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EXECUTIVE BOARD MEETING

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From: The Secretary

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INTERNATIONAL MONETARY FUND

LEBANON

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

May 18, 2023

KEY ISSUES

Context. Lebanon's severe and multifaceted crisis, triggered by sizable deposit outflows and followed by the country's first ever external public debt default, has been raging for more than three years. It was aggravated by the COVID-19 crisis and the Beirut port explosion in August 2020, but also allowed to persist and deepen by a failure to take much needed policy action, hampered by a lasting political crisis and resistance from vested interests to reforms. The economic and social impact of the crisis has been staggering: output contracted by an estimated 40 percent over 2019–22, the lira lost about 98 percent of its value in the parallel market, triple digit inflation has decimated real incomes, and unemployment and poverty have increased sharply. After three years, the public sector is failing, the provision of public services is almost nonexistent, and the banking sector has collapsed. Informality and the shadow economy have increased sharply.

Outlook and risks. Uncertainty is very high and the outlook hinges on the authorities' willingness to implement overdue reforms. Without reforms, the economy will remain depressed with irreversible consequences for the country.

Policy recommendations. The focus should be on policies to restore domestic and external sustainability, promote greater transparency and accountability, and strengthen the social safety net to support the most vulnerable in a targeted manner. In particular, the reforms should be based on the following pillars:

- Credible financial sector restructuring. Actions are urgently needed to restructure and rehabilitate the banking system, by addressing the large losses in the sector, while respecting the hierarchy of claims, protecting small depositors to the extent possible, and minimizing recourse to public financing, given the need to restore debt sustainability. Viable banks should be recapitalized under credible and time-bound plans, and unviable banks should exit the market.
- Medium-term fiscal strategy consistent with debt sustainability. A restructuring of Eurobonds together with an ambitious but feasible improvement in the primary balance should aim to reduce the debt-to-GDP ratio and the gross financing needs to sustainable levels. The tax base should be broadened to create space for higher social and reconstruction spending, while expenditure policy reforms should create a more efficient public administration. Strong international donor financing on concessional terms would be needed to support the authorities' efforts.

- Monetary policy and unification of the exchange rate. The unification of the official exchange rates for current account transactions is critical to restore credibility and external viability. This needs to be supported temporarily by capital and deposit withdrawal restrictions. Foreign exchange interventions should be limited given the need to rebuild reserves.
- Reforming state-owned enterprises (SOEs). Wide-raging SOEs reforms are needed to improve their governance, operational viability and limit fiscal risks, particularly, the energy sector to provide better and fairly priced services without draining public resources.
- Governance, anticorruption, and AML/CFT efforts. Reforms should aim at strengthening transparency and accountability, addressing governance vulnerabilities, and generating a strong buy-in from the population, which views the crisis as the result of systemic corruption. This requires institutional reforms, including removing bank secrecy where needed, mandatory publication of high-level public officials' asset declarations, modernization of the legal framework and governance of the central bank and other banking authorities, and publication of the special audit of BdL, large SOEs, and the port of Beirut.

Approved By
Thanos Arvanitis (MCD) and Mark Flanagan (SPR)

Discussions took place in Beirut during March 15–24 2023. The IMF team comprised Ernesto Ramirez Rigo (Head), Svetlana Cerovic, Robert Tchaidze (all MCD), Frederico Lima (Resident Representative), Hanin Al Fakih, and Rita El Achkar (local economists), Atilla Arda (MCM), Ender Emre (LEG), Geoffrey Keim (SPR), and Natalia Salazar (FAD). Maya Choueiri (OED) participated in policy discussions. The mission was assisted by Subi Velkumar, Cecilia Pineda, Helida Graca, and Ingrid Nehme (local office) (all MCD).

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CONTEXT

1. It has been more than three years since Lebanon plunged into a severe economic crisis, intensified by policy failures and external shocks. Nonresident deposits and other inflows that helped finance large twin deficits for decades, began reversing in 2018 as confidence in the prevailing economic system eroded. This reversal came after many years of challenging economic conditions, policy mismanagement, and pervasive corruption. Regional conflicts, including in Syria and the large inflow of displaced people added to domestic vulnerabilities (Annex V.A). These were further exacerbated by the default on Eurobond debt service in March 2020, the COVID-19 crisis, the explosion at the Beirut Port in August 2020, and Russia's war in Ukraine.

