

LEBANON ECONOMIC MONITOR

THE BIG SWAP: DOLLARS FOR TRUST

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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 Macro-Fiscal Management (MFM) team. It was prepared by Wissam Harake (Country Economist), Samer Matta (Economic Analyst) and Zeina Hasna (Economic Analyst), under the general guidance of Eric Le Borgne (Lead Economist) and Auguste Kouame (Global Practice Manager). Ibrahim Jamali (Assistant Professor at the American University of Beirut) authored the Special Focus on central bank interventions. May Ibrahim (Senior Executive Assistant) provided Arabic translation, Nada Abou-Rizk (Program Assistant) provided French translation and Zeina El Khalil (Communications Officer) print-produced the report.

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LIST OF KEY ABBREVIATIONS USED

bps:	Basis points
H1, H2:	First half of the year, second half of the year.
3mma:	Three-months moving average
pp:	Percentage points
Q1 (Q2, Q3, Q4):	First (second, third, fourth) quarter of the year
qoq:	Quarter-on-quarter
sa:	Seasonally adjusted
saar:	Seasonally adjusted, annual rate
yoy:	Year-on-year
lhs, rhs:	Left hand side, right hand side (for axis of figures)

EXECUTIVE SUMMARY

I. As the political stalemate continues, policy-making bodies of the country are mostly inoperative. This is manifested by a presidential vacancy for two and a half years, a parliament that seldom convenes and a cabinet that hardly finds a consensus to take decisions. These illustrate how Lebanon's system of governance is incapable of resolving the country's acute predicaments, including endemic corruption and the collapse of public services (electricity, water supply and waste treatment). All the while, Lebanon continues to face momentous challenges emanating from the war in Syria, including hosting the largest assembly of Syrian refugees (in proportion to the population).

II. Amid fiscal policy paralysis, monetary policy under the proactive Banque du Liban (BdL) continues to actively manage economic and financial challenges facing the country. The BdL has provided critical support to the real economy as well as acting as a backstop to the financial sector. To respond to the shock from the Syrian conflict on the Lebanese economy, BdL has introduced since 2013 successive packages of subsidized loans for the private sector, helping to support demand especially to the real estate sector. In 2016, and faced with weaker capital inflows—a main resource for an economy with sizable fiscal and current account deficits—BdL financially engineered a swap that was able to boost its foreign exchange reserves and capitalization in local currency at commercial banks. Notwithstanding the short-term needs, given the current fundamentals and lack of structural reforms, such interventions can exacerbate macro-financial risks.

III. Economic activity in 2016 is marginally picking up, thanks to the construction and travel sectors in the context of benign security conditions. Real GDP growth is estimated to have

reached 1.3 percent in 2015 and is projected to accelerate slightly to 1.8 percent, in 2016, partly on account of a moderate first half of 2016. In H1-2016, the construction sector rebounded somewhat: construction permits and cement deliveries both expanded by 6.5 percent and 9.9 percent yoy, respectively. Tourist arrivals grew by 7.7 percent (yoy) in H1-2016.

IV. The fiscal stance is expected to be largely unchanged in 2016, maintaining a primary surplus. The overall fiscal deficit for the year until April grew by 10 percent (yoy), equivalent to 3.3 percent of GDP and compared to 3 percent of GDP during the same period in 2015. Both revenues and expenditures rose during this period, with the latter outpacing the former, partially due to sizable transfers to municipalities. For the year, we project that an increase in tax revenues, from a marginally improving economy, will offset slightly higher expenditures, leaving the overall fiscal deficit at around 8 percent of GDP and a primary surplus of 1.8 percent of GDP. With subdued GDP growth and high interest rates, such a surplus remains insufficient to prevent the debt-to-GDP ratio from continuing its unsustainable path; remaining elevated at a projected 149 percent by end-2016.

V. A pick up in imports of merchandise goods combined with deteriorating exports is expected to induce a widening in the already sizable current account deficit. H1-2016 witnessed a 5 percent growth (yoy) in merchandise imports, led by minerals and metals, while exports continued to be afflicted by the closure of the last remaining Syrian route, which occurred in May 2015 and through which exporters were able to access the GCC market. The widening trade-in-goods deficit is expected to induce a deterioration in the current account balance in 2016, to a deficit of 19 percent of

GDP, among the largest in the world, which exposed the country to significant refinancing risks.

VI. BdL policy interventions in the real economy has provided critical support to the real estate sector and, ultimately, to the banking sector (Special Focus). As Lebanon's economic landscape came under duress following the eruption of the war in Syria, the BdL introduced successive subsidized lending packages targeting the real economy. The real estate sector has been the largest beneficiary of these packages. Nonetheless, preliminary evidence suggests that, given current economic fundamentals, 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.

الملخص التنفيذي

IV. يُتَوَقَّع أن يراوح الوضع المالي مكانه في العام ٢٠١٦ بشكل عام، مع الإبقاء على فائض أولي. ارتفع العجز المالي العام لهذا العام حتى نيسان/أبريل بنسبة ١٠ في المئة (مقارنةً مع العام الماضي)، ليُساوي ٣,٣ في المئة من إجمالي الناتج المحلي ومقارنةً مع ٣ في المئة من إجمالي الناتج المحلي في خلال الفترة نفسها في العام ٢٠١٥. كما ارتفعت الإيرادات والنفقات في خلال هذه الفترة، مع تجاوز الأخيرة للأولى، ويعود ذلك بشكل جزئي إلى التحويلات الكبيرة إلى البلديات. وبالنسبة إلى هذا العام، يُتَوَقَّع أن تعوّض زيادة في العائدات الضريبية من اقتصاد يتحسن ببطء النفقات الأعلى بشكل طفيف، ليترك العجز المالي العام يتراوح عند ٨ في المئة من إجمالي الناتج المحلي وفائضاً أولياً بنسبة ٨,١ في المئة من إجمالي الناتج المحلي. ومع نمو طفيف لإجمالي الناتج المحلي ومعدلات فائدة مرتفعة، يبقى مثل هذا الفائض غير كافٍ من أجل منع معدل الدين العام إلى إجمالي الناتج المحلي من مواصلة مساره غير المستدام؛ فيبقى مرتفعاً عند نسبة ١٤٩ في المئة في نهاية العام ٢٠١٦.

V. يُتَوَقَّع أن تولّد زيادة في واردات السلع المُرفّقة بتدهور الصادرات اتساعاً في رقعة عجز الحسابات الجارية الذي يُعتَبَر أصلاً كبيراً. شهد النصف الأول من العام ٢٠١٦ نمواً قدره ٥ في المئة مقارنةً مع العام الماضي في واردات السلع، منها المعادن بشكل خاص، بينما لا تزال الصادرات تتأثر بإقفال الطريق الأخيرة المتبقية في سوريا، في أيار/مايو ٢٠١٥ التي من خلالها كان باستطاعة المُصدّرين النفاذ إلى سوق دول مجلس التعاون الخليجي. ويتوقَّع أن يولّد العجز المتزايد في تجارة السلع تدهوراً في رصيد الحسابات الجارية في العام ٢٠١٦، لتسجيل عجز قدره ١٩ في المئة من إجمالي الناتج المحلي، وهي من النسب الأعلى في العالم التي تعرّض البلد إلى مخاطر إعادة تمويل وخيمة.

VI. منحت تدخّلات مصرف لبنان في الاقتصاد الحقيقي دعماً ملحوظاً لقطاع العقارات، وفي نهاية المطاف، لقطاع المصارف (التركيز الخاص). بما أن الوضع الاقتصادي في لبنان عانى صعوبات جمّة إثر اندلاع الحرب في سوريا، أدخل مصرف لبنان رزمات إقراض مدعومة متتالية تستهدف الاقتصاد الحقيقي. وكان قطاع العقارات المستفيد الأكبر من هذه الرزم. لكن، تشير الأدلة الأولية إلى أنه نظراً إلى الأوضاع الاقتصادية الحالية، والشلل السياسي القائم، والبيئة الأمنية المتطايّرة، وانعكاسات النزاع السوري، لكان النشاط الاقتصادي في لبنان أبطأ لولا تدخّلات مصرف لبنان في مجال السياسات.

I. مع استمرار الجمود السياسي، تُعتبر الهيئات المعنية بصناعة السياسات غير فاعلة بأغليبيتها. ويتبلور ذلك من خلال فراغ رئاسي للسنة الثالثة على التوالي، وبرلمان نادراً ما يلتئم، ومجلس وزراء بالكاد يتوصّل إلى إجماع لاتخاذ القرارات، ممّا يعكس نظام حوكمة في لبنان عاجز عن تبيد الصعوبات الحادة التي يشهدها البلد، بما في ذلك الفساد المستشري وانهيار الخدمات العامة (الكهرباء، وإمدادات المياه، ومعالجة النفايات). وفي خلال هذه الفترة، يستمرّ لبنان في مواجهة تحديات كبيرة ناشئة عن الحرب في سوريا، بما في ذلك استضافة أكبر عدد من اللاجئين السوريين (نسبة إلى عدد السكان).

II. وفي ظل شلل السياسة المالية، تستمر السياسة النقدية تحت مظلة مصرف لبنان الفاعل في إدارة التحديات المالية والاقتصادية التي تعانيها الدولة بشكل ناشط. في هذا السياق، أمّن مصرف لبنان الدعم الضروري للاقتصاد الحقيقي وشكّل سندا للقطاع المالي. ورداً على الصدمة التي ألحقها النزاع السوري بالاقتصاد اللبناني، أدخل مصرف لبنان منذ العام ٢٠١٣ رزمات متتالية من القروض المدعومة للقطاع الخاص، ممّا ساعد في دعم الطلب، لا سيّما على قطاع العقارات. وفي العام ٢٠١٦ ومع تباطؤ التدفقات الرأسمالية إلى البلد - وهي تشكل مورداً أساسياً لاقتصاد يُعاني عجزاً كبيراً في الحسابات الجارية والمالية - أطلق مصرف لبنان عمليةً مقابضة مالية دعمت احتياطي النقد الأجنبي لديه والرسمة في العملة المحلية في المصارف التجارية. وبالرغم من الحاجات القائمة على الأمد القصير، ونظراً إلى المعطيات الحالية وفي غياب الإصلاحات البنوية، يُمكن لهذه التدخّلات أن تزيد من المخاطر المالية الماكروية.

III. يستعيد النشاط الاقتصادي في العام ٢٠١٦ أنفاسه ببطء، بفضل قطاعي البناء والسياحة في ظل ظروف أمنية غير خطيرة نسبياً. يُقدَّر نمو إجمالي الناتج المحلي الفعلي بـ ٣,١ في المئة في العام ٢٠١٥ ويُتَوَقَّع أن يتسارع بشكل طفيف ليبلغ ٨,١ في المئة في العام ٢٠١٦، ويعود ذلك جزئياً إلى النصف الأول المُعتدل للعام ٢٠١٦. في الواقع، في النصف الأول من العام ٢٠١٦، تحسّن قطاع البناء نوعاً ما، إذ ارتفع عدد تراخيص البناء وتسليمات الاسمنت بنسبة ٥,٦ في المئة و٩,٩ في المئة على التوالي مقارنةً مع العام الماضي. كما أن عدد السياح القادمين إلى لبنان ارتفع بنسبة ٧,٧ في المئة في النصف الأول من العام ٢٠١٦ مقارنةً مع العام الماضي.

SOMMAIRE EXÉCUTIF

I. Comme l'impasse politique se poursuit, les organismes de prise de décision dans le pays restent, dans leur majorité, non fonctionnels. Cette situation s'illustre par une vacance présidentielle pour la troisième année consécutive, un parlement qui se réunit rarement et un conseil de ministres qui peine à parvenir à un consensus pour prendre des décisions. Le système de gouvernance au Liban est désormais incapable de résoudre les problèmes graves auxquels le pays est confronté, notamment la corruption endémique et l'écroulement des services publics (électricité, approvisionnement en eau et traitement des eaux usées). Dans le même temps, le Liban continue à être confronté à d'immenses défis en raison de la guerre en Syrie, dont principalement le fait d'accueillir le plus grand nombre de réfugiés syriens (par rapport à sa population).

II. Dans un contexte marqué par une paralysie de la politique financière, la politique monétaire de la Banque du Liban (BdL), qui joue un rôle proactif, permet de gérer activement les défis économiques et financiers auxquels le pays fait face. La BdL a ainsi apporté un soutien primordial à l'économie réelle et a constitué un filet de sécurité pour le secteur financier. Réagissant au choc né du conflit en Syrie qui s'est répercuté sur l'économie libanaise, la BdL a introduit, depuis 2013, des prêts bonifiés destinés au secteur privé, aidant à soutenir la demande, particulièrement pour le secteur foncier. En 2016 et face à un ralentissement des flux de capitaux—soit une ressource principale pour une économie souffrant d'un déficit significatif des comptes budgétaires et courants—la BdL a mis en place une opération de swap qui a donné un élan à ses réserves en devises étrangères et a consolidé la capitalisation en monnaie locale dans les banques commerciales. En dépit des besoins à court terme et au vu de la situation actuelle et de l'absence de réformes structurelles, de telles interventions

peuvent exacerber les risques macro-financiers.

III. L'activité économique en 2016 reprend lentement du poil de la bête, grâce aux secteurs de la construction et du tourisme, à l'ombre de conditions sécuritaires clémentes. La croissance réelle du PIB est estimée à 1.3 pour cent en 2015 et devrait s'accélérer légèrement pour atteindre 1.8 pour cent en 2016, due en partie à une première moitié de 2016 considérée comme ayant été modérée. Durant la première moitié de 2016, le secteur de la construction a relativement rebondi: les permis de construction et les livraisons de ciment ont augmenté de 6.5 pour cent et de 9.9 pour cent respectivement, par rapport à l'année dernière. Le nombre de touristes a augmenté de 7.7 pour cent (par rapport à l'année dernière) durant la première moitié de H1-2016.

IV. La position budgétaire devrait rester inchangée en 2016, maintenant un surplus primaire. Le déficit budgétaire général pour l'année jusqu'en avril a augmenté de 10 pour cent (par rapport à l'année dernière), équivalentes à 3.3 pour cent du PIB contre 3 pour cent du PIB durant la même période en 2015. Les revenus et les dépenses ont augmenté durant cette période aussi, les dépenses dépassant les revenus, ce qui est partiellement dû à des transferts de taille aux municipalités. Pour cette année, une hausse des recettes fiscales et une économie connaissant une légère amélioration devraient compenser en quelque sorte des dépenses légèrement supérieures, laissant un déficit budgétaire général avoisinant 8 pour cent du PIB et un surplus primaire de 1.8 pour cent du PIB. Avec des taux d'intérêt élevés et une faible croissance du PIB, un tel excédent demeure insuffisant pour empêcher le ratio de la dette publique au PIB de poursuivre sur sa tendance non durable ; demeurant élevé et estimé à 149 pour cent à la fin de 2016.

V. Une reprise des importations de biens associée à une régression des exportations devrait creuser davantage un déficit des comptes courants déjà important. La première moitié de 2016 a été marquée par une croissance de 5 pour cent (par rapport à l'année dernière) des importations de marchandises, essentiellement les minéraux et les métaux, alors que les exportations continuent à être affectées par la fermeture, en mai 2015, de la dernière route menant en Syrie, à travers laquelle les exportateurs étaient capables d'accéder au marché du CCG. Le déficit des échanges de biens qui se creuse de plus en plus, devrait provoquer une détérioration de la balance des comptes courants en 2016, pour accuser un déficit de 19 pour cent du PIB, parmi les plus grands du monde, ce qui expose le pays à des risques de refinancement significatifs.

VI. La politique d'intervention de la BdL au niveau de l'économie réelle a apporté un soutien d'envergure au secteur foncier, et éventuellement au secteur bancaire (Intérêt particulier). Vu que la situation économique au Liban a été mise à rude épreuve depuis que la guerre a éclaté en Syrie, la BdL a introduit des séries successives de prêts bonifiés visant l'économie réelle. Le secteur foncier en a été le plus grand bénéficiaire. Toutefois, les preuves préliminaires montrent qu'au vu de la situation économique actuelle, la paralysie politique en place, un environnement sécuritaire qui peut être instable, et les répercussions du conflit en Syrie, l'activité économique au Liban aurait pu être encore plus faible, sans la politique d'intervention de la BdL.

