ASSOCIATION OF
BANKS IN LEBANON

CONTRIBUTION TO THE LEBANESE GOVERNMENT'S FINANCIAL RECOVERY PLAN

May 2020

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Disclaimer

This document ("Contribution") is submitted by the Association of Banks in Lebanon ("ABL") for discussion purposes with the Lebanese Government and all concerned parties, including professional and trade associations, in order to reach a consensus on a strategy that is in the best interest of the country, the depositors and the people of Lebanon. It outlines some of the ABL's views, ideas and suggestions in response to the present economic crisis that Lebanon, and particularly the banking sector, is experiencing. Nothing in this document shall be deemed to include any representation, undertaking or warranty by either the ABL or any of its individual members and all data included herein reflects the information available to ABL, which has not been independently verified or audited, and no responsibility is accepted as to the accuracy, reliability or completeness of such information or as to the reasonableness of any assumptions.

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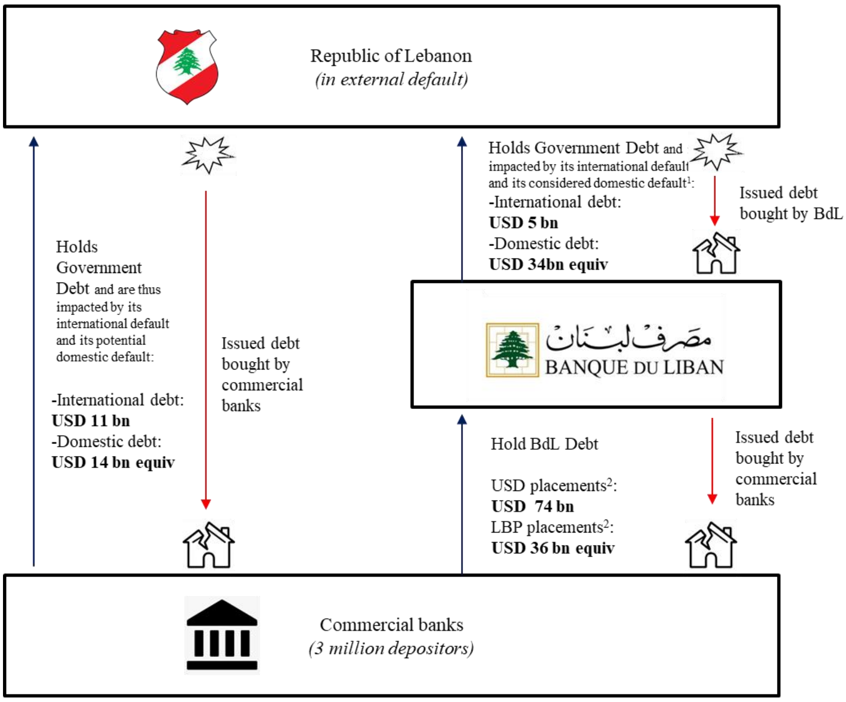
FOREWORD BY THE CHAIRMAN OF THE ASSOCIATION OF BANKS IN LEBANON

"Representing c. 3 million depositors, the Association of Banks of Lebanon ('ABL') is willing to contribute to the effort required to take Lebanon out of the crisis it is facing. This starts with good faith discussions with the authorities about the optimal solution to be implemented, in the interest of the country. Until now, the ABL has not been associated to the ongoing work and in particular has not been consulted before the release of the Financial Recovery Plan on April 30th. This document is a contribution to the design of an optimized and consensual solution.

The Lebanese banking sector is one of the most dynamic sectors of our economy. We contribute 6% of our GDP, a very significant amount of the public sector financing needs and fiscal revenues, and we employ nearly 26,000 highly skilled employees.

<u>Figure 1 : Banking sector's contribution to Government financing: Overview of Government debt holdings</u>



As of March 31st, 2020 – Official exchange rate (1507.5 LBP/USD) – Commercial banks holdings on BdL are net of BdL holdings on Commercial banks – Note1: as per the Government's Financial Recovery Plan of April 30th, 2020 Note 2: ABL estimates

Several features are unique to Lebanon. First, the fact that, with a highly speculative rating[1], the Republic had only limited access to the capital markets. The country has indeed been mostly funded by its banks which acted as lender of last resort by buying the vast majority of bonds issued by the Republic of Lebanon, in particular in recent years (banks hold 27% of total debt, split into 35% of foreign debt and 24% of domestic debt as of end of March 2020). Second, uniquely among emerging markets, Lebanon is a cash-poor but asset rich economy. The country has the ability to settle at least its intra-public sector debt with existing assets that are poorly exploited, or not exploited at all.

The banking sector is prepared to contribute to the solution to the current crisis and to support Lebanon's growth. Yet the Government's plan overlooks this positive contribution of the banking sector to the Lebanese economy and only talks about the fiscal impossibility to bail out Lebanon's banks. This statement is misleading and not accurate. Lebanon's banking sector is sound and doesn't need a bailout: banks just need the Government to pay back its dues.

[1] Highest rating since 2009: S&P B Positive (December 2019), Moody's B1 stable (April 2010), Fitch Ratings B stable (November 2011)

Having chosen to default on its foreign debt, the Government in its April 30 Financial Recovery Plan now envisages an almost unprecedented and highly damaging internal default. Such move would have dramatic consequences on economic growth and the Lebanese population. That is why ABL is proposing a Contribution in which all stakeholders would take their fair share of the burden to avoid such an outcome, in the interest of the current and future generations of Lebanese.

The ABL is prepared to make a meaningful contribution to this serious crisis by making financial and economic concessions conducive to its resolution, while upholding its members' fiduciary duties. The ABL is also looking forward to providing support to the more diversified, more dynamic, more efficient, and more export-oriented economy we outline in this document. In doing so, the ABL is intent on being fully engaged in the reconstruction of the country's economy and to contribute to strengthen and increase its growth potential, building in particular on Lebanon's extraordinary talented population."

EXECUTIVE SUMMARY: FIVE STRATEGIC PRIORITIES FOR AN ORDERLY RESOLUTION OF THE CURRENT CRISIS

ABL's Contribution to the Government's Financial Recovery Plan rests on **an IMF-supported two-pillar approach with a clearly phased and timely implementation:**

- **A balanced and effective immediate response[2]** addressing the external financing needs and putting the medium-term fiscal and debt path on a sustainable footing, while avoiding an internal debt default that would have damaging consequences on the Lebanese people and on confidence;
- **The launch of long-overdue structural reforms in the coming months[3]**, to promote sustainable and inclusive growth as the result of economic diversification.

ABL's Contribution recognizes that **Lebanon's economy has been stuck for many years in a vicious economic cycle.** At the heart of the crisis is the fact that the country suffers fiscal and current account deficits (twin deficits) which have been largely financed, indirectly, by bank deposits from Lebanese residents and non-residents. From a fiscal standpoint, the primary surplus required to stabilize Lebanon's debt-to-GDP ratio exceeded 5% in October 2019, according to the IMF[4]. The Governments' reluctance to implement the necessary fiscal effort led to Lebanon's first-ever external default[5]. This event only worsened the economic crisis Lebanon is facing, including geopolitical and political instability and a low contribution of productive sectors to GDP.

Our approach deploys **five strategic priorities allowing a prompt and sustainable economic and financial recovery in the wake of expected IMF (or 'the Fund') Balance of Payments ('BoP') support** requested on May 1st by the Government:

1. A debt restructuring process[6] that minimizes the damaging consequences to the nearly 3 million domestic bank depositors and to the economy as a whole, while priming the economy for a faster recovery and higher medium-term potential growth

(i) Avoiding internal default

The ABL contribution's **crisis management pillar** takes stock of the fact that Lebanon has historically financed large current account deficits with a combination of financial and capital account surpluses. By choosing to hard-default on its Eurobonds in March, Lebanon has delayed the recovery of Eurobond issuance as an important factor in the financial account**.**

Further, **should Lebanon choose to default on its internal debt**, **the damage to economic confidence and to the financial account will be of such magnitude and permanence that Lebanon will be expected to run financial account deficits for the foreseeable future**. The negative financial account balance, added to the structural trade deficit, would lead to unsustainable external financing

[2] Cf. strategic priorities 1, 2 and 3 below.
[3] Cf. strategic priorities 4 and 5 below.
[4] IMF, article IV consultation, October 2019
[5] Lebanon had indeed never defaulted on its debt, including during war times
[6] This approach rests on a model that aims at protecting all deposits – and not only "a vast majority" as in the Government's plan

requirements, exceeding the USD 28 bn[7] forecast by the Government over the 2020-2024 period. Also, based on reputable empirical research, an internal default would lead to a GDP drop 10-12% in excess of the 14% forecast by the Government. Social indicators, like unemployment and poverty, would also grow proportionally.

ABL's contribution is predicated on the need to avoid an internal default, and brings the external financing requirement to a realistic c. USD 8 bn over the same time horizon as the Government's plan[8].

It relies on the recognition of **BdL's key role in Lebanese financial sector restructuring and public debt reprofiling**. Therefore, as a first step, the Government's debt to BdL needs to be settled fairly.

Our plan envisages a settlement mechanism that would include the following features:

1) The creation of a Government Debt Defeasance Fund ("GDDF");
2) The contribution by the Government of public assets[9] valued at USD40 bn to the GDDF in exchange for 100% of the GDDF's shares;
3) The issuance by the GDDF of long-dated, interest-bearing, covered securities in the amount of USD 40 bn to BdL in exchange for and final settlement of the Government's debt to BdL[10];
4) The delivery by BdL to GDDF of all title and interest related to its Government's holdings;
5) The delivery by GDDF to the Government of all of the above title and interest in BdL's Government's holdings, in exchange for the assets contributed by the Government to GDDF; and
6) The Government 's cancellation of the debt previously owed to BdL.

This default-avoiding internal exchange can be executed both quickly and smoothly in the interest of all stakeholders – allowing the Government to move on into dealing with other much needed matters.

Should Lebanon reach a consensual reprofiling deal with its internal creditors, the financial account would swing back to a positive balance as soon as 2021 and reach a USD 1.8 bn average surplus for the 2022-2024 period[11]. Avoiding an internal default would indeed preserve existing and future depositors' confidence.

Even if Lebanon does not default internally, IMF support will still be needed to finance BoP deficits which will remain elevated in the near future, i.e. c. USD 8 bn cumulated in the 2020-2024[12] period. We believe that, if Lebanon doesn't default on its internal debt, the country will be in a better position to secure an exceptional access IMF program[13], to cover such a significant financing gap. Whatever its size, the successful closing of an IMF deal is likely to catalyze the release of other substantial sources of financial support such as multilateral (World Bank, EBRD, IFC, EIB, etc.), CEDRE conference, and bilateral financial support.

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[7] Compared to Lebanon's USD 4 bn IMF quota over the same period
[8] The delta stems mainly from the fact that deposits would not flow out of the country (impact of USD 9 bn in 2021 only and of USD 13 bn by 2024 in the Government's Financial Recovery Plan)
[9] Public assets include some or a combination of shares in State Owned Enterprises (e.g. telcos), public lands and other public real estate assets, and/or exploitation rights/concessions (e.g., Lebanon's waterfront).
[10] BdL would benefit from the interest of the GDDF securities
[11] See table 2
[12] See table 2
[13] Exceptional access program required above 145% of a country's quota annually or 435% over the life of the program, amounting respectively to USD 1.3 bn and USD 3.9 bn

This program will require a major effort on the part of Lebanon's Government to meet IMF's conditionalities, but would spare Lebanese people from the very exigent import-suppression adjustment or hyperinflation that would result from internal default or BdL's bankruptcy.

(ii) Domestic debt reprofiling

ABL's Contribution underlines that domestic debt defaults are extremely rare events. The most prominent case in modern history was Russia's 1998 default on its GKOs[14] with highly damaging economic consequences[15]. In the case of Lebanon, the fallout of an internal default is likely to lead to a brain drain which will reduce future growth potential, thus leading to a "lost decade" of depressed economic activity.

It is thus imperative that Lebanon negotiates a relief package with its domestic creditors. Such relief package would include significant coupon reductions, which would contribute to putting Lebanon back on a sustainable debt path. This would require the Ministry of Finance to launch **a voluntary debt exchange offer which would be subject to a minimum acceptance threshold, to be set by the Government.**

Table 1 : Republic of Lebanon Internal Debt (USD bn)

	Banking Sector	BdL	Other
Eurobonds (USD, NY Law)	11	5	0
Overdrafts (USD, Leb. Law)	0	16	0
T-Bills (LBP, Leb. Law)	14	34	6

(iii) Foreign debt reprofiling

Lebanon's foreign debt (i.e. the portion of its debt held by non-residents) accounts for 16 % of total public debt.

This feature would allow for a debt reprofiling consistent with Lebanon's medium-term debt-servicing capacity. This would, in turn, facilitate returning to the international capital markets in the medium-term.

The Eurobond restructuring will consist of a menu of options, including at least one option to exchange the outstanding Eurobonds for new New York law securities and one option to exchange for new securities governed by Lebanese law. The exchange negotiation will be a consensual one based on the IIF's Principles for Stable Capital Flows and Fair Debt Restructuring, including transparency and timely flow of information, close debtor-creditor dialogue and cooperation, good faith actions and voluntary good faith process, and fair treatment avoiding unfair discrimination among affected creditors.

The exchange offer will comply with all legal requirements of the relevant indentures and fiscal agency agreements, including, but not limited to, pari passu, uniform treatment, and collective action clauses.