2. With the economy buffeted by a series of shocks, economic activity collapsed, and social conditions deteriorated sharply. Since the onset of the crisis, GDP has declined by about 40 percent, the parallel exchange rate has lost 98 percent of its value, inflation is at triple-digits, and the central bank has lost two thirds of its FX reserves. Unemployment is on the rise, poverty is at historic highs, and many Lebanese have emigrated hoping for a better future abroad. Amidst collapsing revenues and suppressed spending, public sector institutions are failing, and basic services (electricity and water) to the population have been drastically cut. The deteriorating situation has also affected the numerous refugees living in Lebanon.

3. Despite the urgency of the situation, the authorities were not able to implement policies and reforms to resolve the crisis and restore macroeconomic stability. Limited action has been taken since 2019 as three successive governments failed to garner support for a comprehensive policy response to the crisis. To tackle imbalances and structural problems, the authorities requested Fund support, and a staff level agreement (SLA) on a package of policies that could be supported by the EFF was reached in April 2022 (Annex VIII). However, progress on implementing the agreed reforms has been very slow (paragraph 11).

4. Although the outlook remains highly uncertain given the complex political situation, the regional context may be becoming somewhat more favorable. The May 2022 elections resulted in a fragmented parliament with no clear majorities. The government has been in a caretaker capacity since the elections, and the president's term expired in October 2022 with no successor yet identified. Both the election of a president and a government with full powers are subject to complex negotiations along sectarian lines, and discussions so far have not been able to bridge the differences.[1] Moreover, BdL governor's term ends in July, and in the current political environment the appointment of a new governor may be delayed. Against this complex political setting, the recent agreement between Saudi Arabia and Iran to reestablish diplomatic relations is viewed positively as it could potentially facilitate the political resolution. The maritime demarcation

[1] The National Pact of 1943 stipulates that the president of Lebanon should always be a Maronite Christian, the Prime Minister a Sunni Muslim, and the Speaker of the Parliament a Shia Muslim. These elements of the National Pact were reconfirmed by the Taif Agreement of 1990 that helped end the fifteen-year long Civil War. Also, it has been a long-standing practice for the BdL governor to be a Maronite Christian.

between Lebanon and Israel on October 27, 2022 was a welcome development providing Lebanon with an opportunity to explore offshore gas and oil reserves and lowering tensions between the two countries. However, these oil/gas resources will take time to materialize.

RECENT DEVELOPMENTS

5. After a sharp contraction since 2018, the economy showed some signs of stabilization in 2022 but remains severely depressed. Economic activity was supported by the end of COVID restrictions, a rebound in tourism, strong inflow of remittances, and a gradual decline in international energy and food prices in the second half of 2022. In addition, a part of the private sector was able to deleverage by repaying FX loans at below-market exchange rates and benefited from a reduced tax burden. While the authorities are yet to publish GDP figures for 2021 and 2022, staff estimates no growth in 2022. BdL is somewhat more positive, estimating growth of 2 percent. However, high uncertainty, banking sector restrictions, and expensive and very limited electricity supply continued to hinder economic activity. Unemployment is estimated at around 30 percent (58 percent among young people), with half of the Lebanese population currently seen as a vulnerable by UN.[2]

6. Currency depreciation has accelerated, dollarization increased, and inflation remains very high, rapidly eroding lira denominated incomes.

- Without a policy anchor, the lira has been on a free fall in the parallel market, with the pace of depreciation accelerating from 4.8 percent per month on average in 2022 to about 32.3 percent per month in Q1 2023, and the lira dropping to 140,000 per US$ in mid-March 2023, before appreciating somewhat, after BdL announced unlimited intervention on the Sayrafa platform at 90,000 (Annex V.C). The official exchange rate was kept unchanged at 1,507.5 LBP/US$ for the first 2½ years and moved to 15,000 LBP/US$ in February 2023.

- Dollarization has accelerated, with businesses such as hotels, restaurants and supermarkets allowed to set prices in US dollars, and a growing share of private-sector contracts and wages denominated in US dollars.

- Against collapsing money demand, currency in circulation and M1 increased by about 70 percent in 2022, due to BdL's quasi-fiscal operations, financing of the budget deficit, liquidity support to banks to support withdrawals of FX deposits in local currency under numerous BdL circulars, and unsterilized BdL purchases of FX in the parallel market.