RECENT ECONOMIC AND POLICY DEVELOPMENTS

1. Lebanon continues to be subject to regional tensions. Despite improved security conditions, violent incidents persist; on June 27, eight suicide bombers targeted the town of Al-Qaa located only a few kilometers from the Syrian border, killing five people and wounding dozens more. Vulnerable Syrian refugees faced a backlash as the suicide bombers were Syrian nationals. In particular, several municipalities announced a curfew on Syrian refugees citing security concerns. Nevertheless, Lebanon remains the largest host (on a per capita basis) for Syrian refugees, and despite significant strain on already weak public finances, the government has received limited international assistance in light of the needs.

2. Corruption scandals make headlines with minimum accountability and an absence of a reliable legal due process. An investigation launched by parliament's Media and Telecommunications Committee reported that four internet networks in the Dinnieh highlands (north of Lebanon), Oyoun al-Siman, Faqra and Zaarour (all three regions in Mount Lebanon) were unlicensed. Additionally, the Internal Security Forces (ISF) have launched a major inquiry into accusations of embezzlement by security members for pocketing large amounts of money via the manipulation of health care bills by ISF members.

3. Lebanese headed to the polls for first time in six years in May for municipal elections, marking a rare positive development amidst pervasive political dysfunctionality. These were the first elections since the last municipal polls in 2010, in a country that has not had a president for over two years nor elected a new parliament since 2009, with the government running *de minimis*. Whereas the nature of municipal elections amplifies local factors at the expense of national trends, thus

limiting its predictive capacity for parliamentary elections outcome, the results do illustrate signs of popular resentment toward the Lebanese political class fueled by endemic corruption and failed public services. This was felt by all political parties, though to varying degrees.

Output and Demand

4. Spillover from the regional turmoil, in combination with a deteriorating domestic political process, has led to sluggish, below-potential real GDP growth since 2011.¹ While the economy since the early nineties has traditionally been susceptible to the frequent political and security shocks resulting in volatile growth rates (Figure 1), the post-2011 period has witnessed a shift in economic fundamentals. Traditional drivers—real estate, construction, finance and tourism—have suffered greatly from the regional turmoil. Instead, support for the economy has originated from other sources, including Syria-related economic activity in Lebanon², in addition to periphery sectors such as pharmaceuticals³ and the ICT sector; the percentage of individuals using the internet jumped from 52 percent in 2011 to 74 percent in 2015, while fixed

1 National accounts data since 2011 are World Bank staff estimates, guided by our coincident economic indicator (for details, see Matta, S. (2015) New Coincident and Leading Indexes for the Lebanese Economy, Review of Middle East Economics and Finance, 11 (3), 277–303), pending updates on GDP estimates from CAS for 2011 to 2015.

2 Positive economic contribution of Syrian nationals in consequence of the war in Syria has been detailed in the Spring 2015 issue of the Lebanon Economic Monitor.

3 According to Société Générale de Banque au Liban in its EcoNews, No. 36, publication in September 2015, pharmaceutical output and capacity have increased significantly over the past five years following a series of new investments in the industry geared mainly towards export markets.

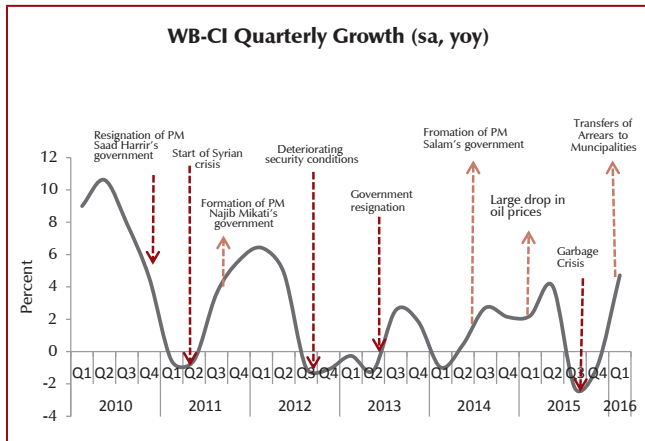


FIGURE 1. Frequent shocks result in volatile economic activity.

Sources: Lebanese authorities and WB staff calculations.

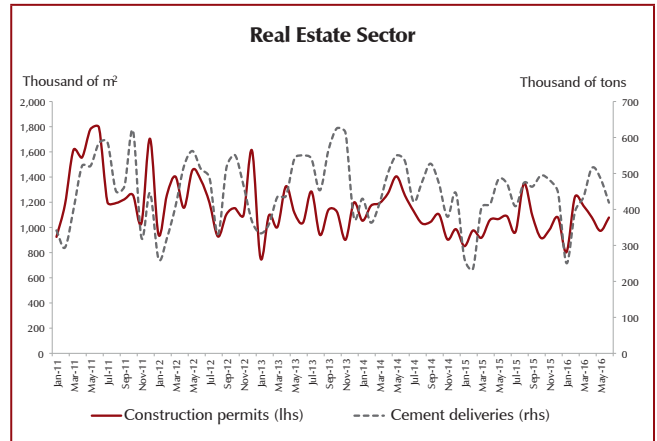


FIGURE 3. The real estate sector shows signs of recovery in H1-2016....

Sources: Banque du Liban

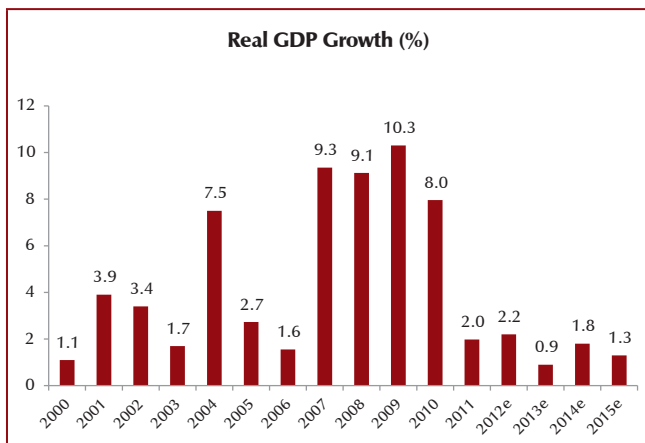


FIGURE 2. A further deceleration in economic activity in 2015.

Sources: Lebanese authorities and WB staff calculations.

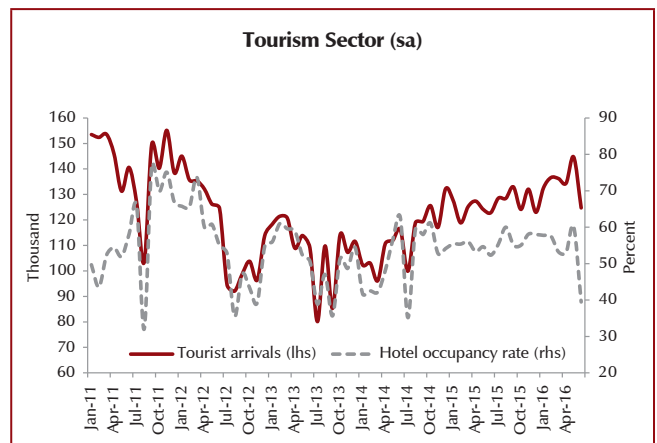


FIGURE 4. ... while an increase in expatriate visitors helps support tourism.

Source: Lebanese authorities and WB staff calculations.

broadband subscriptions almost trebled to reach over 1.1 million persons, and mobile-cellular telephone subscriptions expanded by 127 percent over the same period.⁴ Nonetheless, this has been insufficient to regain pre-crisis growth rates or even reach potential.

5. A pickup in economic activity was observed during the first half of 2016. Following a further deceleration in economic activity in 2015 (Figure 2), and despite continued political paralysis, the World Bank Coincident Index (WB-CI), a monthly proxy for real GDP in Lebanon, grew by 4.1 percent (yoy) during the first four months of 2016, compared to 3.5 percent over the same period in 2015. A principal driver was increased

public expenditures, where total expenditures excluding debt service rose by 7.4 percent (yoy) for the year through April. This was led by sizable, most likely provisional, disbursements in the amount of US\$ 502.1 million in arrears to municipalities, representing their share of telecom revenues from previous years. Excluding transfers to municipalities, the WB-CI still grew by 2.5 percent (yoy) due to a tempered rebound in the construction sector, reflecting a low-base effect; construction permits and cement deliveries both underwent respective yoy expansions of 6.6 percent and 9.9 percent in H1-2016, compared to respective contractions of 18.9 percent expansion and 18.7 percent during the same period in 2015 (Figure 3). In this regard, BdL subsidized loan schemes continue to provide crucial support to the real estate and construction

⁴ Source: International Telecommunication Union (ITU).

sectors. In addition, expatriate visitors to the country continue to provide a much needed boost to the tourism sector, helping it recover from low levels; tourist arrivals increased by 7.7 percent (yoy) in H1-2016 (Figure 4). The hotel occupancy rate, however, fell by 1.2 percentage points (pp), suggesting that the additional tourist arrivals are for the most part Lebanese expatriates who refrained from visiting in earlier years due to security conditions. As a result of this mild pick up, we project real GDP growth for 2016 to accelerate slightly to 1.8 percent.⁵

6. From the demand side, private consumption continues to be a principal driver, while the external sector has become a drag. Improved security conditions and low oil prices helped partially offset the negative impact on

consumer sentiment caused by the deteriorating political climate. While the two consumer confidence indices (CCIs) appear contradictory⁶ (Figure 5), both share a similar trend of deteriorating consumer sentiment from Q3-2015 to early 2016, followed by a recovery. Private lending toward consumption and real estate purchases continued to expand, in part thanks to another BdL stimulus package in 2015; commercial banks' claims on residents grew by 6.5 percent (yoy) by July 2016, largely unchanged from July 2015. Anecdotal evidence suggests that private demand is also supported by Syrian investment and consumption, concentrated in the informal sector; as the Syrian turmoil endures, Syrians in Lebanon are gradually shifting their economic role from being mainly consumers reliant on handouts to income earners, albeit for many, confined

BOX 1. Counting Syrian Refugees as Part of the Population Figures.

The World Bank now counts Syrian refugees in Lebanon's population estimates.* The national accounts published by Central Administration of Statistics (CAS) do not differentiate between refugee and non-refugee contributions to output, meaning that, de facto, GDP figures include the contribution of Syrian refugees to the formal economy. On the other hand, the majority of refugees work in the informal economy, with unregistered enterprises or lacking a work permit. As such, refugees' principal contribution would be unaccounted for by the national accounts.

Per capita growth has been on a decline. Table 1 below compares main macroeconomic indicators per capita when the refugees are excluded (panel I) and which until recently has been our working assumption, with the same per capita indicators but including Syrian refugees** (panel II). The sluggish economic growth that has been in effect since 2011, combined with the larger denominator (population), generates an 8.3 percent drop in real GDP per capita for the 2012-2015 period, for a total loss of US\$ 726 million. This compares to an increase of 4.1 percent if the refugees are not counted. While this suggests that the average standard of living has worsened in Lebanon, the caveat remains that the full contribution of Syrian refugees is not captured since the bulk of it is concentrated in the informal economy. Hence, the above-estimated contraction in real GDP is exaggerated.

TABLE 1. Macroeconomic Indicators with and without Syrian Refugees.

	Panel I - Without Syrian refugees				Panel II - With Syrian refugees			
	2012	2013	2014	2015	2012	2013	2014	2015
Population (Million)	4.44	4.49	4.55	4.65	4.92	5.29	5.61	5.85
GDP per Capita (US\$)	9,729	9,870	10,058	10,130	8,774	8,389	8,149	8,048
GDP Growth per Capita (%)	1.0	-0.3	0.6	-0.9	-4.7	-6.0	-4.1	-2.8

* This is now consistent with UN Population Division, which has been using complete de-facto definition of the population, therefore they count everyone (including refugees) in the country.

** This is based on United Nations High Commissioner for Refugees (UNHCR) data, which could underestimate the number of Syrians in Lebanon since many Syrians are not registered for assistance.

⁵ Box 1 presents the key macroeconomic variables after counting Syrian refugees as part of the resident population in Lebanon.

⁶ The three-month-moving average for the Byblos/AUB index contracted by 7.7 percent (yoy) in H1-2016, while the ARA index increased by 5.7 percent (yoy) during the first 5 months of the year.

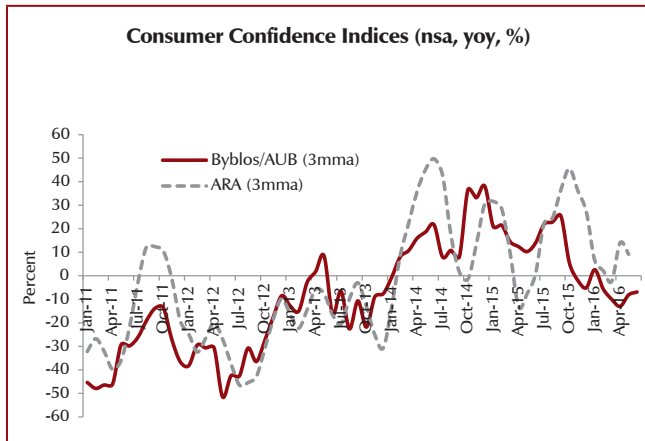


FIGURE 5. Consumer sentiment is volatile.

Source: Byblos Bank, ARA Marketing Research and Consultancy and BdL..

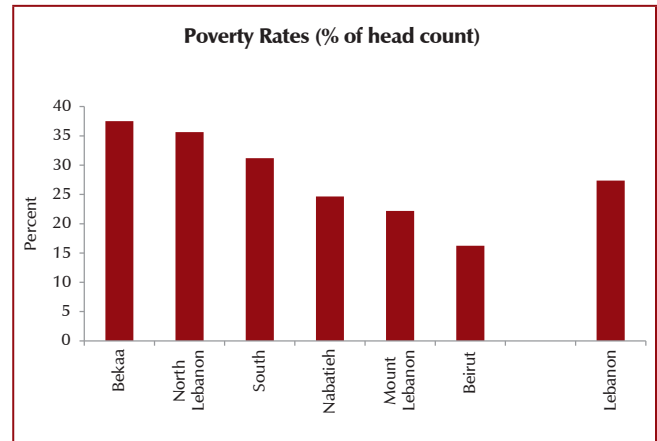


FIGURE 6. Poverty rate highest in the Bekaa and North 2011/12.

Sources: Lebanese authorities and WB staff calculations.

within the informal sector. This includes the establishment of micro and small businesses that sell goods (including those originating in Syria) at lower prices targeting the Syrian community (ILO, 2014)⁷. However, Lebanese businesses, which are not able to compete at those prices are negatively impacted. The external sector, on the other hand, has contributed negatively to real GDP growth during H1-2016 as merchandise imports recovered from 2015 lows, when a sharp decline in oil prices combined with a euro depreciation provided temporary favorable conditions. Merchandise exports have also suffered from road closures through Syria that connected exporters to the lucrative GCC market. We expect this to induce a widening of the trade deficit in goods and services this year. Moreover, public investment continues to lag due to the political paralysis, whereas private investment might improve marginally, driven by a better performing construction sector.

Poverty and Labor

7. About 27 percent of the population in Lebanon were poor according to the most recent household budget survey in 2011/12. The

⁷ International Labor Organization, 2014, *Assessment of the Impact of Syrian Refugees in Lebanon and Their Employment Profile*.

highest poverty rates were in North Lebanon and Bekaa regions, while the largest poverty count was observed in the most populous Mount Lebanon region (Figure 6). The unemployment rate was about 9 percent, based on the same household survey, which predates the impact of regional hostilities, including the influx of refugees. Poverty rates were significantly higher for workers employed in the agricultural and construction sectors who are paid on weekly or daily basis.