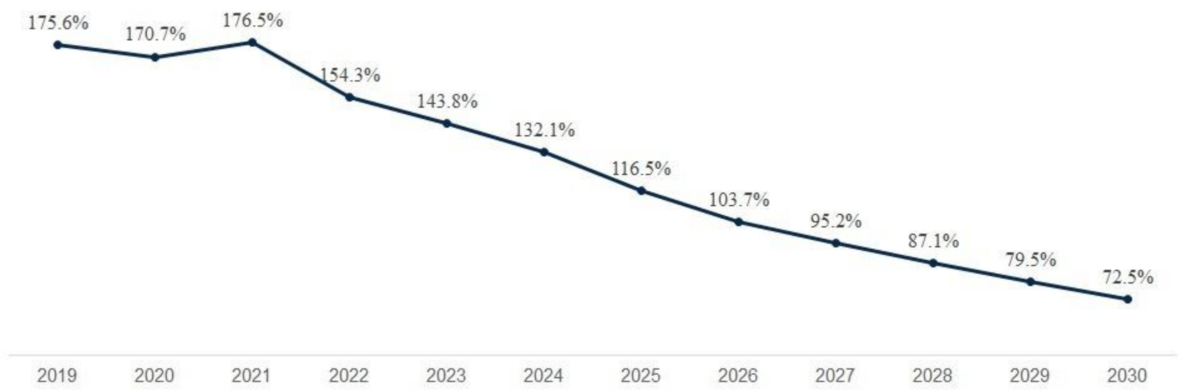
[14] Gosudarstvennoye Kratkosrochnoye Obyazatyelstvo, or Government Short-Term bonds

[15] The default led to a severe economic depression (cumulative 36% output contraction), even though Russia kept a lifeline to the capital markets open by keeping current on the Eurobonds issued by the Russian Federation (as opposed to the old Soviet debt). Should Lebanon default on its internal debt, it is not likely to experience a sharp rebound since the country has scarce natural resources and a limited industrial base.

(iv) Debt sustainability analysis

If successful, the internal and foreign debt reprofiling would result in a decreasing trajectory for Lebanon's debt to GDP ratio as soon as 2020 and over the next ten years (except for 2021). **We outline below the results of our debt sustainability analysis ("DSA"),** as applied to our projected macro framework and comprehensive debt restructuring proposal[16]. Debt would decrease in 2020 to 171%, slightly bounce in 2021, and would after that steadily decline to **72.5% in 2030.**

Figure 2 : Evolution of Debt-to-GDP ratio



2. A sustainable medium-term fiscal strategy leaving a significant fiscal space to finance much-needed social measures, including an Expanded Social Safety Net to fight poverty and concrete steps against social exclusion

The main goal of ABL's economic adjustment program is to reach a credible 2.1% of GDP primary surplus allowing to reverse the adverse dynamics of the debt-to-output ratio through a combination of revenue and expenditure measures as well as through a comprehensive set of debt relief measures.

However, a multi-annual economic adjustment program could exacerbate already existing adverse trends in inequality, poverty and social exclusion and further damage social cohesion[17]. **To contain the social cost of fiscal consolidation, the authorities should create a wide Social Safety Net** ('SSN') - mainly through budget reallocation - with the goal to protect the most vulnerable segments of society and eliminating entrenched forms of inequality.

Building on the National Poverty Targeting Program ('NPTP') and its Emergency expansion until end 2020 enables a swift implementation. The original aim of that program was to support up to 450,000 beneficiaries. **ABL's Contribution seeks to increase significantly social spending up to 4 % of GDP[18].**

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[16] Our DSA was performed following the IMF's current market access country (MAC) framework.

[17] Before the execution of this adjustment program, a World Bank's estimate dated April 2020 already pointed to Lebanon's critical social situation. In particular, the current crisis could result in more than 155,000 households living under the extreme poverty line (850,000 individuals, equivalent to 22% of the Lebanese population); and 356,000 households under the upper poverty line (1.7 million individuals, equivalent to 45% of the Lebanese population).

[18] The 4% of GDP (including 0.7% of electricity subsidies) level of social expenditures targeted on the medium term has to be compared with 1.1% of GDP today (including 0.7% of electricity subsidies).

3. A monetary and exchange rate unification policy that addresses the massive external imbalances while containing considerable inflationary pressures and avoiding hyperinflation

Exchange rate unification, that needs to come in the wake of the IMF program, gives incentives for the immediate recovery of domestic production and props the long-term development of the tourism sector despite the COVID-19 headwinds. **Agriculture will see a sudden boost**, as the overvalued currency suppresses local farming and the agri-processing industry. Exchange rate unification will further reduce the large external financing needs that expose Lebanon to a severe shortage of inflows when a crisis like COVID-19 hits.

Going forward, the exchange rate unification will be administered as a "dirty float", with central bank intervention limited to periods of unwarranted volatility[19].

4. A financial sector restructuring based on an orderly banking sector approach on a case-by-case basis when needed, upgrading regulatory matters to international standards

Following the **settlement of the debts owed by the Government to BdL**, the banking sector restructuring should be implemented with a careful, progressive, and case-by-case approach. **A one-size-fits-all approach of the banking sector restructuring would be very detrimental to the economy as a whole given the specific place of banks in the Lebanon.**

In addition to the specific contribution of banks to the financing and the economy and the overall GDP, banking sector restructuring is a major building block of the recovery as:

(i) **The banking sector's overall health has a strong impact on any sovereign rating** and especially in Lebanon, given its relative size. A credible banking sector (i.e. a banking sector which didn't default on its depositors) is therefore key to Lebanon's plan to re-access the international capital markets;

(ii) **The banking sector's consolidated balance sheet is closely linked to those of BdL and the Government,** which renders the banking sector central to the solution of the current crisis;

(iii) The banking sector has traditionally accounted **for a disproportionate share of the Government's tax receipts**; and

(iv) A properly functioning banking sector serves as the **breeding ground for the early career of professionals and other educated employees** who would then move on to become entrepreneurs or find a place in the newly diversified Lebanese economy.

The deep recession which started last year, together with the de-facto devaluation, the Government's decision to default on its Eurobonds, and its announcement of their intent to default on the remainder of the country's internal debt have all negatively affected the banking sector's capital position.

In this context, ABL's Contribution rests on the principle of an absence of banking sector's default on its depositors in order to reinstate confidence[20].

Capital shortfalls will have to be **assessed by the regulator on a case-by-case basis** under the aegis of the Basel III systemic event forbearance system and the regulator will decide what institutions, if any,

[19] At present, 43% of countries globally employ this mechanism.

[20] Restored confidence would enable to benefit from renewed capital inflows from the diaspora.

need to be resolved. The plan anticipates that **the regulator may also encourage some of the more weakly-capitalized financial institutions to merge,** while others will be allowed to continue operating.

5. A strong diversification strategy of the economy as well as much-needed structural reforms including anticorruption measures, a lower cost of Doing Business in the country as well as reforms that reduce the size of the informal sector

ABL's Contribution underlines that **one of the structural deep-rooted origins of this vicious cycle is the extremely low contribution of productive sectors to GDP**. Indeed, several countries with characteristics similar to Lebanon's (small territory with large neighbors, limited population, abundant human capital, limited natural resources, large diaspora) have managed to create sustainable economic growth. The most relevant examples are Hong Kong, Ireland, and Singapore which share the following key success factors:

- ✓ **Integrated National Vision/ Economic Plan;**
- ✓ Emphasis on **high value-added productive sectors;**
- ✓ Continued development of **human capital;**
- ✓ **Efficient and credible Government** supported by disciplined macro policies (fiscal and monetary);
- ✓ **Competitive business environment**;
- ✓ **Open economy.**

In order to replicate the economic success of comparable countries, Lebanon would need to:

- ✓ **Focus the Government's resources and efforts on priority areas,** including Transport and Electricity production and distribution, to diversify the economy;
- ✓ **Improve its business environment (**cost of Doing Business; public sector corruption)
- ✓ **Develop high value-added, future-proofed productive sectors –** e.g. in agriculture, health, high tech medical equipment, IT, cybersecurity... - while relieving balance of payment's distress;
- ✓ **Ensure macroeconomic stability** through fiscal discipline and consistent monetary and exchange rate policies.

In the wake of all these ABL plan's efforts to restore confidence by avoiding internal debt default, Lebanon's productive transformation along these lines would lead to:

- Economic **diversification** (35% of GDP from productive sectors: knowledge economy, manufacturing, agriculture…);
- A sustainable **BoP surplus** in the medium-term (reserve assets growing by USD 170 mm in 2024);
- **350,000 incremental jobs in the formal economy,** in particular thanks to export-oriented logistics and freight-forwarding, including +50,000 jobs in Manufacturing; +50,000 jobs in Agriculture; +60,000 jobs in Knowledge Economy; +10,000 jobs in Financial services;
- **A potential real growth significant increase** and a GDP per capita of USD 15,000 by 2030 in a newly diversified economy.

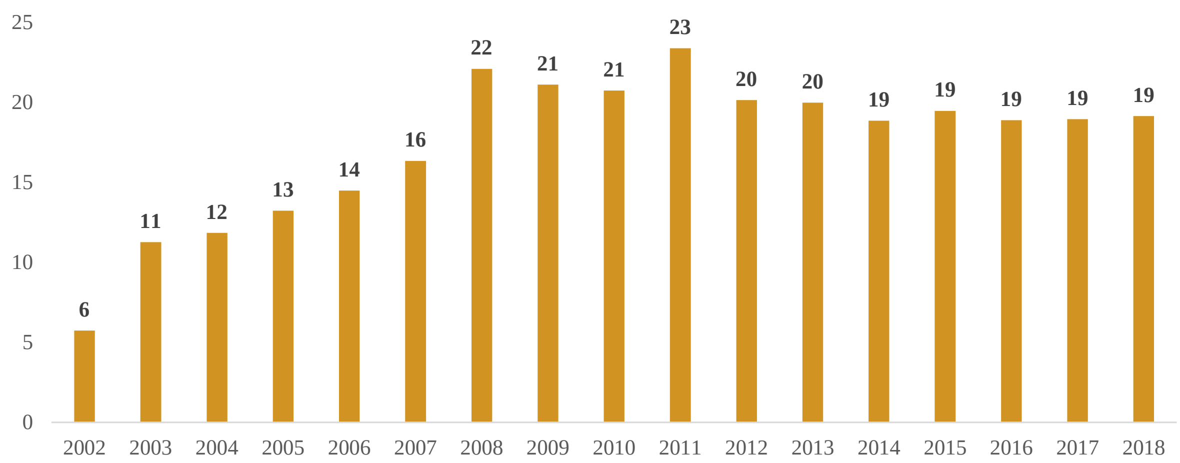
INTRODUCTION:
AN AMBITIOUS ECONOMIC VISION FOR LEBANON

ABL's contribution takes stock that **Lebanon's economy is stuck in a vicious economic cycle.** At the heart of the crisis is the fact that the country suffers from twin deficits (fiscal and trade deficits) which used to be largely indirectly financed by bank deposits from resident and non-resident Lebanese.

Starting in 2016, a slowdown in financial inflows, partly as a consequence of decreasing oil prices, the events in Syria, the border closure, the refugee crisis, and the internal political turmoil, tilted Lebanon's debt and deficit on unsustainable paths. By October 2019, Lebanon's required primary surplus to achieve debt sustainability exceeded 5% of GDP as per the IMF.

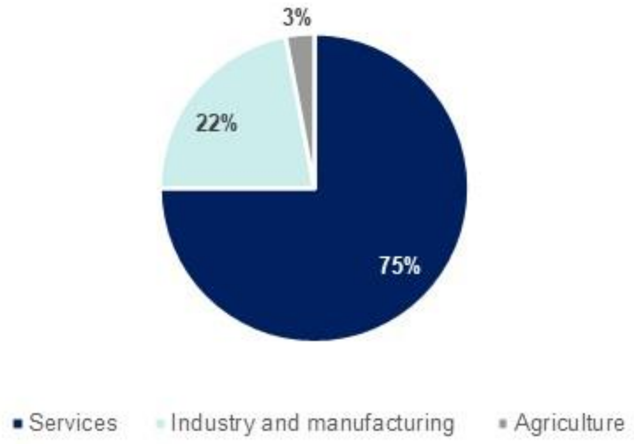
Lebanon's Balance of Payments ('BoP') challenges trace back to the 1990s with an economy with a very small productive sector and lacking exports of goods and services (Figure 3) resulted in anemic income per capita growth in total over the last forty years (30%, compared to a 125% world average). In turn, the stagnant domestic market resulted in an unconducive business environment and to large and growing BoP deficits. In fact, the Lebanese business environment continues to be unfavourable: the country ranked 143 out of 190 countries in the World Bank's Doing Business Index (2018, last available data, to be compared with and ranking of 104th in 2015).

Figure 3: Exports of goods and services, current USD billion, source: World Bank



Fundamentally**, the origin of the vicious cycle is the extremely low contribution of productive sectors to GDP (Figure 4) although Lebanon has enormous potential and a promising future ahead of itself** if it adopts a clear economic vision. Indeed, countries with characteristics similar to Lebanon's (small territory with large neighbors, limited population, abundant human capital, limited natural resources, large diaspora) have managed to create sustainable economic growth. The most relevant examples are, among others, Hong Kong, Ireland, and Singapore.