- Without effective monetary policy control, inflation remains in triple digits, and has accelerated recently reaching 190 percent year-on-year in February 2023, with food prices increasing by 261 percent (Figure 3).

[2] 2022 Lebanese Crisis Response Plan and January 2022 Lebanon Labor Force Survey.

- Despite the informal capital controls and deposit withdrawal restrictions, FX reserves at the central bank declined to about US$10 billion, compared to US$36 billion at its peak in 2017. The central bank holds an additional US$17 billion in gold.

7. The fiscal deficit widened to an estimated 5 percent of GDP in 2022. Fiscal revenues are estimated to have collapsed to 6 percent of GDP in 2022 (compared to 10 percent of GDP in 2021 and over 20 percent before the crisis). This reflects insufficient valuation adjustment of taxes, excises and fees to exchange rate depreciation and surging inflation, and growing non-compliance due to the collapse of tax administration.[3] The erosion of revenues and limited financing options have forced a disorderly spending adjustment, including on health and education. Real wages for government workers have sharply decreased, causing a significant deterioration of public services and very high absenteeism and resignations among public sector employees.[4] The government has been relying on BdL financing, limited donor support, and the SDR allocation to fund critical spending, including subsidized medicine and electricity. Fiscal accounts do not incorporate large quasi fiscal operations of BdL which, in staff estimates, would further widen the deficit to around [8.5] percent of GDP.[5]

8. After a sharp contraction in 2020–21, the current account deficit increased significantly in 2022. The wider deficit was largely due to accelerating imports, which (in addition to higher international prices) reflect opportunistic purchases to take advantage of favorable exchange rate valuations for tax purposes and possibly over-invoicing to facilitate movement of capital abroad. FDI has remained depressed, as have been other financial inflows. Lebanon remains in default on its Eurobonds and there are reports of some arrears on bilateral and multilateral loans.[6] Reflecting these developments, the overall external sector is assessed as weaker than implied by fundamentals and desirable policies in 2022 (Annex III).

9. Banks have reduced their services to a minimum, and essentially stopped extending credit. While they continue imposing informal deposit withdrawal restrictions, there is considerable leakage, and FX deposits have declined by US$30 bn since the crisis. The FX loan book has decreased by US$27 bn with many loans repaid in local currency at the official exchange rate (Box 1). Although the sector reports a positive capital position of US$12 bn at the official exchange rate, recognition of losses on their BdL and sovereign exposures will mean large capital shortfalls for most banks.

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[3] The recent FAD TA mission estimated the revenues forgone in 2022 due to mis-valuation of customs and taxes at the border to be 4.8 percent of GDP, and additional 0.8 percent of GDP to have been lost because of the inflation impact on specific taxes and excises.

[4] Starting from end 2021 the government increased several times salary and transportation allowances, including 200 percent salary allowance increase ratified by the 2022 Budget, and allowing government employees to withdraw their paycheck in US dollars at the Sayrafa rate subsidized by BdL. The latest increase was approved in April 2023.

[5] Quasi-fiscal operations of the BdL primarily pertain to: implicit subsidies through the sale of FX to government, public sector employees and certain segments of the economy at favorable exchange rates, and not collecting interest on its holdings of T-bills.

[6] At the end of 2022, Lebanon reported arrears of US$ 39.6 million owed to both bilateral and multilateral creditors.

10. The electricity company is under significant financial and operational strains and only able to provide electricity for 3–4 of hours per day. Limited supply from Electricité du Liban (EdL) creates severe constraints on economic activity, with households and businesses dependent on expensive privately-run small-scale generators. The government struck a deal with the World Bank in June 2022 to finance gas purchases from Egypt that could increase EdL electricity provision, but the project conditions have not been met. In November 2022, electricity tariffs were increased for the first time since the 1990s (Annex V.E). Other SOEs are also in a precarious financial position.

11. Faced with the enormous challenge of addressing an unprecedented crisis and rehabilitating the economy, the authorities requested the formulation of a program that could be supported by the Fund (Annex VIII). However, there has been little progress in implementing the prior actions agreed under the 2022 SLA.

