The combination of higher interest rates, especially on LBP deposits, and restrictions on withdrawal of term deposits prior to maturity, led to a sharp rise in the maturity profile of deposits. Average maturity on deposits have risen to 5.7 months—4 months for LBP deposits and 7 months for US$ deposits—compared to 45 days just prior to the November 2017 crisis, and where it had been stable for some 20 years. This significantly lowers the chances of bank runs, compared to conditions just prior to November 2017, when term deposits could be withdrawn at any point prior to maturity without significant penalty. Additionally, tighter liquidity in LBP, as mentioned earlier, limits speculation power against the exchange rate.

44. **Another achievement has been a rise in the maturity profile of commercial banks’ holdings of BdL assets.** In May 2018, BdL, along with Ministry of Finance, conducted a SWAP operation that led to a rise in the maturity profile of BdL’s debt held by commercial banks. BdL’s latest financial engineering operation can be summarized as follows:

i. MoF swapped $US 5.5 billion in newly issued Eurobonds for an equivalent amount in LBP-denominated TBs held by BdL. The MoF issue was in 4 different tranches ranging from 10 to 16-year maturity, paying 8 to 8.25 percent.

ii. BdL also subscribed to LBP 8250 billion (~US$ 5.5 billion) in new TBs issued by MoF at 1 percent coupon rate over 2 maturities: 3 years and 10 years.

iii. BdL proceeded to swap $US 3 billion of the $US 5.5 billion with dollar-denominated BdL debt held by commercial banks, which were maturing in 2018 and 2019. In this step, BdL issued instruments with a 10 to 16-year maturity and redeemed short term debt (3 month to 3 years).

iv. To incentivize the banks to rollover $3 billion at longer maturities, for each $100 new subscription by banks, BdL loaned banks $125 equivalent in LBP at 2 percent interest rate, on the condition that this is once again investment in BdL debt instruments at long maturity.

This helped increase average maturity of banks’ holdings of TDs and CDs from 14.5 years to 15.5 years.

45. **BdL also put a halt to the majority of its subsidized lending that have been administered via the banking sector.** This allows for further

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29 Anecdotal episodes circulated that rates of up to 15 percent annually were offered for long term-deposits.

30 Source: BdL.

31 BdL has indicated that a primary reason for cancellation of these loans is improper use of these loans by some banks.
control over liquidity. As a result of all these measures, by June 2018, gross foreign exchange reserves at BdL constituted 81.5 percent of M2 measure of liquidity.\textsuperscript{32} In theory at least, the stock of Lebanese LBP in the market can be exchanged for dollars at the fixed exchange rate.

\textsuperscript{32} M2 is composed of currency in circulation, demand deposits in LBP and term deposits in LBP.
IV. SUMMING UP

46. The resultant macro-financial system has developed to be a potent but brittle structure, and any failure in any of its components can be a systemic threat. Hence, no single commercial bank, no matter the size, can be allowed to fail and default on its depositors; neither can the public sector be allowed to default on its debt, nor the fixed exchange rate regime broken. Confidence by depositors is key to the sustainability of the whole structure.

47. BdL has successfully navigated serious challenges using conventional and nonconventional tools, but risks have also risen, and the global environment is much less supportive. Beefing up its stock of foreign exchange reserves in anticipation of needed interventions in response to shocks is an important buffer. Also, controlling liquidity and lengthening the maturity of deposits is an effective inhibitor to speculation against the currency in a high-risk environment. Additionally, some room remains for interest rate increases when compared to other emerging market economies. On the other hand, the depleting utility of some tools after years of application (i.e. SWAPs, subsidized loans), along with the convergence of a number of negative factors are raising the risk profile for Lebanon. These factors include rising political and geopolitical disputes that elevate the chances of negative confidence shocks, such as the November 2017 crisis. Furthermore, global monetary conditions along with increased, albeit limited, integration into the global markets subjects Lebanon to emerging market pressures it has traditionally avoided. It is also important to note that tighter monetary conditions are likely to lead to increased deterioration in economic activity and the subsequent worsening of both private and public balance sheets, with implications on the financial sector.