8. In view of their protracted presence, Syrian nationals have de facto become part of the labor market. With around half of the working age Syrian refugees economically active (ILO, 2014),⁸ by end-2014 the labor supply in Lebanon was estimated to have expanded by 50 percent (IMF, 2014⁹). The majority of Syrian refugees are low- to semi-skilled workers, engaged primarily in construction, agriculture, and personal and domestic services. The vast bulk of refugee employment, regardless of the level of education attained, focused on the informal sector (ILO, 2015).¹⁰ It is unclear to what extent low-

⁸ International Labor Organization (2014), *Assessment of the Impact of Syrian Refugees in Lebanon and Their Employment Profile 2013*. The study surveyed the employment profile of refugees and the impact of their economic participation on the host communities' livelihoods. Data was collected from 400 households, which included a total of 2,004 individuals.

⁹ IMF (2014), *Article IV Consultation and Selected Issues*, July, Washington DC.

¹⁰ International Labor Organization (2015), *Towards Decent Work in Lebanon: Issues and Challenges in Light of the Syrian Refugee Crisis*, Beirut, Lebanon.

skilled refugees have been competing with Lebanese nationals since, even prior to the crisis, the low-skilled labor market was dominated by foreigners (e.g., Syrians, Bangladeshi, Ethiopians, Filipinos). As such, it is more likely that low-skilled foreign labor in Lebanon, including other Syrians who were present before 2011, will bear the brunt of the competition from refugees. This can explain the lack of significant tensions between the refugees and host communities, considering the sheer number of refugees.

9. Employment growth has been concentrated in low productivity activities as those involving higher productivity have not grown proportionally. Over the past decade, 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, relatively low productivity activities dominated employment growth, while growth in productive activities such as communications, financial services, 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. In fact, the long-run employment-growth elasticity is estimated to be 0.2 (World Bank, 2012¹¹), much lower than an estimated MENA average of 0.5 (IMF, 2014).

Fiscal Policy

10. The fiscal stance is expected to be largely unchanged in 2016, maintaining a primary surplus. The overall fiscal deficit for the year until June grew by 9.9 percent (yoy) to be equivalent to 3.8 percent of GDP, compared to 3.5 percent of GDP during the same period in 2015. Both revenues and expenditures rose during this period, with the latter outpacing the former partially due to sizable transfers to municipalities, which we expect to continue to be lumpy. For the year, we project that an increase

11 World Bank (2012), "Republic of Lebanon—Good Jobs Needed: The Role of Macro, Investment, Education, Labor and Social Protection Policies", December, Washington DC.

in tax revenues, from a marginally improving economy, will offset slightly higher expenditures, leaving the overall fiscal deficit at around 8 percent of GDP (Figure 7) and the primary deficit at a slightly improved 1.8 percent of GDP. The slowdown in economic activity since 2011 has induced a general softening in total revenues; in 2015 total revenues amounted to 20.3 percent of GDP compared to the 2002-2011 period average of 23.4 percent of GDP. On the other hand, primary spending (excluding interest payments) has remained close to the period average (21.2 percent of GDP in 2015, compared to a 2002-2011 period average of 21 percent of GDP).

11. Slower price deflation and the small pickup in growth would help stabilize the debt-to-GDP ratio in 2016. Gross public debt is forecast to reach around 149 percent of GDP by end-2016, largely unchanged from end-2015 (Figure 8). While absolute gross debt is expected to continue growing at a comparable rate to 2015, nominal GDP is forecast to expand at an accelerated rate due to slower deflation and slightly higher real GDP growth.

12. Sizable Eurobond issues by the Ministry of Finance highlight large financing needs. The government continues to primarily finance the fiscal deficit by issuing Treasury bills and Eurobonds. In April 2016, Lebanon successfully issued \$US 1 billion in Eurobonds to replace maturing debt. The Eurobond issue was divided into two tranches: the first was for \$700 million, maturing in 2024 with a 6.65 percent interest rate, and the second was for \$300 million that matures in 2031 with an interest of 7 percent. The ministry announced that the issue was oversubscribed. The stock of debt outstanding remains mostly in local currency, albeit, decreasing in proportion; by June 2016, 60.3 percent of gross public debt was denominated in LBP, compared to 61.4 percent in June 2015.

13. Longstanding structural bottlenecks in public finance are important manifestations of the perceived endemic corruption¹² and political

12 In the 2013 Global Corruption Barometer survey, 93 percent of Lebanese respondents reported that corruption is a (serious) problem in the public sector, while 77 percent reported that the government is (very) ineffective in the fight against corruption.

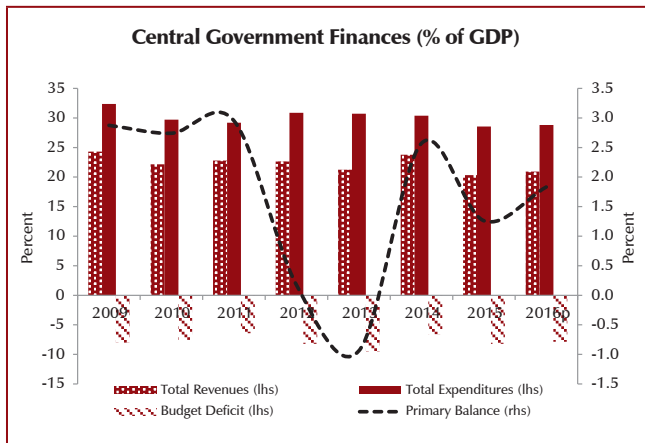


FIGURE 7. Fiscal stance largely unchanged in 2016...

Sources: MoF and WB staff calculations.

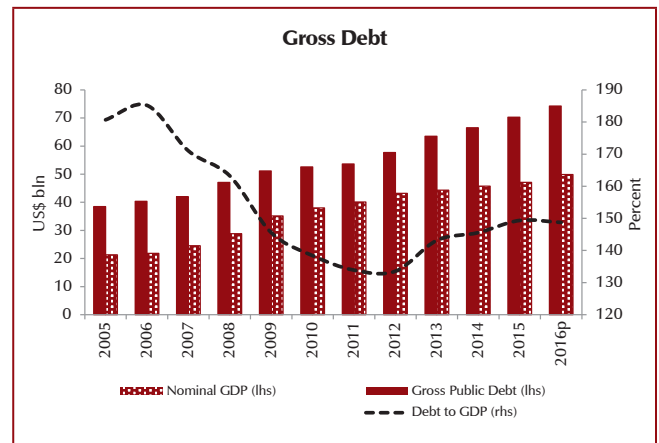


FIGURE 8. ... as price deflation drove debt-to-GDP higher.

Sources: BdL, CAS and WB staff calculations.

malfunction, impeding the development of the country. Since 2005, budgets have not been ratified by parliament due to discord regarding accountability over previous fiscal accounts. Moreover, none of the post-war budgets were voted within the constitutional period and the last officially closed fiscal accounts are those of 2003, although those from 1993 till 2003 need major adjustments. Spending has been conducted largely through treasury advances and ad-hoc measures in times of pressures. This leaves fiscal policy without an anchor. Even prior to 2005, fiscal policy has been missing a medium-term perspective. The lack of proper oversight and extra-budgetary entities that receive significant government funding help entrench a perception of non-transparency and might encourage corruption in fiscal affairs.

External Sector

14. A pick up in imports of merchandize goods combined with deteriorating exports is expected to induce a widening in the already sizable current account deficit. In 2015, the current account deficit underwent an 8.6 pp contraction to reach 17.2 percent of GDP. This came as a result of a large retrenchment in the value of merchandise imports driven by lower commodity prices, especially fuel products, and the depreciation of the euro. While favorable valuation effects due to low import

inflation continued to mitigate nominal merchandize imports in 2016, they are expected to less than offset a pickup in volumes imported, reflecting the slightly improving economic activity; H1-2016 witnessed a 20 percent growth (yoy) in volumes of merchandize imports, led by minerals and metals, whereas nominal imports rose by only 7 percent. Regarding exports, Lebanon continued to be afflicted by the closure of the last remaining Syrian route, which occurred in May 2015, through which exporters were able to access the GCC market.¹³ As a result, in H1-2016, merchandize exports underwent yoy volume and nominal contractions of 21.6 percent and 11 percent, respectively. The widening trade-in-goods deficit will induce a deterioration in the current account balance in 2016, which is projected to reach a deficit of about 19 percent of GDP, one of the largest in the world, exposing the country to significant refinancing risks.

15. World Bank staff's expectations of resiliency of remittances over the short to medium term against low oil export prices in the GCC area are confirmed. Recently released balance of payments data by the central bank for 2015 indicate that net remittances rose by 1.7 pp to reach 7.6 percent of GDP, helped by a 5.8 percent

13 On August 10, 2015, the government agreed to subsidize the cost of exporting goods to Arab countries through the sea over a period of 7 months. The total subsidy amount was set at US\$14 million. Despite this, volumes exported showed a yoy decline of 23.6 percent during the period September-December 2015, compared to a yoy contraction of 10 percent for the period May-August 2015.

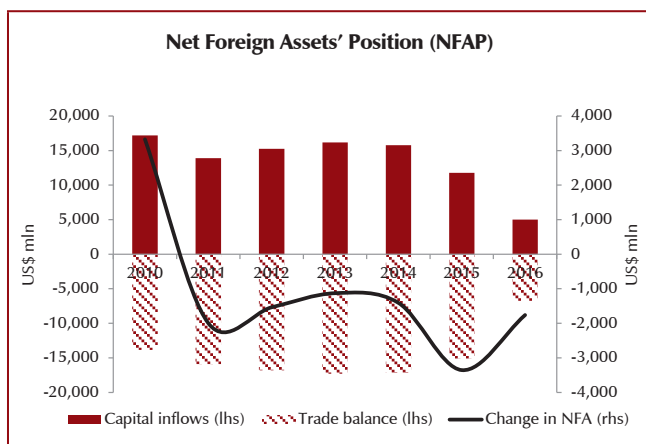


FIGURE 9. Regression in capital inflows exacerbated in 2015...

Source: Bdl and WB staff calculations.

increase and a 11.7 percent decrease in remittances inflows and outflows, respectively. As expounded on in earlier issues of the Lebanon Economic Monitor, this resiliency stemmed from GCC fiscal buffers that mitigated the negative effects on remittances from the Gulf region in 2015. As for the fall in remittances outflows, that is partially due to (i) the slowdown in economic activity in 2015, and (ii) the siphoning off of the refugee influx by end-2014.

16. The widening trade-in-goods deficit drove the deterioration in Lebanon's net foreign asset position. The country's net foreign assets (commercial banks plus central bank) have been on a decline every year since 2011. In 2015, it was a deceleration in capital inflows that more than offset an improved trade balance, draining the economy of around US\$ 3.4 billion in foreign assets (Figure 9). Roles have reversed in 2016; for the year to July, an 8 percent growth in the trade deficit more than offset an 8 percent rise in capital inflows, leading to a loss of US\$ 1.4 billion in foreign assets. This registers the largest loss compared to those incurred during the corresponding periods for all years since 2011. The economy is structurally and heavily dependent on capital inflows to finance its current account deficit.¹⁴ Since 2012, leading sectors towards which the majority of foreign capital has traditionally gravitated have suffered a significant decline in activity, becoming a less attractive destination for FDI (e.g., real estate, tourism). While net FDI in

¹⁴ The current account deficit has averaged 17 percent of GDP during the past ten years.

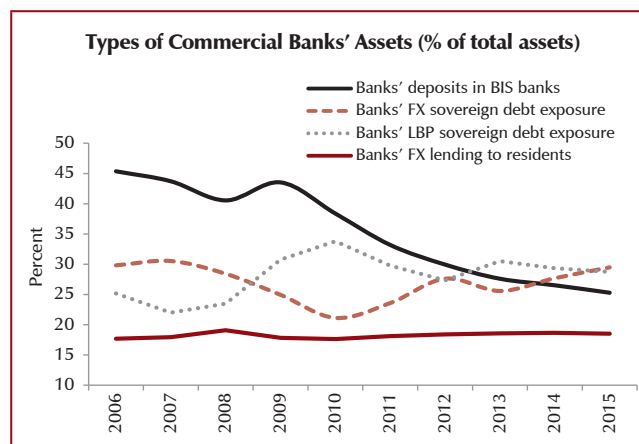


FIGURE 10. Banks increase their exposure to foreign currency-denominated sovereign debt.

Sources: Bdl and WB staff calculations.

2015 grew by 1.7 percent to US\$ 1.7 billion (3.7 percent of GDP), this is primarily due to a sharp fall in outbound FDI, which fell by 49 percent. This compares poorly with the pre-crisis period, where between 2000 and 2010 net FDI averaged 9.5 percent of GDP. The presence of Syrian refugees has partially compensated for the overall loss of inflows since 2010; international aid targeting Syrian refugees provides additional support to the balance of payments.¹⁵ Support is also generated by the wide, albeit slightly narrowing, spread between domestic and international interest rates; by June 2016, this spread registered 379 basis points (bps), compared to 416 bps in June 2015.¹⁶

17. After falling in 2015, gross foreign reserves at the central bank started growing again. From 2012 to 2014, the loss of foreign assets (see paragraph above) did not reflect on gross foreign exchange reserves at the central bank, which continued rising. A principal reason has been that commercial banks, faced with globally depressed interest rates, repatriated foreign assets in search of higher yields. Indeed, as illustrated in Figure

¹⁵ Inflows to Lebanon have also included international aid targeting Syrian refugees, albeit via various international organizations and not through the government, which continues to appeal for assistance. A United Nations Development Program (UNDP) study assesses the impact on the Lebanese economy of international humanitarian aid delivered via UN agencies to the Syrian refugees in Lebanon. It estimates that this aid, estimated at over a billion dollars between 2012 and 2014, has a multiplier effect that added 1.3 pp to 2014 GDP growth.

¹⁶ This is the interest rate differential between the 3-month Lebanese T-bill and the 3-month LIBOR.

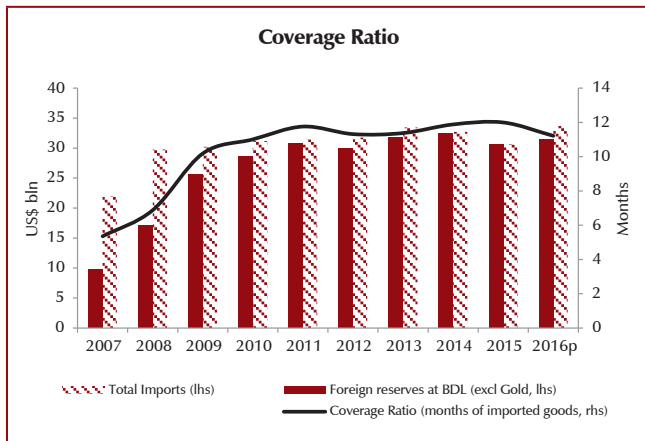


FIGURE 11. ... inducing a decline in gross foreign reserves at BdL.

Source: Bdl, Lebanese Customs and WB staff calculations.

10, since 2010, and except for a brief interruption in 2012, commercial banks have increased their exposure to foreign currency-denominated sovereign debt;¹⁷ simultaneously, they have sharply decreased the share of total assets held as balances abroad, as proxied by balances held with Bank of International Settlement (BIS) reporting banks. In 2015, portfolio preferences have weakened this dynamic, and in combination with a growing need for government foreign currency financing, led to a 5.4 percent decline in central bank reserves to reach US\$ 30.6 billion.

18. To re-incentivize commercial banks to hold domestic assets, Banque du Liban (BdL), the Lebanese central bank, engineered a financial swap. This swap proceeded as follows: (a) in coordination with the ministry of finance, it exchanged LBP-denominated debt with equivalent amount in Eurobonds; (b) BdL proceeded to buy Lebanese Treasury bonds from commercial banks (probably at a premium), with the condition that (c) the banks buy government Eurobonds held by BdL, and/or BdL-issued, foreign currency-denominated, certificate of deposits (CDs) (For a more technical discussion, please refer to the Appendix on page 22). A number of confidence boosting factors resulted: (i) with the sale of Eurobonds, the central bank was able to increase its foreign exchange reserves, ultimately

¹⁷ This includes Eurobonds and World Bank staff estimates of commercial banks' foreign currency reserves held at the central bank (which we are assuming to include outstanding foreign-currency denominated Certificate of Deposits (CDs) issued by the central bank).