- The budget for 2022 was enacted only in mid-November with parameters different from those that were discussed during the SLA negotiations and few reform measures.
- The current draft law on capital controls and deposit withdrawals falls short of staff advice and requires considerable revisions to effectively support the banking sector restructuring strategy.
- The Banking Control Commission of Lebanon (BCC)—in consultation with IMF staff—is preparing an emergency bank resolution law and the terms of reference for independent external assessments of the 14 largest banks. However, this work cannot be completed without political decisions on the specifics of the banking sector restructuring strategy.
- In October 2022, parliament adopted a new banking secrecy law. Despite major improvements over previous framework, critical issues complicate implementing the banking sector restructuring strategy.
- The special audit of BdL by an internationally reputable firm was completed, and the report is expected to be released soon.

OUTLOOK AND RISKS: REFORMS VS. STATUS QUO

The outlook is highly uncertain. The discussions with the authorities focused both on a reform scenario, which is the authorities' stated strategic objective, and the continuation of the status quo.

12. The reform scenario is based on discussions staff and the authorities had in recent months on a comprehensive program that, if decisively implemented, could steadily reduce imbalances, rebuild institutions, and set the stage for the rehabilitation and recovery of the economy. While the authorities remain committed to the reforms envisioned in the program, their implementation is unlikely until the election of a new president and an approval of a cabinet with full powers take place.

13. The quantification of the macro framework under such a reform scenario is subject to very high uncertainty, given the depth of the damage to the economy, the need for a large

balance sheet adjustment, and the distortions in the past three years. Although a strong reform program will provide a policy anchor that will help gradually restore confidence and facilitate the return to growth, it will also advance the necessary recognition of large wealth losses by addressing upfront the legacy problems in the financial sector. While the public at large may have factored in expectations of losses, the extent of it is unclear, and therefore could result in a temporary drag on growth (Annex I). For illustrative purposes only, the framework assumes the sovereign debt and banking sector restructurings to be completed in 2024H1. The precise timing is unlikely to have a material impact on the overall medium-term economic outlook, although, as discussed below, delaying reforms has a very large near-term cost and, if not implemented, could set the country on a different trajectory. In addition, given the complexity of the reforms, their proper sequencing would be particularly important. The policies under the reform scenario are elaborated in subsequent sections, but in brief, the macro framework assumes:

- The banking sector restructuring strategy sets the process for restoring bank soundness and addressing the overhang of losses. It protects small FX deposits in viable banks, which become available for withdrawal in domestic currency at the market exchange rate though subject, initially, to withdrawal limits. However, medium-to-large deposits are assumed to contribute to banks' rehabilitation strategy.

- Control over monetary policy and the unification of the current multiple exchange rates takes place at end-2023. Disinflation sets in and the pace of nominal depreciation slows down. The REER stabilizes at 20 percent below its pre-crisis level.

- Fiscal policy, focused primarily on revenue mobilization, improves the primary balance, while also creating space for social and development spending. Multiplier effects of this consolidation would be contained by more favorable composition of spending and the fact that revenue measures would fall disproportionately on those with a lower propensity to consume. Structural fiscal reforms will gradually help improve tax administration and public financial management, and revamp the fiscal framework.

- Public debt declines to around 80 percent by 2027, supported by fiscal consolidation, and debt restructuring that restores public debt sustainability (Annex II).

- Reform of SOEs, with support from multilateral partners, helps improve their financial position and the provision of services.

- Broader governance and institutional reforms help improve and people's confidence in the system. Together with other policies, informality gradually declines.

- On the basis of these policies, growth accelerates to about 4½ percent in 2025 and then settles at around 3 percent over the medium term. This is supported by unlocking of international bilateral financing and the already signed agreement with Egypt for gas, resulting in more than doubling of electricity supply. The tourism sector remains an important driver of growth over the medium term, consistent with recent developments in 2022, given the popular perception of the country as tourist destination. In addition, other sub-sectors that could help support growth

include: production of high-value agricultural crops and products, given the relative abundance of water resources that give Lebanon a competitive edge; food processing, high-end design, and pharmaceuticals; and software development and IT services that were an emerging and diversified segment of the economy before the crisis (Annex V.B).

