Lebanon's Economy: Meltdown & Redemption Through the IMF?

Presentation to

Lebanon

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Agenda

- ✓ **Macroeconomic Developments 2011-2020**
- ✓ **What is an IMF programme? What can be expected?**
- ✓ **Reform Plans**
- ✓ **What does this mean for YPO businesses?**

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Lebanon is in Economic & Financial Meltdown

- Sharp fall in level of economic activity by 15% or more in 2020, accompanied by large increase in layoffs, bankruptcies & insolvencies leading to a rapid increase in banks' non-performing loans & growing losses
- COVID-19 is deepening the sharp contraction
- Informal capital controls & payment restrictions generating sharp liquidity squeeze and internal & external economic meltdown
- Sharp reduction in government revenues and increase in budget deficit, inability to fund investment or social protection
- BDL monetization of deficits & debt => rapid acceleration of inflation and depreciation of the Lira's black market value => sharp fall in real wages & salaries
- Growing unemployment rates, poverty (+50%; food poverty +25%) & famine => political & social conflagration
- Lost decade(s) looming: permanent economic decline, out-migration and destruction of economic fundamentals

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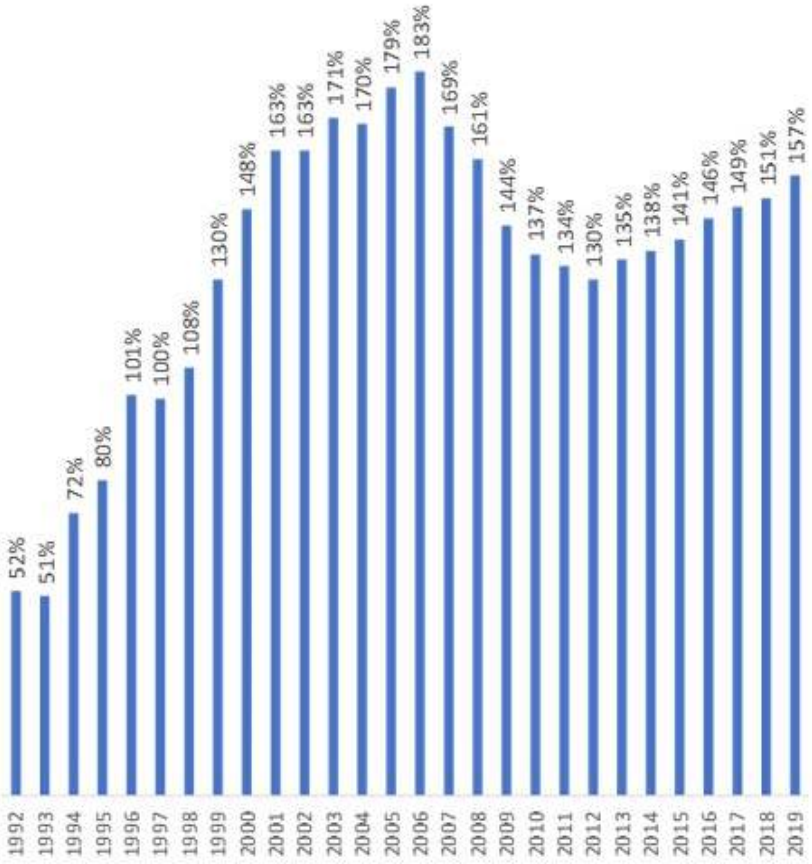
Medium-Term Macroeconomic Framework, including Implementation of Reforms (Source: IIF)

	Actual						Est.	IIF Projections				
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Nominal GDP in LL, trillion	70.7	72.6	75.3	77.2	80.1	82.9	82.3	103.6	130.0	150.8	168.5	186.7
Nominal GDP in $ billion	46.9	48.1	49.9	51.2	53.1	55.0	52.3	33.4	35.7	38.7	41.2	43.9
Real GDP growth. %	3.8	2.5	0.2	1.5	0.9	-1.9	-6.9	-13.8	1.3	3.5	5.1	5.9
CPI inflation, average, %	5.6	1.1	-3.8	-0.8	4.5	6.1	2.9	35.2	21.4	11.5	6.6	5.2
GDP deflator, %	2.6	0.1	3.5	1.0	2.9	5.4	6.8	46.0	23.8	12.1	6.3	4.6
Exchange rate, **average***, LL/$	1,508	1,508	1,508	1,508	1,508	1,508	1,575	3,102	3,640	3,895	4,090	4,253
Current account bal., $ billion	-12.0	-12.6	-8.5	-10.5	-12.1	-13.4	-10.9	-3.8	-4.5	-3.3	-2.3	-1.5
Nonresident capital flows, $ bn	6.5	9.7	3.2	11.6	9.9	4.1	3.1	2.6	4.5	5.3	5.6	5.3
Private (mostly FDI beyond 2019)	6.5	9.6	3.1	11.5	9.7	3.9	2.9	0.5	0.5	0.7	0.9	1.0
Official (IMF+CEDRE)	0.0	0.1	0.1	0.1	0.2	0.2	0.2	2.1	4.0	4.6	4.7	4.3
Liquid foreign assets**, $ billion	25.9	27.3	25.5	28.1	29.4	25.0	22.3	19.8	19.8	21.8	25.1	29.0
Fiscal balance, % GDP	-8.8	-6.2	-9.1	-9.4	-7.3	-11.5	-11.9	-4.5	-2.9	-1.7	-0.4	1.0
Government debt, % GDP	135.3	138.3	140.8	146.3	149.7	154.9	175.3	114.7	103.5	99.5	97.6	94.9