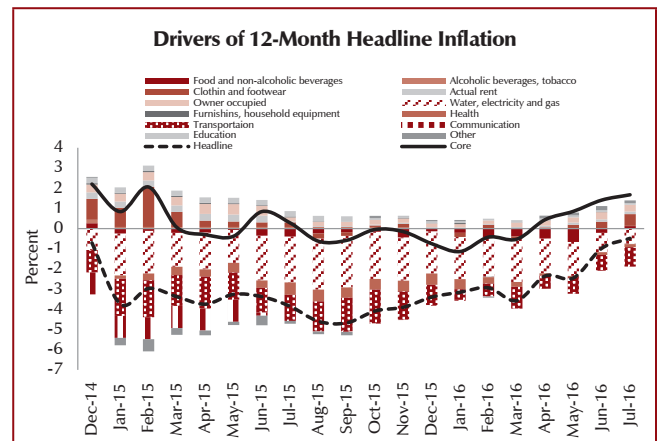


FIGURE 12. Deflationary trend reversed in 2016, as provisional import deflation abates.

Sources: CAS WB staff calculations

reinforcing confidence in the exchange rate; (ii) to the extent that Eurobond purchases by commercial banks have been funded from external resources, this scheme will boost capital inflows;¹⁸ (iii) the MoF was able to exchange more expensive debt (T-bonds) for cheaper debt (Eurobonds); and (iv) commercial banks' boosted their capital position. As a result, by July 2016, gross reserves at the central bank were back up to US\$ 32.7 billion (Figure 11). On the other hand, a number of challenges arise including an increase in foreign exchange risk and liquidity management issues. In addition, moving forward, and unless non-resident deposits regain robust growth, commercial banks' appetite for Eurobonds in the primary market can diminish. This will reinforce BdL's mediating role of government paper, whereby it participates heavily in the primary market, and then pass it at a discount to commercial banks, carrying the cost on its balance sheets.

Money and Banking

19. The deflationary trend in prices has reversed in 2016. In 2015, headline CPI inflation contracted by 3.7 percent, with the deflationary trend cutting across most categories (Figure 12), reflecting

¹⁸ In fact, in August alone, the country's net foreign asset position (commercial banks and BdL) rose by almost US\$ 1.8 billion, helping net inflows to regain positive territory for the year to August, compared to a loss of US\$ 1.6 billion during the same period in 2015.

the decline in the global prices for energy, food and commodities as well as an appreciating effective exchange rate given the country's peg to the dollar, and subdued economic activity (below potential output). Due to the provisional nature of this import deflation, we have been expecting this trend to be temporary, notwithstanding the persistent sluggish economic activity. In fact, after reaching a trough in Q3-2015, the trend in headline inflation reversed and turned positive as deflation abated in (i) water, electricity, gas and other fuel, (ii) transportation and (iii) communication, with the former two reflecting the steady, albeit low, energy prices since Q4-2015. By April 2016, core inflation turned positive for the first time since August 2015 and has since remained positive.

20. Exchange rate stability, a negative output gap and price deflation constitute the motivations for the central bank for expansionary monetary policy in 2016. The dollarization rate—a key gauge of confidence in Lebanon—has been largely unchanged since early 2015, registering 65 percent in July 2016. Simultaneously, real GDP growth continues to lag behind the 1993-2014 average rate of 4.4 percent, and well below potential, generating a negative output gap.¹⁹ These, along with price deflation, allowed BdL to extend its loan subsidy program in 2015 for the third year running,²⁰ with an additional injection of US\$ one billion. The swap undertaken by BdL (see Appendix) this year has also injected additional liquidity into the banking system.

21. To maintain the peg, BdL ensures banks offer attractive dollar spreads to finance the current account. Under sustained and large fiscal needs and a banking sector balance sheet that is over three times GDP, BdL ensures that banks keep attracting foreign deposits and that the public sector

gross financing needs are met. For the former, BdL introduced various subsidized refinancing schemes as well as new certificate of deposits for the 15-year, 20-year and 30-year tenors, lengthening the maturity structure. As to public finance, BdL bids on the TBs primary market and acts as a buyer on the secondary sovereign debt market. In absence of government, the central bank has aimed at sustaining or even boosting private demand (e.g., the stimulus packages) as well as the financial sector's stabilizer of last resort, multiplying the financial burdens on BdL. The resulting banking-sovereign feedback loop, however, is a source of significant macroeconomic risk (Le Borgne and Jacobs, 2016²¹).

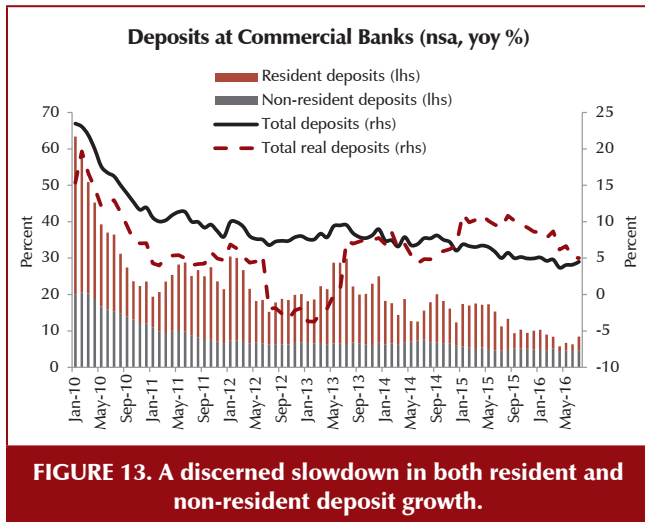
22. Lending to the resident private sector continues to expand in 2016. The stock of commercial banks' credit to the private sector increased by a sluggish 4.3 percent (yoy) in July 2016, albeit an improvement from 2015 when it registered 2.6 percent (yoy) in July 2015. However, this comes with a couple of caveats. First, with a deflationary environment, the change in real private lending was larger; second, this conceals diverging dynamics; while claims on non-residents contracted by 1.3 percent (yoy) over the same period, those on residents grew by 7 percent (yoy). Part of the growth in credit to residents, which nonetheless signaled a deceleration from 10.4 percent (yoy) growth in July 2015, was related to the BdL's stimulus packages. The deceleration possibly reflects declining marginal returns to the stimulus package as the pool of viable borrowers shrinks. Going forward, authorities need to exert scrutiny and caution to risks associated with the over-leveraging of households. In precaution of such risks, BdL introduced in 2014 a number of macro prudential measures.²²

19 For a more in-depth analysis on the output gap, please refer to Box 1 in the Fall 2015 issue of the Lebanon Economic Monitor.

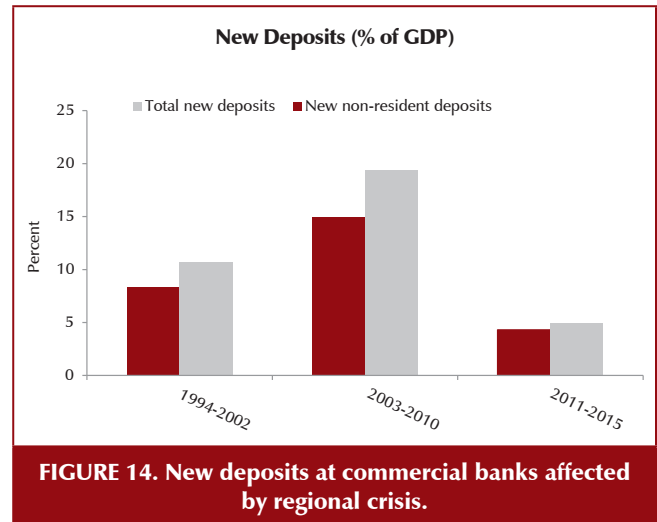
20 This program was launched by the BdL in 2013 and continued in 2014 in the amounts of US\$1.46 billion and US\$800 million, respectively. The real estate sector has been the principal beneficiary, boosting domestic demand after demand from Lebanese expatriates and foreign buyers dropped sharply. To a lesser extent, BdL's subsidized loans also targeted start-ups and venture capital (relatively nascent in Lebanon), with yet undetermined effect.

21 *Lebanon: Promoting Poverty Reduction and Shared Prosperity, Systematic Country Diagnostic*, World Bank, Washington DC.

22 To limit leverage risks on the consumer side and the fallout impact on banks, in 2014, BdL instructed banks to require a minimum down-payment of 25 percent for any car or housing loan and to limit the value of the loan such that the monthly installment does not exceed 45 percent of family income (35 percent for a housing loan).



Source: BdL and WB staff calculations.



Source: BdL and WB staff calculations.

Financial Markets

23. Lebanon's banking sector is liquid, profitable and well regulated, but highly exposed to the public sector. Banks are well capitalized and resilient owing to prudent investments and conservative regulation by BdL and the Banking Control Commission. The liquid asset-to-total deposit ratio²³, an indicator of short-term liquidity, stood at 71.4 by July 2016, compared to 70.3 in January 2016. Nonetheless, commercial banks are highly exposed to sovereign credit risk as they are a large investor in public debt.²⁴ In fact, Lebanese banks' sovereign debt exposure²⁵ increased slightly from 58.4 percent end-January 2016 to 59.2 percent end-July. In an attempt toward diversification, banks expanded regionally, an effort that has been severely compromised by the recent regional upheaval.²⁶

24. Deposit growth decelerates. Commercial banks' balance sheets continued to grow, rising by 6.1 percent (yoy) by July 2016, compared to

23 Liquid assets consist of commercial banks' deposits with central bank, Treasury Bills in LBP held by commercial banks and Eurobonds held by commercial banks.

24 Interest income, as obtained from BilanBanques, amounted to 66.15 percent and 66.31 percent of total consolidated banks' income in 2013 and 2014, respectively.

25 The sovereign debt exposure is computed as a ratio of commercial banks' aggregate investment in Treasury bills, Eurobonds and deposits at BdL relative to total assets.

26 Expansion of Lebanese commercial banks in Turkey continues, however, helping to increase profitability.

6 percent in July 2015. Deposits constitute the principal funding source for commercial banks, with the deposit-to-total liabilities ratio²⁷ at 82.9 percent by July 2016. However, over the past few years, there has been a discerned slowdown in deposit growth, with total private sector deposits at commercial banks increasing by 4.5 percent (yoy) by July 2016, compared to 5 percent a year earlier; resident and non-resident private deposits increased by 4.7 percent (yoy) and 3.7 percent (yoy) (Figure 13).

25. Non-resident deposits, a principal source of inflows to the country, have been on a sharp decline. Non-resident deposits have been a vital factor in the stability of the banking sector, and in fact the whole economy, constituting 21 percent of total private deposits (end-July 2016). Attracted by interest rate spreads²⁸, new private deposits at commercial banks²⁹ have averaged a significant 7.8 percent of GDP annually since 1994. In fact, between 2003 and 2010 total new private deposits (TD) averaged 19.4 percent of GDP, while non-

27 This is the ratio of total private and public sector deposits at commercial banks to commercial banks' balance sheet.

28 The main interest rates that matter in this arrangement are the international dollar rate, a local rate on dollar deposits and a local rate on LBP deposits. A spread between the local and international dollar rates attracts deposits in dollar, while a spread between LBP and local dollar rates encourages deposits in local currency. Nonetheless, like much of the country, Lebanon's banking system is highly dollarized (65 percent dollarization rate).

29 New deposits are calculated as deposits minus interest paid on the previous year's deposits.

resident new private deposits (NRD) averaged 15 percent (Figure 14). 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 2011-2015, however, TD and NRD shares of GDP fell to 5 percent and 4.3 percent, respectively. Despite this deterioration, Lebanon's financial sector retains key advantages. To begin with, exceptionally low global interest rates warrant a reduction in Lebanon's rates. Furthermore, non-resident deposits, which are largely sourced from Lebanese expatriates, are resilient to shocks due to the diaspora's familiarity with the country's political and security volatilities. Additionally, the BdL has demonstrated its readiness to be the ultimate guarantor of the financial sector via its large foreign exchange reserves and good crisis management overall.

PROSPECTS

26. The regional turmoil, especially the war in Syria, poses serious security threats in Lebanon and the recent relative calm is not a guarantee of stability. 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. Real GDP growth for 2016 is projected to be a sluggish 1.8 percent, albeit slightly improved from an estimated 1.3 percent in 2015. Over the medium term, we expect real GDP growth to be around 2.5 percent. The return to potential output growth critically hinges on a resolution of the conflict in Syria as well as a marked improvement in the security and political situations in Lebanon.

27. Absent significant structural reforms on either revenue or spending, Lebanon's public finances are projected to remain structurally weak. The overall fiscal deficit is expected to continue widening over the medium term. Current spending is projected to grow as a result of increased debt servicing due to pass through from higher global interest rates and higher oil prices that will reflect on transfers to EdL. Moreover, assuming political paralysis eases by 2017, we expect some limited public sector wage increases. In addition, and despite the expected return of positive inflation in 2017, the trend for debt-to-GDP ratio based on current policies and real GDP growth rates remains unsustainable and is expected to notably worsen once global dollar interest rates start normalizing (a pace which is expected to start with a tightening of policy rates by the U.S. Federal Reserve Board).

28. Structural reforms are supplanted by an increasingly active central bank. Notwithstanding the short-term need, such interventions can

exacerbate macro-financial risks other than the liquidity and balance-sheet challenges discussed above. First, expected normalization of global interest rates will make it harder to attract hard currency unless domestic interest rates rise in commensurate, which is inconsistent with the objectives of BdL's interventions. Second, the enthusiastic response to BdL initiatives (subsidized loans) has helped boost economic activity but after several years of such lending, more attention will need to be paid to the issue of household leveraging and repayment capacity. Third, the swap just undertaken, if not made clear that it is an exceptional instrument for exceptional times, can further erode the role of commercial banks in favor of BdL in the primary market for public debt. Banks will instead expect a premium on government paper paid for by BdL.

APPENDIX

29. The details of the swap are not fully disclosed, but the main provisions include the following steps:

- Banque du Liban (BdL) exchanged with the Ministry of Finance (MoF) LBP-denominated debt for Eurobonds;
- BdL proceeded to buy Lebanese Treasury bonds (T-bonds) from commercial banks, with the condition that:
- Commercial banks buy either (i) government Eurobonds held by BdL, or (ii) BdL-issued, foreign currency-denominated, certificate of deposits (CDs), or (iii) an equivalent combination of both.

30. Assuming that banks' initial portfolio reflected risk-return preferences, for banks to be incentivized to hold additional Eurobonds (and fewer T-bonds), as illustrated by the conditioning of step b on step c, necessitated a financial gain for the banks. Let us assume that this gain comes in the form of a premium, p , paid on top of the market price of the T-bonds³⁰. For simplicity, let us also assume that the transaction values of each of steps

a, b and c were equivalent at the present exchange rate, plus the incentivizing premium, p , for step b.

31. To analyze the central bank's swap scheme we apply a balance sheet approach focusing on the three relevant institutions—MoF, BdL and commercial banks. Initial balance sheets for the three institutions are presented in Table 2, whereby all components are denominated in LBP including foreign assets and liabilities. We now list the assets and liabilities for each institution:

MoF

- Assets:** (i) MoF balances in LBP with the central bank, LP_f^c ; (ii) MoF balances in LBP with commercial banks, LP_f^b ; (iii) MoF balances in US dollar with the central bank, $\$f^c$; (iv) MoF balances in US dollar with commercial banks, $\$f^b$; and (v) other.

TABLE 2. Initial Balance Sheet for the Three Institutions.