Figure 4: Output composition by sector, as a share of GDP, source: World Bank



Therefore, in order to replicate the economic success of comparable countries, Lebanon would need to:

- **Ensure macroeconomic stability** through fiscal discipline and consistent monetary and exchange rate policies;
- **Focus the Government's resources and efforts on priority areas,** including transport and electricity production and distribution, to diversify the economy;
- **Improve its business environment (**cost of Doing Business; public sector corruption);
- **Develop high value-added, future-proofed productive sectors –** e.g. in agriculture, health, high tech medical equipment, IT, cybersecurity, media, advisory, asset management...-relieving the balance of payment's distress.

In the wake of efforts to restore confidence, Lebanon's productive transformation along these lines would lead to:

- Economic **diversification** (35% of GDP from productive sectors: knowledge economy, manufacturing, agriculture…);
- A sustainable **Balance of Payments surplus** in the medium-term;
- **350,000 incremental formal jobs** in particular thanks to export-oriented logistics and freight-forwarding, including +50,000 jobs in Manufacturing; +50,000 jobs in Agriculture; +60,000 jobs in Knowledge Economy; +10,000 jobs in Financial services;
- **A potential real growth increase** to 5-6% p.a. and a GDP per capita of USD 15,000 by 2030 in a newly diversified economy.

1. IMMEDIATE RESPONSE

a. Lebanon's external financing needs

Historically, Lebanon has financed large current account deficits with a combination of financial and capital account surpluses.

By choosing to hard-default on its Eurobonds in March, Lebanon has delayed the return to the capital markets as an important factor in the financial account. Further, should Lebanon choose to default on its internal debt, the damage to the financial account will be of such magnitude and permanence that Lebanon will be expected to run financial account deficits for the foreseeable future. In case of internal default, the negative financial account balance, added to the structural trade deficit will lead to unsustainable external financing requirements. Indeed, should internal default occur, Lebanon's external financing needs would exceed the Government's USD 28bn projection over the 2020-2024 time horizon.

Our plan assumes no default on internal debt.

Table 2: Macroeconomic assumptions

	2020	2021	2022	2023	2024
Inflation (yoy, %)	53.00%	12.00%	10.25%	8.50%	6.75%
GDP deflator (yoy, %)	36.20%	11.00%	6.20%	5.80%	5.50%
Real GDP growth (yoy, %)	-13.80%	2.00%	2.50%	3.00%	4.00%

An improved macro-economic environment would also enable Lebanon to swing back to a positive financial account balance in 2021. The avoidance of internal default would preserve deposits, hence reducing the financing needs[21].

Should Lebanon reach a consensual reprofiling deal with its internal creditors, **the financial account would return to a USD 1.8bn average surplus for the 2022-2024 period (i.e., c. 25% of the pre-crisis level).** Avoiding an internal default would indeed restore depositors' confidence, and lead deposits to remain flat over the period. Additionally, foreign direct investments (FDI) are expected to grow significantly in such a context, as investors may also be more keen to invest in Lebanon if the Government does not renege on its contracts, violate property rights, or interfere with private contracts. Increased disbursement from CEDRE will also contribute to support FDI, which is projected to grow from USD 148 mm in 2021 to USD 808 mm in 2024.

[21] By c. USD 9 bn in 2021 and c. USD 13bn by 2024 *versus* the Government's Financial and Recovery Plan forecasts of Other investments in the Balance of Payments

Table 3: Projected Balance of Payments of Lebanon without internal default, USD million

	2019	2020	2021	2022	2023	2024
Current Account	(11724)	(3555)	(2834)	(2578)	(2456)	(2361)
Goods Balance	(13365)	(7614)	(7431)	(8121)	(8877)	(9632)
Services Balance	198	1406	1950	2450	2900	3350
Income Balance	(1438)	(64)	(381)	(237)	(100)	19
Current Transfers	2881	2717	3028	3330	3621	3902
Capital Account	994	668	668	668	668	668
Financial Account	7635	(3896)	850	1765	1809	1863
Direct Investment	1534	148	750	765	784	808
Portfolio Investment	1641	(1062)	100	1000	1025	1056
Other Investment	4460	(2982)	0	0	0	0
Reserve Assets (Depletion)	2390	6783	1316	145	(21)	(170)
External Financing Requirements (Cumulative)		**6783**	**8099**	**8244**	**8223**	**8052**

IMF lending is limited to 145% annually of a country's quota and a cumulative limit over the life of the program of 435% of the quota. The Fund may, however, lend amounts exceeding these limits in exceptional circumstances[22]. Lebanon's quota is small: SDR 633.5 million ('mm') or USD 867 mm. Under regular access, Lebanon could receive a maximum program of USD 3.9bn with an annual limit of USD 1.3bn (145% of Lebanon's quota). Therefore, a regular access IMF program could finance about 15% of the projected 2020-2022 BoP deficit.

Even if Lebanon does not default internally, BoP deficits will remain elevated in the near future, i.e. c. USD 8 bn cumulated in 2020-2024. This would require an exceptional access IMF program, complemented by (i) additional multilateral and bilateral external financial support in the framework of CEDRE and beyond, and (ii) potential diaspora support.

This program will require a major effort of Lebanon's Government but would spare Lebanese people from the very exigent import-suppression adjustment or hyperinflation.

An exceptional access program can be much larger but is also more exigent. The conditions for obtaining exceptional access financing are demanding and the Lebanese Government will have to work hard on implementation to meet them. Indeed, an IMF member is eligible for exceptional access financing provided that it fulfils the following conditions:

(i) The country is experiencing or has the potential to experience exceptional Balance of Payments pressures on the current account or the capital account, resulting in a need for Fund financing that cannot be met within the normal limits;
(ii) A rigorous and systematic analysis indicating that there is a high probability that the member's public debt is sustainable in the medium term (if debt is assessed to be unsustainable ex ante, exceptional access will only be made available where the financing being provided from sources other than the Fund restores debt sustainability with a high probability);
(iii) The country has prospects of gaining or regaining access to private capital markets within a timeframe and on a scale that would enable the member to meet its obligations falling due to the Fund;

[22] Nine of these programs were above 1000% of quota and 4 above 2000%: Greece 2010 (3212% of quota), Ireland 2010 (2322%), Portugal 2011 (2306%), Greece 2012 (2159%), South Korea 1997 (1938%), Turkey 1999 (1560%), Turkey 2002 (1330%), Romania 2009 (1111%), and Hungary 2008 (1015%) https://www.nber.org/papers/w21805.

(iv) The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

Once approved by the IMF staff on its technical merits, any IMF program (whether regular or extraordinary) requires the approval of the Fund's Executive Board, with an 85% voting threshold.

b. Exchange rate unification

(i) Impact of an overvalued currency on the Lebanese economy

Lebanon runs a chronic trade imbalance, which drives one of the largest current account deficit-to-GDP ratios globally (>20% of GDP[23]). Exports and imports underwent a marked decline over the past decade. Although Lebanon has never been a big exporter of goods and services (exports peaked at 80% of GDP in 2008), the country's trade balance further deteriorated as a consequence of the regional turmoil that started in 2011. By 2018, exports had contracted to 35% of GDP, the lowest share for this century, with both goods and services sharing this dynamic.

This reflects both real economy and financial conditions. Official estimates of the Lebanese pound's ('LBP') overvaluation range between 33% and 60%. The parallel foreign exchange market is less benign, with implied very significant devaluation.

Exports of merchandize goods have been particularly affected by the closure of Syrian routes, through which exporters traditionally accessed the Gulf and Iraqi markets. Although some of these routes have since reopened, Lebanese exports have not recovered substantially, due to the overvalued currency and lost markets. Exports of services have also regressed since 2010, dragged by travel and financial services, with the former reflecting a contraction in the tourism sector and the latter a retreat of Lebanese banks' regional expansion strategy.

Imports of goods and services underwent a similar dramatic shift, falling from a high of over 100 percent of GDP in 2008 to a low of nearly 55 percent in 2019. Since much of the consumption basket is imported, and consumption being by far the largest component of GDP, lower economic growth rates have directly hurt imports.

(ii) Concrete implication of an exchange rate unification

The exchange rate unification that will follow the IMF program will give incentives for the recovery of domestic production and will support the long-term development of the tourism sector. Agriculture will also recover, since the overvalued currency suppressed local farming and the agri-processing industry. Further, exchange rate unification will mitigate the large external financing needs that expose Lebanon to a severe shortage of inflows when a crisis like COVID-19 hits.

The immediate effect on household consumption may be small, as food prices are already priced on the basis of the parallel exchange rate. Yet, for poor households as much as 80% of the food basket (chiefly cereals) is imported. Local producers will benefit from reduced foreign competition eventually, but production may take time to expand. The slack in production means higher inflationary pressure.

[23] Average of 24.9% GDP over 2013 – 2019 period – Source World Economic Outlook, April 2020

A distinctive characteristic of personal income in Lebanon is that consumption amongst lower income households is often supported by dollar remittances. However, much of these remittance inflows originate in Gulf economies, themselves severely impacted by the crisis. The net effect on the average household is unclear.

Following the unification, the monetary authority will manage a dirty float FX regime, intervening only in cases of unwarranted volatility. At present, 43% of countries globally employ this mechanism. Monetary policy authorities should quickly endorse a new credible monetary policy framework with the aim to anchor inflation expectations into an explicit inflation forecast target.

The real exchange rate will appreciate over time following the lifting of capital controls. We expect the initial devaluation stimulus to be relatively brief as examples from other relevant countries show a clear trend to real appreciation in the 10-25% following the lifting of capital controls imposed in the context of a sudden stop.

c. Medium Term Fiscal Strategy

(i) Outline of the Fiscal strategy

Primary goals of a Fiscal Strategy: restore sustainability and protect the vulnerable

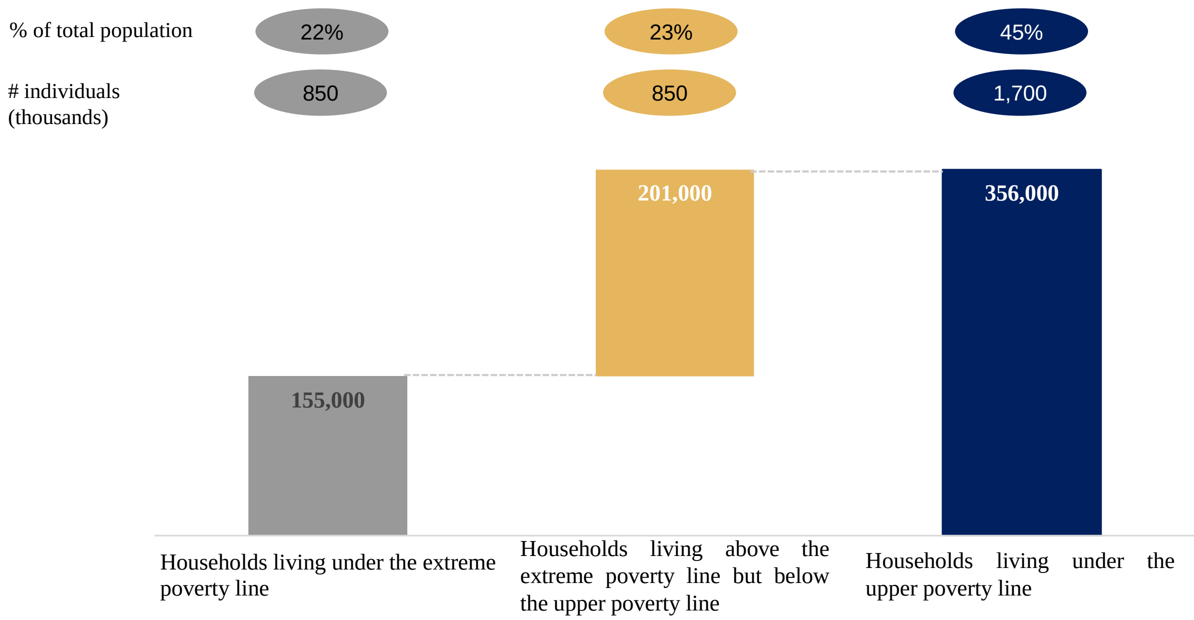
Against a backdrop of slow growth, sharply deteriorating fiscal and external imbalances and an escalating stock of debt, the authorities will have to endorse a multi-annual economic adjustment program aiming to **dispel uncertainty, restore stability, and provide the foundations for a new era of robust and inclusive economic growth**.

The primary goal of the economic adjustment program should be to set fiscal policy on a sustainable track. A new fiscal strategy should have the ambition to reverse the adverse dynamics of the debt-to-output ratio through a combination of revenue and expenditure measures as well as through a comprehensive set of debt relief measures. A sustained commitment to correcting fiscal imbalances after several years of economic mismanagement will be key to enhance the credibility of fiscal policy, restore economic confidence, and support the gradual return of the country to international capital markets at sustainable rates.

Yet a multi-annual economic adjustment program could exacerbate already existing adverse trends in inequality, poverty and social exclusion and damage social cohesion. To contain the social cost of fiscal consolidation, the authorities should create and finance a social safety net with the ambition to protecting the most vulnerable parts of society and eliminating already entrenched forms of inequality. In addition to permanent targeted social protection measures, the authorities should also extend temporary emergency relief to households and firms whose economic activity has been severely hampered by the COVID-19 crisis.

Indeed, Lebanon faces a Gini coefficient of 50.7[24]: the country ranked 129 out of 141 countries in terms of income distribution equality as of 2017[25], and the World Bank's estimates of April 2020[26] forecast that the current crisis could result in having 356 000 households under the upper poverty line[27] and more than 155 000 households living in extreme poverty[28].