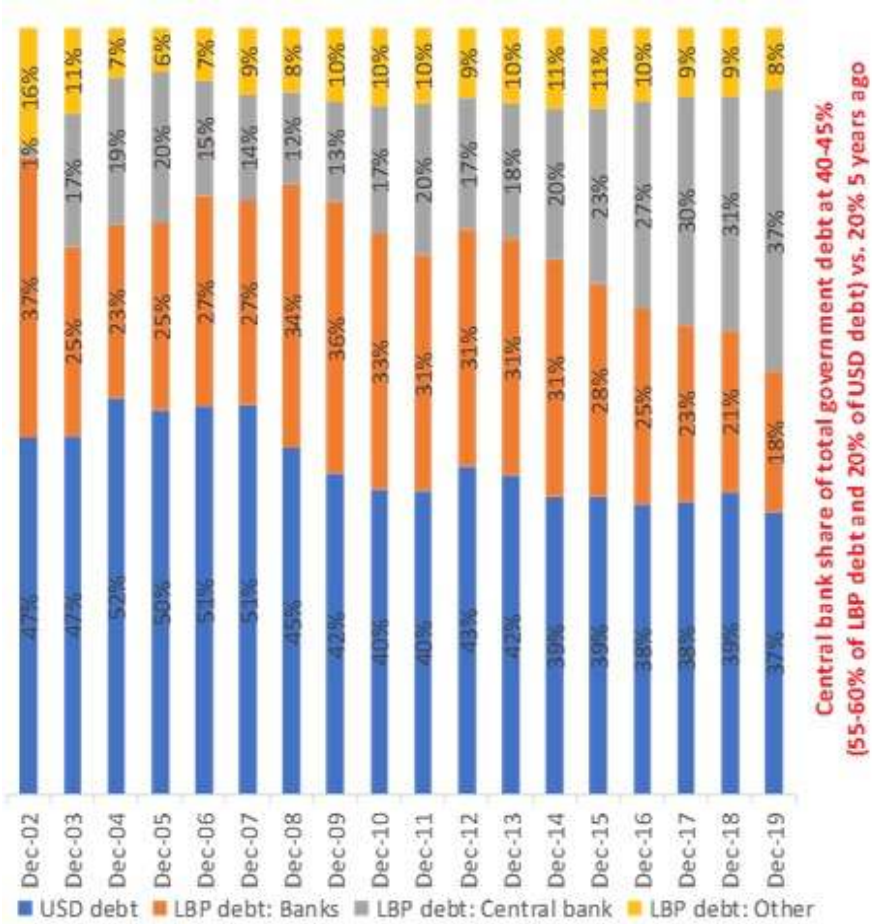
*Source: Institute of International Finance. *Weighted average of the official and parallel rates in 2019 and 2020, with the two rates assumed to be unified before July 2020. **Includes $18 billion of commercial banks' reserve requirements that the BdL may not spend.*

Unsustainable Fiscal & Current Account deficits led to a rapid build-up of debt; limited real investment

Public debt since 1992 (% GDP), now third highest in the world



Composition of public debt (% of total)



Source: Moubayed & Zouein (2020) "Finding a way out of Lebanon's crisis", Feb

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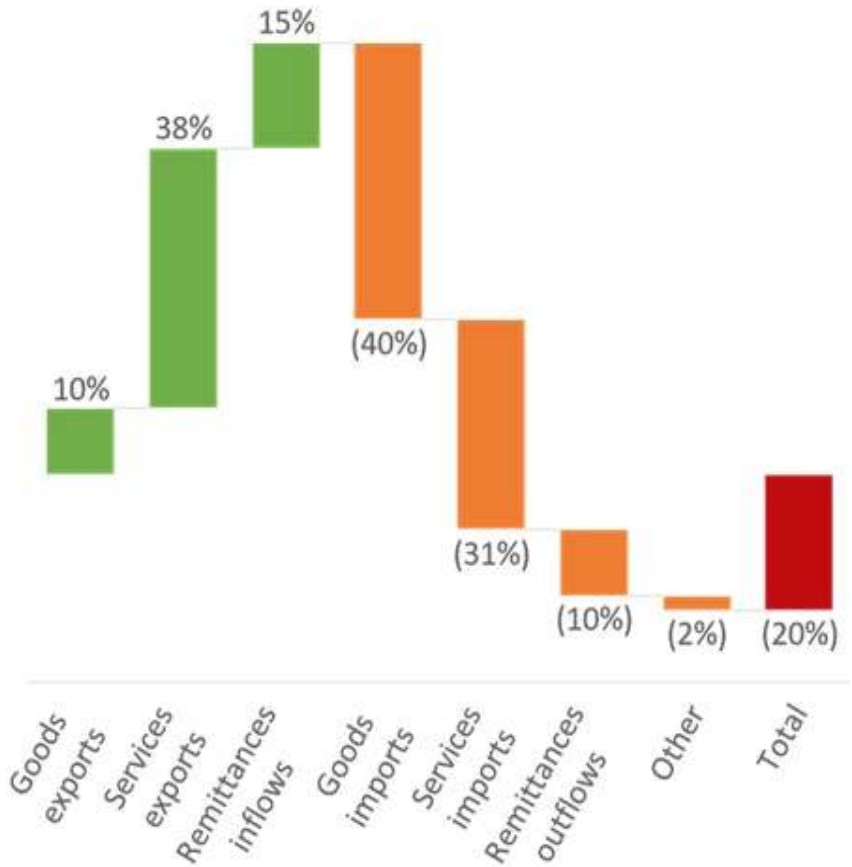
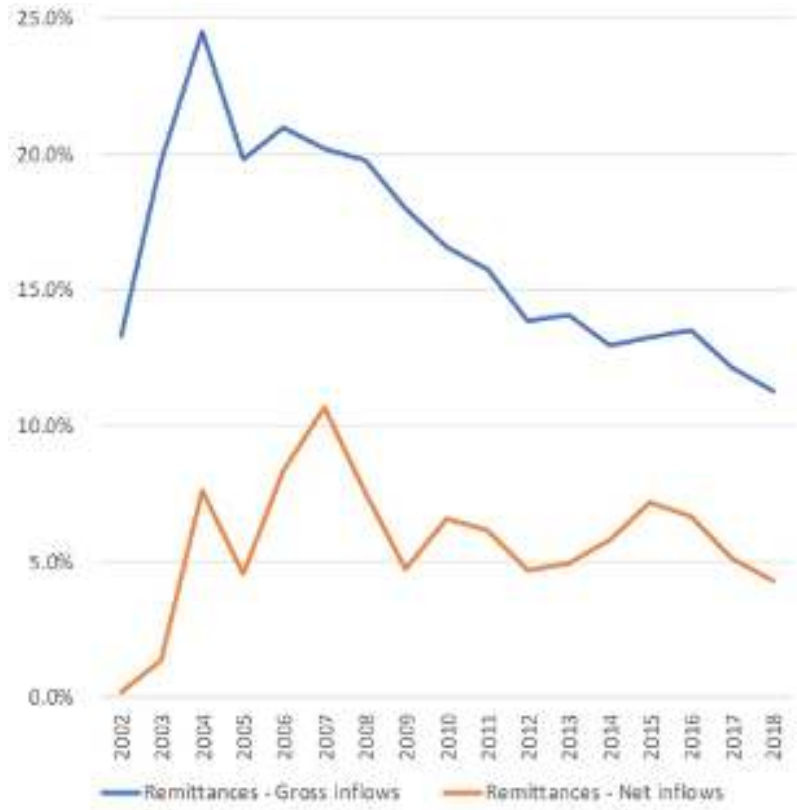
Lebanon has been living above its means for decades, paid for by remittances & debt