48. A key enabler of stability over the medium term is a boost to Lebanon’s growth potential through structural reforms and effective capital spending targeting key infrastructural projects. The Paris investor conference in early April 2018 presents a unique opportunity for Lebanon to effect a sustained boost to the economy, attract much needed capital inflows and catalyze job creation. An essential component of this process is the adoption and implementation of a structural reform program, including a debt management strategy that aims to lower the public debt-to-GDP ratio toward a more sustainable trajectory.
The Turkish currency has been gradually softening against major currencies for a few years now, depreciating by over 60 percent vis-à-vis the US dollar since the beginning of 2018 (Figure 21). Several factors are exerting pressures on the Turkish Lira (TRY), including political and geo-political factors, especially the tense relationship between President Recep Tayyip Erdogan and Western powers. However, global economic conditions have also been a critical determinant.

Contagion effects to other economies, including Lebanon, can occur via economic linkages, which primarily include: trade of goods and services, as well as via the impact on confidence. Depending on the potency of these channels, the impact on the Lebanese economy can be (i) pseudo-simultaneous exchange market pressures, with lagged real economy effects; (ii) lagged real economy effects and balance of payments pressures; or (iii) minor ripples. We examine these effects on Lebanon.

**I. THE TRADE CHANNEL**

*Trade in Goods*

The sharp depreciation in the TRY more than offsets higher Turkish inflation, leading to the worsening of Lebanon’s terms of trade, both directly and indirectly. As illustrated by (Figure 22), the TRY—Lebanese pound (LBP) real exchange rate (RER) has been on a rising trajectory, boosting the competitiveness of Turkish products vis-à-vis Lebanese products. This will likely lead to a rise of Turkish imports to Lebanon at the expense of Lebanese exports to Turkey. More indirectly, and to the extent that Lebanese products compete with Turkish products in third countries, Lebanon’s exports of goods can lose global market share. The agricultural sector and agri-businesses are

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33 This is as of September 12, 2018, where the Turkish currency approached 6.4 TRY to the US$.

34 It is interesting to note that the TRY lost about 30 percent in value against the US dollar since July 10—the date Erdogan took office for elections won in June, under new and expanded constitutional powers for the presidency.

35 When the TRY-LBP RER rises, there is an appreciation in the real purchasing power of the LBP vis-à-vis the TRY.
likely to be of the most affected due to relative substitutability between Turkish and Lebanese products in these sectors, as suggested by the close culinary cultures and related raw materials. As an indicator of the importance of these sectors, agricultural, animal and food products constituted an average of 22.6 percent of Lebanon’s total annual merchandise exports and 16.8 percent of its imports over the period 2013-2017.

Turkey is a moderately significant trading partner for Lebanon’s merchandise. In fact, Lebanese exports of goods to Turkey averaged around US$ 120 million annually over the 2013-2017 period, constituting 3.7 percent of Lebanon’s total merchandise exports (Figure 23), and making Turkey the 6th destination for Lebanon. Main products exported to Turkey are agricultural and food products, as well as non-capital goods equipment. On the other hand, and over the same period, Turkey ranks as the 8th main source for Lebanon’s merchandise imports, exporting to Lebanon an average of US$ 787 annually, which constitute 3.9 percent of Lebanon’s total imports of goods (Figure 24). Lebanon’s top imports from Turkey are agricultural and food products, textiles, non-metallic products and capital goods.

For both Lebanon and Turkey, energy imports compose a sizable portion of the trade deficit. That vulnerability is currently deteriorating more sharply for Turkey, where the float induces depreciation against dollar-denominated energy prices, accelerating price increases. While Lebanon does not have the exchange rate exposure to energy prices given the dollar peg, it will feel pressures via other conduits, such as higher import volumes (since the price adjusts by less) and currency overvaluation due to the lack of exchange rate flexibility.

Despite the above, Lebanon’s balance of payments position is likely to be impacted only marginally and with some lag. With the
trade in goods deficit amounting to over US$ 14 billion (2017), equivalent to almost 27 percent of GDP, a deterioration by an extra percentage point (pp) or two is only a marginal worsening.

**Trade in Services: Tourism**

Tourism is not an effective channel of economic contagion from the TRY crisis to Lebanon as the country is not a main destination for Turkish tourists. Turkish visitors to Lebanon constituted an average of only around 0.5 percent of total visitors over the period 2013-2017. This compares to Iraqis who comprised 12.8 percent of all tourists visiting Lebanon, followed by French (8.9 percent) and Americans (8.8 percent) (Figure 25).