Figure 5: Estimates of Lebanese households living under poverty lines in the context of the current crisis, source: Word Bank



Key Elements of a Fiscal Strategy: a credible and consistent policy framework

The key objectives of restoring fiscal sustainability while simultaneously creating a robust social safety net is a difficult exercise in policy trade-offs. To maximize the probability of success, it requires the active involvement of - and the build-up of a broad consensus among - all stakeholders including political parties and social and civil society partners. Importantly, it requires a credible and consistent overall policy framework within which to embed the consolidation program.

In face of the current global economic headwinds and elevated uncertainty, a large fiscal consolidation program should be extended over a number of years and should be based on realistic fiscal targets and credible parametric expenditure and revenue measures. It should also

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24 Ministry of Finance, United Nations Development Programme, Assessing Labor Income Inequality in Lebanon's Private Sector, February 2017.
25Ibid. Note: "*Results show that private sector earnings are disproportionately distributed between income groups with the top 2 percent capturing a share of income almost as high as that of the bottom 60 percent*".
26 The World Bank, Factsheet, Targeting Poor Households in Lebanon, April 21, 2020.
27 The World Bank recalls that '*To estimate the upper poverty line, a non-food component is added to the food poverty line (rents, durables, education, health etc.), and households whose consumption expenditure falls below this line are considered poor*.
28 Lebanon's Central Administration of Statistics (CAS) uses the standard international approach to set a poverty line (the cost-of-basic-needs approach (CBN)). In particular, the World Bank highlights that '*to estimate the extreme poverty line, a minimal nutrition requirement for healthy living is identified - usually defined in terms of minimal caloric requirements. Households whose consumption expenditure falls below this line are considered extreme poor.*'.

be **back-loaded** and should accommodate a set of immediate temporary **emergency relief measures** to deal with the adverse economic effects of the COVID-19 crisis and a set of permanent targeted measures that strengthen the social safety net for the vulnerable.

The latter should aim to contain poverty and social exclusion but, to the extent possible, they should also have the ambition to go beyond this and offer support to middle income households. To this end, a review of family allowances, unemployment benefits, housing benefits, and social welfare benefits should be considered with the view to widen their scope and effectiveness. In addition, active labor market policies should be deployed urgently with the aim to increase the probability of the young and the long-term unemployed to find employment as the economy recovers and therefore reduce brain drain and contain a sharp decline in labor force participation.

The IMF Article IV Consultation with Lebanon of October 2019 concludes that, to set the debt-to-output ratio on a sustainable trajectory, the primary surplus will have to be maintained in the territory of 4-5 percent for the next two decades. Since the publication of the IMF findings, economic conditions and the fiscal balance have deteriorated significantly, raising thus the debt-stabilizing primary surplus further. The implied extent of discretionary fiscal effort is unsustainable and attempting to deliver it would be harmful for the economy. **The needed fiscal consolidation should therefore be accompanied by a well-designed debt relief package that is consistent with a considerably milder primary surplus path while minimizing the damage to domestic debt holders and distributing the costs of fiscal adjustment fairly.**

Abandoning the peg in favor of an initially undervalued dirty float is one tool to counteract the recessionary pull of fiscal consolidation. As explained in section b, aligning the official with the shadow parity by means of discrete devaluation would offset part of the adverse effect of fiscal retrenchment but would also help correct the massive external imbalances in a less painful way than through pure expenditure reducing policies.

Finally, **fiscal consolidation should be backed by structural fiscal reforms** that could safeguard the sustainability of fiscal policy over the medium run, by strengthening the transparency and accountability of the conduct of fiscal authorities (see part 2).

A backloaded consolidation based on credible measures, the implementation of a well-designed debt restructuring plan, the deployment of targeted social programs for wide segments of society, the discrete devaluation of the currency, and the endorsement of ambitious fiscal structural reforms are key integral elements of a strategy that could deliver stability and inclusive growth.

(ii) *Components of fiscal consolidation - Discretionary measures*

Table 3 presents the primary balance path and the key components of the consolidation plan (as a share of GDP). **In order to avoid a further aggravation of the domestic economic conditions, the consolidation plan is gradual, and the primary balance converges to the medium-term path of 2.1% in 2024**. Indeed, a great deal of evidence suggests that fiscal multipliers are counter-cyclical, hence, synchronizing the fiscal adjustment with a domestic recovery and a global return to economic growth once the COVID-19 crisis has subsided, will significantly reduce its output and employment cost.

The share of expenditure – and, in particular, the share of social welfare expenditure – to GDP is already low. Reducing it further would leave key sectors, such as health, education, and social protection, without vital resources with severe implications for social cohesion and stability. **There is however significant scope for rebalancing public expenditure by reallocating resources away from areas with low to areas with potentially high social and economic returns**. The rebalancing of public expenditure by gradually reallocating resources equal to 4 % of GDP towards widening, reshaping and strengthening the country's social safety net is a key component of the consolidation plan.

To converge to, and sustain, the medium-term fiscal path of 2.1 % while simultaneously rebalancing public expenditure**, the share of revenue to GDP will have to increase by 5.5 %** over the next four years. To be credible, and therefore create expectations that the country's public finances are on track to sustainability, the rise in public revenues will require parametric measures that are based on the existing tax collection infrastructure such as the VAT and the income tax. These measures should be legislated upfront in their entirety to demonstrate the authorities' commitment to sustainable public finances.

In addition, these measures should be **accompanied by the endorsement and implementation of structural tax reforms in revenue administration and enforcement**, with the aim to widen the tax base by improving tax collection and strengthening compliance. Once these structural reforms yield fruit, the authorities will be able to accommodate sustainable public finances with low tax rates, thus rebalancing public revenue in a growth-friendly way.

Table 4: Fiscal path (% GDP)[29]

Fiscal Consolidation Path	**Estimate**	**Projections**				
as a % of GDP, unless otherwise stated	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Total Revenue (without measures)	21.5%	17.2%	15.8%	15.9%	15.2%	15.0%
Impact of Revenue Measures		0.0%	3.2%	3.7%	4.8%	5.5%
Total Revenue (with measures)		**17.2%**	**19.0%**	**19.6%**	**20.0%**	**20.5%**
Total Primary Expenditure (without measures)	22.4%	18.7%	18.6%	19.1%	18.7%	18.4%
Impact of Expenditure Measures		0.9%	1.6%	2.6%	3.3%	4.0%
Impact of Social Protection Measures		1.0%	2.0%	2.5%	3.5%	4.0%
Total Primary Expenditure (with measures)		**18.8%**	**19.0%**	**19.0%**	**18.9%**	**18.4%**
Primary Balance (without measures, baseline)	-0.9%	-1.5%	-2.8%	-3.2%	-3.5%	-3.4%
Primary Balance (with measures, fiscal consolidation scenario)		**-1.6%**	**0.0%**	**0.6%**	**1.1%**	**2.1%**

Revenue Enhancing Measures

Revenue measures are expected to yield up to **5.5% of GDP by 2024**[30]. These include:

- **Higher indirect tax revenue** stemming in particular from an increase of VAT on certain non-essential items from January 2021 and the elimination of certain VAT exemptions benefiting non-vulnerable demographics, partly introduced in 2021, and fully implemented from 2022 onwards. A specific reform aiming at improving border and custom tax collection would also contribute to increase fiscal revenues;

[29] Total Revenue and Total Primary Expenditures without measures are based on the Government 's Financial Recovery Plan, except for Total Revenues in 2022: in order to have a smoother trajectory, we assume they will be at 15.9% GDP versus 16.9%
[30] Relative to baseline scenario included in the Government's Financial and Recovery Program

- **Higher direct tax revenues and improvement in tax collection will lead to higher fiscal receipts.** These will be enabled in particular by the strengthening of the Tax Administration (*see Structural fiscal reforms*).

Table 5: Revenue enhancing measures (% GDP)

Revenue-Enhancing Measures	Estimate 2019	Projection 2020	2021	2022	2023	2024
Total revenue (without measures)	**21,5%**	**17,2%**	**15,8%**	**15,9%**	**15,2%**	**15,0%**
Impact of Revenue Measures		**0,0%**	**3,2%**	**3,7%**	**4,8%**	**5,5%**
Indirect Tax Revenues		0,0%	2,5%	3,0%	3,0%	3,0%
Removal of certain VAT exemptions		0,0%	0,5%	1,0%	1,0%	1,0%
Other measures including border and custom taxes		0,0%	2,0%	2,0%	2,0%	2,0%
Direct Tax Revenues and Tax collection		0,0%	0,7%	0,7%	1,8%	2,5%
Increase tax on interest income and capital gains		0,0%	0,7%	0,7%	0,7%	1,4%
Improvement in tax collection		0,0%	0,0%	0,0%	1,1%	1,1%
Total revenue (with measures)		**17,2%**	**19,0%**	**19,6%**	**20,0%**	**20,5%**

Expenditure Reduction Measures

Expenditure measures are expected to yield up to **4.0% of GDP by 2024**[31]. These include:

- **Implementation of the, already legislated, electricity sector reform,** which will eliminate all state subsidies to Electricité du Liban ('EDL') by 2024. However, one should note that the part of the state transfers related to the subsidization of electricity prices for households (estimated at 0.7%) will be included in the Social Safety Net package;
- **Measures targeted at the reduction of the wage bill**, related to the freezing of certain public sector headcount, as well as the revision of certain excess benefits for specific sectors;
- **Revision and proper implementation of measures on special pensions;**
- **A comprehensive spending review** across all departments of central Government and state-owned enterprises aiming to yield savings of at least 0.5% of GDP.

The expenditure measures will also include a significant envelope for the financing of permanent **targeted social protection programs, rising gradually to 4.0% in 2024.**

Table 6: Expenditure measures (% GDP)

Fiscal measures, as a % of GDP	Estimate 2019	Projections 2020	2021	2022	2023	2024
Total Primary Expenditure (without measures)	**22,4%**	**18,7%**	**18,6%**	**19,1%**	**18,7%**	**18,4%**
Impact of Expenditure Measures		**0,9%**	**1,6%**	**2,6%**	**3,3%**	**4,0%**
Electricity sector reform		0,9%	1,0%	1,5%	2,2%	2,9%
Measures targeted at the wage bill reduction		0,0%	0,2%	0,2%	0,2%	0,2%
Freezing of public sector headcount, conditional promotions		0,0%	0,1%	0,1%	0,1%	0,1%
Revision of certain excess benefits		0,0%	0,1%	0,1%	0,1%	0,1%
Pension reform		0,0%	0,4%	0,4%	0,4%	0,4%
Spending Review		0,0%	0,0%	0,5%	0,5%	0,5%
Introduction of a Social Safety Net Package		**1,0%**	**2,0%**	**2,5%**	**3,5%**	**4,0%**
Total Primary Expenditure (with meaures)		**18,8%**	**19,0%**	**19,0%**	**18,9%**	**18,4%**

[31] Relative to baseline scenario included in the Government's Financial and Recovery Program

(iii) Structural Fiscal Reforms

The gains from fiscal consolidation and debt restructuring need to be safeguarded and sustained by strengthening the functioning of fiscal institutions. In this respect, the following fiscal structural reforms should be introduced, in line with best practice in the rest of the world:

- **A stronger Tax Administration**, either through the enhancement of the already existing entity (for example though digitization (including services towards taxpayers), better management of internal data, the establishment of an independent internal audit unit and a new framework for external audit reporting), or through the creation of an Independent Tax Authority operating on the basis of Strategic Targets agreed with the Government and evaluated on the basis of the accomplishment of Key Performance Indicators.
- **A stronger management of core tax functions**, with reforms to the Tax Identification Number (TIN) system, compliance risk management and collection of tax arrears.
- **Setting up an Independent Fiscal Council**, or an Independent Panel of Experts, on the lines of European fiscal institutions, that will oversee budget execution and report on performance, including possible recommendations on overcoming bottlenecks and inefficiencies.
- **Treasury Single Account (TSA):** The objective of a TSA would be to pool liquid resources and set up an improved cash management framework that would lead to an efficient use of entities' idle reserves and to a reduction in the cost of financing for the State. This will significantly improve the State's capacity to perform treasury operations and manage its liquidity, hence reducing financing costs

d. Debt reprofiling

(i) Settlement mechanism to avoid an internal default

Our Contribution for an economic and financial recovery of the Republic of Lebanon is predicated on the need to avoid an internal default which would compound the already prohibitively high costs of the external default (see below section on Domestic debt reprofiling).

Internal default can be avoided by the Government 's recognition of a simple fact: BdL has acted as the Government 's lender of last resort and, as such, its claims on the Government are those of a preferred creditor. Therefore, as a first step in any viable recovery plan, the Government 's debt to BdL needs to be settled fairly.

Also, Lebanon is a cash-poor but asset-rich country that owns assets worth well in excess of what is needed to restore financial stability.