CA deficit breakdown (% GDP) cumulative 2002-18



Remittances (net and gross as % GDP)



Source: Moubayed & Zouein (2020) "Finding a way out of Lebanon's crisis", Feb

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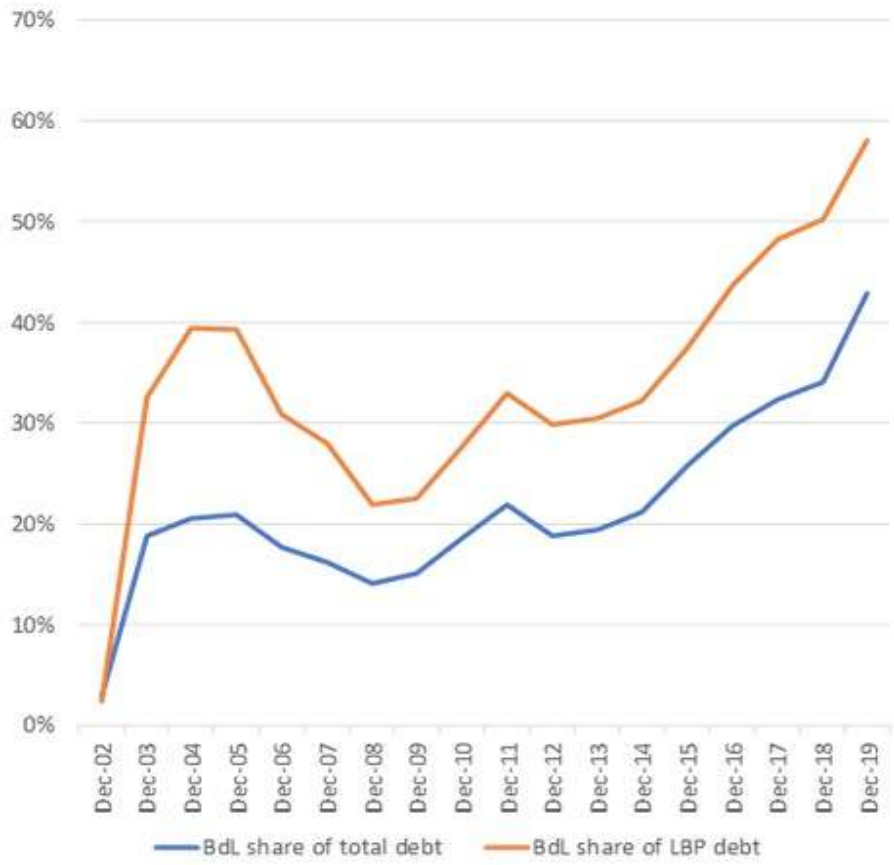
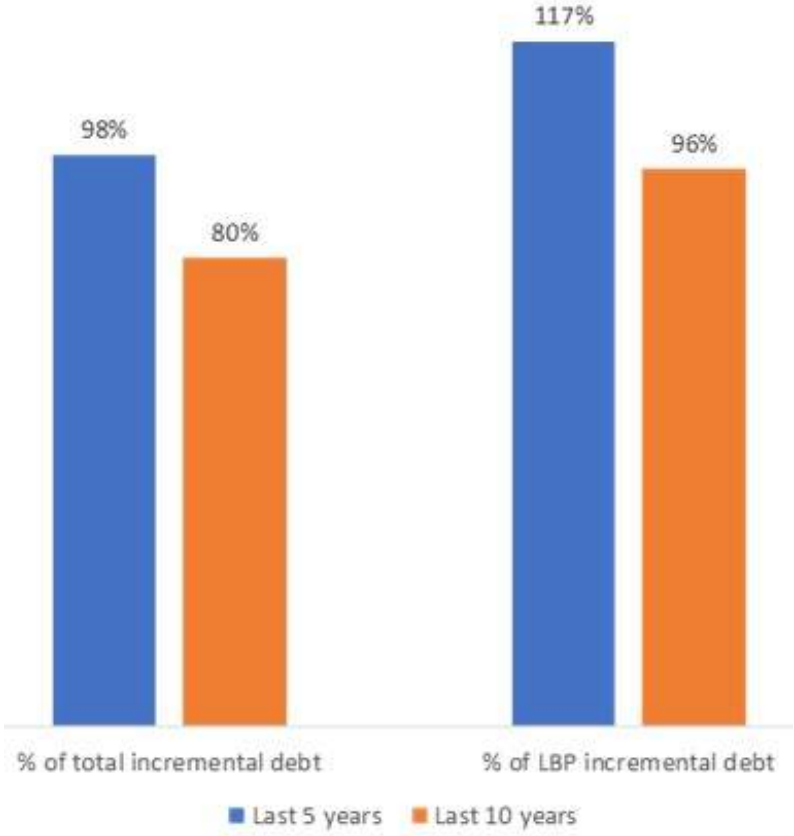
As creditworthiness deteriorated, local banks reduced their exposure to the sovereign, while BDL monetized large and persistent fiscal deficits and debt