**Trade in Services: Financial Services**

The Lebanese financial sector is exposed to the Turkish economy via the presence of two large Lebanese banks: Audi Bank and Bank Med. The former is a majority shareholder (76 percent of shares) for Odea Bank, while Bank Med owns 50 percent of Turkland Bank. Odeo bank comprised about 16 percent and 13 percent of Bank Audi’s assets (by June 2018) and net profits (over H1-2018), respectively. By end-2017, almost 8 percent of BankMed’s assets were in Turkland Bank, with the latter reporting a net operating loss in 2017.

Audi and BankMed are both systemic banks and any significant erosion of their capital base will likely require interventions by the Lebanese Central Bank. Audi is in fact Lebanon’s largest bank in terms of assets, raising the likelihood of recapitalization in case of significant damage to its capital. This will add to BdL’s already intensive and costly interventions (financial engineering operations).

### II. CONFIDENCE CHANNEL

Turkey has traditionally been dependent on inflows to finance external deficits, exposing its economy to sudden stop scenarios, especially during times of monetary policy transition for the US FED from expansionary to contractionary policy. Indeed, Turkey was part of a group of emerging economies, which also included South Africa, Argentina and Brazil, that benefited from the search for yield in periods of low global interest rates. The downside is that these are main characteristics of economies which would face refinancing pressures as global interest rates pick up and international investors deleverage risk. This is a main dynamic behind the current depreciation of the TRY, and indeed other emerging market assets.

More global integration for Lebanon’s debt market means higher correlation with emerging market assets. The recent normalization of global interest rates has had an impact on Lebanese Eurobonds as indicated by a sharp rise in Lebanon’s Credit-default Swap (CDS) spread (Figure 26) and a higher correlation with Turkish debt instruments (Figure 27).

If a confidence shock should materialize into systemic failures, the stabilizing tools available to Lebanon are limited compared to those available to Turkey. The floating TRY acts as a shock absorber, compared to Lebanon’s fixed exchange rate regime that is a principal pillar for its macro-
financial structure. Moreover, due to Lebanon’s much less diversified export base compared to Turkey (small merchandise exports, non-WTO member, weak trade agreements), it lacks the routes to an export-led adjustment that Turkey clearly has (large industrial base, WTO membership, customs union with EU, growing integration with Caucasus/ Central Asia).
V. RECENT ECONOMIC DEVELOPMENTS

49. Following the Hariri resignation crisis in November 2017, BdL abruptly siphoned off its subsidized lending that was being channeled via the banks to the real estate sector, providing a rare source of growth impetus since 2012. As such, WB projection for 2018 real GDP growth is revised downwards to 1 percent, from a previous forecast of 2 percent.

50. Indeed, high frequency indicators—mostly based on H1 2018—point to a deceleration in economic activity thus far in 2018 across all but the external sector, where a 7.3 percent year-on-year (yoy) rise in merchandise exports over H1 2018 neutralized higher imports to leave the trade deficit minimally varied in absolute value (and lower as percentage of GDP). Meanwhile, tourist arrivals rose by 3.3 (yoy) in H1 2018, while marking a sharp deceleration compared to 14.2 percent growth in H1 2017. Hence, whereas private consumption has traditionally led real GDP growth, net exports are expected to be the main driver in 2018 for the second year running.36 On the other hand, real estate indicators also point to a contraction in the sector, with cement deliveries down by 3.4 percent (yoy) in H1 2018 (Figure 28). Structurally, the economy remains heavily based on services (especially real estate, retail and financial services) and oriented towards the region, rendering it vulnerable to volatility in growth and sizable macroeconomic imbalances.

51. In 2018, the lack of an exceptional tax windfall (generated in 2017 from large banking sector profits reaped from financial engineering operations in 2016), are expected to be offset by the full impact of additional revenue measures introduced by the salary scale reforms. The latter will nonetheless increase current spending driving up the fiscal deficit from an exceptionally low 6.6 percent of GDP in 2017 to a projected 8.3 percent in 2018. Moreover, subdued GDP growth and high interest payments mean that the debt-to-GDP ratio is expected to persist in an unsustainable path toward close to 155 percent by end-2018.