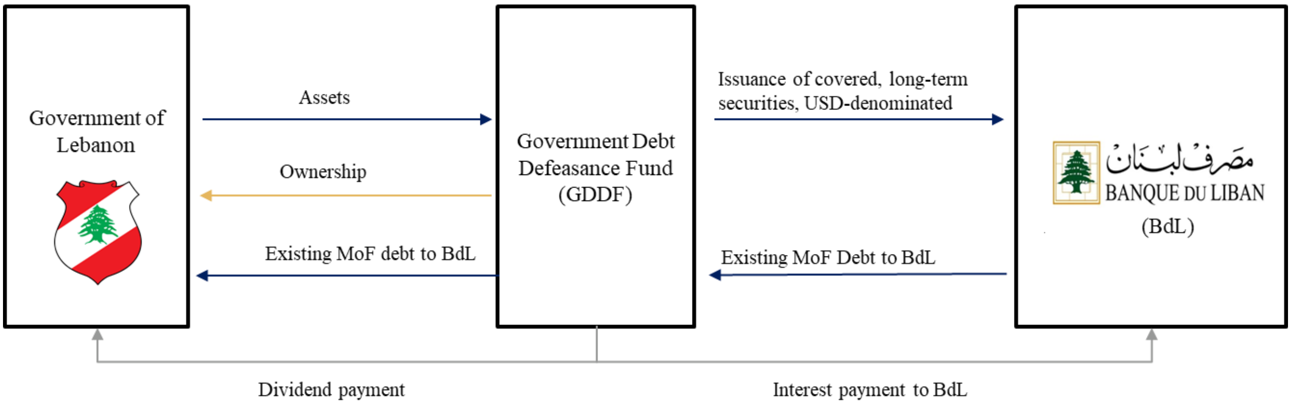
Our plan envisages a settlement of the Government's debt to BdL that would include the following features:

1) The creation of a Government Debt Defeasance Fund (“GDDF”);
2) The contribution by the Government of public assets[32] valued at USD40 bn to the GDDF in exchange for 100% of the GDDF's shares;
3) The issuance by the GDDF of long-dated, interest-bearing, covered securities in the amount of USD40 bn to BdL in exchange for and final settlement of, the Government 's debt to BdL;
4) The delivery by BdL to GDDF of all title and interest in its claims against the Government ;

[32] Public assets include some or a combination of shares in States Owned Enterprises (e.g. telcos), public lands and other public real estate assets, and/or exploitation rights/concessions (e.g., Lebanon's waterfront).

5) The delivery by GDDF to the Government of all of the above title and interest in BdL's claims against the Government , in exchange for the assets contributed by the Government to GDDF; and
6) The Government's cancellation of the debt previously owed to BdL.

Figure 6 : Settlement mechanism



This default-avoiding internal exchange can be executed both quickly and smoothly in the interest of all stakeholders – allowing the Government to move on into dealing with other much needed matters.

(ii) Domestic debt reprofiling

Domestic debt defaults are extremely rare events. The most prominent case in modern history was Russia's 1998 default on its GKOs[33]. While, by keeping current on the Eurobonds recently issued by the Russian Federation (as opposed to the old Soviet debt), Russia kept a lifeline to the capital markets open, the GKO default led to an economic depression (cumulative 36% output contraction). While the Russian economy started growing again in the year following the domestic default, the rebound was largely due to an externality: a sharp increase in the price of oil in 1999-2000 which eliminated the twin deficits. In addition, import substitution from an already existing industrial base which benefited from the devaluation further helped along the recovery.

Should Lebanon default on its internal debt, it is not likely to experience a sharp rebound since the country has scarce natural resources and a limited industrial base. On the contrary, in the case of Lebanon, the fallout of an internal default is likely to lead to a brain drain which will reduce future growth potential, thus leading to a potential "lost decade" at a very low level of economic activity.

Given their rarity, internal defaults have not been widely covered in the academic literature. Reinhart and Rogoff (2008) evaluated the differential response of output to internal and external defaults and confirmed that output fluctuation around default is smaller when default is limited to external debt. Enrico Mallucci (2015) went further and empirically proved that while pure external defaults are associated with output contraction in the 1-2% range, defaults also involving domestic holders are associated with a GDP drop greater than 12% (with the t-test of the means confirming the difference). Reinhart et al.'s and Mallucci's stylized facts are both germane to the current Lebanese situation and the Government's projected 14% output contraction for 2020 underestimates the magnitude of the

[33] Gosudarstvennoye Kratkosrochnoye Obyazatyelstvo, or Government Short-Term bonds

expected recession (should there be an internal default) by at least 10 percentage points. Needless to say, the depression that would result from an internal default would have severe social consequences, with the 2020 unemployment rate projected to reach 45% and the poverty rate 65%.

Lebanon should therefore seek to negotiate a relief package with its domestic creditors. Such relief package would include both maturity extensions which would reduce Lebanon's gross financing needs and monetary pressures, and coupon reductions which would contribute to putting Lebanon back on a sustainable debt path.

This package would require the Ministry of Finance to launch a voluntary debt exchange offer which would be subject to a minimum acceptance threshold of the resident holders (excluding the debt treated with the settlement mechanism) to be set by the Government. The terms of the domestic exchange offer would include a significant coupon reduction to be negotiated in good faith among the parties.

(iii) *Foreign Debt reprofiling*

Lebanon's foreign debt (i.e. the portion of its debt held by non-residents) is, at 16 % of total public debt, at the low end of the spectrum for similarly developed economies. This feature would allow for a relatively friendly restructuring (i.e. one consistent with Lebanon's medium-term debt-servicing capacity) that would, in turn, facilitate the return of Lebanon to the international capital markets. **This is provided that Lebanon does not default in its domestic debt.**

The Eurobond restructuring will consist of a menu of options, including at least one option to exchange the outstanding Eurobonds for new New York law securities and one option to exchange for new securities governed by Lebanese law. The exchange negotiation will be a consensual one based on the International Institute of Finance's Principles for Stable Capital Flows and Fair Debt Restructuring, including:

1) Transparency and timely flow of information

2) Close debtor-creditor dialogue and cooperation
    a. Best practices for investor relations.
    b. Policy action and feedback.
    c. Consultations.
    d. Creditors' support of debtor reform efforts.

3) Good faith actions and voluntary good faith process.
    a. Sanctity of contracts.
    b. Vehicles for restructurings.
    c. Creditor committee policies and practices.
    d. Debtor and creditor actions during restructuring.

4) Fair treatment avoiding unfair discrimination among affected creditors.
    a. Fairness of voting

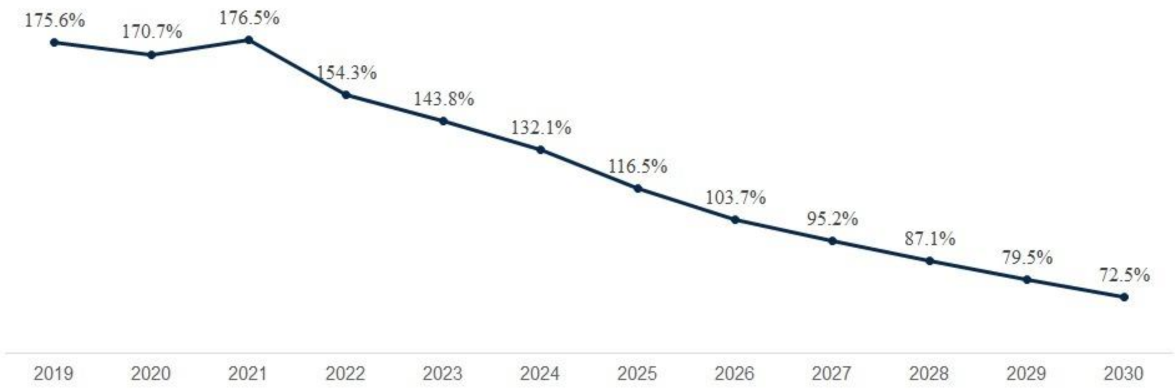
(iv) *Debt sustainability analysis*

The comprehensive debt restructuring outlined above needs to be i**) sustainable for the purposes of Lebanon's capacity to attract capital to finance its ambitious economic vision, and ii) "sustainable**

with high probability”[34] in order for Lebanon to be eligible for an IMF exceptional access program.

It is. We outline below the results of our debt sustainability analysis (“DSA”), as applied to our projected macro framework and comprehensive debt restructuring proposal, including the settlement mechanism. The debt-to-GDP ratio would **decrease in 2020 to 171**%, slightly bounce in 2021, and would after that steadily decline to **72.5% in 2030.**

Figure 7: Evolution of debt-to-GDP ratio pro forma of ABL’s restructuring scenario, % of GDP



e. Financial sector restructuring

There is a need for a clearly phased and timely implementation of measures in order to maintain confidence in the financial sector of Lebanon. **The first priority is the settlement of the Government’s debt to BdL**. The banking sector restructuring should follow with a careful, progressive, and case-by-case approach. **A one-size-fits-all approach of the banking sector restructuring would be very detrimental to the economy as a whole** given the specific place of banks in the Lebanon. The process should thus avoid any banking sector’s default on its depositors.

In addition to the specific contribution of banks to the financing and the economy and the overall GDP (banking sector accounts for 6% of GDP), banking sector restructuring is a major building block of the recovery as:

- **(i)** **The banking sector’s overall health has a strong impact on any sovereign rating** and especially in Lebanon, given its relative size. A credible banking sector (i.e., a banking sector which didn’t default on its depositors) is therefore **key to Lebanon’s plan to re-access the international capital markets;**
- (ii) **The banking sector’s consolidated balance sheet is inextricably linked to those of BdL and the Government,** which renders the banking sector central to the solution of the current crisis;
- (iii) **The banking sector has traditionally accounted for a disproportionate share of the Government’s tax receipts**; and
- (iv) **A properly functioning banking sector serves as the breeding ground for the early career of professionals and other white-collar employees** who would then move on to become entrepreneurs or find a place in the newly diversified Lebanese economy.

[34] As defined in the IMF’s 2015 Exceptional Access Framework.

Banking sector and sovereign rating

Rating Agencies assess banking as follows:

- **S&P**: the banking sector assessment impacts the fiscal score and can lead to adjustment of up to three notches. Additionally, S&P has the flexibility to adjust the indicative rating by two notches to take into account specific weaknesses of the sector;
- **Moody's**: the banking sector health is factored in the Susceptibility to Event Risk, which may have a strong impact on the overall rating as it sets the floor for the overall risk assessment. Moody's assesses the banking sector based on two metrics: the quality of the banking sector, as per its own methodology, and the Asset/GDP ratio;
- **Fitch**: the Sovereign Rating Model does not rely on an indicator specific to the banking sector. However, the qualitative overlay enables the agency to adjust the rating by up to three notches in total, through structural features, which take into account financial sector risk, and public finances, through the contingent liabilities.

Potential options ahead

The deep recession which started last year, together with the de-facto devaluation, the Government's decision to default on its Eurobonds, and its announcement of their intent to default on the remainder of the country's internal debt, have all undermined the banking sector's capital position.

Capital shortfalls will have to be assessed by the regulator on a case-by-case basis under the aegis of the Basel III systemic event forbearance system and the regulator will decide what institutions, if any, need to be resolved. We anticipate that the regulator may also encourage some of the more weakly-capitalized financial institutions to merge, while others will be allowed to continue operating as going concerns subject to full compliance with Basel III capital and leverage ratios by December 31st, 2025.

Each Lebanese financial institution seeking to continue to engage in banking activities in Lebanon will have to file the following documents:

- **A business plan** for the period commencing 01/01/2021, consistent with the economic activity diversification vision articulated in this plan and with the Government's anticipated financing needs;
- **A recapitalization plan** including:
    - Capitalization modality:
        - Voluntary deposit-to-capital conversions,
        - Revaluation surplus of fixed assets,
        - Fresh capital (Tier 2, Additional Tier 1, Core Equity Tier 1)
    - Source of capital (for beneficial ownership greater than a percentage to be determined)
        - Identity of beneficial capital provider
        - Capital provider due diligence memorandum
        - Capital provider audited financial statements
    - Capital adequacy timeline
        - Capital event deadline
        - Type of capital
        - Date of full Basel III compliance

f. Emergency Social Safety Net to fight poverty

Lebanese people are facing rising poverty and social distress, compounded by the outbreak of the COVID-19 crisis (Figure 5), that could result in having c. 45% of the population living under the upper poverty line[35]. Already before the pandemic outbreak, high inequality (Lebanon ranked 129 out of 141 countries in terms of income distributions equality as of 2017[36]) and unemployment rate (estimated at 20% by the IMF in October 2019[37], before the sovereign default), coupled with the country's sizeable informal economy (estimated to account for 60% of the economic activity) translated into a situation where more than half of the labor force is not covered by social insurance[38].

Despite that, the Government's much needed social spending is almost non-existent and anti-poverty measures account for less than 1% of the country's GDP in 2020[39], excluding the Treasury advances to Electricité du Liban.

The Treasury advances to EDL – which are not included in the Government's budget **– may, to a large extent, be considered as additional public support for the Lebanese households, amounting to around 2% of the country's GDP in 2020.** The rationale behind that is that bulk of the Treasury's transfers to EDL are usually dedicated to the reimbursement for purchases of gas and fuel to the suppliers KPC and Sonatrach. Hence, 2020's transfer of LBP 1,500bn[40] can be considered as subsidies to the energy sector that benefits Lebanese households by reducing their electricity bills.

Social spending is also supported so far by the National Poverty Targeting Program (NPTP) and its expansions (such as the Emergency NPTP). This Program played a key role in protecting the most vulnerable Lebanese households (target is to support more than 450,000 direct beneficiaries by end 2020). These programs are co-financed by the World Bank, the United Nations High Commissioner for Refugees (UNHCR) and the Government of Lebanon. Over 2014, 2015 and 2016, the NPTP materialized into USD 202.2 mm for social assistance (equivalent to c. 0.4% of GDP) in the form of (i) food vouchers, (ii) health benefits and (iii) education benefits to the poorest households in Lebanon.

The current crisis calls for an important uplift of social policies overall. First, in the immediate term, the magnitude of the crisis calls for additional spending dedicated to fight the pandemic outbreak. Second, making a fresh start by reallocating unproductive current spending towards social measures will be key for Lebanon's output growth.

