LEBANON

Table 1	2018
Population, million	6.1
GDP, current US$ billion	56.6
GDP per capita, current US$	9295
National poverty rate[a]	27.4
Gini index[a]	318
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)

Following 9 months of political jostling and discourse, Lebanon ushered a new government on January 31st. The government is inclusive of all major political parties and mirrors the new parliament that was elected based on a proportional law, which was a novelty for Lebanon. In response, financial market anxiety moderated after risk premia peaked to record levels in the period preceding government formation. This breathing space is likely to be brief unless implementation proceeds on important reforms and investments in the near term.

Recent developments

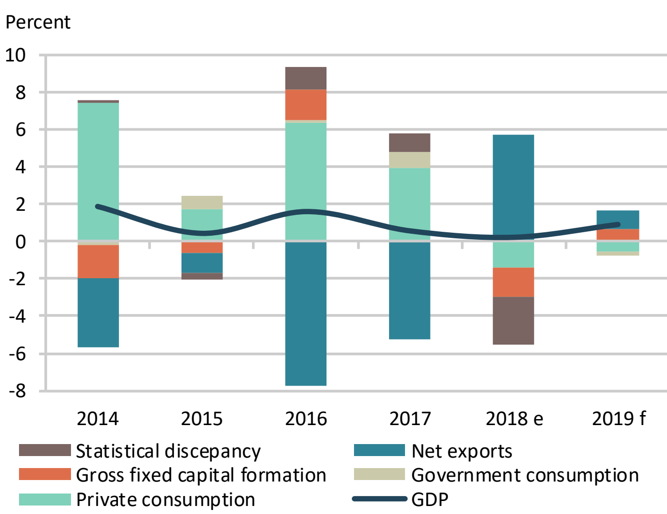
Real GDP in 2018 is estimated to have grown by only 0.2 percent, reflecting a deceleration in economic activity linked to policy-based tightening of liquidity. The latter includes a halt in subsidized lending by the central bank, the Banque du Liban (BdL) that was being channeled via commercial banks to (mostly) the real estate sector, providing a rare source of growth impetus since 2012. Further, growth in 2017—when BdL schemes were still in effect—was revised downward to 0.6 percent (from 1.5), illustrating economic frailty.

Indeed, high frequency indicators point to a broad-based economic slowdown in 2018. Tourist arrivals rose by only 5.8 percent in 2018, almost half of the 2017 rate, while real estate indicators point to an outright contraction in the sector; cement deliveries decreased by 5.3 percent year on year (yoy) in the first eleven months of 2018. The external sector was a net positive for GDP, driven by a 13.6 percent decline in merchandize imports which induced a 16 percent narrowing in the trade in goods deficit. Hence, whereas private consumption has traditionally led real GDP growth, net exports are estimated to be the main driver in 2018 (Figure 1). Structurally, the economy remains heavily based on real estate, retail and financial services, and oriented towards the region, rendering it vulnerable to volatility in growth and sizable macroeconomic imbalances.

The fiscal position deteriorated sharply in 2018 with the fiscal deficit widening by an estimated 4.5 pp to reach 11.5 percent of GDP. This is despite Lebanon's commitment in the CEDRE donor conference in April 2018 to an annual one percentage point (pp) decline in the deficit-to-GDP ratio over a 5 year period for a total reduction of 5 pps in 5 years. Similarly, the primary balance went from a surplus of 2.3 percent of GDP to -1.8 percent. This deterioration is driven by higher current expenditures, likely motivated by the elections as illustrated by a 266 percent increase in transfers to municipalities in 9M-2018. These expenditure surges are overlaid on large and persistent fiscal drain from electricity subsidies and poorly managed infrastructure. The debt-to-GDP ratio is expected to persist in an unsustainable path, at 150.3 percent by end-2018.

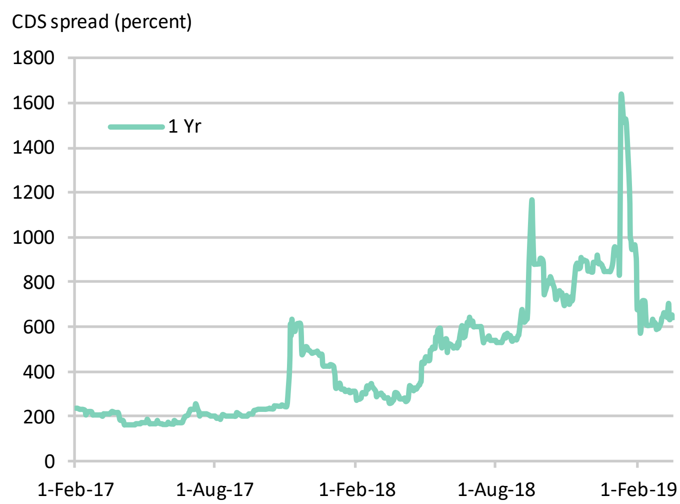
Monetary conditions have tightened significantly since the November 2017 Hariri resignation crisis, with BdL using direct as well as indirect tools. The former include (in addition to the afore-mentioned termination of BdL-backed loans) a cap on LL lending by banks to 25 percent of LL deposits, with many banks at or passed this threshold. Moreover, average interest rates on deposits in dollars and LL rose by 274 and 143 basis point (bps), respectively, over the October 2017-December 2018 period. A principal objective for the policy -induced monetary tightening has been to limit the LL liquidity in the market that can be used against the exchange rate. This is in a context of high-risk premia, which despite declines since government formation, remain at elevated levels (Figure 2). As a result, banks' total credit to the private sector increased by a mere

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: WB staff calculations.