52. CDS and EMBIG spreads, indicators of risk premium, are at elevated levels, surpassing those registered in November 2017 (Figure 19). This is being driven by foreign deleveraging from Lebanese assets due to political (lack of government), geopolitical (Iran, Syria tensions) and emerging market pressures. In response, BdL financial engineering continues, with the latest being a SWAP of TBs held by BdL with newly MoF-issued Eurobonds in the amount of US$ 5.5 billion, around US$ 3 billion of which were subsequently sold (along with enticements) to banks. The main objective of this operation was to raise BdL’s foreign exchange (Forex) reserves, which reached around US$ 44 bln by end-June, equivalent to about 15 months of imports of goods and services, compared to US$ 42 bln at end-2017. Nonetheless, this primarily is driven by BdL’s cache of government Eurobonds, which it began counting as part of its forex stock since November 2017. That is, while the stock of foreign currencies

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36 The recent re-opening of Syria-Jordan Nassib border crossing will positively impact Lebanese exporters.
at BdL decreased by US$ 2.7 bln over H1 2018, its stock of foreign-denominated securities increased by US$ 4.8 bln.

53. **Inflationary pressures are persisting in 2018.** The 12-month headline inflation rate averaged a 6.2 percent (yoy) over 7M-2018, in good part due to the salary scale increases in 2017, a strong rebound in commodity prices, especially fuel products and a low-threshold effects after 2 deflationary years. Meanwhile, the halt in BdL subsidized loans has had a palpable impact on lending activity; commercial banks’ total credit to private sector increased by only 1.9 percent (yoy) in June 2018, compared to a growth of 8.4 percent (yoy) in June 2017.
VI. OUTLOOK

54. The regional turmoil, especially the war in Syria, continues to impose a security risk premium for Lebanon, despite diminution of the prospect of violence. A key assumption underlying projections for the Lebanese economy regards the Syrian conflict and its spillovers. World Bank staff projections assume that current conditions hold, i.e., spillovers continue to be contained without precluding the occurrence of occasional serious security events. Moreover, in light of robust inflation and heightened macro-financial risks, we assume continued monetary tightening.

55. Lack of obvious sources for an economic boost suggests Lebanon’s medium-term economic prospects remain sluggish remaining below 2 percent annually.

56. World Bank fiscal projections do not assume implementation of Lebanon’s commitment in Paris to an annual 1 pp decline in the fiscal deficit ratio over the next 5 years, and as such, Lebanon’s public finances are projected to remain structurally weak. Debt servicing is expected to continue rising due to pass through from higher global interest rates, while rising oil prices will reflect on transfers to EdL. Meanwhile, government revenues are unlikely to improve significantly. As a result, and despite the return of positive inflation, the trend for the debt-to-GDP ratio based on current policies and real GDP growth rates remains unsustainable and is expected to notably worsen as global interest rates continue rising.

57. Externally, the current account deficit is expected to moderate somewhat due mainly to suppressed imports, as slow economic growth is weighed down by monetary tightening.

58. The Lebanon Economic Monitor has continuously urged the implementation of a structural reform program, identifying essential short-term and medium-term reform measures.37 We have also indicated that interventions by the central bank, even when successful, offer only temporary reprieve, and are not without additional macro-financial risks. This has been corroborated by the heightened macro-financial risks over the past year, and the increased susceptibility to future shocks. The government’s commitments in Paris to a number of important reforms is an important first step, but ultimately effective implementation is key. Building on that, the commitment to and implementation of a more comprehensive and integrated medium-term reform roadmap would be an essential boost to confidence, which is also much needed in the short term.

37 World Bank (2017), the Lebanon Economic Monitor, Spring 2017 issue.
A critical first step is the formation of a new government, upon which, the risk premium for Lebanon would likely improve quickly. This can relieve some of the burden placed on the central bank. Ultimately, structural solutions are the prerogative of the political authority as enshrined in the executive branch of government.

A new government is essential to take advantage of the unique opportunity offered by the CEDRE conference, which can help effect a sustained boost to the economy, attract much needed capital inflows and catalyze job creation. The World Bank Group (WBG) has favorably assessed Lebanon’s capital investment plan that was presented in the Paris conference. The WBG Assessment generally finds that the choice of sectors is appropriate for a Capital Investment Plan (CIP) for Lebanon, and that many of the listed projects are relevant, indeed, some are critical, to help alleviate infrastructural bottlenecks. Nonetheless, the Assessment also notes that implementation of projects, which has traditionally been a challenge in Lebanon, is key. To enable the CIP, the WBG Assessment proposed a set of horizontal and vertical reforms, to which the government’s CEDRE commitments converge.

Fiscal reforms and re-structuring of the power generation sector have been continuously highlighted as critical short-term initiatives. Low credibility in government is such that an announced commitment alone is insufficient. Implementation is needed.