Lebanon is thus left with no choice but to establish a bolder version of its Social Safety Net amounting to 4% GDP by 2024, to contain poverty, vulnerability and social distress inherited from the past and from the ongoing crisis. This is particularly relevant as the Government's Financial Recovery Plan aims to get rid of Treasury's advances to EDL by 2024. Hence, a revamped SSN would need to offset the negative impact on Lebanese citizen's electricity bill, stemming from the considered decrease of Treasury advances to EDL. A relevant option to be considered to bolster the SSN would be to establish a universal basic income. To ensure smooth implementation, a gradual approach could be

[35] The World Bank, Factsheet, Targeting Poor Households in Lebanon, April 21, 2020.
[36] Ministry of Finance, United Nations Development Programme, Assessing Labor Income Inequality in Lebanon's Private Sector, February 2017. Note: "*Results show that private sector earnings are disproportionately distributed between income groups with the top 2 percent capturing a share of income almost as high as that of the bottom 60 percent*".
[37] IMF Country Report No 19/312.
[38] Ibid.
[39] Ministry of Finance, Citizen budget, Lebanon 2020.This number does not include the Treasury advance to EDL (LBP 1,500bn in 2020) and other treasury expenditures of the central Government (LBP 1,300bn).
[40]As per Ministry of Finance, Citizen budget, Lebanon 2020

adopted, starting from a 1% GDP increase in 2021, up to 4% in 2024. 2020 and 2021 exercises should see the steeper increase in social spending to help households withstand the impact of the crisis (Table 5).

2. STRUCTURAL REFORMS TO RESTORE SUSTAINABLE AND INCLUSIVE GROWTH

Lebanon's economy is caught in two-crises-in-one: a chronic crisis of public sector mismanagement that has long impeded Lebanon's development, and the devastating COVID-19 crisis that took the world by storm this year. The path to economic development involves resolving some long-term imbalances as a matter of priority; dealing with the effects of the COVID-19 crisis and laying the stage for economic recovery next (within 6 months and 18 months, respectively); and finally focusing on a medium-term legislative and institutional pro-growth agenda.

Lebanon needs to diversify the economy towards high value-added productive sectors and hard-currency generating services, away from the domestic services-dependent current GDP structure. This will lead to higher resilience, improved sustainability of the Balance of Payments, bolstered productivity, and, eventually, higher GDP per capita. We have identified key sectors that will support such a strategy. The energy sector is one such cornerstone, as its reform will also contribute to public finance sustainability and overall enhance business environment in Lebanon.

Other reforms considered to bolster Lebanese growth are related to **the business environment,** and include regulatory, administrative, and governance challenges. Besides, Lebanon must take action to **reduce the informal economy.**

Several sources of external funding could support the implementation of these reforms.

a. The path towards economic diversification

(i) Key productive and high value-added sectors to diversify Lebanese economy

If properly managed, the Lebanese economy can be diversified away from the domestic services sector and increase its growth potential[41]. Even if the COVID-19 crisis may delay the full expansion of new businesses, the sectors listed below can structurally thrive in Lebanon and contribute to its growth, beyond the crisis.

Productive sectors could include:

- **Transportation:** in 2016, the sector accounted for 3.6% of GDP with 70% of trade flows passing through the Port of Beirut and 20% through Rafic Hariri International Airport. However, products seem to stay at the Port of Beirut for an excessive 13-day average. The transportation sector seems to suffer from *"inefficient integration between ports and roads and an unclear differentiation approach between Beirut Port and Tripoli Port*". With regards to the airport, 6 million passengers' capacity is exceeded by its 8 million annual demand above. The sector is also characterized by low-quality roads (only 15% of roads are deemed to be of good quality). **Lebanon has sub-par infrastructure because of limited capital expenditure.** In 2018, Lebanon ranked low out of 137 countries in terms of quality of roads (121), air transport (100) and ports (91)[42]. Constraints on land transportation have been further aggravated by the

[41] McKinsey, 2018 also covering some sectorial findings included in this section
[42] World Economic Forum.

Syrian crisis since 2011. More **capital spending is needed** to build efficient infrastructure. Also, there must be a focus on **developing a public transportation network** system (share of public transportation is extremely low at 2%) that is efficient and safe.

- **Agriculture:** Lebanon possesses **the largest arable lands in the Middle East** and has therefore the potential to become one of the main suppliers of high-quality fruits and vegetables to the region. However, Lebanon's agricultural sector suffers from many shortcomings such as **low productivity** for many crops because of old techniques (olives); low-value crops (tobacco is cultivated at a loss); unfair practices by markets and distributors to farmers, non-compliance with international standards, and **poor infrastructure for after-harvest activities**, making it hard to reach global markets as exports. Even though cannabis cultivation has been recently legalized, the lack of supervision makes it uncertain whether this legalization will be efficiently exploited to benefit local producers or create even more illegal trade amongst locals.
    - The agricultural sector can benefit from the **adoption of modern methods and technologies**; supporting the transition towards **higher-value crops** and livestock: value chain analysis across all products, an opt-in subsidy program for tobacco farmers, support R&D ; and most importantly easing **access to international markets**.

- **Manufacturing industry:** Lebanon should exploit its creative edge to become a leader in high value-added artistic products. It should prioritize high-potential domains such as **food-processing, high-end design, marketing in jewellery, furniture, fashion, cosmetics and soaps**; and high-value added products such as **pharmaceuticals**. This developmental leap could rely on industrial parks or **special zones with dedicated and improved infrastructure and services**.

Other high value-added sectors could include:

- **Knowledge economy:** the knowledge economy relies on the **importance of skills** in a service economy like Lebanon's, and on **information** as a differentiating factor for businesses, in particular as information technology facilitates trade in the **digital economy**.
    - Lebanon has a strong educational system and talented graduates; however, most of these talents have been leaving the country to build a more secure future abroad. However, digitization is low across economic sectors and the Government; the sector is small and relies on outsourcing. However, there are creative industries (fashion, film) that are inherently competitive but face challenges such as limited access to funding and subpar sector governance and infrastructure.
    - To enhance the knowledge economy, Lebanon should increase **the attractiveness of its educational programs to international students, perhaps** through exchange programs with selected international schools and seeking in general more collaboration with foreign programs. Moreover, Lebanon has the potential to become **a regional creative hub** in specific niches such as branding. The country could also target becoming a leading regional **outsourcing destination for back-office services** such as finance and accounting, HR, marketing and sales, as well as a global hub for research and analytics service desks.

- **Healthcare:** the healthcare sector is one of the most important sectors to be reformed and the most in need of reform, a need that has been even more aggravated in the current context of the COVID-19 crisis.

- Performance-wise, Lebanon is in line with OECD countries with respect to average life expectancy at birth (81 years) and neo-natal mortality (5 per 1000 live births). The country is also in line with its peers with respect to the number of hospital beds and doctors (3.4 per 1000 population) and health expenditure per capita (USD 1,100).
- However, there is strong potential in the sector, hampered by structural challenges**: the extremely high share of uninsured people** (40% of total population remains totally uninsured), and **the fragmented hospital network** (65% of hospitals have less than 100 beds). Addressing these shortcomings would yield significant economic and sanitary results.

(ii) *Reform of the electricity sector*

The energy sector is pivotal for the implementation of the much-needed structural reforms of the Lebanese economy. Investing in its electricity sector would allow Lebanon to start filling its electricity gap[43]. Importantly, leveraging renewable energy sources could allow Lebanon to double[44] its energy supply, while increasing its reliability and reducing the country's dependence on imported energy (in particular from Sonatrach and Kuwait Petroleum Corp 'KPC'). The implementation of the long-delayed energy sector reform features prominently in our strategy for an orderly resolution of the crisis.

Ensuring the availability of and access to energy is an enabler for the country's potential output and for the effective reduction of poverty in Lebanon. Building additional energy capacity - through renewable energy sources - would thus help to alleviate the continuous power shortages that have been constraining the country's GDP growth for years.

- **The Government should aim for more ambitious and gradual targets by 2030 regarding the share of renewable energy in the overall energy mix**[45] (i.e., up to 40% to 50% of energy to be sourced from renewable energy by 2030, as proposed by the Lebanese Foundation for Renewable Energy);
- Hence, bolstering the Lebanese energy sector will indeed contribute to **unlock the growth potential of Lebanese productive sectors such as industry and agriculture**, which to date, respectively account for only 8% and for 3% of the country's GDP. It would in turn, pave the way for durable (and sustainable) growth.

In addition to securing more efficient and affordable energy sources[46] (reduced generation and distribution costs), developing Lebanon's renewable energy would **positively impact the country's public finances - in a structural manner.**

- In the short-term, building plants would weigh on public deficits and potentially eat away already insufficient Government's capital expenditures from more needed investments (e.g. transport infrastructures). Indeed, in 2020, budgeted capital expenditures are set to reach the historically low level of 2% of the total budget, accounting for less than 0.5% of the country's GDP[47]. Reallocating the budget towards more relevant capital expenditures will increase the country's potential output growth;

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[43] Note: In 2018, while electricity demand peaked at 3500MW, maximum recorded available power was 2,050MW.
[44] Estimates from, the Lebanese Foundation *for* Renewable Energy (A new energy vision for a new Lebanon - Solar, wind and hydro unleash a Green Energy Revolution), May 2020.
[45] The Government energy plan targets to integrate renewable energy at 30% of the energy mix by 2030.
[46] Note: Lebanese energy costs are estimated at 17 cents per kWh (35 cents per kWh including losses and generators), according to the Lebanese Foundation *for* Renewable Energy.
[47] Source: Ministry of Finance, Citizen budget, Lebanon 2020.

- Overall, total budget expenditures for 2020 (as per the Ministry of Finance's Citizen Budget for 2020) were estimated at LBP 18,231bn, excluding Treasury's advances to EDL, which amount to additional LBP 1,500 bn, (i.e., 2% of GDP). The purpose of those sizeable Treasury transfers is to reimburse energy purchases from international suppliers (KPC and Sonatrach). Achieving energy autonomy would facilitate cutting those transfers, as shown in our medium-term fiscal strategy;
- In addition, reducing the country's reliance on relatively expensive imported energy will also translate into a positive impact on the country's external account.

Multilaterals' appetite for renewable energy projects is high and could help funding the country's transition towards a cleaner energy mix. The International Finance Corporation, the World Bank, CEDRE and/or the European Investment Bank[48] may be interested in supporting the growth and diversification of Lebanon's energy mix. The support of multilaterals[49] should in turn attract private sector investments into the country. Additionally, private sector and multilaterals involvement in the development of the Lebanese energy sector might also result in the curbing of existing corruption dynamics.

b. Improving the business environment

(i) Legal and administrative improvements in the environment for Doing Business

Creating a favorable business environment in Lebanon is instrumental to successfully exit the crisis as it will contribute to both attract foreign direct investments and bolster domestic growth. To guide reforms that will contribute to recovery from the crisis, the Lebanese Government benchmark itself against the World Bank's Doing Business Index. This index has recently been used to guide the reform efforts in Jordan, Bahrain, Saudi Arabia and the United Arab Emirates, all top reformers in 2018 and 2019 globally.

Significant progress can be achieved in Lebanon in 2020-2021. Lebanon has been falling in Doing Business ranking since 2015, when it ranked 104th. Moving from the current 143rd place to 100th place would be associated with a 1.9% increase in annual economic growth over the next ten-year period. This would add USD 1.1bn to the Lebanese economy in 2021, and USD 14bn cumulatively by 2030.

To achieve this, particular focus should be given to the areas of starting a business (where Lebanon ranks #151st out of 190 economies), registering property (#110), protecting minority investors (#114), and dealing with construction permits (#164).

- **Cost and procedures to start a business could be simplified.** The minimum capital requirement of LL5 million could be eliminated, as Turkey and Egypt did in 2018. Also, numerous procedures could be merged. It takes 8 steps in Lebanon versus 6 on average in the region to create a company. For instance, all the steps performed by the Ministry of Finance could be merged (Notifying the creation of the company, registering the company at the National Social Security Fund and Registering for VAT);

- **Registering property** could be significantly eased, as it requires 37 days in Lebanon versus 17 in Jordan, and costs 6% of the property value to be compared with 1% in Egypt. Lebanese quality of land administration lags behind peers, as the country scores 16 out of 30 in the World Bank's indicator, while Jordan scores 22.5 and Turkey 27;

[48] This list is purely indicative and not exhaustive.
[49] Multilaterals like the EIB have a multiplier effect of 8.

- **Minority investors' protection** could be improved, in particular corporate director liability (more limited in Lebanon versus Egypt, Jordan, and Turkey), shareholders' rights (presence of audit committees like in Jordan, presence of non-executive board members like in Egypt), and corporate transparency (e.g., disclosure of individual managers' compensations like in Jordan, or board members' primary employment and directorships in other companies like in Turkey);

- **Requirements to get a construction permit** could be streamlined. 22 procedures are needed in Lebanon, as compared to an average of 16 in the region. As a result, it takes more than nine months to secure a construction permit in Lebanon, i.e., more than the double that in the rest of the region. In Jordan for instance, the process takes only two months.

Announcing a goal to join the top-100 in the Doing Business ranking by the end of 2021 will have a positive effect on investor sentiment.

(ii) *Comprehensive reform of public procurement*

Public procurement - the process by which Governments purchase goods, services and works from the private sector- amounted **to USD 6.7bn or 12% of Lebanon's GDP in 2019.** Improving the efficiency of the procurement process can save significant Government resources. Empirical analysis suggests that up to a third of contract value is lost in inefficient processes.

The World Bank has developed a prototype Contracting with the Government indicator, which contains four components: 1. Procedures, 2. Duration, 3. Legal framework, and 4. e-procurement. This indicator serves as a basis for Government action.