BDL share of government debt over time (in %)



BDL share of incremental govt debt (in %)



Source: Moubayed & Zouein (2020) "Finding a way out of Lebanon's crisis", Feb

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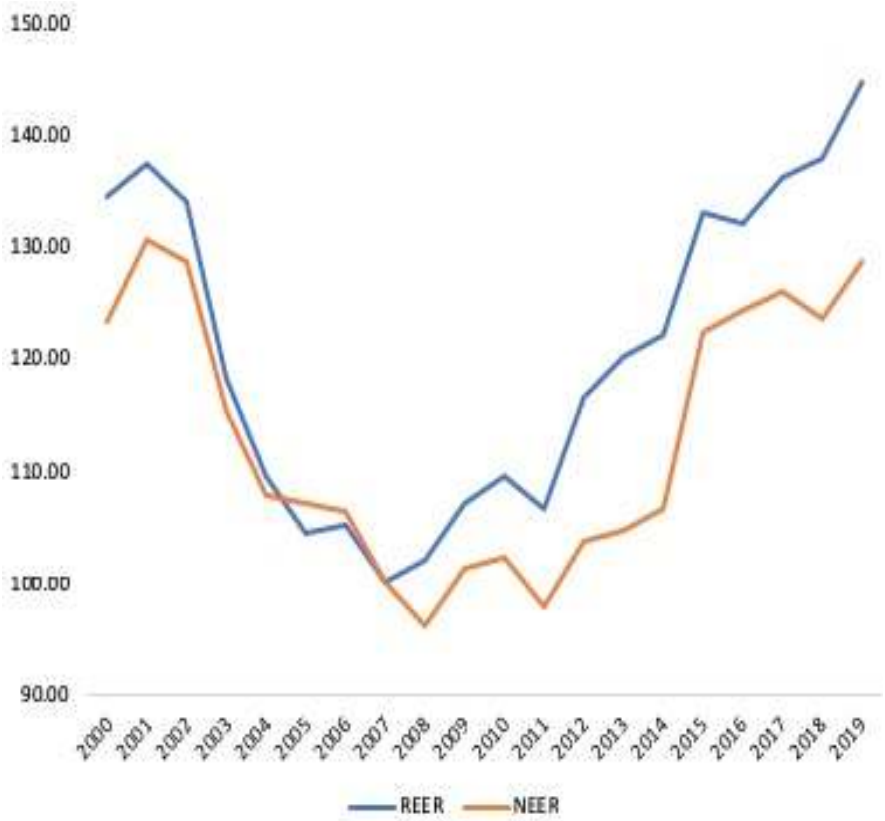
Unsound macro policies exacerbated the overvaluation of LBP & led to black market

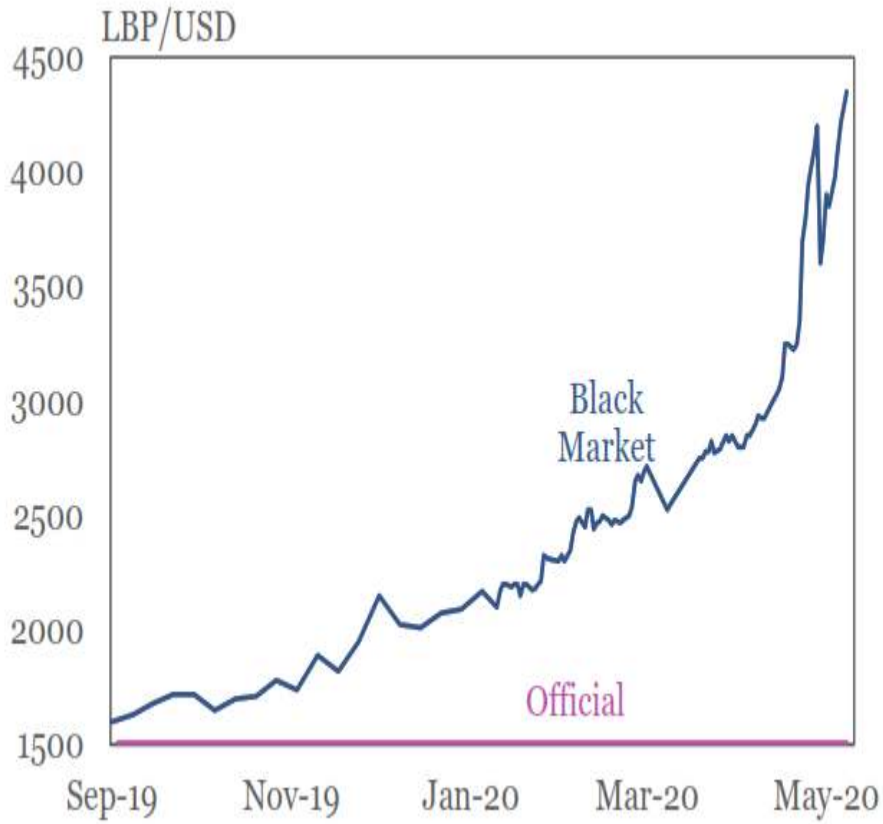
The appreciation of the REER has accelerated since 2015/16 and severely undermined (with other factors) the external competitiveness of the economy.