The Government of the Lebanon (GoL) committed during CEDRE to an ambitious fiscal consolidation program. The government presented at the conference a Vision for Stabilization, Growth and Employment in which it pledged “a fiscal consolidation of 5 percentage points of GDP over the next five years (i.e. one percentage point a year). This will be achieved through revenue measures, including improved collection and a reduction of loopholes, as well as a reduction in spending where possible, including through a reduction in the government’s transfers to EdL which exceeded 4 percent points of GDP in recent years, as part of a broader effort to improve cost recovery in infrastructure services.”

To realize this necessary commitment, the following strategy is suggested:

a. GoL should embark on a comprehensive reforms, investment and capacity building program for the electricity sector, with the objective of bringing EdL to cost recovery in the medium term (See Section VIIB).

b. To increase the likelihood of success, transparency and confidence in the government’s fiscal reform program can be solidified early on via a formal adoption of a fiscal rule with the following suggested contours:

i. Any increase in power supply from new power generation output would be matched by a commensurate rise in the average tariff;

ii. All savings generated from electricity reforms would be directed at the budget deficit;

iii. New current primary spending would replace existing non-EdL related current
primary spending, so as to be deficit neutral and not require new resources. This achieves the following objectives: (a) to prevent a widening of the fiscal deficit, and (b) to increase efficiency of current expenditures by incentivizing the elimination of less effective transfer programs; and iv. Capital expenditures to be financed from soft loans, an opportunity presented by CEDRE.

c. GoL to identify and cut wasteful and inefficient spending;
d. GoL to streamline tax administration based on a progressive revenue generating mechanism.
e. GoL to articulate a debt-management strategy that is consistent with the above.

B. Electricity Sector:
Reforms, Investment and Capacity Building

64. Deficiencies in the power sector have long had an economy wide bearing, with direct implications on Lebanon’s growth potential, the economy’s competitiveness and productivity, household and firm welfare, the country’s balance of payments and its precarious fiscal position.

65. Electricité du Liban (EdL), the national utility company, imparts a staggering burden on Lebanon’s public finances. Government transfers to EdL averaged 3.8 percent of GDP from 2008 to 2017, amounting to about half of Lebanon’s fiscal deficit. At their peak in 2012 and 2013, the government transferred around US$ 2 billion per year to EdL. As the overall fiscal balance has been in deficit since 1992, EdL transfers have been effectively paid through borrowing, rendering the electricity sector a principal determinant of Lebanon’s debt burden.

66. Underlying the fiscal burden of the power sector in Lebanon is a high cost structure for power production combined with shortcomings on the revenue side. In a comparison of 14 countries in the MENA region, Lebanon ranked last in terms of the power sector’s quasi-fiscal deficit (QFD), with a QFD of 8.9 percent, worse than Sub-Saharan African countries. This is driven by both cost and revenue factors. On the cost side, more expensive and polluting diesel fuel is used at existing dual-fired combined-cycle gas-fired (CCGT) power plants. On the revenue side, technical and non-technical losses in distribution and transmission can reach 40 percent. Moreover, electricity is significantly underpriced, with tariffs largely unchanged over the last 20 years.

67. These challenges were further exacerbated by a huge influx of refugees resulting from the ongoing conflict in Syria. The number of displaced Syrians in Lebanon is estimated at 1.5 million, representing more than 30 percent increase in the country’s population in a relatively short period. The United Nation’s Development Program (UNDP) estimates that government transfers to EdL to cover the costs of electricity provided to the displaced totaled approximately US$ 1 billion during the 2012-2016 period. UNDP further estimates that increased electricity demand from Syrian refugees amounted to 486 MW, which absorbed much of the new generation capacity added to EdL’s system over the past decade.

68. The power sector also represents a major handicap for Lebanon’s productive sector. Despite extensive subsidies, EdL is unable to provide a reliable 24/7 supply of electricity services, resorting to rolling blackouts of 3-18 hours per day. Recent World Bank surveys also indicated that availability of reliable electricity in Lebanon is the second biggest obstacle to private sector growth, after political instability. Almost all firms run private generators at considerable additional expense.
69. **Any subsidy reform process in Lebanon will require a coordinated and very carefully sequenced action in three areas.** First, while tariffs clearly need to move on an upward trajectory, the magnitude of the current disparity between prices and costs cannot be eliminated overnight. Second, there is a need to adopt aggressive cost-reduction measures to reduce gross inefficiencies in generation as well as transmission and distribution, to bring the cost recovery benchmark down to a more reasonable level. Third, raising tariffs in a context where quality of electricity service is so inadequate risks a strongly adverse social reaction. Measures to improve the quality and reliability of supply will need to be an integral element of subsidy reform so that willingness to pay for EdL service increases over time.