MoF		BdL		Banks	
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
$LP_f^c + LP_f^b$	$Tb^c + Tb^b$	Tb^c	$LP_f^c + LP_b^c$	$Tb^b + CD_L$	LP_f^b
$\$f^c + \f^b	$\text{€}b^c + \text{€}b^b$	$\text{€}b^c$	$\$f^c + \b^c	$\text{€}b^b + CD_s$	$\$f^b$
Other	Other	Fx	$CD_L + CD_s$	LP_b^c	DP_L
		Other	Other	$\$b^c$	DP_s
				FC_b	
				Other	Other

³⁰ For example, news outlets have reported that BdL, after buying the T-bonds from banks, would split the coupon rate with them. The premium in such a case would be banks' portion of the coupon payment, present-valued for a one-time payment

TABLE 3. Changes in the Balance Sheets after the Swap between MoF and BdL.

MoF		BdL		Banks	
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
$LP_f^c + LP_f^b$	$Tb^c + Tb^b - X$	$Tb^c - X$	$LP_f^c + LP_b^c$	$Tb^b + CD_L$	LP_f^b
$\$f^c + \f^b	$\text{€}b^c + \text{€}b^b + X$	$\text{€}b^c + X$	$\$f^c + \b^c	$\text{€}b^b + CD_s$	$\$f^b$
Other	Other	Fx	$CD_L + CD_s$	LP_b^c	DP_L
		Other	Other	$\$b^c$	DP_s
				FC_b	
				Other	Other

TABLE 4. Changes in the Balance Sheets after the Swap between BdL and Commercial Banks.

MoF		BdL		Banks	
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
$LP_f^c + LP_f^b$	$Tb^c + Tb^b - X$	$Tb^c - X + X$	$LP_f^c + LP_b^c + X + p$	$Tb^b + CD_L - X$	LP_f^b
$\$f^c + \f^b	$\text{€}b^c + \text{€}b^b + X$	$\text{€}b^c + X - X_1$	$\$f^c + \b^c	$\text{€}b^b + CD_s + X$	$\$f^b$
Other	Other	$Fx + X$	$CD_L + CD_s + X_2$	$LP_b^c + X + p$	DP_L
		Other	Other	$\$b^c$	DP_s
				$FC_b - X$	
				Other	Other

- **Liabilities:** (i) T-bonds held by BdL, Tb^c ; (ii) T-bonds held by banks, Tb^b ; (iii) Eurobonds held by BdL, $\text{€}b^c$; (iv) Eurobonds held by banks, $\text{€}b^b$; (v) other.

BdL

- **Assets:** (i) T-bonds, Tb^c ; (ii) Eurobonds, $\text{€}b^c$; (iii) foreign exchange reserves, Fx; and (iv) other.
- **Liabilities:** (i) MoF balances in LBP held at BdL, LP_f^c ; (ii) banks' balances in LBP held at BdL, LP_b^c ; (iii) MoF balances in US\$ held at BdL, $\$f^c$; (iv) banks' balances in US\$ held at BdL, $\$b^c$; (v) BdL-issued certificate of deposits in LBP, CD_L ; (vi) BdL-issued certificate of deposits in US\$, CD_s ; and (vii) other.

Commercial banks

- **Assets:** (i) T-bonds, Tb^b ; (ii) BdL-issued certificate of deposits in LBP, CD_L ; (iii) Eurobonds, $\text{€}b^b$; (iv) BdL-issued certificate of deposits in US\$, CD_s ; (v) banks' balances in LBP held at BdL, LP_b^c ; (vi) banks' balances in US\$ held at BdL, $\$b^c$; (vii) foreign placed US\$, FC_b ; and (viii) other.
- **Liabilities:** (i) MoF balances in LBP with commercial banks, LP_f^b ; (ii) MoF balances in US\$ with commercial banks, $\$f^b$; (iii) private sector deposits in LBP, DP_L ; (iv) private sector deposits in US\$, DP_s ; and (vi) other.

32. The first transaction BdL undertook was that it exchanged with the MoF LBP-denominated debt with an equivalent amount in Eurobonds. Assuming this amount to be X, the balance sheets become as illustrated in Table 3 (with the changes in red font):

33. In this case, the MoF redeemed an X amount of T-bonds and issued new Eurobonds in the same amount, with both changes occurring on the liability side of its balance sheet. On the other hand, changes to BdL balance sheet were on the assets side, as an X amount of T-bonds were swapped for Eurobonds. Both institutions maintained the total balance sheet value.

34. **BdL proceeded to buy Lebanese Treasury-bonds from commercial banks at face value, paying a premium, p, over the market price X.** This was with the condition that the banks buy X amount of (i) government Eurobonds held by BdL, or (ii) BdL-issued CD_s, or (iii) a combination thereof. Table 4 presents the new balance sheets. Here we assume that $X=X_1+X_2$, such that X_1 and X_2 are the values for Eurobonds and CD_s, respectively, that banks bought from BdL as a condition for being part of the scheme. Moreover, and since a principal objective of this exercise is to improve the stock of foreign exchange in the economy, we assume that commercial banks used their foreign-placed, foreign currency-denominated liquid assets to fund the purchase of the Eurobonds and CD_s.³¹

35. **In the final standing, BdL holds the initial amount of T-bonds it started with, Tb^c, but is now liable by an additional X+p amount in LBP balances, as it credits banks' balances for the purchase.** BdL also holds $X_2=X-X_1$ more Eurobonds and has issued X_2 additional CD_s. Crucially, central bank foreign exchange reserves have risen by X. BdL's total balance sheet has increased by $X+X_2$, whereas its capital (assets minus liabilities), has declined by p.

36. **Commercial banks on the other hand, hold X amount less (more) in T-bonds ($\text{€b}^b + \text{CD}_s$), and have used up X amount from their foreign-placed foreign assets.** Their balances with the central bank have increased by X+p. Both, commercial banks' total balance sheet and capital have been enlarged by p.

31 As an alternative, commercial banks can issue foreign currency bonds and/or raise deposits in their foreign branches. A small capital market precludes the former while raising foreign deposits is more involved and requires time and strategy.

37. Let us now list the advantages and disadvantages of this scheme for each institution:

MoF

- **Advantage:** it substituted dearer debt (Eurobonds) for cheaper debt (T-bonds), on which it pays a lower interest.
- **Disadvantage:** it increased sovereign exposure to exchange rate risk.
- **Net impact:** a continuation of the authority's recent strategy that favors borrowing in foreign currency over local currency.

BdL

- **Advantage:** it boosted its stock of foreign exchange reserves by X, re-enforcing confidence in the exchange rate and the financial system at large.
- **Disadvantage:** BdL raised its exposure to sovereign foreign-denominated debt by holding X_2 more Eurobonds on its asset side.
- **Disadvantage:** BdL expanded its liabilities in foreign currency by issuing X_2 CD_s.
- **Disadvantage:** BdL expanded its liabilities in local currency by holding X+p more in balances for commercial banks.
- **Net impact:** a boost to foreign exchange reserves comes at the expense of a weakened balance sheet, with capital declining by p.

Commercial Banks

- **Advantage:** a fall in banks' sovereign exposure in local currency by X.
- **Advantage:** an increase banks' liquidity in local currency by X+p.
- **Advantage:** an increase in banks' capital position by p.
- **Disadvantage:** an increase in banks' sovereign exposure in foreign currency by X.
- **Disadvantage:** a decrease in banks' foreign-placed liquid foreign assets by X.
- **Net impact:** an increase in banks' liquidity in local currency and banks' capital position, further strengthening their balance sheet. This, however, is achieved at the expense of lower liquidity in foreign exchange, which can be

deployed globally, compared to LBP liquidity that can only be utilized locally.

Macroeconomy:

- **Advantage:** to the extent that there is sufficient demand for the additional liquidity in local currency, this should have a positive impact on private lending and, thus, economic growth.
- **Disadvantage:** to the extent that there is insufficient demand for the additional liquidity, and in an attempt to keep the interest rate margin sufficiently attractive for exchange rate stability, there would be liquidity management challenges.
- **Disadvantage:** moving forward, and unless non-resident deposits regain robust growth, commercial banks' appetite for Eurobonds in the primary market can diminish. This will reinforce BdL's mediating role of government paper, whereby it participates heavily in the primary market, and then passes it at a discount to commercial banks, carrying the cost on its balance sheets.
- **Disadvantage:** an increase in foreign exchange risk.
- **Disadvantage:** rent is transferred from the public to the banking sector.

SPECIAL FOCUS

CENTRAL BANK INTERVENTION IN THE LEBANESE ECONOMY³²

Abstract

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 borne by BdL, which are difficult to quantify but have possible implications on long-term monetary policy.

³² The author is Ibrahim Jamali, Assistant Professor at the American University of Beirut.

SMEs in Lebanon, the State of SME Financing and Obstacles to Firm Growth

38. Existing studies confirm that SMEs are an integral component of the Lebanese economic landscape and that younger firms are the main engine of job creation in the country. A survey undertaken by Hamdan (2003) on behalf of the Economic Research Forum summarizes SMEs' importance to the Lebanese economy by noting that "Lebanon's economy is dominated by SMEs" and that "small enterprises employing less than five employees make up the bulk of operational enterprises, constituting 88 percent of the total, while those employing less than 50 individuals make up 96 percent of the total".³³ The importance of SMEs as an engine for growth and job creation was echoed by the Ministry of Economy and Trade (MoET)'s SME strategy (MoET, 2014).³⁴ Furthermore, the World Bank (2014a) finds that young firms (young startups and microenterprises and SMEs) are the main engine of job creation in the country.

³³ The study clearly points to a preponderance of micro enterprises, defined as having a maximum of five employees, in Lebanon.

³⁴ The MoET (2014) defines micro enterprises as companies with an annual turnover of less than LBP 500 million and less than 10 employees, small enterprises as firms with an annual turnover of less than LBP 5 billion and less than 50 employees and medium enterprises as companies with an annual turnover of less than LBP 25 billion and less than 150 employees.

39. While Lebanon compares favorably to MENA in terms of the development of the banking sector and SME access to finance, SMEs did report facing some challenges in accessing finance.

According to the World Bank and the Union of Arab Banks (2010), SMEs' share of total bank loans in Lebanon is around 16 percent. This firmly places the country as second in MENA in terms of an overall measure of SMEs' access to finance.³⁵ Claessens and Tzioumis (2006) rank Lebanon's highly liquid banking sector as 50th (out of 95 countries) in terms of development. While Lebanese banks seem to have a preference to lend the Sovereign, banks have increased their engagement with Lebanese SMEs, including via the Circular 331 initiative of the BdL which put in place a facility through which commercial banks – most often through investment fund intermediaries – could provide equity for knowledge sector start-ups. Nevertheless, Lebanese SMEs remain highly dependent on bank lending and places banks at the center of financial intermediation in the country.

40. SMEs do not identify the lack of access to finance as the most important constraint to firm growth but existing studies suggest that financing gaps are present. The most recent 2016 report³⁶, drawing on 2013/14 enterprise survey data identified Lebanon as one of the foremost countries in the region with a share of bank finance at 20 percent which is above that of peer economies in the lower middle income bracket (12 percent). The results from the enterprise survey in Lebanon indicate that SMEs' access to checking or savings accounts and to bank loans/lines of credit compare favorably to

³⁵ The overall measure is composed of the following indicators, as used by the OECD scorecards to assess the state of SME financing: (1) share of SME loans in total business loans; (2) share of SME short-term loans in total SME loans; (3) total SME loan and credit guarantees; (4) total SME direct government loans; (5) the ratio of SME loans used to SME loans authorized; (6) the ratio of SME non-performing loans to SME loans; (7) interest rate charged on SME loans; (8) interest rate spread between large and small company loans; (9) percent of SMEs required to provide capital; (10) venture capital and growth capital; (11) payment delays; and (12) bankruptcies.

³⁶ "What's Holding Back the Private Sector in MENA – Lessons from the Enterprise Survey", a joint World Bank-European Investment Bank and European Bank for Reconstruction and Development report, 2016. This included enterprise surveys conducted in eight MENA countries.

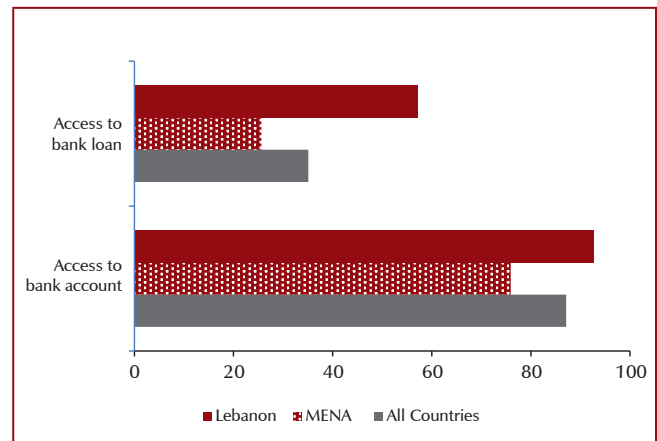


FIGURE 15. Access to bank accounts and bank loans.

Source: World Bank Enterprise Survey.

world and MENA averages (Figure 15). Nonetheless, gaps in SME access to finance persist. The 2013/14 enterprise survey results show that 41.5 percent of Lebanese micro and SMEs (MSMEs) cite access to finance as an obstacle. This proportion is higher than both the 35.7 percent of MENA-region firms and the global average of 27 percent of firms citing access to finance as a constraint to growth. Firms in Lebanon rarely resort to supplier credit in contrast, for example, to Tunisia and, at approximately 10 percent, more Lebanese firms report being credit-constrained than other Magreb countries, but slightly less than is the case in Jordan. Moreover, access to finance is a greater constraint the smaller the business is. This was evident in the 2008 survey undertaken by IFC which looked at 539 micro and small enterprises in four areas in Lebanon (IFC, 2008). A more recent study by IFC (2014) finds that entrepreneurs and small businesses face difficulties in applying to (or obtaining) loans due to high collateral requirements, lack of an established relationship with the financial intermediary or due to a limited track record.³⁷ World Bank (2015a) acknowledges Lebanese MSMEs' financing constraints and discusses the potential for NBFIs to offer leasing, factoring, microfinance and other capital markets solutions to ease access to finance.

41. SMEs overwhelmingly identify political instability as the most important constraint to

³⁷ The same study also finds that female entrepreneurs and small companies run by women face significant difficulties in accessing finance.

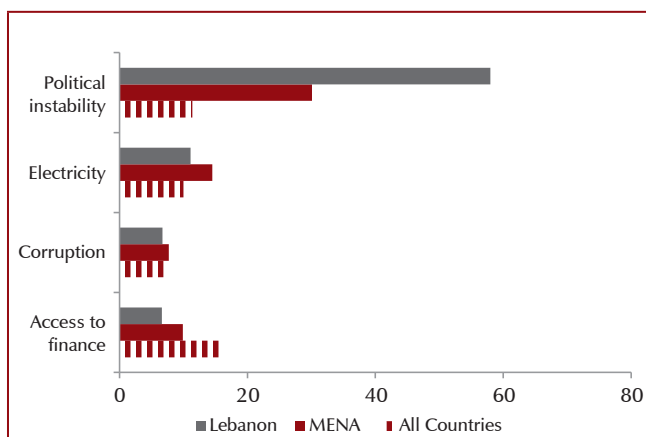


FIGURE 16. Major obstacles to firm growth.

Source: World Bank Enterprise Survey.

business growth. The 2013/14 enterprise survey results showing that 58 percent of Lebanese SMEs identify political instability as a major obstacle to growth (Figure 16). This proportion is significantly larger than the 30.1 percent (11.4 percent) of SMEs in MENA (globally) identifying political instability as a constraint to growth.³⁸ The second and third most important obstacles to SME growth in Lebanon are, respectively, electricity and corruption.³⁹ While access to finance compares favorably to global and MENA averages, it continues to be the fourth most important obstacle to Lebanese SMEs' growth (with 6.6 percent of firms identifying it as an obstacle to growth).

BdL's Policy Interventions

42. Recurrent and sizable fiscal deficits and a high debt-to-GDP ratio characterize Lebanon's fiscal stance. Lebanon's fiscal imbalances are an important constraint to growth (Berthélemy, Dessus and Nahas, 2007) and have deprived the private sector and SMEs from adequate access to finance.