Real & Nominal Effective Exchange Rates (2000-2019)



Source: Bruegel; updated Apr 2020

LBP/USD Black Market Rate



Source: https://lirarate.com/ , IIF

BDL Policies led to a Crowding-out of both the Private & Public Sectors

- BDL's high interest rate policy to protect an over-valued LBP led to higher borrowing costs for government exacerbating loose fiscal policy and deficits

- BDL policies led to a growing credit and liquidity squeeze on private sector and a **crowding out of the private sector** and the **public sector** due to high rates paid by BDL.

- At end-Dec 2019, ~60% of banks' risk assets were placed at BDL vs 44% at end 2015. The Financial Engineering operations provided high marginal returns in LBP and in USD on new bank USD deposits at BDL => **combined bank exposure to BDL and government thus reached 75% of total assets**

- **BDL policies led to disintermediation** => the government could no longer tap markets, so BDL acted as financial intermediary i.e. paying high rates to the banking system while allowing the government to borrow at lower rates

=> BDL losses estimated at more than $53 bn and ongoing (May)

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Real Economy Impacted by Unfavorable Geopolitical Factors since 2011

- **Impact of Arab Firestorm:** deteriorating growth in the region with spillover effects for Lebanon: lower trade, tourism, FDI;

- **Impact of war in Syria**: refugees and displaced but also cutting off road access to GCC countries + lower tourism levels + remittance outflow;

- **Impact of oil and commodity prices on remittances**: expats are located in countries in Africa and the Arab world (mainly GCC) that are highly vulnerable to volatility of commodity prices;

- **Geopolitics**: Lebanon caught in the maelstrom of US-Saudi-Iran confrontation affecting trade, FDI and tourism from GCC.

- **Noxious geopolitics may limit external financing under IMF program**

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IMF Programs & Lending

- **Quotas are the IMF's main source of financing**. Each member of the IMF is assigned a quota, based broadly on its relative position in the world economy.

- **Borrowing against a quota**: The IMF extends financing by selling IMF currency holdings and SDRs to borrowing members in exchange for their own domestic currency: e.g. Lebanon could borrow against its quota:

  $860mn (quota) x 4.25= $3.64bn

- **What constitutes an IMF program?**
  - **A combination of borrowing and economic reforms**: when a country borrows from the IMF, it agrees to adjust its economic policies to overcome the problems that led it to seek funding in the first place
  - The **borrower's performance vis-à-vis commitments** agreed under the program are reviewed on a regular basis (quarterly/semi-annual reviews)

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IMF: Designing effective programs

Overarching goal of an IMF program = restore or maintain BoP viability + macroeconomic stability (i.e. sustained, high-quality growth) + social protection

All IMF members are eligible to access the Fund's General Resources Account (GRA) on non-concessional terms

Historically, when a nation is in crisis:

- The bulk of IMF assistance has been provided through **Stand-By Arrangements** (SBAs) to address short-term or potential BoP problems
- Often for countries facing prolonged BoP problems, the **Extended Fund Facility** (EFF) and the corresponding **Extended Credit Facility** (ECF) are the Fund's main tools for medium-term support
- To help prevent or mitigate crises and boost market confidence during periods of heightened risks, members with already strong policies can use the **Flexible Credit Line** (FCL) or the **Precautionary and Liquidity Line** (PLL)
- The **Rapid Financing Instrument** (RFI) and the corresponding **Rapid Credit Facility** (RCF) provide rapid assistance to countries with urgent BoP need, including from price shocks, natural disasters, and domestic fragilities.

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IMF Lending in Action

A country's govt & IMF **must agree** on a program of economic policies **before IMF provides lending.**

Commitments to undertake policy actions - **policy conditionality -** integral part of IMF lending.