70. **Sequencing is of utmost importance.** Electricity tariffs cannot be increased until residents, who are already heavily burdened by a high electricity bill (private and public), first experience an improvement in the public utility’s power supply that can allow them to lessen their dependence on private generation. Moreover, reductions in technical and non-technical losses are a major prerequisite for the tariff increases.

71. **Given the significant impact the power sector has on Lebanon’s economy, the GoL committed during CEDRE to undertaking important reforms in the sector.** In the government’s Vision for Stabilization, Growth and Employment, power sector reforms and modernization initiatives are central. These reforms include the following package of measures:

a. Power generation to be enhanced by:
   i. The construction of new power plants in partnership with the private sector under an independent power producer (IPP) arrangements enabled by the PPP law;
   ii. Construction of photovoltaic and wind power facilities under PPP arrangements as part of the objective to diversify to clean energy;

b. Power generation cost structure to be reduced by:
   i. Construction of LNG infrastructure under PPP arrangements as part of the strategy to adopt a less costly source of energy for power generation, which would reduce electricity generation costs;
   ii. Transportation infrastructure will be restructured for the optimal transportation of gas and fuel to the power plants.
   iii. The transmission network infrastructure will be improved to secure vital requirements for the efficient and successful operation of the distribution service providers.

c. Electricity tariffs will be adjusted with a view to reduce EdL’s financial losses. In the short term, the increase will be limited to the equivalent of the reduction in the cost of private generation that results from the additional EdL supply.

d. Establishing a regulatory authority to regulate the sector with a view to update Law 462 (2002);

e. Modernizing EdL’s operations and internal systems to make it a well-established company with an assigned Board. The Board must overview EdL’s functions based on commercial foundations and create the necessary framework for activities related to generation, transmission and distribution;

f. The status of the contracted employees within EdL will be settled in order to secure EdL’s operation and sustainability.
72. Implementing the Government’s Vision in the electricity sector over the next 4 years is vitally important to materially shift the sector’s current cost trajectory. In the short-term (1-2 years), reducing EdL’s fuel costs and its technical and non-technical losses on the distribution network are key priorities. In the medium-term (3-4 years), increasing EdL’s electricity supply, through expansion of both thermal and renewable energy generation capacity, are important. In the long-term (>4 years), EdL modernization is key to ensuring the utility’s health and stability to operate the sector in the future.

73. It is important to note, however, that the timeframes needed to implement these priorities require that they be commenced now to address the burdens on the country’s broader economic and fiscal performance within a reasonable time. These priorities also need to be pursued in parallel, rather than in sequence. Procuring, financing and installing marine LNG infrastructure for example, typically requires at least 2 years to complete; thermal power plants require 3-4 years to complete; and EdL modernization is likely to require at least 5-6 years.
TABLE 1. Lebanon Selected Economic Indicators, 2013-2020

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<td>Gross Reserves (months of imports GNFS) /2 /3</td>
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<td>Total Debt Stock (in million US$)</td>
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<td>66,564</td>
<td>70,325</td>
<td>74,900</td>
<td>79,539</td>
<td>84,023</td>
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<td>Debt-to-GDP ratio (percent)</td>
<td>136.6</td>
<td>137.2</td>
<td>140.9</td>
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<td>148.3</td>
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<td>Nominal GDP (in billion LBP)</td>
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<td>73,151</td>
<td>75,240</td>
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<td>80,767</td>
<td>81,918</td>
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<td>GDP (in million US$)</td>
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Source: Government data, and World Bank staff estimates and projections.
/1 Population figures, which include Syrian refugees registered with the UNHCR, are taken from the United Nations Population Division
/2 Gross Reserves (months of imports GNFS) = (Imports of Goods & Services / Gross Res. excl. Gold)*12
/3 Total Imports using the BOP data from the Quarterly Bulletin of BDL
SELECTED SPECIAL FOCUS FROM RECENT LEBANON ECONOMIC MONITORS

SPRING 2017 LEM: A CALL FOR ACTION

Priority Reforms for the Government of Lebanon (Special Focus): The end to the long political stalemate offers Lebanon a unique window of opportunity to mitigate impending risks and tackle longstanding and, by now, pressing development challenges. The sense of urgency is reinforced by rising macroeconomic risks and a palpable deterioration in the quality of public services and institutional performances. This has been compounded by the Syrian war and the massive influx of refugees, taking a toll on the economy and placing added strain on Lebanon’s education, health, municipal and other sectors. This Special Focus presents a menu of reforms that would enable the country to rapidly and significantly turn the page of inaction and decline and return the country to a prosperous and inclusive development path. To that end, reforms are prioritized over two time horizons—the short term, allowing for initiative by the present government to establish a record of achievements and government credibility that is currently sorely absent, and the medium term for more comprehensive and systemic reforms, which can alter Lebanon’s fundamentals toward sustainable and inclusive development.