38 Given that the events of the Arab Spring (or its reverberations) were continuing to unfold in some MENA region countries in 2013, the much higher proportion of Lebanese firms identifying political instability as the most severe constraint to growth (relative to MENA) is very noteworthy.

39 World Bank, 2015a discusses the problems with the Lebanese electricity sector as well as the costs of the inadequate provision of electric power.



FIGURE 17. Commercial banks' exposure to sovereign debt.

Source: BdL and WB staff calculations.

In fact, Lebanon's fiscal imbalances have created a dynamic, dubbed the "fiscal dominance" by the World Bank (2015b), in which the well-capitalized domestic banking sector⁴⁰ finances the fiscal deficits at the expense of the private sector and SMEs (World Bank, 2015a). In fact, Lebanon's central bank, the Banque du Liban (BdL), acts as residual buyer of sovereign debt, resulting in a high and increasing exposure of the banking sector to sovereign debt (Figure 17) compared to smaller loan portfolios (Figure 18). The high exposure to the Sovereign can potentially become a source of systemic risk and serves as an indicator of potential crowding-out of private borrowing. In fact, Ali Abbas and Christensen (2007) note that the availability of high-yielding government debt can act as a disincentive for banks to increase private sector lending.⁴¹

43. Since 2011, the growth rate of lending to the private sector exhibited a remarkable slowdown (Figure 19). The year-on-year (yoy) growth rate in lending to the private sector averaged a remarkable 15.4 percent over the January 2008 to December 2010 period. However, the post-2011 sluggish economic growth, combined with an increasing exposure by banks to the Sovereign, resulted in a significant slowdown in the growth rate of lending to private sector to 7.8 percent (yoy) over

40 By end of 2015, balance sheets of commercial banks amounted to 395 percent of GDP.

41 The authors note, however, that evidence of crowding out at the macroeconomic level is mixed. For further details, see Abbas and Christensen (2007).

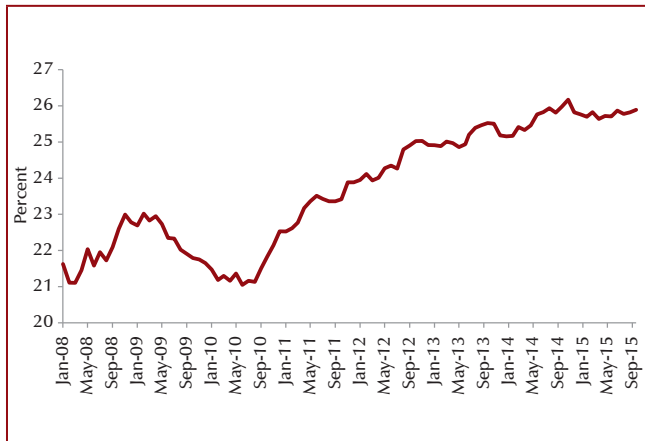


FIGURE 18. Loan-to-deposit ratio of commercial banks.

Source: BdL and WB staff calculations.

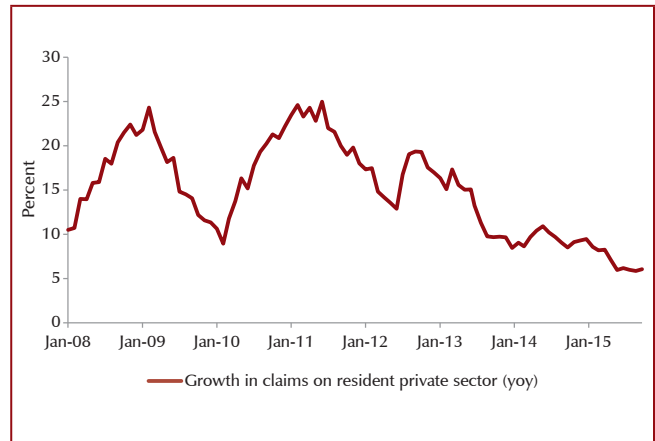


FIGURE 19. Growth of lending to the private sector.

Source: BdL and WB staff calculations.

the January 2011 to December 2013 period. This noticeable deceleration might imply that SMEs and other firms faced significant difficulties in accessing finance. The ratio of loans to private sector to total commercial banking assets over the January 2008 to October 2015 did not exceed 26.17 percent again indicating the preference of banks to lend to the Sovereign.

44. Since 1997, BdL has embarked on several interventions which aim to entice banks to increase private sector lending in Lebanese Pounds. The earliest among such interventions consisted of an interest rate subsidy scheme for medium and long-term loans which BdL initiated in 1997. In 2001, the central bank allowed for reductions in the reserve requirements of banks which lend to firms in the industrial, information technology (IT), agriculture and tourism sectors (Box 2).

45. Faced with a slowdown in lending to the private sector, BdL initiated an incentive scheme in 2009 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 June 2009, BdL scaled up the 2001 incentive scheme by allowing for a larger reduction in the effective reserve requirements of commercial banks which extend loans to the industrial, Information Technology (IT), agriculture and tourism

sectors⁴². The success of these incentive schemes led BdL to increase the deduction ceiling to 90 percent in January 2011.

46. Since early 2013, BdL introduced three sizeable stimulus packages to fuel the tepid economic activity (Box 3). According to BdL (2015), the principal goal from launching the stimulus packages is "to create new job opportunities for the Lebanese youth and stimulate the Lebanese economy through ensuring the necessary financing for small and medium enterprises". In detailing the stimulus packages launched, BdL (2015) makes an explicit link between the growth in lending to the private sector and economic growth by noting that "The economic slowdown that Lebanon has witnessed, mainly due to the unstable political and security situations in the region, stirred Banque du Liban to launch a new initiative, with the aim to motivate private lending, and hence economic growth". A first stimulus package of LBP 2,210 billion (US\$ 1.46 billion), launched in January 2013, was designed to spur lending to

42 The IMF (2012) notes that "Additional reserve requirement exemptions introduced in 2009 allowed banks to deduct 60-100 percent of a qualifying loan in LL (depending on type of loan) from required reserves on customer deposits, up to a ceiling of 75 percent of the reserve requirement for all qualifying loans." IMF (2012) continues, "During June 2009-August 2011, there were about US\$ 1.1 billion in housing loans and US\$ 59 million in new education loans; in addition, there were loans to environmental friendly projects and small and medium enterprises. Real estate development and consumption-related lending do not qualify. Education loans qualify for a 100 percent reduction, housing for 65 percent and housing loans to military for 60 percent."

BOX 2. Types of Loans Benefitting from Reduction in Reserve Requirements Held at BdL.

The subsidized loans department of the Banking Control Commission identifies the following loans as eligible for direct reductions in reserve requirements:

- Subsidized loans guaranteed by Kafalat S.A.L.
- Housing loans granted by banks based on a protocol signed with the Public Housing institution.
- Housing loans granted by banks based on a protocol signed with the Military Volunteers Housing Unit.
- Long term housing loans that banks grant to their clients, and which are subject to the exemptions that long term and investment banks are subject to.
- Private and public sector bonds denominated in foreign currency and purchased without recourse.
- Direct loans that the banks grant to the Public Housing institution to construct buildings for rent for the benefit of limited income groups.
- Loans granted to the Housing Bank S.A.L. that are used to finance the loans granted by the bank.
- Micro credits granted with the approval of Micro – Credits institutions.
- Housing loans granted by banks based on a protocol signed with the Mutual Fund of the Magistrates.
- Housing loans granted by banks based on a protocol signed with the Directorate General of the ISF.
- Housing loans granted by banks based on a protocol signed with the Directorate General of the SG.
- Housing loans granted by banks based on a protocol signed with the Ministry of Displaced.
- Loans granted by banks to finance environmental loans in both energy and non-energy.
- Loans granted by banks for high school education.
- Loans granted by banks based on a protocol signed with the Ministry of Agriculture.
- Loans granted by banks to students to buy tablets.

Source: <http://www.bccl.gov.lb/committee/subsidized-loans-department/>

TABLE 5. A Chronology of BdL's Policy Interventions.

Year	Policy Intervention
1997	Introduction of a Subsidy Scheme for Medium and Long-Term Loans
2001	Initiation of Reductions in Reserve Requirements
2009	Additional Reductions in Reserve Requirements up to 75 Percent for all Qualifying Loans
2011	Increase in the Allowable Ceiling of Reductions in Reserve Requirements to 90 Percent
2013	Launch of the First Stimulus Package totaling US\$ 1.46 Billion
2014	Increase in the Size of the First Stimulus Package by 0.92 US\$ Billion

industry, IT, agriculture, environment, housing, education and tourism sectors. According to the World Bank (2013b), 56 percent of the funds in the first stimulus package were earmarked to the housing sector. In view of the success of the first package, BdL increased it by an additional LBP 1,400 billion (US\$ 0.92 billion) in 2014⁴³. In 2015, a third stimulus package of LBP 1,500 billion (US\$ 0.99 billion) was launched to stimulate lending to the aforementioned sectors. The funds from the stimulus packages are provided as soft loans

to commercial banks who on-lend the funds at a subsidized rate of interest. A timeline of BdL's policy interventions is provided in Table 5.

47. Operationally, the financing unit at BdL oversees the administration of subsidized interest rate loans and facilities in reserve requirements.

The financing unit assesses the applications submitted by banks and leasing companies for subsidized loans and grants exemptions for required reserve requirements. Subsidized interest rate loans

⁴³ Stimulus package funds which are not lent during a given year are rolled over to the following year.

BOX 3. Subsidized Loans Provided under BdL's Stimulus Packages.

The following is a summary of some of the subsidized loans provided under BdL's 2015 package (BdL, 2015):

1. Financing of projects in the tourism, agriculture, industry and handicrafts sectors.

Target Beneficiaries: Manufacturing firms information technology equipment, design programs and specialized technologies.

Loan Specifics:

- i. The loans guaranteed by Kafalat s.a.l. are excluded.
- ii. The funds must be fully invested in Lebanon to finance a new project (with a minimum value of LBP 50 million).
- iii. The loan's duration ranges between five and seven years.
- iv. The loan can be made in LBP, Euro or US\$.
- v. Total funds received by any one institution should not exceed LBP 15 billion.

2. Subsidized SME loans in LBP.

Target Beneficiaries: Firms in the industrial, agricultural, tourism and handicrafts industries as well as technologically-intensive sectors.

Loan Specifics:

- i. The loans are guaranteed by Kafalat s.a.l.
- ii. The interest rate charged on the loan should not exceed 40 percent of the yield on the one-year T-bill plus 3.3 percent.

3. Subsidized loans, subject to the approval of a microcredit institution, to small enterprises and individuals in LBP.

Target Beneficiaries: Individuals or small enterprises, defined as having no more than four employees, embarking on new projects in the production, services, tourism or commercial fields.

Loan Specifics:

- i. The principal value of the loan should not exceed LBP 20 million.
- ii. The loan's tenure should not exceed five years.

4. Subsidized loans in LBP for expanding existing projects or starting new projects.

Target Beneficiaries: Firms not operating in the real estate or land purchasing sectors. The funds should also not be used to finance working capital, refinance existing projects or to reimburse previous loans.

Loan Specifics:

- i. The loan's principal value should not exceed LBP 22.5 billion.
- ii. The loan's duration is not to exceed ten years.
- iii. The interest rate and commissions on the loan should not exceed 40 percent of the one-year Treasury bill yield plus 3.3 percent.

5. Loans in LBP to entrepreneurs.

Target Beneficiaries: Entrepreneurs undertaking new projects in the fields of knowledge and education.

Loan Specifics:

- i. The principal value of the loan is not to exceed LBP 300 million.
- ii. The reimbursement period of the loan should not exceed seven years.
- iii. All interest and commissions should not exceed 0.75 percent.

6. Educational loan in LBP.

Target Beneficiaries: Higher education student pursuing academic, vocational or technical studies.

Loan Specifics:

- i. The loan's maximum reimbursement period is ten years.
- ii. Interest and commissions on the loan should not exceed 3.5 percent.

In an earlier document, BdL (2011a) describes the types of loan that would benefit from an interest rate subsidy or other incentives. These loans comprise: housing loans, loans to microcredit organizations, educational loans and medium and long-term loans to selected sectors.

In a separate document, BdL (2011b) specifies the support it provides to environmentally- friendly projects. More specifically, the central bank would provide incentives for organizations whose projects involve (i) green buildings, (ii) recycling, (iii) ecotourism and (iv) roofing. BdL would also provide incentives for loans falling under the National Energy and Renewable Energy Action (NEEREA). Examples of loans falling under the latter initiative include (i) energy saving and (ii) renewable energy projects.

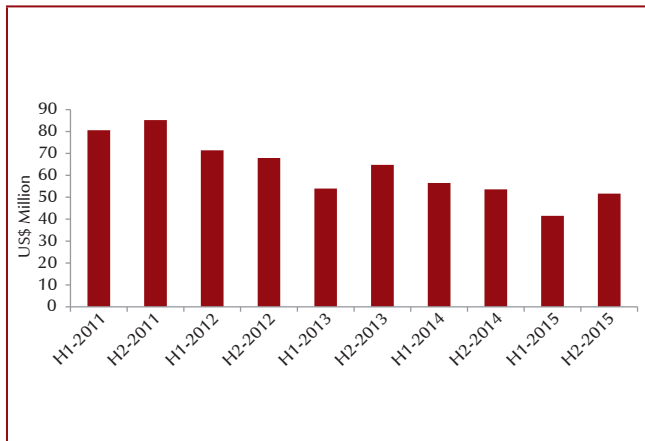


FIGURE 20. Value of credit guarantees by Kafalat.

Source: Kafalat and WB staff calculations.

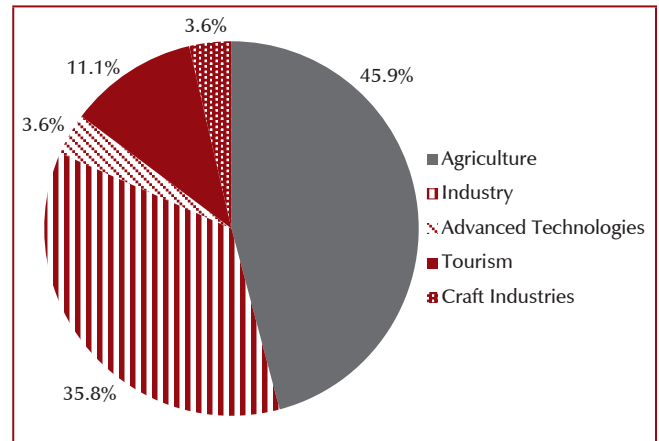


FIGURE 21. Kafalat credit guarantees by sector for the period July to December 2015.

Source: Kafalat and WB staff calculations.

are governed by basic circular 80⁴⁴ while facilities in the reserve requirements are governed by basic circular 84.

48. Kafalat plays an instrumental role in providing credit guarantees on some of the subsidized loans. Kafalat, a credit guarantee institution established by the government in 2000, plays a key role in facilitating MSMEs’ access to subsidized BdL lending. Figure 20 provides the value (in US\$ millions) of credit guarantees granted by Kafalat over the 2011-2015 period. The observed decline in the value of the credit guarantees extended in 2014 and 2015 (relative to 2011 and 2012) is likely attributable to a volatile security and political environment as well as lukewarm economic activity. The agricultural and industrial sectors have consistently been the largest recipients of credit guarantees (Figure 21). According to Nasr and Pearce (2012), the Kafalat credit guarantee schemes have achieved the broadest coverage in all of MENA. Kafalat also provides innovative partial equity guarantee schemes for selected start-up SMEs which exhibit an ability to create value added (Nasr and Pearce, 2012).