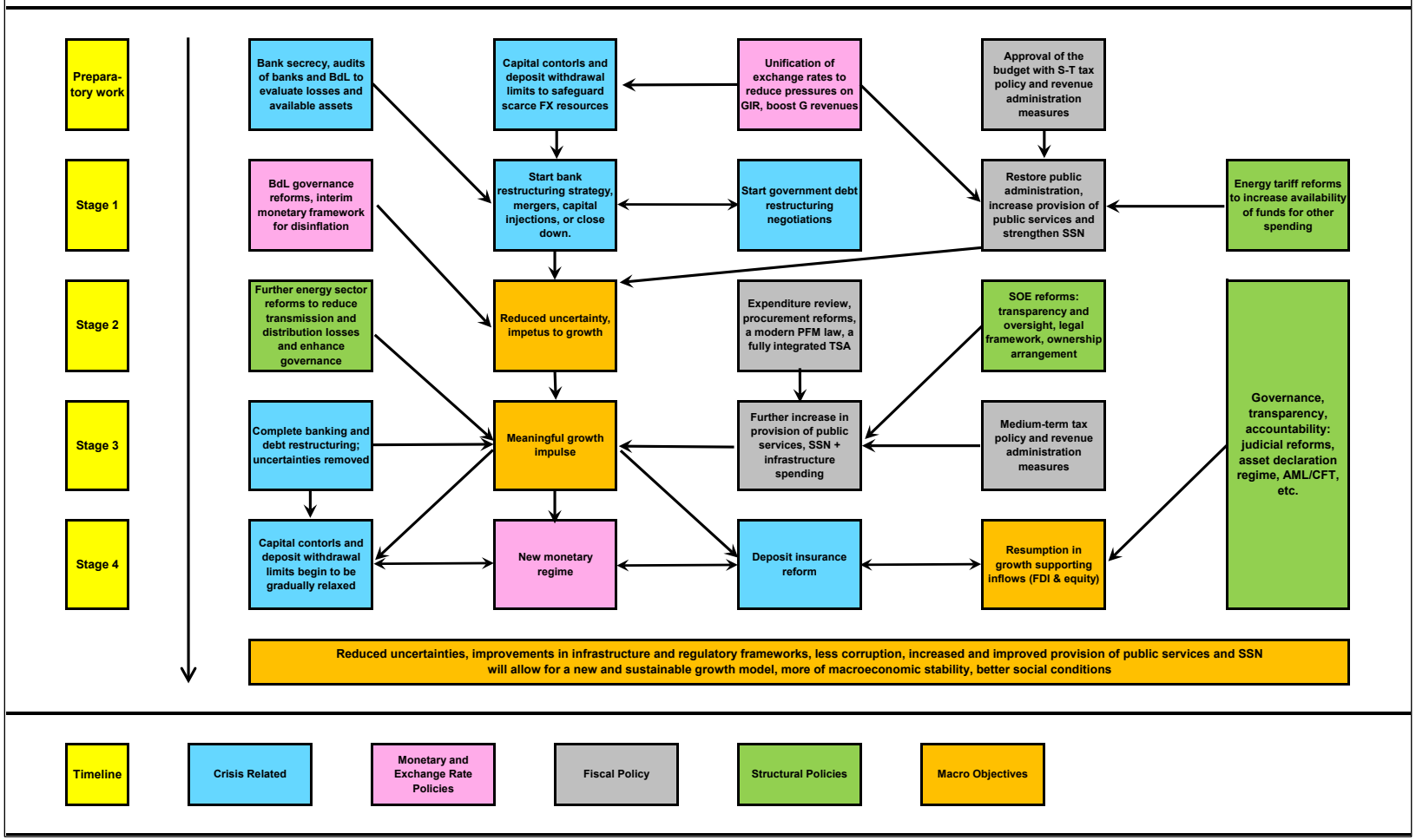
- Tight policies and a weaker exchange rate will help narrow the current account deficit (excluding official transfers) to around 5 percent of GDP by 2027, financed by foreign official financing and FDI. Gross reserves gradually increase to over 100 percent of the floating ARA metric.