FALL 2016 LEM: THE BIG SWAP: DOLLARS FOR TRUST

Central Bank Intervention in the Lebanese Economy (Special Focus): Small and Medium Enterprises (SMEs) occupy a central role in the Lebanese economic landscape and are primary engines for job growth. To ensure adequate SME access to finance and stimulate economic activity, the Banque du Liban (BdL) has established a number of schemes. The Special Focus reviews SMEs’ role in Lebanon’s activities and outlines the various BdL policy interventions in the real economy. The preliminary findings suggest that the real estate sector was the largest recipient of subsidized lending by BdL and that the proportion of subsidized funds channeled to SMEs continues to be modest. Nonetheless, the preliminary evidence suggests that, with the existing political paralysis, a volatile security environment and spillovers from the Syrian conflict, economic activity in Lebanon would have been more sluggish in the absence of BdL’s policy interventions. These interventions, however, come at a cost born by BdL, which are difficult to quantify but have possible implications on long-term monetary policy.

SPRING 2016 LEM: A GEO-ECONOMY OF RISKS AND REWARD

Industrial Parks and Special Economic Zones in Lebanon (Special Focus 1): Lebanon’s industrial sector in Lebanon has lagged, both on a regional and global comparative basis. Lebanon’s macroeconomic structure, being heavily dependent on tourism and real estate at the expense of industry and agriculture, renders the economy vulnerable to political and economic shocks. In this context, Lebanon needs to focus on its industrial potential and provide solutions to the numerous constraints hindering its industrial establishments from functioning at their full capacity. One possibility to strengthen the industrial sector is via spatial industrial policies, most notably, industrial parks and special
economic zones (SEZs), which support increased investment and competitiveness in the industrial sector. Special care should be allotted to fiscal incentives which evidence suggest are ineffective and might instead lead distortions such as the relocation of existing businesses to the zones rather than the establishment of new business. Under suitable conditions, industrial zones have proven successful in various locations and industries across the world which make them an attractive tool in Lebanon.

Tech Startup Ecosystem: The Case of Lebanon (Special Focus 2): A new wave of entrepreneurship driven by small digital businesses is sweeping both developed and emerging economies. Information and Communications Technology (ICT) has dramatically reduced the cost of innovation and market access, allowing small tech entrepreneurs to compete with established businesses. Today, a startup can be created with just a laptop and Internet connection. This has led to the surge of tech startup ecosystems worldwide, where communities of entrepreneurs interact. Lebanon in particular can benefit from this phenomenon, particularly for job creation. Tech startup founders are predominantly young and have a college degree, generating employment for educated youth. The innovation that startups generate also helps make the tech sector more dynamic and sustainable. Lebanon’s tech scene is becoming increasingly attractive driven by the example of successful startups that have tapped regional and global markets and the innovative initiative by the country’s central bank in facilitating venture capital financing. The nation now needs to leverage these developments by finding solutions to constraints hindering the blossoming of its tech startup ecosystem.

FALL 2015 LEM:
THE GREAT CAPTURE

Elite Capture and the Hollowing of the State: an Overarching Constraint to Lebanon’s Development (Special Focus 1): Lebanon’s post-war governance endures systemic failures. Institutionalized confessionalism intended as protection for the mosaic of communities in a country that lacks a demographic majority has developed into pervasive elite capture and patronage system. This elite commands the main economic resources, generating large rents and dividing the spoils of a dysfunctional state. In the process, the public sector has become increasingly governed by bribery and nepotism practices, failing to deliver basic public services and incapable of resolving the most urgent needs. This has culminated in the comprehensive breakdown in the political process, with the three branches of government either vacant or effectively idle, and the only national plebiscite abrogated. This has triggered a series of protests and civil disobedience measures targeting the ruling political class with emphasis on corruption and incompetence. Current conditions are unsustainable, and without significant political and economic reforms, a widening and worsening of socio-economic unrest is not unfathomable.