At present Lebanon can improve significantly in each of its components.

- For **procedures and duration**, the indicator benchmarks two phases of the procurement lifecycle:
  - Lebanon takes nearly 15 months to complete the bidding phase;
  - Lebanon takes a further of 17 months in the contract management phase.
- Lebanon's **legal framework** on public procurement is outdated**.** A proposed draft law has not been advanced to Parliament since 2016. Its articles address Government practices that promote transparency, competition and integrity of the evaluation of the bids.
- Lebanon also needs an **electronic platform** to carry out the public procurement process. The current procurement portal of the Lebanese Government is not functional.

(iii) *Streamlining public administration to improve the quality of services for households and businesses*

Lebanon scores poorly on many indicators of public sector governance. Its performance is not only below the regional average, but also has declined significantly over the past decade. According to the Global Competitiveness Index (GCI), institutions are the third weakest comparative constraint of the country, and although the gap between Lebanon and comparable countries is not as large as in the case of infrastructure (main constraint) and the macroeconomic environment (perceived by investors as the second largest constraint), it is nonetheless substantial.

Lebanon's institutions rank 139 out of 144 countries in the 2019 GCI. Lebanon ranks among the 10 percent worst countries in the world (71 percent) in 15 of the 21 institutional sub-indices. Out of 144 countries, Lebanon's worst rankings are for public trust in politicians (144), wastefulness of Government spending (143), favoritism in decisions of Government officials (142), and irregular payment of bribes (142).

A significant gap exists between the official dimensions of governance and the practical implementation of regulation, leading to weak accountability and impunity. A large and growing number of senior positions in the administration remain vacant due to deadlock on hiring based on confession, exacerbating unclear lines of accountability. Regulations governing income and asset disclosure are weak, as are conflict of interest regulations.

More generally speaking, any guided change should be associated with reforms in the role of the state. The state has to be positioned as enabler to catalyze private sector development. As in most economies in the region, Lebanon has large employment in the public administration — some of it part of the long-standing social contract and some as employer of last resort. The unraveling of the old, inequitable social contract should be accompanied by public service reforms that retain talented workers, while providing everyone a basic income. Having a more efficient public administration focused on such key state functions as promoting universal education and health and assuring fair competition will end the rent-seeking behavior that has retarded Lebanon's growth. It will empower the millions of educated women and men hoping to ride a wave of innovation to prosperity.

(iv) Asset disclosure and conflict of interest regulation

In Lebanon, the **World Bank's stolen assets recovery initiative (StAR) initiative can be invoked as part of a National Recovery Plan**, with the goal of redressing past abuses of public trust. StAR may prove useful for assessing the allegations that some former politicians have benefited from their public office and advise on the process of asset recovery. The two national laws designed to control, prevent, and criminalize acts of corruption in Lebanon—Law 44 (2015) on anti-money laundering and terrorism financing, and Law 55 (2016) on the exchange of information for tax purposes - are ineffective and need strengthening.

- In particular, **Law 44** states that the Special Investigation Commission (SIC) of Banque du Liban (BdL) is the focal point within the authority to seize possibly suspicious bank accounts and to confiscate the movable and immovable assets that are proven to be the results of money laundering activities;
- The **National Anti-Corruption Commission (NACC)** is yet to be established, and support from StAR could result in its timely creation.

The Stolen Asset Recovery Initiative ('StAR') has been jointly established by the World Bank Group and the United Nations Office on Drugs and Crimes (UNODC) as a catalyst of international efforts to put an end to safe havens for stolen assets. StAR is active in every part of the world. Countries that have resorted to World Bank for StAR support include:

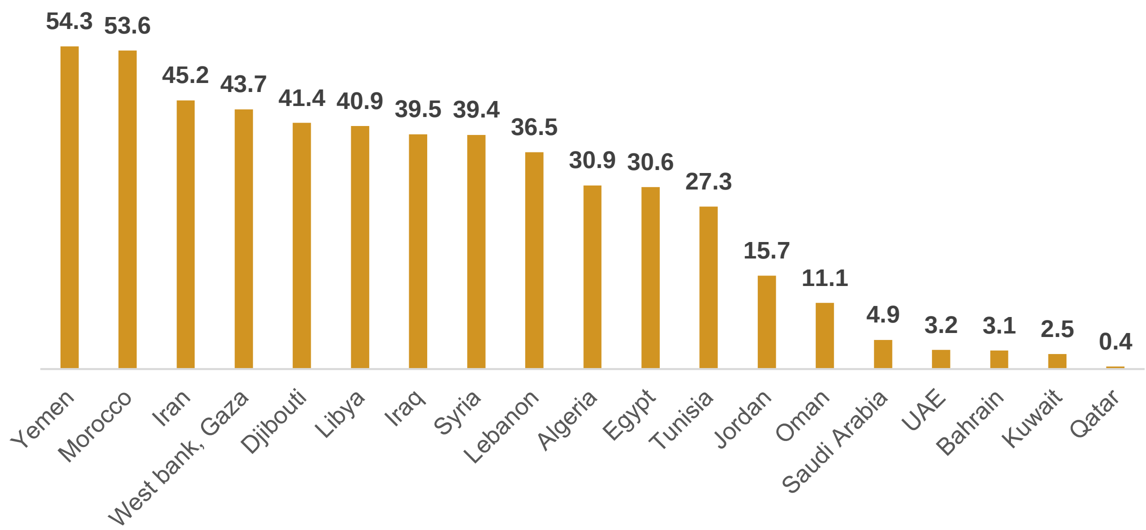
- **Ecuador**, where StAR assisted in the work to establish an inter-agency asset recovery group, in addition to training 73 staff in the newly created anti-corruption commission;
- **Ukraine** which was supported by StAR when seeking a USD 75 million asset recovery in the United Kingdom;
- **Tanzania**, where assets recovered with StAR's support financed the creation of an anti-corruption office;

- **Argentina**, which used the initiative for the creation of a new financial disclosure system for public officials.

(v) Incentives for business to join the formal economy

A key challenge in the recovery phase is to **redirect fiscal incentives toward job creation in the formal sector**. The challenge is widespread in the MENA region, which has to take steps to move away from the corrosive duality of a split informal and formal society (Figure 8). The pandemic has left the informal sector in distress and an even riper source of unrest than before the COVID-19 crisis emerged.

Figure 8: Informality looms large in Lebanon – Self-employment in the MENA Region, as % of total employment in 2018, source: ILO



Note: Bars indicate self-employment as a percentage of total employment in 2018, modelled ILO estimate

Reducing informality should be at the top of the Government's long-term plan. Only formal firms can participate in regional or global value-chains. Only formal firms can grow by using various financing schemes supported by the Government. Yet around 60 percent of economic activity in Lebanon is informal. Small firms are reluctant to register and formalize their activities, largely because they see registration as having few benefits. Among larger informal firms, the time, fees, taxes, and inspections that registering involves also matter for their decision to remain informal, indicating a propensity to opt out of the formal sector as a mechanism to escape policy enforcement. According to the World Bank, three-quarters of informal owners report that they do not register their firm because they see no real benefits to registration. The other main reasons given are the time and fees involved with the process and higher taxes. As said earlier, the World Bank's Doing Business report shows that the minimum capital requirement for a new company in Lebanon far exceeds that in other countries in the region.

Policies designed to incentivize the joining of the formal economy involve easing the participation of small firms in the public procurement process, a new credit factoring program, and strengthening existing SME credit guarantee schemes with the participation of commercial banks. Other SME support programs have to be revamped, with a view towards sectors in need of liquidity. During the recovery phase, some sectors will be slow to regain their demand, as uncertainty will weigh on consumers or restrictions will make it difficult to do business as usual. For such sectors, prolonged support is necessary, focusing on job retention.

Programs to increase formalization would have more impact if they were combined with policies to improve access to finance, reduce taxes, and simplify tax procedures for small firms. Informal entrepreneurs see the main benefits to formalizing as being to improve access to finance (nearly half the firms), to be able to issue receipts and attract customers, and to have better access to raw materials and Government services. Few entrepreneurs expect formalization to reduce bribe payments – other mechanisms for improving public sector governance are necessary.

Productivity should be enhanced by promotion of fair competition and the adoption of digital technology, especially in electricity and telecommunication. These enhancements would be especially important to the informal sector, as it would gain access to services and markets previously accessible only to the formal businesses.

(vi) Enhanced education system

Competitiveness of Lebanese businesses will be mostly enhanced by a concerted investment in human capital. Education in Lebanon is characterized by multiple adjacent systems, including public and private systems, functioning independently from each other. Public schools educate only about a third of students, even though they are free. This preference for private schooling reflects the poor quality of public education. Indeed, the 2018 Human Capital Index suggests that Lebanese children to age 18 accumulate about half (54%) of the human capital that children in most European countries do.

The higher quality associated with private schools means that public school students are likely to learn less and face more difficult job prospects on graduation. This sets up intergenerational transmission of both lower learning levels and lower income. The education system in Lebanon, because of its strong stratified nature—along income and confessional lines—does not perform its civic mission of being the accelerator of entrepreneurship and ultimately economic growth. Relative to other countries in the region, Lebanon's secondary net enrolment lags behind, at 67 percent, compared with the regional average of 72 percent. When compared with countries at similar levels of development, Lebanon's secondary net enrolment rate is significantly lower than the average of 81 percent.

Improving the quality of public education requires massive investment, at a scale that Lebanon cannot afford without restructuring its expenditures.

c. External financial support to structural reforms

Mobilizing the diaspora

Lebanon's chronic fiscal deficit has been traditionally indirectly supported by the large Lebanese diaspora. Attracted by high interest rates, the diaspora has deposited billions of dollars in the country's banking system, thus affording the central bank much-needed leverage and flexibility. Deposits from the Lebanese diaspora have accounted for as much as 40% of GDP.

An economic recovery plan designed to avoid internal default and restore confidence will provide incentives to the diaspora to continue banking in Lebanon.

Additional or renewed capital inflows could be channelled in a dedicated vehicle administered independently so as to maximize its impact on the Lebanese real economy.

International financial institutions ('IFIs') and donors

Several IFIs or groups of bilateral donors could also contribute to support Lebanon's economy and finance structural reforms. They include in particular:

- **CEDRE conference**: The objective of the CEDRE conference hosted in Paris on April 6, 2018 is to support the development and the strengthening of the Lebanese economy as part of a comprehensive plan for reform and for infrastructure investments prepared by the Lebanese authorities and presented during the conference. The Government of Lebanon presented its ambitious Capital Investment Program ('CIP'), which is mainly focused on infrastructure development and rehabilitation.
- **IFC:** The IFC is an important contributor to Lebanon's development, in particular alongside the banking sector where it has mostly invested. Indeed, the IFC's cooperation with Lebanon may be summarized by the following:
    - 24 active projects with an estimated budget of USD 306 mm;
    - Top 2 investments being "Bank Audi Equity" (2014) and "SGBL SSL MCPP" (2018) amounting respectively to USD 88.5 and 58.66 mm;
    - The IFC already has ownership stakes in Lebanese banks after acquiring a percentage of the lenders' capital. The IFC also provides long-term soft loans to finance infrastructure investments in collaboration with the private sector;
    - The IFC has already signed a contract with the Government to expand Rafic Hariri International Airport.

  This support could be beefed up. As reported on January 2019, IFC was willing to provide Lebanon with USD 1 billion in investments and soft loans each year if the Government started executing fiscal reforms and allowed the private sector take part in projects. This envelope could be invested to foster any of the high value-added future-proofed productive sectors identified above.

  Naturally, should the Government's plan to forcibly cancel all bank capital instruments be implemented, it is unlikely that the IFC, and indeed even the World Bank, will be willing to continue supporting Lebanon's economy.

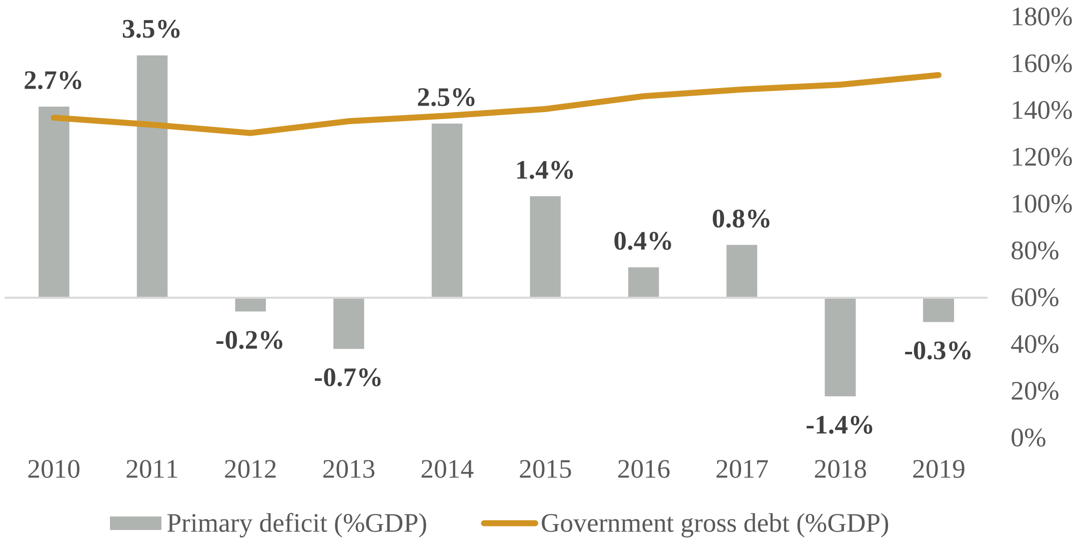
Other Development banks, such as the European Bank for Reconstruction and Development ('EBRD') and the European Investment Bank ('EIB'), are already present in Lebanon and contribute to the development of the private sector in productive areas. Their support could be increased in the context of an internally consistent economic plan.