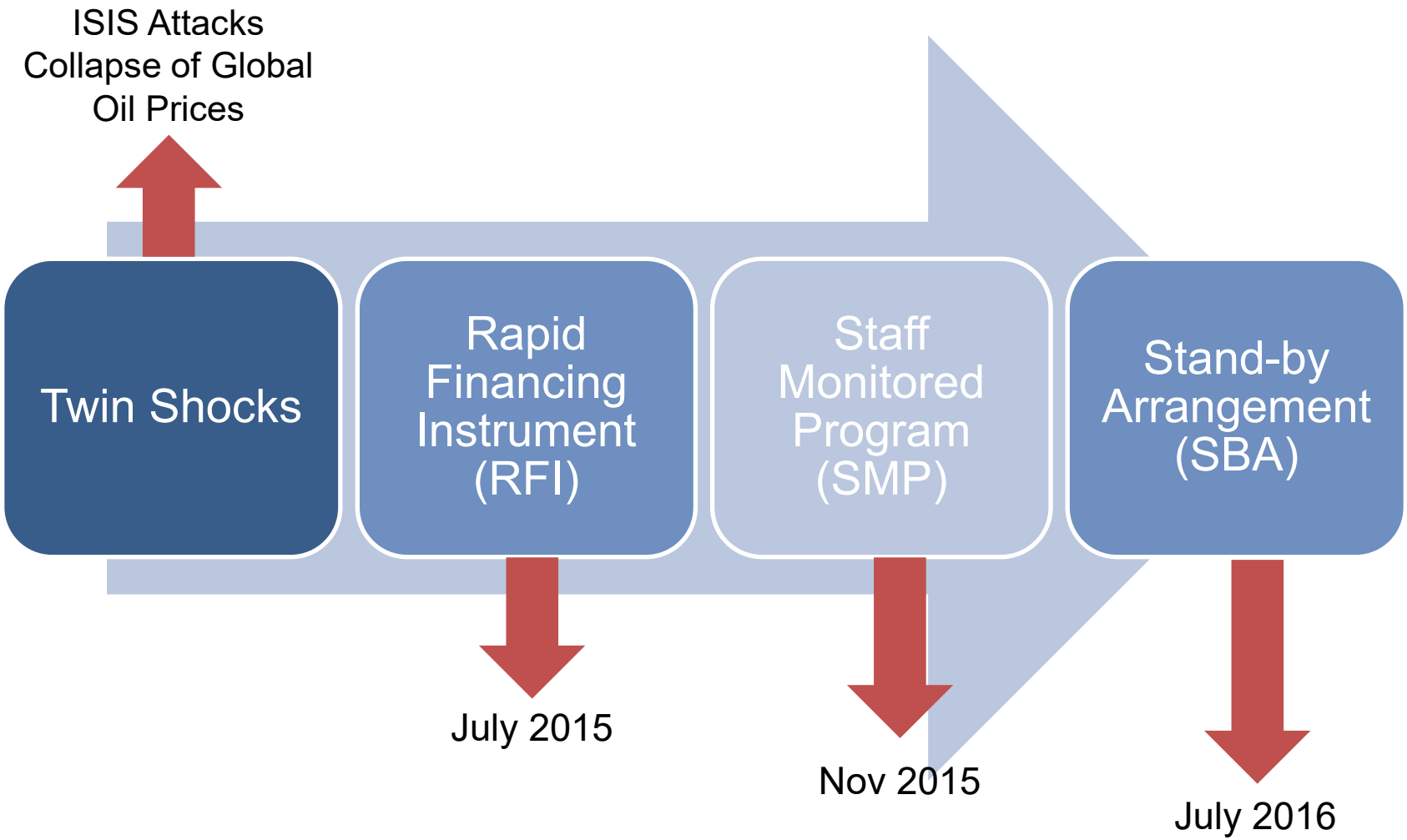
The **IMF program is described in a Letter of Intent**, which often has a detailed **Memorandum of Understanding** (e.g. economic and financial policies)

Progress is **typically reviewed by monitoring** the implementation of policy actions.

Once an understanding is reached, **recommendation is made to the Executive Board to endorse policy** & extend IMF resources

Purpose	Facility	Financing	Duration	Conditionality
Present, prospective, or potential BoP need	SBA	GRA	Up to 3 years, but usually 12-18 months	Ex-post
	SCF	PRGT	1 to 2 years	
Protracted BoP need/ medium-term assistance	EFF	GRA	Up to 4 years	Ex-post, with focus on structural reforms
	ECF	PRGT	3 to 4 years, extendable to 5 years	
Actual and urgent BoP need	RFI	GRA	Outright purchase	No Fund-supported program/ex-post conditionality, but prior actions possible
	RCF	PRGT	Outright disbursement	
Present, prospective, or potential BoP need (very strong fundamentals and policies)	FCL	GRA	1 or 2-year	Ex-ante (qualification criteria) and annual reviews for the two-year arrangements
Present, prospective, or potential BoP need (sound fundamentals and policies)	PLL	GRA	6 month (liquidity window) or 1 or 2-year	Ex-ante (qualification criteria) and ex-post
Non-financial/ signaling instruments	PSI	n/a	1 to 4 years, extendable to 5 years	Ex-post
	PCI	n/a	6 months to 4 years	

Example: Iraq – The Path to a Fund Program



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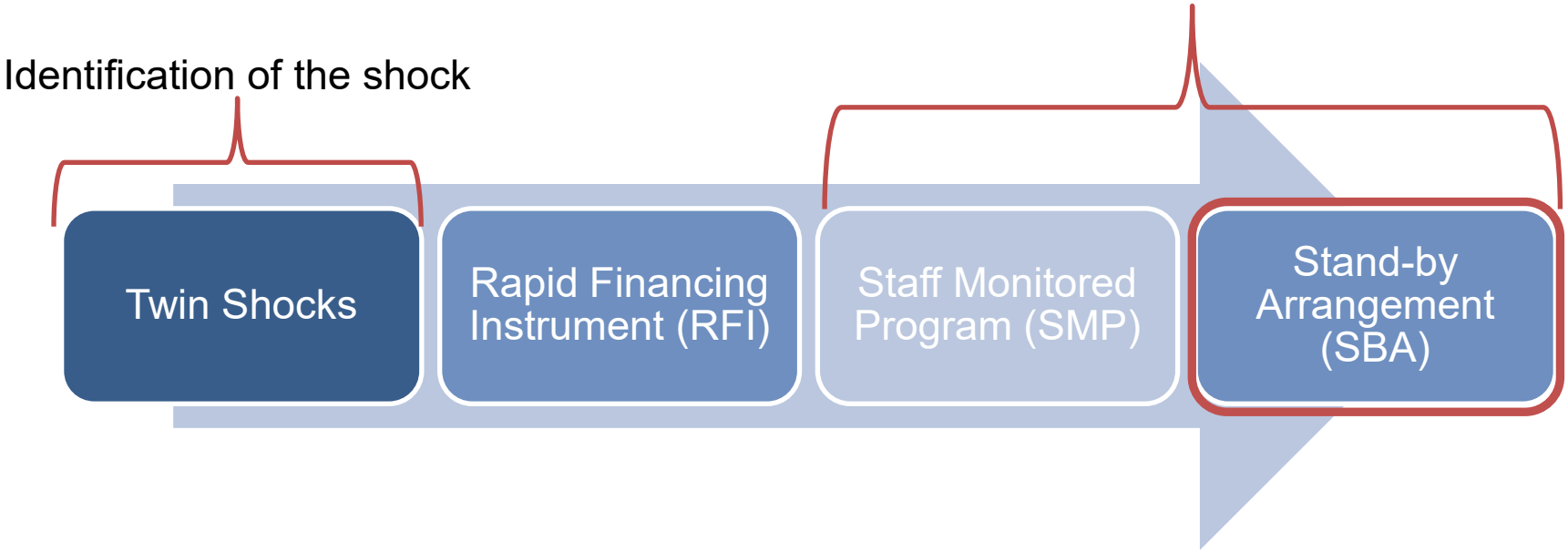
What do these phases share?

