LEBANON

Table 1	2017
Population, million	6.1
GDP, current US$ billion	53.6
GDP per capita, current US$	8809
National poverty line[a]	27.4
Gini index[a]	31.8
School enrollment, primary (% gross)[b]	89.1
Life expectancy at birth, years[b]	79.6

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2011).
(b) Most recent WDI value (2016)

A slowdown in economic activity, delay in government formation as well as global monetary conditions are re-introducing heightened macro-financial risks, after having waned somewhat in the follow-up to the successful CEDRE conference in which the Government presented a Capital Investment Plan (CIP). The CIP won pledges of over US$11 billion from donors. Global emerging market strains are putting Lebanon's bank-dependent twin-deficit financing to severe test. In the meantime, a legacy of underinvestment and severe social strains from the refugee influx are compounding.

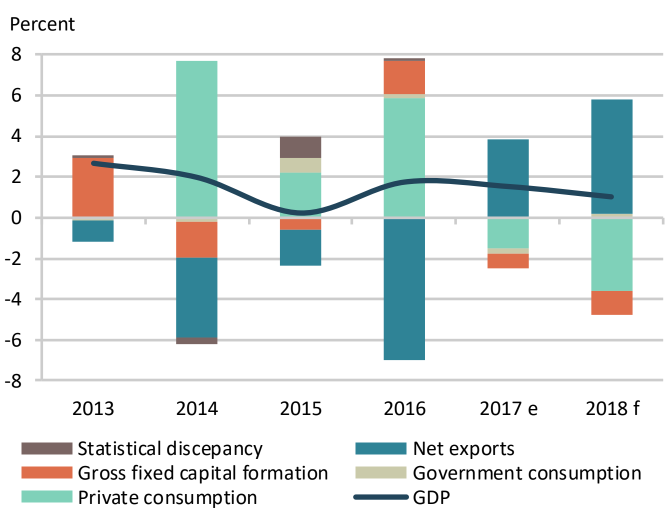
Recent developments

Following the Hariri resignation crisis in November 2017, the central bank (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. Indeed, high frequency indicators 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 merchandize exports over H1 2018 neutralized higher imports to leave the trade deficit similar in absolute value (and lower as percentage of GDP). Meanwhile, tourist arrivals rose by 3.3 (yoy) in H1 2018, 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. 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 1). 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.

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 155 percent by end-2018.

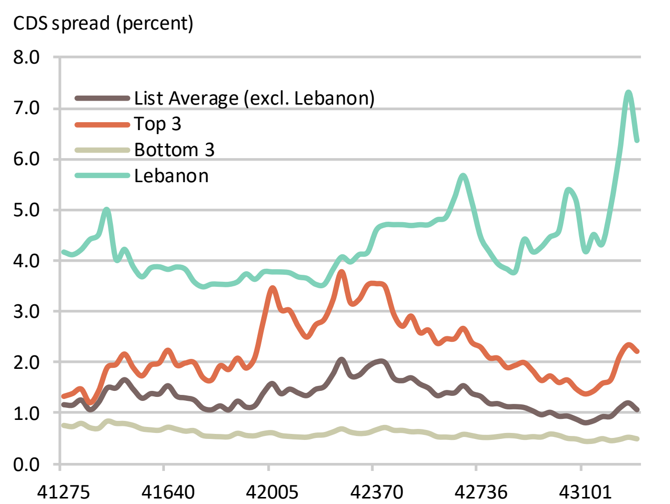
Credit-default Swap (CDS) and EMBIG spreads, indicators of risk premium, are at elevated levels, surpassing those registered in November 2017 (Figure 2). This is being driven by foreign deleveraging from Lebanese assets due to political (lack of government), geopolitical (Iran, Syria tensions) and emerging 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 billion by end-June, equivalent to about 15 months of imports of goods and services, compared to US$42 billion 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 at BdL decreased by US$2.7 billion over H1 2018, its stock of foreign-denominated securities increased by US$4.8 billion.