0.8 percent (yoy) in December 2018, compared to 6 percent (yoy) in December 2017. Still, the 12-month headline inflation rate averaged a 6.1 percent in 2018, due to a strong rebound in commodity prices, especially fuel products, as well as low-threshold effects after 2 deflationary years. Despite the improved trade in goods balance, the Net Foreign Asset (NFA) position accumulated a loss of US$4,823 million in 2018, compared to a loss of US$156 million in 2017. The tapering of capital inflows has reflected on BdL's foreign exchange reserves, which decreased by US$2.3 billion to reach US$39.7 billion (including Lebanese Eurobonds) by end-2018, equivalent to 13.5 months of imports of goods and services.

Prior to the large refugee influx, the national poverty rate was 27 percent (2011/12 data). An updated picture of poverty and its dimensions will require more recent survey data.

Outlook

The Ministerial Statement for the new Government, which motivated a vote of confidence by Parliament, reflects a commitment to significant structural reforms and the will to effect the CEDRE opportunity. While this constitutes a positive signal, our baseline scenario precludes this outlook. Instead, lack of obvious sources for an economic boost suggests medium-term economic prospects remain sluggish. 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. Externally, the current account deficit is expected to decline somewhat due mainly to suppressed imports, as slow economic growth is weighed down by tightened monetary policy. On the social side, poverty projections are unavailable; substantial structural changes that the country has been undergoing in large part due to the significant refugee influx preclude the use of 2011/12 survey data for estimating poverty in recent years.

Risks and challenges

External financing needs persist as a principal challenge. In 2019, it is estimated that the Government will need close to US$5 billion in foreign currency financing, for which the Ministry of Finance has expressed the desire to tap the Eurobond market. While it is unclear that market appetite for Lebanese Eurobonds is sufficient, BdL stands ready to intervene, or *engineer*, as in recent years. Despite the narrowing of the current account deficit, it remains one of the highest in the world. This is within the context of decelerating growth for bank deposits. A slight reprieve is the expected slowing in global monetary tightening conditions.

Lebanon remains significantly vulnerable to confidence shocks, especially those emanating from political quarters. Should this materialize, the stabilizing tools available are limited. The dollar peg is a central pillar for its macro-financial structure and cannot be abandoned without a significant risk of systemic financial failures. Moreover, due to the narrow export base, it lacks the routes to an export-led adjustment.

Even netting out such a shock scenario, monetary tightening along with slower growth is likely to further degrade loan performance, leading to balance sheet vulnerabilities.

One of the key challenges to empirically informed policy is to strengthen the data and analytical base of the government, especially the Central Administration of Statistics for poverty monitoring. In the absence of such data, distributional analysis of the impact of shocks and reform scenarios is severely constrained, including for extremely urgent reforms as in the electricity sector.

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

	2016	2017	2018 e	2019 f	2020 f	2021 f
Real GDP growth, at constant market prices	1.6	0.6	0.2	0.9	1.3	1.5
Private Consumption	6.9	4.1	-1.4	-0.5	0.5	1.5
Government Consumption	1.3	6.3	0.4	-1.5	2.3	1.5
Gross Fixed Capital Investment	7.2	-0.3	-6.6	3.1	6.1	1.5
Exports, Goods and Services	-3.5	-3.2	8.4	3.8	2.0	1.5
Imports, Goods and Services	10.9	6.4	-4.6	0.4	2.3	1.5
Real GDP growth, at constant factor prices	0.9	0.4	3.3	1.2	1.2	1.4
Agriculture	6.1	11.7	0.0	2.4	-0.3	4.4
Industry	0.6	-3.9	12.9	3.3	2.2	4.4
Services	0.7	0.6	1.9	0.7	1.1	0.7
Inflation (Consumer Price Index)	-0.9	4.5	6.1	1.5	3.0	3.0
Current Account Balance (% of GDP)	-20.4	-22.7	-20.6	-18.6	-17.7	-17.7
Net Foreign Direct Investment (% of GDP)	3.1	2.3	2.6	2.6	2.5	2.5
Fiscal Balance (% of GDP)	-9.3	-7.0	-11.5	-12.4	-13.2	-13.3
Debt (% of GDP)	146.3	149.0	150.3	151.2	154.7	158.4
Primary Balance (% of GDP)	0.0	2.3	-1.8	-2.5	-2.6	-2.3

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