- Qualitative and quantitative assessment of shock's impact.
- Agreement with country authorities on commitments including specific conditionality.
- Performance and conditions assessed at regular reviews.



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Iraq – Agreeing on a Stand-by Arrangement (SBA)

- Discussions with country authorities to agree on commitments to address underlying issues making the country vulnerable to shocks. Commitments are laid out in program documents:

- **Letter of Intent (LOI)** is prepared by the member country describing the shock facing the economy, putting forward a request for financial support from the Fund and describing the policies that the country intends to implement.

- These policies are detailed in the **Memorandum of Economic and Financial Policies (MEFP)** attached to the LOI.

- The LOI also includes a **Technical Memorandum of Understanding (TMU),** defining the program quantitative conditions.

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IMF: How compliance with program conditions is assessed => conditionality framework still evolves

Policy Actions

- Steps a country agrees to take *before* IM F approves financing or completes a review
- Examples: elimination of price controls, budget consistent with fiscal framework

Quantitative Performance Criteria (QPCs)

- Specific, measurable conditions for IMF lending that relate to macro variables under the control of the authorities
- Examples. monetary and credit aggregates, international reserves, fiscal balances, and external borrowing

Indicative Targets (ITs)

- Sometimes ITs are set instead of QPCs because of uncertainty about economic trends.
- As uncertainty is reduced, these targets may become QPCs, with appropriate modifications.
- Examples. minimum level of the general govt primary balance, min domestic revenue collection, min level of social assistance spending

Structural Benchmarks (SBs)

- Reform measures that often are non-quantifiable but are critical for achieving program goals
- Examples. Improve financial sector operations, build up social safety nets, strengthen public financial management

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Some Lessons for Lebanon from IMF Programs

- **Strong political ownership & leadership** is needed for programs to succeed.
- **Treating the macro problems without addressing the structural components has not been successful**
- **Social protections need to be integrated into programs**
- **Front-loading IMF disbursements while back-loading conditionality usually leads to partial success or failure**
- **Execution of reforms** within agreed timeframes has been a **major risk factor**
- **Policy sequencing & coordination** (fiscal, monetary, structural) **is critical**
- **Equitable/'Fair' Burden sharing must be integral part of program design**

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Overview of the Government's Recovery Plan

- **Reform of the Banking Sector**
- Restructuring of the commercial banking sector (size & organization), including disentangling the links between commercial banks and BDL
- Ensuring banking sector role to provide to the real economy

- **Fiscal Reform**
- Reforming the electricity sector (3% of GDP) and the pension system to reduce transfers
- Rationalizing current expenditures and streamlining gov't institutions and enterprises
- Improving tax collection, compliance rates and reorienting the tax system towards increasing the burden on rent income and privileges given on public properties and assets

- **Growth Enhancing Structural Reforms**
- Strengthening of the judicial system (continue ongoing reforms on bankruptcy / procurement / competition laws, etc.)
- Sectorial strategies with a focus on land reform, energy, water, waste management, education and health
- Promotion of new dynamic industries and development of productive economy
- Gather external support to finance high value-added infrastructure projects and initiatives

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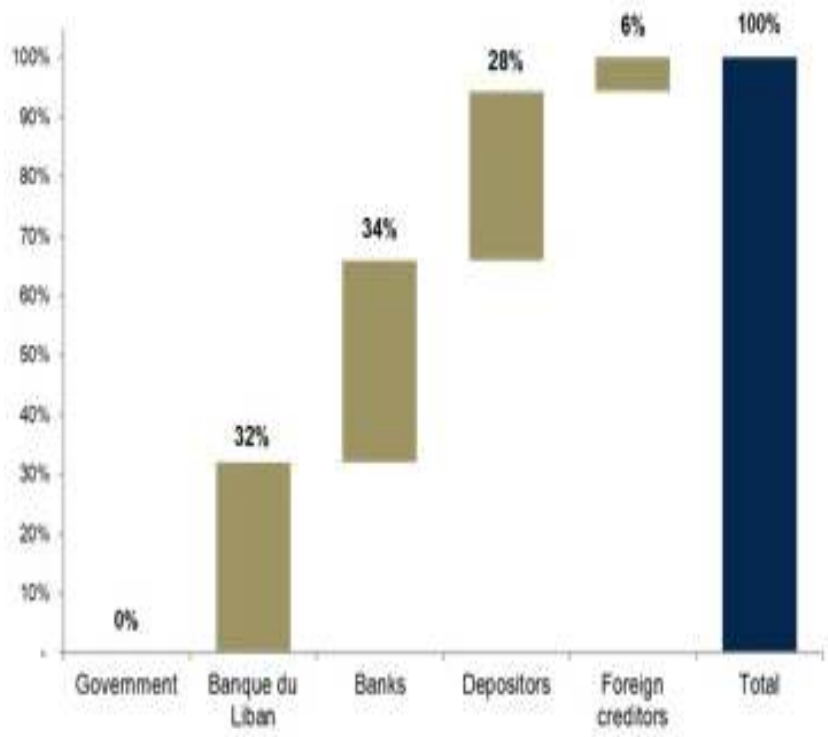
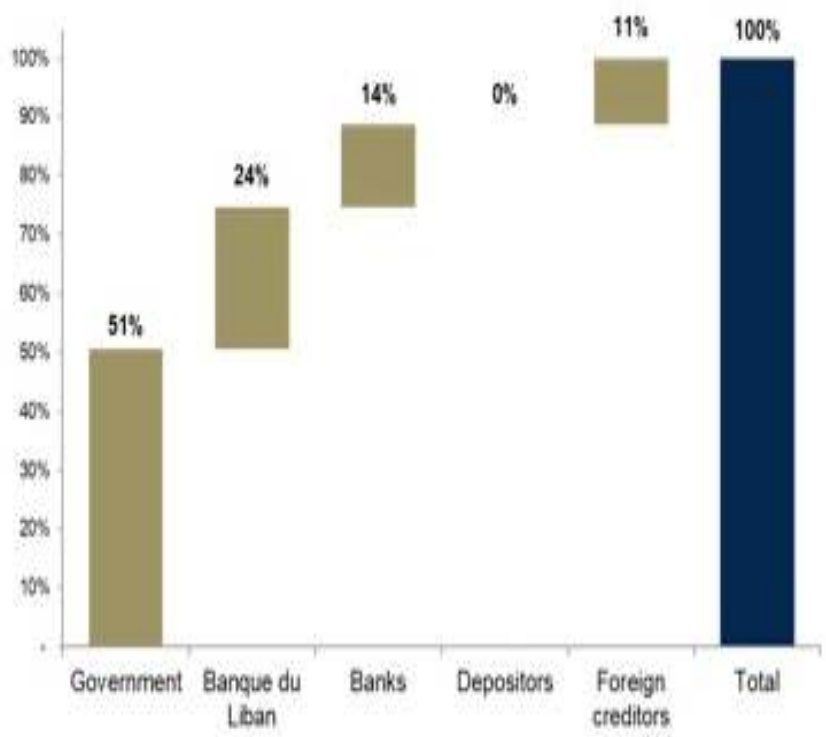
Comparison of the economic losses implied by the Government and the ABL plans