Lebanon: Key Selected Indicators Under the Reform Scenario, 2021–27

	Act./Est.		Projections				
	2021	2022	2023	2024	2025	2026	2027
Growth (percent)	-10.0	0.0	-0.5	3.9	4.5	3.2	3.0
Consumer Prices (percent change, average)	154.8	171.2	296.1	148.7	75.1	33.6	12.1
Nominal GDP (in billions of U.S. dollars)	20.5	21.8	16.2	18.2	24.7	26.7	27.9
REER (cumulative, since 2019)	-31.8	-26.5	-46.1	-41.9	-24.5	-20.7	-20.2
Current Account (percent of GDP)	-17.3	-29.0	-12.5	-12.2	-11.0	-9.3	-6.0
Overall Fiscal Balance (percent of GDP)	1.2	-5.2	-6.9	-19.9	-3.5	-2.0	-1.7
Primary Fiscal Balance (percent of GDP)	2.4	-4.3	-3.5	-16.3	-0.6	0.7	0.9
Public Gross Debt (percent of GDP)	349.9	282.3	509.3	110.0	91.5	83.6	80.9

Sources: Lebanese authorities; IMF staff estimates and projections.

Lebanon: Sequencing and Interplay of the Proposed Reforms



14. The continuation of the status quo presents the largest risk to Lebanon's economic and social stability, taking the country down an unpredictable road. Uncertainty will keep confidence depressed and cash dollarization of the economy will continue, until Lebanon becomes *de facto* dollarized. Until then, the exchange rate will continue to depreciate, fueling the already high inflation. Economic activity will move into informal (and illicit) sectors, further complicating the collection of fiscal revenues. BdL, saddled with unaddressed losses and a lack of credibility, will continue to lose international reserves. Emigration, especially among skilled professionals, may gain pace, undermining future growth. Investment into physical capital will be limited to real estate and maintenance of existing facilities. Banks will not be able to meaningfully extend credit and real growth will remain subdued. Small depositors will continue to gradually withdraw their FX savings with large haircuts, while medium-to-large deposits will remain inaccessible. In this scenario, the allocation of losses in the financial sector will fall disproportionally to smaller depositors, while large depositors might eventually extract compensation in the form of state assets. The external position will be highly volatile, with limited aid from multilateral and regional partners. Import compression will continue with the trade balance driven by imports of essential products and energy inputs. Public debt will remain unsustainable as restructuring is unlikely in the absence of reforms, severely limiting the government's ability to borrow (Annex II). Provision of services by the state will be limited, as low revenues and lack of financing will force further expenditure compression (capital investment, employment, and wages). Social conditions will become increasingly untenable.

Lebanon: Key Selected Indicators Under the Status Quo Scenario, 2021–27

	Act./Est.		Projections				
	2021	2022	2023	2024	2025	2026	2027
Growth (percent)	-10.0	0.0	-0.5	-0.5	-0.5	-0.5	-0.5
Consumer Prices (percent change, average)	154.8	171.2	296.1	152.6	135.1	169.0	207.3
Nominal GDP (in billions of U.S. dollars)	20.5	21.8	13.7	13.2	12.8	12.5	12.3
REER (cumulative, since 2019)	-31.8	-26.5	-53.7	-55.1	-56.1	-56.9	-57.6
Current Account (percent of GDP)	-17.3	-29.0	-20.0	-19.1	-9.6	-7.2	0.2
Overall Fiscal Balance (percent of GDP)	1.2	-5.1	-9.2	-8.7	-6.7	-6.7	-6.3
Primary Fiscal Balance (percent of GDP)	2.4	-4.2	-5.5	-5.4	-4.9	-5.4	-5.6
Public Gross Debt (percent of GDP)	349.9	282.7	512.0	453.2	485.3	516.7	547.5

Sources: Lebanese authorities; IMF staff estimates and projections.

Box 1. Lebanon: The Cost of Delaying Reforms for Depositors

Postponing reforms has been costly for Lebanon. The reduction in economic activity and increased unemployment have led to dramatic and prolonged declines in consumption and investment. The large depreciation of the LBP has drastically reduced the value of LBP-denominated assets, including deposits. The rationing of FX has resulted in many depositors (mainly small liquidity constrained individuals and households) having to accept losses as they access their FX deposits at highly disadvantageous exchange rates.

Moreover, the inaction has led to a decrease in the FX deposits that could be recovered when the financial sector is restructured. Looking at a change in the hypothetical discount to FX deposits necessary to rebalance the financial system helps illustrate this particular cost.