The Impact: A Preliminary Look

49. BdL circular 84 and intermediate circular 185 define banks’ reserve requirements exemptions. According to circular 84 dated June 2001, commercial banks’ LBP reserve requirements are 25 percent of demand deposits and 15 percent of time deposits. BdL’s credit support schemes include (i) interest subsidies, (ii) deductions of new loans from bank liabilities subject to reserve requirements and (iii) outright reductions in banks’ reserve requirements. For the first type of supported lending schemes, an interest rate subsidy, ranging between 5 to 7 percent, is paid directly to the borrowers by the Ministry of Finance (IMF, 2015b).⁴⁵ According to the IMF (2015b), the “direct reductions in reserve requirements have a larger effect on banks’ effective reserve requirement, as 60 to 100 percent of qualifying loans can be deducted from banks’ required reserves on customer deposits”. The difference between the two reserve requirement reductions is, according to the IMF (2015b), that the deductions of new loans from bank liabilities subject to reserve requirements only have the effect of reducing the basis over which the reserve requirements is computed. Reductions in reserve requirements and deductions from liabilities apply

44 Other circulars relating to subsidized interest rate lending include intermediary circulars 286, 195, 187, 135, 121 and 57.

45 Both foreign currency and LBP loans are eligible for the subsidy. Subsidized-interest lending started as early as 1997 while deductible loans were scaled up after 2009 (IMF, 2015b).

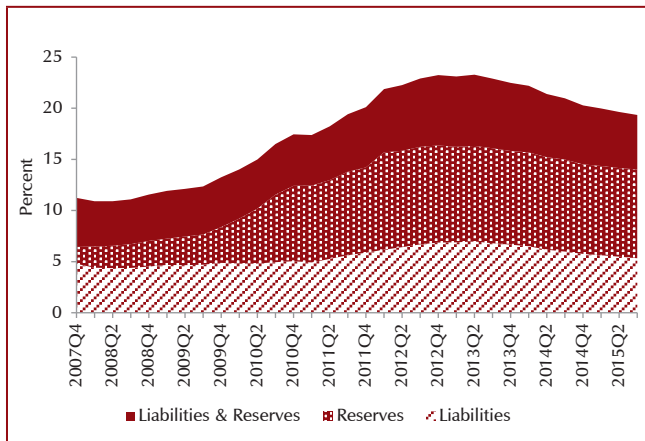


FIGURE 22. Loans which benefit from a reduction in reserve requirements, liabilities subject to reserve requirements or both (as a % of total loans).

Source: Bdl Quarterly Bulletins and WB staff calculations.

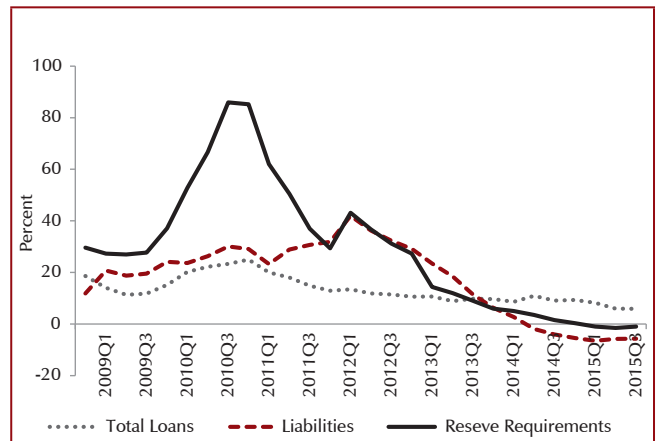


FIGURE 24. Year-on-year growth in total lending deductible loans.

Source: Bdl Quarterly Bulletins and WB staff calculations.

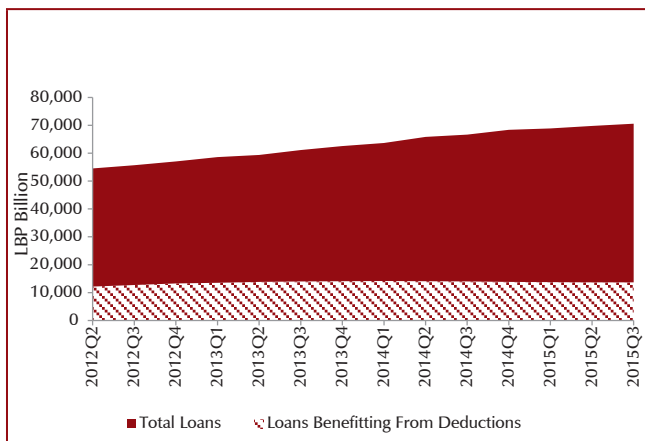


FIGURE 23. Total loans and loans benefiting from reductions in reserve requirements and in liabilities subject to reserve requirements.

Source: Bdl Quarterly Bulletins and WB staff calculations.

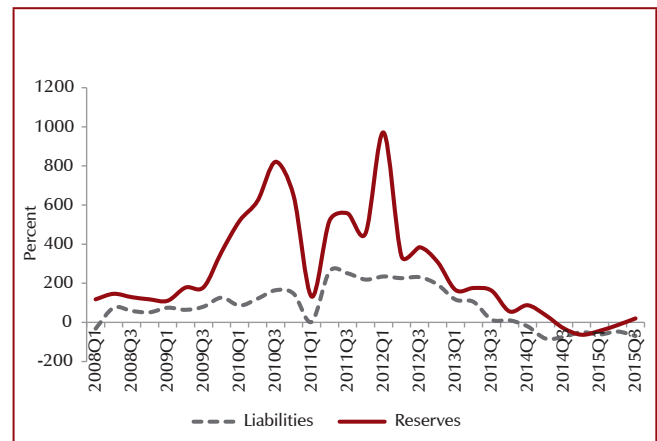


FIGURE 25. New deductible loans.

Source: Bdl Quarterly Bulletins and WB staff calculations.

to both LBP and foreign currency loans. Reserve requirements exemptions also apply to all subsidized interest loans.

50. Loans benefitting from reductions in reserve requirements and liabilities (subject to reserve requirements) exhibited a sharp increase after 2011. After BdL increased the deductions' ceilings in 2011, the share of loans benefitting from deductions in liabilities and reserve requirements saw a marked increase. The deductible loans outstanding reached a peak at the end of 2012 and the positive trend slowly reversed between 2012 and 2015 (Figure 22 and Figure 23). The year-on-year growth in loans benefitting from reductions in reserve requirements or liabilities was larger than the growth

in total lending over the 2008 to 2013 period (Figure 24). However, this trend reversed in 2014 and 2015 as reflected by the lower volumes of new deductible loans (Figure 24 and Figure 25). In contrast to the pre-2011 period, the share of loans benefitting from direct reductions in reserve requirements exceeded the share of loans benefitting from deductions in liabilities over the 2011 to 2015 period (Figure 22).

51. The share of loans benefitting from direct reductions in reserve requirements (as a percent of total loans) was larger than the share of loans which benefitted from reductions in liabilities subject to reserve requirements. The share of total loans benefitting from deductions in reserve requirements averaged 15.41 percent over the

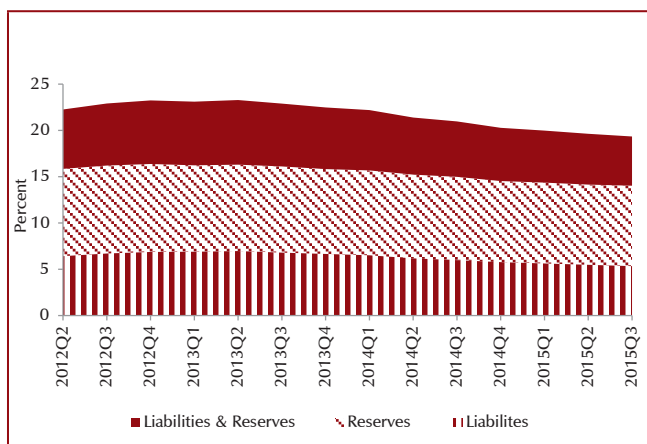


FIGURE 26. Loans which benefit from a reduction in reserve requirements, liabilities subject to reserve requirements or both (as a % of total loans).

Source: Bdl Quarterly Bulletins and WB staff calculations.

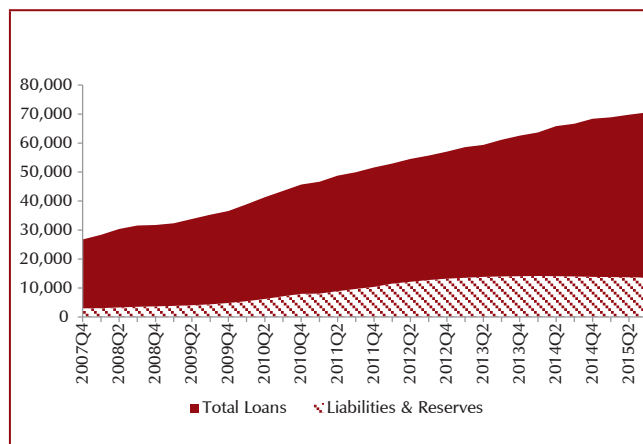


FIGURE 27. Total loans and loans benefiting from reductions in reserve requirements and in liabilities subject to reserve requirements (LBP Billion).

Source: Bdl Quarterly Bulletins and WB staff calculations.

period Q2-2012 to Q3-2015, compared to only 6.3 percent for loans benefiting from deductions in liabilities. Nonetheless, the average share of loans benefiting from either of the two credit incentive schemes exhibited a downward trend over the same period (Figure 26). While the value of total loans benefitting from the two deductions remained broadly stable over the Q2-2012 to Q2-2015 period (Figure 27), the downward trend observed in the share of deductible loans is attributable to a larger growth rate in total lending over the same periods.

52. The housing sector was the largest recipient of Bdl loans which benefit from deductions in reserve requirements. Housing loans account for the largest share of utilized credit which benefits from deductions in reserve requirements. In fact, housing loans accounted for over 76 percent of total utilized credit benefitting from deductions in reserve requirements over the

March 2012 to March 2015 period (Table 6)⁴⁶. In contrast, loans to productive sectors, microcredit institutions (and microcredit to corporations), education and environmentally-friendly projects (benefiting from reserve requirement deductions) accounted for, respectively, around only 3.5 percent, 0.4 percent, 1.6 percent and 0.5 percent of total utilized credit over the same period. While the share of housing loans exhibited a moderate increase between March 2012 and March 2015, the percent of credit allocated to the productive and microcredit sectors did not exceed 4 percent and 1 percent, respectively.

53. The share of housing loans benefiting from deductions in banks' liabilities is smaller. In June 2013, the share of housing loans benefiting from deductions in bank

46 This proportion is computed from Table 3.4.8 of BDL's Quarterly Bulletin (2015Q1). The share is obtained by adding utilized credit under "Housing loans in LBP benefiting from incentives 2009", "Loans in LBP to military volunteers", "Loans in LBP granted by the military housing unit", "Housing loans in LBP under the Protocol between banks and the Ministry of Displaced", "Housing loans in LBP under the Protocol between banks and Mutual Fund of the Magistrate", "Housing loans in LBP granted from credits to the Banque de l'Habitat upon decision 2010/26/16", "Housing loans in LBP under the Protocol between banks and the Directorate General of the ISF", "Housing loans in LBP under the Protocol between banks and the Directorate General of the SG", "Housing loans in LBP granted from credits to the Banque de l'Habitat", "Housing loans in LBP under the Protocol between banks and the Public Corporation for Housing" and "Housing loans in LBP granted from credits to the Housing Bank benefiting from incentives 2009".

TABLE 6. Sectoral Distribution of Utilized Credit Benefiting from Deductions in Banks' Reserve Requirements or in Banks' Liabilities (in Percent).

	Deductions in Reserve Requirements			
	Mar-12	Mar-13	Mar-14	Mar-15
Housing Sector	76.60	77.11	77.94	79.59
Productive Sectors	3.89	3.65	3.91	3.89
Microcredits and Microcredit Institutions	0.06	0.43	0.37	0.24
Educational Sector	1.34	1.54	1.72	1.87
Environmentally-Friendly Projects	0.40	0.46	0.57	0.50
	Deductions in Liabilities			
	Mar-12	Mar-13	Mar-14	Mar-15
Housing Sector	12.67	16.70	19.64	22.87
Productive Sectors	4.10	4.12	2.70	1.79
Subsidized Loans Guaranteed by Kafalat	1.96	2.31	2.17	1.96

Source: BdL Quarterly Bulletin (2015 Q1) Table 3.4.7 (for utilized credit benefiting from deductions in banks' liabilities subject to reserve requirements) and Table 3.4.8 (for utilized credit benefiting from deductions in banks' reserve requirements). The figures provided in the Table account for utilized credit in both LBP and/or foreign currencies.

liabilities stood at around 17.6 percent⁴⁷. However, the share of housing loans to total utilized credit benefiting from deductions in banks' liabilities increased significantly over the March 2012 to March 2015 period (Table 6) whereas the share of loans to the productive sector exhibited a decrease from an already low base of around 4 percent over the same period.

54. The effective reserve requirements after taking into account the reductions on required reserves which banks receive under the credit support schemes is significantly lower than 25 percent. According to the IMF (2015b), the effective interest rate once reductions in banks' reserve requirements are taken into account averaged 5.4 percent at the end of 2014.

55. Subsidized-interest loans account for a more modest share of total lending (Figure 28) spiking in 2011 as BdL scaled up of its public support programs. According to BdL, the cumulative subsidized-interest loans over the Q1-1997 to Q3-2015 period amounted to 9,694.4 Billion LBP. Assuming an average subsidy of 4 percent, the interest rate subsidy's cumulative cost (for the period Q1-1997 to Q3-2015) is 0.62 percent of GDP (using

the CAS's 2013 real GDP).⁴⁸ Banks are estimated to have generated, on average, around US\$ 0.49 million in revenues per quarter as a result of BdL's deductions in reserves and liabilities over the Q2-2012 to Q3-2015 period. Assuming that US\$ 0.49 million of revenues per quarter accrue to banks as a result of the use of deductible loans, revenues from the use of deductible funds account for 18 percent of total banking sector revenues in 2014.⁴⁹ In contrast, subsidized-interest loans account for a negligible source of additional revenues for the banks.

56. The industrial, tourism and agricultural sectors were the largest recipients of BdL subsidized-interest rate loans over the 2008 to 2014 period (Figure 29 and Figure 30). The sectoral distribution of the subsidized medium- and long-term loans and the subsidized interest loans guaranteed by Kafalat demonstrates that the industry, tourism and agricultural sectors were the largest recipients of BdL subsidized loans. Although the industrial sector accounts for a smaller proportion of Lebanon's Gross Domestic Product

⁴⁸ The last official (CAS) national accounts figure dates back to 2013. The IMF (2015b) estimates the cost of the interest rate subsidy to be 0.3 percent of GDP. It is unclear, however, whether the IMF (2015b) refers to the cumulative cost of the subsidy.

⁴⁹ According to the Association of Banks in Lebanon (2014), the consolidated revenues of the banking sector were LBP 16,317 billion.

⁴⁷ These percentages are computed from Table 3.4.7 of BdL's Quarterly Bulletin (Q1-2015).

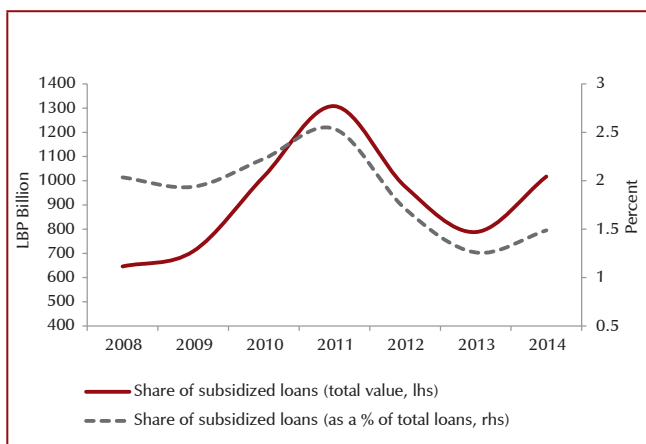


FIGURE 28. Subsidized-interest loans.

Source: Bdl Quarterly Bulletins and WB staff calculations.