FIGURE 1 Lebanon / Volatile economic activity reflects frequent shocks.



Sources: Lebanese authorities and WB staff calculations.

FIGURE 2 Lebanon / Already elevated risk premium on the rise due to global monetary conditions.



Sources: JP Morgan and WB staff. Plotting Lebanon's CDS spread against (i) the average for a group of emerging markets; (ii) the 3 highest spreads–Turkey, Russia and Brazil; and (iii) the 3 lowest spreads–Czech Republic, South Korea and Poland.

Inflationary pressures are persisting. The 12-month headline inflation rate averaged a 6.2 percent (yoy) over 7M-2018, in good part due to a strong rebound in commodity prices, especially fuel products, as well as 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.

The latest available official poverty rate shows that nearly a third of the population is poor. There have been substantial structural changes, such as the large refugee influx, since 2011/12, when data on households' living standards were last collected. These structural changes have likely impacted households' incomes. However, because the conditions today are very different from those in 2011/12 when household data were last collected, it is not possible to estimate by how much households may have been impacted or to construct poverty projections.

Outlook

Lack of obvious sources for an economic boost suggests Lebanon's medium-term economic prospects remain sluggish. Such difficult economic conditions in the medium term are likely to adversely impact poverty rates as well. On the fiscal side, a gradual rise in the fiscal deficit-to-GDP ratio is expected over the medium term, in light of rising debt service. The government committed in Paris to an annual 1 pp decline in the fiscal deficit ratio over the next 5 years, along the lines of the recommendations of the IMF Article IV assessment, but this is not in the Bank (or IMF) baseline.

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, itself partially driven by BdL's financial engineering.

The follow-up to the Paris investor conference in 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. Reforms pledged by the government in CEDRE have yet to be enacted.

Risks and challenges

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 markets. Consequently, the recent normalization of global interest rates has had an impact on Lebanese Eurobonds, as indicated by a sharp rise in the CDS spread.

Should this confidence shock materialize into more systemic failures, 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 narrow export base, it lacks the routes to an export-led adjustment.

A key challenge to improving empirically informed policy is to strengthen the data and analytical base of the government, especially the Central Administration of Statistics for poverty measurement and monitoring. As it stands, distributional analysis of the impact of shocks and reform scenarios is severely constrained.

TABLE 2 Lebanon / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017	2018 e	2019 f	2020 f
Real GDP growth, at constant market prices	0.2	1.7	1.5	1.0	1.3	1.5
Private Consumption	2.4	6.3	-1.6	-4.0	-0.3	0.6
Government Consumption	5.8	1.3	-1.6	1.2	-1.1	2.5
Gross Fixed Capital Investment	-2.6	7.2	-3.0	-5.7	3.6	6.0
Exports, Goods and Services	6.9	-3.6	2.2	9.3	4.2	2.2
Imports, Goods and Services	6.6	9.8	-4.9	-3.8	0.8	2.5
Real GDP growth, at constant factor prices	-0.3	1.1	4.9	1.0	1.3	1.5
Agriculture	-13.9	6.1	13.2	1.0	2.5	0.0
Industry	-5.5	0.1	3.9	6.5	3.4	2.5
Services	1.4	1.0	4.7	0.1	0.9	1.4
Inflation (Private Consumption Deflator)	-3.1	-0.7	5.1	5.5	1.0	1.0
Current Account Balance (% of GDP)	-17.1	-20.3	-23.1	-21.4	-20.0	-19.2
Net Foreign Direct Investment (% of GDP)	3.0	3.0	2.8	4.1	4.2	4.1
Fiscal Balance (% of GDP)	-7.7	-9.2	-6.6	-8.3	-8.9	-9.2
Debt (% of GDP)	140.9	145.5	148.5	154.6	161.2	166.0
Primary Balance (% of GDP)	1.2	0.0	2.7	1.4	1.1	1.1

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.