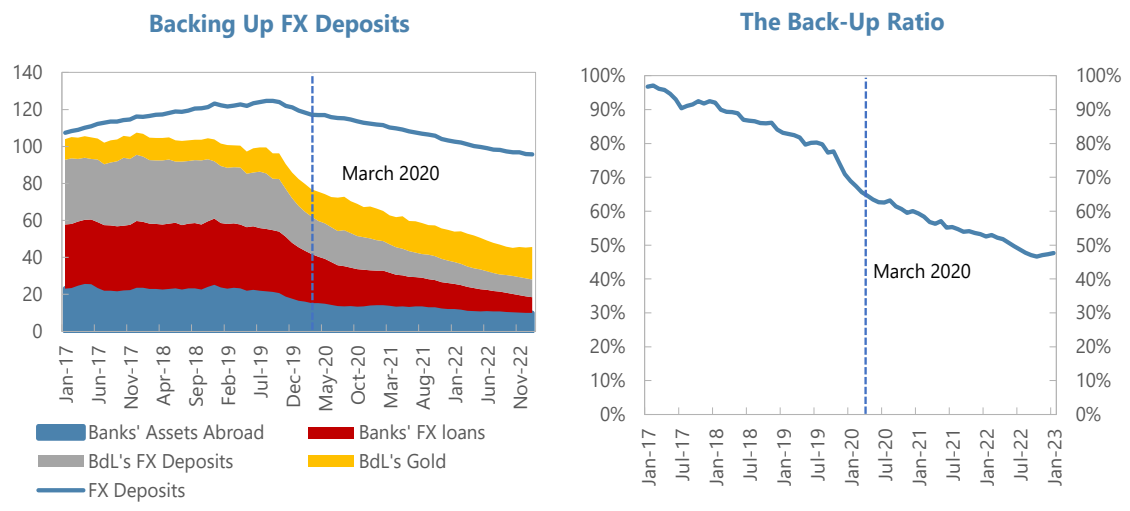
- The evaluation is done using aggregate banking data and illustrative assumptions.
- First, banks' balance sheets are restated assuming (i) the depreciation of the LBP/USD to the parallel market rate; (ii) a haircut of 75 percent to the Eurobond holdings (in line with market commentary); and (iii) an assumption that 25 percent of the banks' FX loan book are non-performing.
- The central bank balance sheet is then restated assuming (i) and (ii), as well as (iv) the wipe-out of public sector claims and liabilities at BdL, and (v) the acknowledgment of BdL equity gap (proxied mostly by BdL's *Other LBP Assets*).
- Lastly, the banks' FX claims on BdL are reduced to bring BdL negative capital and net FX positions to balance. As a result of this, FX deposits in banks are in part reduced to bring to balance their aggregate capital and net FX positions.
- No use of government resources is assumed for easier tractability.

This scenario is evaluated at two points in time, March 2020 (the Eurobond default) and January 2023, and shows that postponing the restructuring of the financial sector has cost depositors US$10 bn. This loss will be borne by owners of mid-to-large size deposits as small deposits will likely be protected in full. The loss arises because FX deposits are recoverable (even if not available immediately) as long as there is a sufficient amount of FX resources in the financial system to back them up. As the value of these resources in the system decreases, so does the value of recoverable deposits.

	FX deposits before restructuring, US$ bn	FX deposits after restructuring, US$ bn	Losses in recovered FX deposits, US$ bn	Average recovery rate
Mar-20	117	71	**-46**	60%
Jan-23	96	40	**-56**	41%