Lebanon’s Health Sector: Modest Reforms despite the Challenges (Special Focus 2): This special focus provides an overview of the health sector in Lebanon and highlights both successes and challenges facing the system. Lebanon’s trends in health outcomes, inputs and spending are analyzed over time and compared to a number of countries with similar levels of income and health spending, as well as to the averages for the Middle East and North Africa (MENA) region. Global comparisons are presented for each of these measures based on the latest available year of data (generally 2011). Key challenges are highlighted; (i) low public spending on health which hinders the Ministry of Public Health’s (MoPH) ability to adequately respond to the health needs of low income groups; (ii) high household out-of-pocket spending on health subjecting low income groups to financial hardship; (iii) disproportionate allocation of resources on expensive curative care; and (iv) emerging epidemiologic and population trends associated with unprecedented influx of refugees having significant implications on the delivery and financing of the health sector. Despite the challenges and prolonged periods of instability,
the MoPH embarked on several successful reforms that contributed to the resilience of the system in the face of the crisis.

SPRING 2015 LEM: THE ECONOMY OF NEW DRIVERS AND OLD DRAGS

The Trade Impact of the Syrian conflict on Lebanon (Special Focus 1): We explore the trade effect of the Syrian war on Lebanon up until the second half of 2014. A dissection of the data reveals that, so far, the war seems to have affected neither merchandise nor services exports at the aggregate level. At the same time the relative stability of merchandise imports is likely a result of increased demand due to refugee inflow being offset by higher transit costs through Syria as well as depressed Syrian production. A gravity-type trade model confirms these findings, suggesting also that Lebanese trade seems to have been less negatively affected by the Syrian war than other Syria’s neighbors. An empirical analysis using micro level exporter data substantiates this finding. While Lebanese exporters to Syria have suffered from a drop in demand in the Syrian market (but less so than their Jordanian counterparts), other Lebanese exporters have started to export to Syria to fill the gap in Syrian production. Further econometric analysis suggests that Syrian refugees in Lebanon provide important impetus to Lebanese services exports.

Challenges in the Lebanese energy sector (Special Focus 2): The Lebanese electricity sector has been underperforming and in crisis for several decades, requiring urgent action to avoid further deterioration of the quality of electricity delivery. The macroeconomic impact has been massive; accruing debt on investments in and transfers to Electricité du Liban’s (EdL) amounts to 40 percent of Lebanon’s gross public debt and is escalating rapidly as transfers now account for over half of the fiscal deficit. Some of the measures needed to improve EdL’s financial situation are well known, such as increased investment, tariff reforms and corporatization of EdL. Political and confessional obstacles, however, have so far hindered any progress.

Water in Lebanon - Coupling Infrastructure with Institutional Reform (Special Focus 3): Despite the relative availability of water resources, the Lebanese water sector has not achieved suitable levels of service provision and is not in line with the level of economic development reached by the country. The cost of inaction in the water sector is estimated at about 1.8 percent of GDP, or 2.8 percent of GDP if the cost of environmental degradation is included. Several factors have led to this situation and require sustained attention. These include: (i) low continuity of water supply due to small storage capacity, large amount of water lost to the sea, growing demand for water and deficiency of the existing water networks; (ii) unfinished reform agenda that contributed to institutional uncertainty and fragmentation of functions particularly relating to wastewater and irrigation; (iii) an irrigation sector that is characterized by inadequate water storage capacity, lack of proper maintenance and a heavy reliance on subsidies; and (iv) regional water establishments (RWE) that severely lack management and financial autonomy and are impeded by limited inter-agency coordination and weak central government oversight. Moving forward, the Government must urgently address priorities within the sector.
# SELECTED RECENT WORLD BANK PUBLICATIONS ON LEBANON

(for an exhaustive list, please go to: http://documents.worldbank.org/curated/en/docadvancesearch/docs?query=&cntry=82571&majorDocTY=90674,658101)

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<td>Why aren’t more Lebanese women working?</td>
<td>2018/05/01</td>
<td>Brief</td>
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<td>Strategic assessment: a capital investment plan for Lebanon –</td>
<td>2018/04/06</td>
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<td>The role of financial services in humanitarian crises</td>
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<td>Lebanon - Lake Qaraoun Pollution Prevention Project (English)</td>
<td>2016/06/22</td>
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