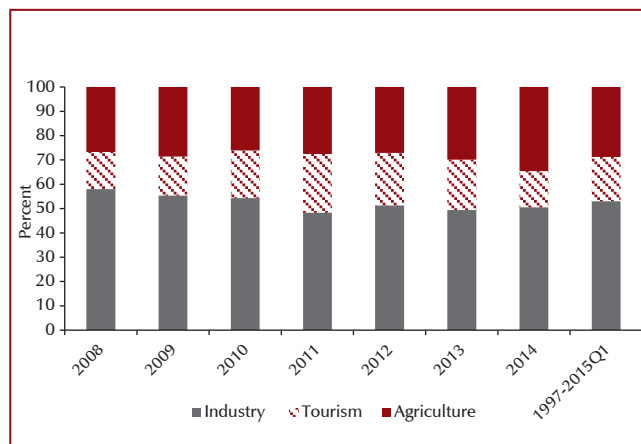


FIGURE 30. Sectoral distribution of Bdl subsidized loans that are guaranteed by Kafalat.

Source: Bdl Quarterly Bulletins and WB staff calculations.

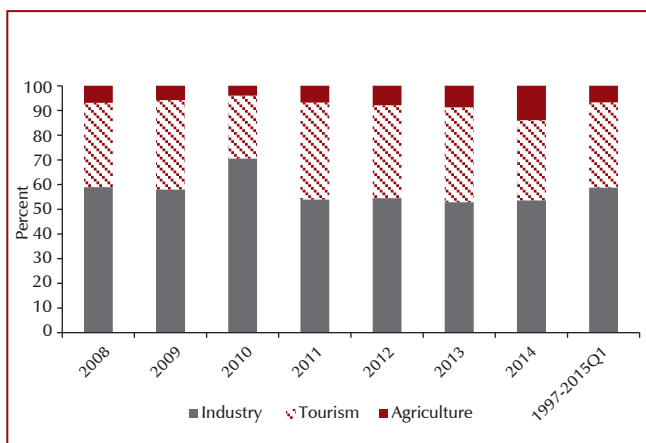


FIGURE 29. Sectoral distribution of medium- and long-term loans subsidized by Bdl.

Source: Bdl Quarterly Bulletins and WB staff calculations.

(GDP) than the tourism sector⁵⁰, it was the largest recipient of both medium- and long-term loans as well as subsidized loans that are guaranteed by Kafalat. In contrast, and despite their eligibility, the specialized technologies and handicraft sectors did not receive any subsidized medium- and long-term loans or any subsidized loans guaranteed by Kafalat. This is likely to be attributable to a lack of demand.

57. Bdl has also introduced specific vehicles targeting SMEs and microenterprises. In an effort to promote a knowledge economy, Bdl (2013)'s intermediate circular 331 encourages banks to invest in equity financing solutions for startup

50 Agriculture, industry and services account for, respectively, 4.5 percent, 20.1 percent and 75.4 percent of Lebanon's GDP (World Bank, 2013b). The contribution of each sector to economic output did not (or is not expected to) exhibit fluctuations over the 2011 to 2015 period.

companies. According to the World Bank (2015a), the initiative makes "US\$ 400 million of non-bank financial products including the provision of start-up equity available". In addition to start-up companies, beneficiaries from the package include business incubators/accelerators and venture capital companies (Bdl, 2013). Eligibility criteria exclude offshore and financial companies and require that the beneficiary from the loan to use the funds for projects supporting "creative intellectual skills and intellectual capital". In tandem with efforts to increase early equity finance, Bdl organized two highly successful international conferences, known as "Bdl accelerate"⁵¹, on startup financing with the aim of establishing Lebanon as an international hub for startup financing. The importance of the prior initiatives is threefold: (i) they limit the extent of Lebanese start-ups and MSMEs' dependence on bank financing⁵²; (ii) they attempt to fill a significant equity financing void resulting from the absence of early stage venture capital, angel financing networks

51 The website for the 2015 conference is: <http://2015.bdlaccelerate.com/>

52 As noted earlier, Lebanon's banks are at the center of financial intermediation in the country and are highly liquid and well-capitalized. This increases SMEs, micro enterprises and start-ups dependence on bank financing. The over-reliance of Lebanese SMEs on bank financing is evinced by the results of the 2013/14 enterprise survey for Lebanon which show that 40.2 percent of firms use banks to finance working capital and that 32.9 percent of firms investments are supplied by banks. Both of the latter numbers are higher than the world and MENA averages. In addition, the 2013 WBES shows that only 2.9 percent of Lebanese firms' investments are financed by equity sales. This is lower than the world average of 4.7 percent and the MENA average of 3.3 percent.

or an SME stock exchange in Lebanon and in MENA (Nasr and Pearce, 2012); and (iii) they boost the supply of capital for early stage companies with the best potential to create jobs.

Conclusion and Preliminary Recommendations

58. Bdl's stimulus packages and other initiatives, in conjunction with the instrumental role played by Kafalat, have provided significant support to the real sector, especially since 2011. Bdl's policy interventions' positive effects are threefold: (i) they entice banks to increase their MSME portfolio shares; (ii) they establish viable alternative sources of start-up and MSME financing; and (iii) they provide avenues which allow MSMEs to access low-cost financing. While the subsidized funds which directly reach SMEs do not appear to be sizeable, Bdl's (and Kafalat's) actions and initiatives induced commercial banks to increase the share of SME investments in their portfolios as evinced by a high reliance of SMEs on bank funding to finance working capital and investments. According to the World Bank (2015b), the more pronounced engagement by banks in SME financing is due "to various incentive and support programs to SME lending provided by the GOL and Bdl since 2000, for example subsidizing interest payments of SME borrowers, extending special guarantees to SMEs, and granting exemptions on compulsory reserves of creditors. It is unclear how much of this business would appeal to the commercial banks in the absence of these incentive programs". Bdl's efforts in fostering viable alternatives to bank financing for startups and establishing Lebanon as a hub for startup financing is likely to lead to higher job growth. This latter observation is also reflected in World Bank's (2015a): "Ongoing efforts initiated by the Central Bank and other governmental and quasi-governmental agencies (such as Kafalat) to promote SMEs and improve their access to finance

are showing potential for some success but limited track records, large collateral requirements, and lack of an established relationship with the financial intermediary hinder particularly start-up firms. As a result of the recent 331 Circular initiated by Bdl, Lebanon currently has had a catalytic effect on venture capital; this bodes well for the future of early-stage equity investments though the sector is still in its infancy."

59. On a broader macroeconomic level, the existing evidence suggests that Bdl's stimulus packages succeeded in closing existing economy-wide financing gaps. The propensity of commercial banks to lend the Sovereign occasionally resulted in economy-wide financing gaps. The IMF (2012)'s econometric analysis of the supply and demand for credit suggests that Bdl's early interventions (through reserve requirement and liability deductions for commercial banks) allowed banks to increase lending capacity in the Lebanese Pound and succeeded in closing economy-wide financing gaps that manifested prior to 2000 and in the 2005-2009 period. No existing studies examine the effects of the recent rounds of subsidized lending on the overall financing environment (or on SMEs' access finance). From a macroeconomic stability perspective, the IMF (2015a) notes, however, that Bdl's stimulus packages do not imperil financial stability in the country⁵³.

Nonetheless, the IMF (2014) expresses concern that the stimulus packages can weaken the central bank's balance sheet.

60. However, little evidence exists regarding the effects of the Bdl stimulus packages on economic growth or job creation. Despite the central bank Governor's repeated reference to the importance of the subsidized lending programs for the economy, no elaborate studies, besides newspaper articles questioning the usefulness of Bdl's subsidized lending programs in stimulating

53 Using the deviation of credit-to-GDP ratio from its long-run trend as a measure of the "financing gap", the IMF (2015a) concludes that "risks to financial stability are not currently out of line" as a result of the US\$ 3.4 billion stimulus packages of Bdl.

economic growth and job creation⁵⁴, of the effects of BdL's subsidized lending programs on economic growth or job creation exist. Such studies are complicated by two factors: (i) the unavailability of contemporaneous and high frequency official GDP figures⁵⁵ and (ii) the fact that the central bank's subsidized lending programs (akin to other accommodative monetary or fiscal policy measures) are likely to affect the real economy with a lag. This, in turn, complicates the measurement of the effect of BdL's subsidized lending programs' on economic activity. A widely shared view suggests that, amidst security and political turmoil, Lebanon's economic growth would have been lower without BdL's stimulus packages. For example, the World Bank (2013a)'s Lebanon Economic Monitor provides the following assessment of BdL's first stimulus package: "Given the current weak consumer, investor, and banker sentiment, the multiplier impact of this stimulus package is expected to be limited. The primary benefit of the package will, therefore, be the lower cost of financing on US\$1.46 billion. Under such a scenario, BdL's stimulus package could boost GDP growth by 0.2 to 0.3 percentage points".

61. While BdL's supported credit schemes appear to have improved Lebanese households' access to real estate finance (as well as their borrowing terms), they also encourage rent-seeking behavior by banks and developers. Lebanese households' ability to afford housing that is consistent with their demand patterns and size preferences is estimated to have increased by around 10 percent as a result of BdL's stimulus packages. However, the supported credit schemes might have allowed banks and real estate developers to extract rent.

54 An article in the Executive magazine argues that the stimulus packages benefit the wealthy homeowners by not the public: <http://www.executive-magazine.com/business-finance/real-estate/lending-homeowners-a-hand>. This sentiment is shared by another article in the Executive Magazine dubbing Lebanon's stimulus package "futile" in spurring growth: <http://www.executive-magazine.com/economics-policy/central-bank-injection-economy-lebanon>. An article in the newspaper Al-Akhbar also expresses strong skepticism regarding the stimulus packages' success in generating growth and employment: <http://english.al-akhbar.com/node/14504>.

55 As of September 2016, Lebanon's national accounts data only cover the 2004-2013 period. The frequency of the existing national accounts data is annual.

62. Costs born by BdL for such interventions are not specified. BdL does not publish income statements, while its balance sheet offers limited information. As a result, the costs associated with these subsidies, which are denominated in local currency and carried by the central bank, are difficult to quantify precisely, but have possible implications on long-term monetary policy (inflation and exchange rate).

63. The enthusiastic response to BdL initiatives (subsidized loans) has helped boost economic activity but, after several years of such lending, more attention will need to be paid to the issue of leveraging and repayment capacity. This is especially relevant in an environment of prolonged low economic growth as has been the case since 2011. Toward that end, and to limit leverage risks on the consumer side and the fallout impact on banks, in 2014, BdL instructed banks to require a minimum down-payment of 25 percent for any car or housing loan and to limit the value of the loan such that the monthly installment does not exceed 45 percent of family income (35 percent for a housing loan). Hence, while monetary policy has been one of the few effective countercyclical policy tools during the ongoing period of sluggish growth, it will likely become a less potent economic stimulant going forward.

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DATA APPENDIX

TABLE 7. Lebanon: Selected Economic Indicators, 2013-2018.

	2013	2014	2015	2016	2017	2018
	Est.	Est.	Est.		Proj.	
<i>(annual percentage change, unless otherwise specified)</i>						
Real sector						
Real GDP	0.9	1.8	1.3	1.8	2.2	2.3
Real GDP per Capita ¹	-6.0	-4.1	-2.8	-0.6	1.4	2.6
Agriculture (share of GDP)	4.4	4.5	4.5	4.7	4.7	4.6
Industry (share of GDP)	14.2	15.5	15.4	14.0	14.3	14.3
Services (share of GDP)	81.4	80.0	80.1	81.3	81.0	81.1
Money and prices						
CPI Inflation (p.a)	2.7	1.2	-3.7	-1.5	2.0	3.0
Money (M3, including non-resident deposits)	9.0	6.0	5.1	3.0	4.5	6.0
<i>(percent of GDP, unless otherwise specified)</i>						
Investment & saving						
Gross Capital Formation	30.4	31.2	27.6	30.4	31.0	31.3
o/w private	28.5	29.6	26.1	28.8	29.5	29.8
Gross National Savings	4.5	5.4	10.3	11.3	11.3	11.8
o/w private	16.4	16.5	22.1	17.6	18.4	19.3
Central Government Finance						
Revenue (including grants)	21.2	23.8	20.3	20.9	21.6	21.6
o/w. tax revenues	15.1	15.1	14.6	15.2	15.7	15.7
Total expenditure and net lending	30.7	30.4	28.5	28.8	30.1	30.6
Current	28.8	28.8	27.1	27.3	28.6	29.1
o/w Interest Payment	8.5	9.2	9.5	9.7	10.0	10.5
Capital & Net Lending (excl. foreign financed)	1.9	1.6	1.5	1.5	1.5	1.5
Overall balance (deficit (-))	-9.5	-6.6	-8.2	-7.9	-8.6	-9.0
Primary Balance (deficit (-))	-0.9	2.6	1.3	1.8	1.4	1.5
External sector						
Current Account Balance	-26.0	-25.7	-17.2	-19.1	-19.7	-19.5
Trade Balance	-28.3	-29.4	-23.2	-26.3	-26.8	-26.4
o/w Export (GNFS)	47.1	42.1	41.9	41.1	42.4	42.7
Exports of Goods	11.7	10.0	8.5	7.4	8.3	8.4
Exports of Services	35.4	32.2	33.4	33.7	34.1	34.3
o/w Import (GNFS)	75.4	71.5	65.1	67.5	69.2	69.1
Imports of Goods	46.2	42.8	36.3	38.7	39.2	39.1
Imports of Goods	29.2	28.7	28.8	28.8	30.0	30.1
Net Private Current transfers	3.1	5.0	7.2	6.3	5.9	5.4
Remittances	4.7	5.9	7.6	6.8	6.4	5.8
Net Income receipts	-0.7	-1.3	-1.2	0.9	1.2	1.5
Gross Reserves (months of imports GNFS) ^{2/3}	11.4	11.9	12.0	11.2	11.2	11.3
Total Public Debt						
Total Debt Stock (in million US\$)	63,490	66,564	70,322	74,249	78,582	83,327
Debt-to-GDP ratio (percent)	143.1	145.6	149.4	148.7	155.5	158.4
Memorandum Items:						
Nominal GDP (in billion LBP)	66,861	68,939	70,980	75,256	76,172	79,318
GDP (in million US\$)	44,352	45,731	47,085	49,921	50,528	52,616

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 Division² Gross Reserves (months of imports GNFS) = (Gross Res. excl. Gold / imports of goods & services) *12³ Total Imports using the BOP data from the Quarterly Bulletin of BDL

SELECTED SPECIAL FOCUS FROM RECENT LEBANON ECONOMIC MONITORS

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:

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Title	Publication Date	Document Type
Lebanon - Lake Qaraoun Pollution Prevention Project (English)	2016/06/22	Project
Lebanon Economic Monitor, Spring 2016: A geo-economy of risks and reward	2016/06/02	Working Paper
Lebanon - Promoting poverty reduction and shared prosperity: systematic country diagnostic (English)	2016/01/01	Publication
The welfare of Syrian refugees: evidence from Jordan and Lebanon (English)	2015/12/22	Publication
Snapshot of poverty and labor market outcomes in Lebanon based on household budget survey 2011-2012: central administration for statistics and World Bank	2015/12/08	Working Paper
Lebanon economic monitor, April 2015: the economy of new drivers and old drags	2015/04/27	Working Paper
MENA Quarterly Economic Brief, January 2015: Plunging Oil Prices	2015/01/29	Brief
Economic effects of the Syrian war and the spread of the Islamic state on the Levant	2014/12/01	Policy Research Working Paper
Lebanon Economic Monitor: Fall 2014 (English)	2014/10/31	Brief
New coincident and leading indicators for the Lebanese economy (English)	2014/06/01	Policy Research Working Paper
Lebanon Economic Monitor: Spring 2014 (English)	2014/04/30	Brief
Lebanon Economic Monitor: Fall 2013 (English)	2013/10/31	Brief
Lebanon - Economic and social impact assessment of the Syrian conflict (English)	2013/09/20	Board Paper
Lebanon Economic Monitor: Spring 2013 (English)	2013/06/25	Brief
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