Source: ABL, May 2020

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Reforming Fiscal Policy for Macroeconomic Stability: deep fiscal reforms required

- Tax collection and expanding income tax net to include all professionals and services; raise VAT
- Phase out all and target remaining subsidies
- Remove all “ghost workers”
- Petroleum prices at international prices
- New government procurement law
- Electronic Customs Management System
- Mobile government services
- Electronic land & property registry
- Pension system reform & Social Security reform
- Reduce size of civil service, military & security
- Move all SOEs & GREs into a National Wealth Fund

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Reforming Monetary & Exchange Rate Policy for Macroeconomic Stability

- End Multiple exchange rates and move to a currency basket crawling peg
- Enact temporary capital controls act
- Phase out all quasi-fiscal operations; subsidised credit
- Phase out government borrowing from the BDL.
- Rebuild reserves to adequate levels
- Institute Inflation Targeting monetary policy: 2-3%
- Strengthen BDL's governance and internal controls framework to ensure transparency, public disclosure & accountability
- Amend Money & Credit Code to limit term of Governor & VGs; outlaw cumulating of functions: CMA, SIC

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Elements of a Credible, Sustainable Reform Program I

1. **Implement a comprehensive National Macro-Fiscal-Financial-Banking reform plan**, a **multilaterally funded Economic Stabilisation & Liquidity fund and program** under the aegis of the IMF to provide balance of payments support, CB swaps, debt guarantees, transitional fiscal support, SSN, private sector funding through PE and PPP and Infrastructure investment. **Size: $25-30 bn: IMF $8.5bn (Quota, RFI, EFF) + CEDRE II $12bn + CB Swaps $5bn + trade facilities $5bn**
2. **Fiscal Reform, Public Sector Restructuring & Structural Reforms**: tax collection, EdL reform, targeting subsidies; reduce cost of doing business, government procurement, pension system reform, civil services pay and benefits, 'ghost workers'
3. **Public debt (government & BDL) restructuring (60-70%haircut)**: reduce principal, reduce interest rates, extend maturities, convert USD to LBP
4. **Monetary & Exchange Rate Policy Reform.** Move to flexible exchange rate; stop quasi-fiscal operations & government financing; amend Money & Credit Code
5. **Economic & Financial Governance**: Establishing strong and independent banking, financial, telecoms, oil & gas, electricity and other regulators

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Elements of a Credible, Sustainable Reform Program II

6. **E**stablish a **National Wealth Fund** to include all SOEs and GREs & future Oil & Gas Revenues : EdL, Telecom, Transport, Water, Ports, Airports, Casino, Tobacco etc. NWF to reform, improve governance, productivity & efficiency, generate revenue. Prepare for PPP and Privatisation
7. **Bank Recapitalisation and Restructuring (bail-in):~$25-$30 bn**, of which **$20bn** shareholders cash injection + capitalisation of reserves+ sale of foreign subsidiaries, branches & investments; sale of client real estate holdings; revaluation of own real estate assets against a cash injection & exemption from capital gains tax; Consolidation: M&A; new Insolvency Law & 'Bad Bank Act'. **$10bn foreign financing. Balance from large depositor haircut**
8. **Establish a Social Safety Net:** about $800 Mn annually are required to alleviate growing poverty rates
9. **Anti-Corruption program and Stolen Asset Recovery Initiative (StAR)**: appoint and empower a special anti-corruption prosecutor and unit; Join StAR initiative: partnership between the WB and UN Office on Drugs and Crime (UNODC)
10. **Early elections and transition to Third Republic**

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What does it imply for YPOers?

- **Immediately move into Survival Mode: operations maintenance**
- **Imperative: Focus on Cash and Financial Management**
- **Inventory management (input, finished goods): Critical**
- **Review Strategy and Business Processes**
- **Focus on import substitution for inputs, export orientation for outputs**
- **Become civically and politically engaged: livelihood & survival of business is at risk**

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