APPENDICES

a. State of the public finances in Lebanon

Lebanon has been running fiscal deficits for consecutive years, leading to a rising public debt to GDP ratio. As in all MENA oil importing countries after the Global Financial Crisis, public finances were under pressure but in the case of Lebanon, the Syrian crisis added to the strains, due to the inflow of refugees and lower revenue from the disruption of trade routes.

Figure 9: Historical evolution of primary surplus and public debt, % of GDP, source: IMF WEO



Lebanon had managed to sustain large fiscal deficits (together with a high current account deficit) with the inflow of FX deposits. The sudden stop of FX inflows brought about the current crisis and led the Government to defer its debt service payments in February 2020. The fiscal outlook of the country has worsened even more, with the collapse of public revenues. The situation had already been dire, as in 2019 the Government passed a budget with various temporary measures in an attempt to bring down the fiscal deficit from 11% of GDP in 2018 (which had increased by almost 3% from 2017) to 7,6% in 2019. IMF had estimated that these measures would not suffice to significantly reduce the primary fiscal deficit – fiscal balance would be -9,7% of GDP. However, even the pessimistic estimates of IMF were proven wrong as the fiscal deficit of 2019 is estimated by the Lebanese authorities to surpass 11% of GDP.

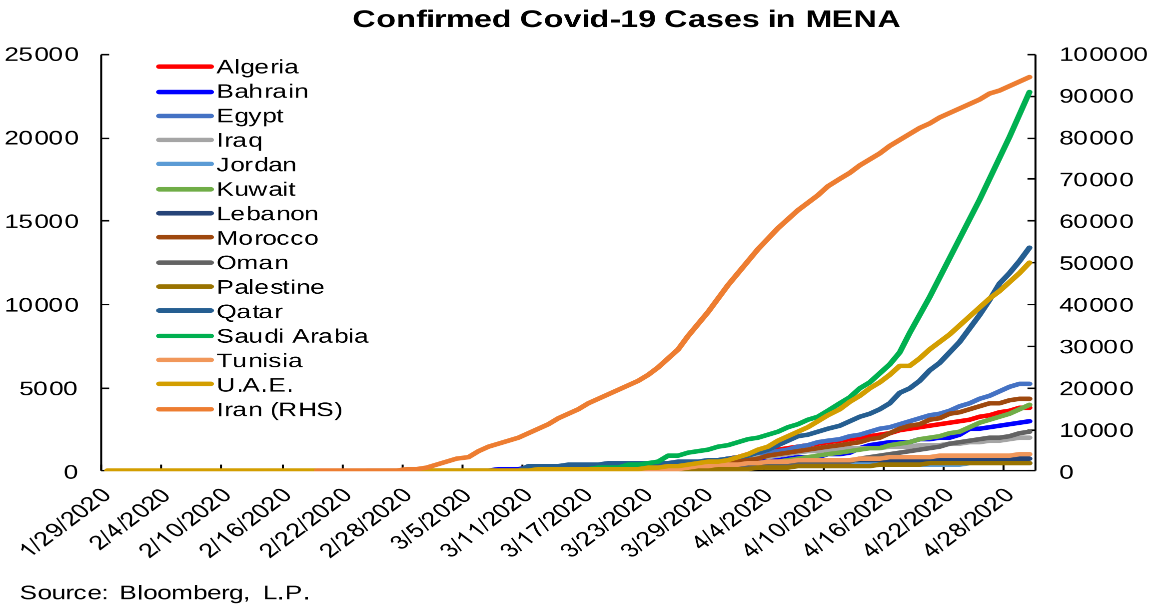
The ease of deficit financing through FX inflows had also led to a loose and inconsistent fiscal policy – the most recent episode being that despite hiring freezes, new hirings in 2017 contributed to higher fiscal deficits. Public revenues have also suffered from the fact that, according to IMF estimates, Lebanon's tax effort is low compared to its peers. Other countries in the region collect on average 60% of potential revenues, while Lebanon collects less than 50%.

Regarding the budget structure of the country, Government primary expenditure is low. Interest payments are extremely high, accounting for 25% of total expenditure in the latest budget. Two thirds of primary expenditure are wages and salaries and more than 10% is directed to the highly inefficient electricity provider. Much needed capital expenditure is very low and has been under-executed in recent years, while the Capital Investment Plan foreseen in the CEDRE conference has not yet been implemented due to the delay in delivering committed reforms. Social protection programs are severely underfunded. Public revenue is close to the average of peers in the region, with 25% being non-tax related, a relatively high portion. Tax revenues remain low, accounting for almost 15% of GDP, mainly due to low rates, especially in income and consumption taxes and a wide range of exemptions. There is also ample room for improvement in the fields of tax administration, compliance and collection, as well as for the strengthening of the function fiscal institutions.

b. Response to COVID-19 crisis

The COVID-19 crisis has brought many sectors of the Lebanese economy to a halt: the result of the lockdowns and social distancing measures imposed to slow the spread of the coronavirus (Figure 10). Locked-down economies have been hit by a combination of supply and demand shocks that threaten mass unemployment and firm closure. Advanced economies and emerging markets have used fiscal and monetary policy measures to finance the health response to the virus, to forestall a collapse in consumption, and to protect the economic fabric—including small- and medium-sized enterprises (SMEs). The policies are also aimed at avoiding mass unemployment by subsidizing employers who keep workers on the payroll and expanding unemployment insurance.

Figure 10: COVID-19 (reported) infections in the Region, number of cases, source: Bloomberg



The global environment has reduced external demand for goods and services from Lebanon—including tourism—cut remittances, and caused capital outflows from the banking sector.

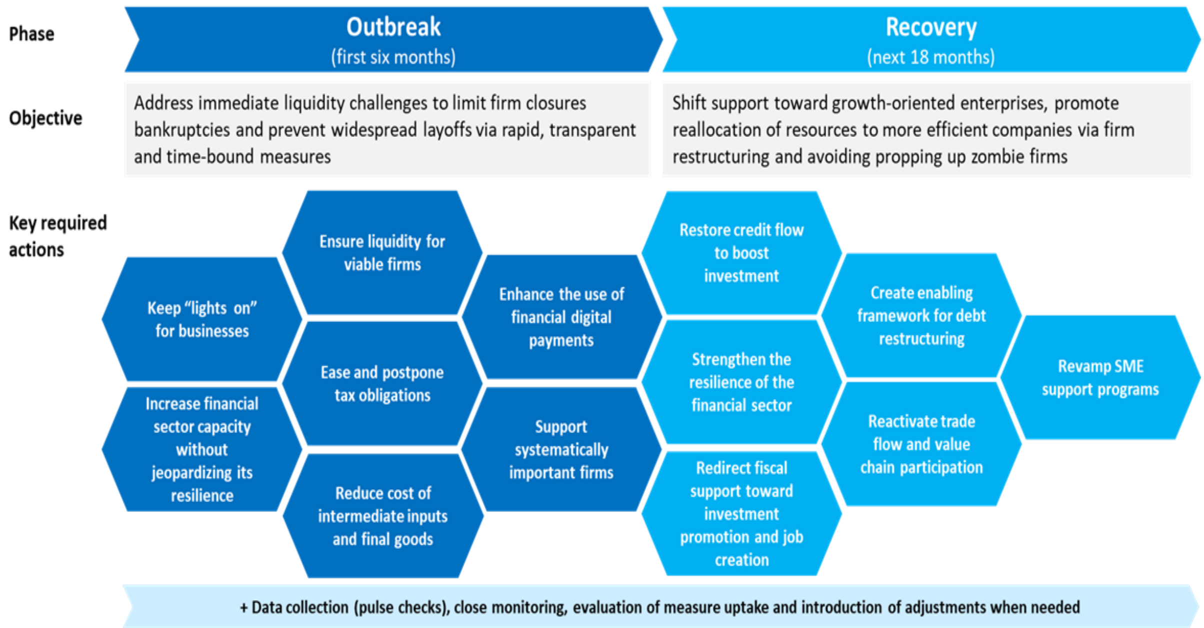
Lockdowns aimed at slowing the spread of virus are however difficult to implement in a country like Lebanon when much of the population works hand-to mouth in the informal sector. The COVID-19 crisis has exacerbated the duality of the Lebanese economy. Workers in the formal sector typically enjoy social protection and a predictable stream of income, faring better during a lockdown than do informal workers who have little access to social protection and no income if they do not work. Because they exacerbate inequality, lockdowns further raise tensions in a period in Lebanon's development already low on social harmony. To soften the economic impact, the Government has extended some measures such as cash transfers and enhanced social protection programs to both existing beneficiaries in the formal sector and non-beneficiaries in the informal sector. But the ability to sustain and enlarge these programs is limited by constraints on Government capacity to spend (fiscal space) that were further squeezed by the large deficit prior to COVID-19.

This limited fiscal space has made it difficult for the Lebanese Governments to pay for medical materials—such as testing kits and respiratory devices—and contact tracing technology and may also impair future access to medicines and vaccines, if they are developed. This danger has to be addressed. Fiscal issues limit Lebanon's ability to contain the disease, which further worsens economic conditions. These, in turn, drive up inequality and poverty.

Monetary policy—which has been overused in recent years—is mainly unfeasible during the COVID-19 crisis, if for no other reason than that it puts further downward pressure on the exchange rate, leading to dire consequences for Lebanon, which is already overindebted. That is in contrast with advanced economies, which largely can borrow in their own currency at close to zero interest rate.

With no venue for monetary or fiscal adjustments, firms in the real economy have no revenues while the lockdown is in place, yet they still pay salaries, rents, and debt interest. These expenditures are often deferred – including through Government-sponsored programs – but rarely waived. The hiatus increases financial pressure on the firms, as a result of which a large number of previously healthy firms may find themselves unable to re-open once the health crisis is over.

Figure 11: The two phases of the COVID-19 Crisis, source: World Bank



The Government and the banking sector have announced crisis response packages to prevent this possibility, for example by rolling over debt and postponing interest payments. These programs inject much-needed liquidity in formal Lebanese firms, but do not resolve a bigger looming issue: insolvency. The gap between lower-than-expected revenues and piling payables – including the new loans that firms have to eventually repay – has to be addressed. And this is not just the case for retailers, travel agencies, businesses in hospitality or entertainment, where demand may pick up only gradually even after the crisis. The COVID-19 crisis has exacerbated existing vulnerabilities in other industries in Lebanon and will slow down their recovery.

Further steps are needed to keep businesses afloat

- First, the Government needs to temporarily suspend bankruptcy procedures, which often dictate that illiquid firms' assets get transferred to their secured creditors. A number of countries have just taken this step. For example, in France bankruptcy law normally gives 45 days from the moment a debtor can no longer pay its debts to filing for bankruptcy. President Macron issued an order that the firms will have three months after the end of the state of emergency (i.e. as things now stand, until September 2020) to file for bankruptcy if needed.

- Second, the Government needs to support systemically important firms, to ensure that widespread layoffs do not take place and that local value chains are not disrupted (Figure 11).
- Third, the use of financial digital payments needs to be rapidly enhanced, both as a health prevention measure but also as a way to reach households whose income is at risk. The banking sector is the only realistic channel through which such intermediation can rapidly take place.
- Fourth, for some sectors reduce the costs of intermediate inputs or final goods, to maintain demand. This propping up can be done through temporary tax measures or subsidies. The purpose, again, is to keep “lights on” for businesses and avoid mass closures.

c. The National Poverty Targeting Program

The cumulated cost of the NPTP amounted to c. USD 214m, which is equivalent to c. 0.4 percentage point of the country's estimated GDP in 2019[50]. The project cost funded the three following components:

- USD 202.2m allocated to the provision of Social Assistance (see Table 9), with the following breakdown:
    - USD 124.2m allocated to E-card Food Vouchers, funding basic food needs;
    - USD 62.3m for Health benefits measures consisting of (i) health coverage through a waiver of 10-15% copayment for hospitalization, (ii) primary healthcare coverage at MOPH primary healthcare facilities or at the MOSA Social Development centers and (iii) coverage of chronic disease prescription medications;
    - USD 15.69m dedicated to Education benefits: registration of fee waivers as well as free books for students in primary and secondary public schools.
- USD 11.18m for administration of the NPTP; and
- USD 0.55m for Fiduciary Operation Team (FOT), responsible for the implementation of the procurement of the project;
- The project targeted to increase the number of eligible NPTP beneficiaries from 2013 baseline 195,000 to 350,000 in 2016.

Table 7 : Cost breakdown of the NPTP (2014-2016)

Cost of the NPTP	USD mm	in % of 2019e GDP
Social Assistance	202.20	0.41%
E-card Food Vouchers	124.20	0.25%
Health Benefits	62.30	0.13%
Education Benefits	15.69	0.03%
Administration of NPTP	11.18	0.02%
FOT	0.55	0.00%
Total Project Cost	213.93	0.44%

NPTP's support was expanded with the Emergency National Poverty Targeting Program Project with the closing date of December 31, 2020. As of January 1, 2020, the Emergency NPTP effectively supported c. 240,000 persons according to the World Bank data, with the aim to support more than 450,000 direct project beneficiaries by end 2020.

[50] Source: Government Financial Recovery Plan

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