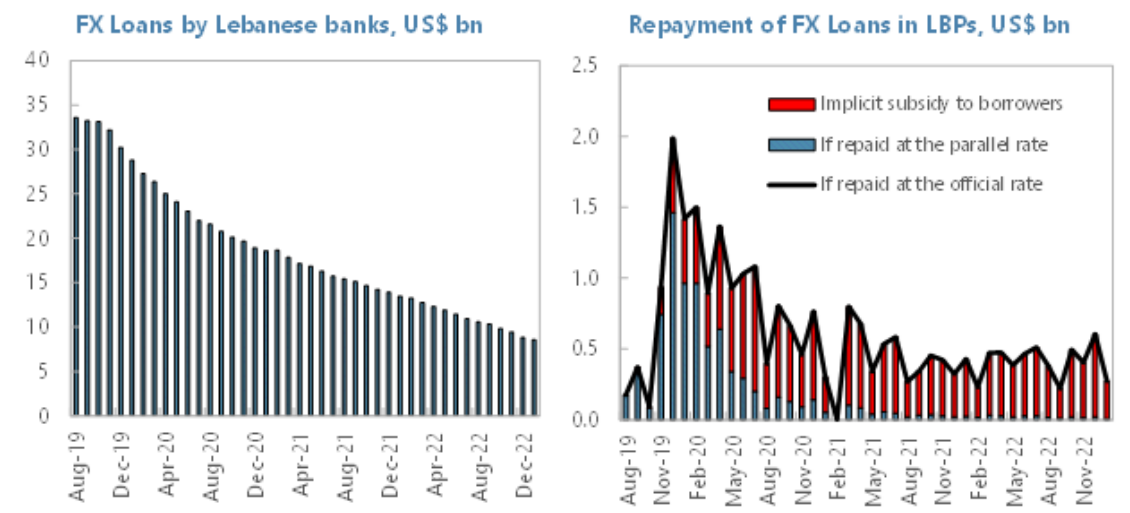
The main components of these back-up resources are BdL's FX deposits and gold holdings, banks' net assets abroad, and their FX assets (mainly loans). In 2017, the system had enough to cover almost all the FX deposits, but over time the gap between the two opened. In particular, the continued financing of subsidized imports and government spending at preferential exchange rates together with BdL's interventions to prop up the exchange rate led to a large decline in the recoverable deposits.

Box 1. Lebanon: The Cost of Delaying Reforms for Depositors (concluded)



Sources: BdL and IMF staff calculations.

The decline in the banks' FX loan book also results in a loss to depositors and a transfer of wealth to borrowers. As many of these loans were repaid in local currency at the official, rather than parallel, exchange rate, borrowers received an implicit subsidy, which we estimate at up to US$15 bn between March 2020 and January 2023. This preferential exchange rate treatment on FX loan repayments will be ultimately borne by depositors as it led to a decline in FX assets and, therefore, recoverable FX deposits.



Sources: BdL and IMF staff calculations.

Authorities' Views

15. The authorities agreed with the assessment of the outlook under both scenarios, although they were more optimistic about growth under the reform scenario. They noted that the non-financial corporate private sector has adjusted to existing circumstances and is showing some signs of recovery due to the large deleveraging and some new activity in import substituting industries. The authorities reiterated their commitment to reforms underlined in the SLA and argued that with the implementation of reforms the economy could recover faster (and stronger), given a very low base and still qualified and skilled human capital. They pointed to advances in digitalization (through software development and the expansion of outsourcing services), agrobusiness, and industrialization at smaller scale, in addition to traditionally dominant tourism activity. However, they noted very high uncertainty going forward and recognized the risks stemming from the status quo. They agreed that without decisive reforms the already fragile economic situation will deteriorate further. They expressed their concern that with increasing dollarization Lebanon may be losing the competitiveness gains of the last three years as prices expressed in US$ have increased. They stressed that prevailing political economy, particularly the divided Parliament, presents a significant strain to unlocking the reform process. Finally, the authorities highlighted that the large presence of refugees is aggravating the situation as it is putting an additional burden on very limited resources. They asked the Fund to assess the economic costs associated with hosting a large number of refugees and to help with mobilizing adequate and timely international support.

POLICY DISCUSSIONS

Discussions centered on policies under the reform scenario that can allow the Lebanese economy to turn the corner, focusing on: (i) revamping the health and viability of the financial sector; (ii) restoring debt sustainability while safeguarding social and development spending; (iii) unifying the official exchange rates and finding a new monetary anchor; (iv) advancing structural reforms; and (v) strengthening public institutions across the board, financial sector oversight, and the AML/CFT framework.

A. Banking Sector Restructuring Strategy

16. The Lebanese financial system faces very large losses (Annex IV). These stem from four main sources: the exchange rate depreciation; non-performing private sector loans; restructuring of public debt; and central bank operations. In particular, BdL has accumulated large losses, especially with the advent of the *financial engineering* (FE) operations in the years before the crisis,[7] as well as large quasi-fiscal operations and various deposit withdrawal schemes during the crisis.[8] As the state does not have the ability to recapitalize BdL, restoring its soundness would require restructuring

[7] See 2019 Article IV Staff Report.

[8] These losses emerge as the official exchange rate is used for the accounting purposes, yet more depreciated exchange rates for actual transactions. For example, under one of the FX deposit withdrawal schemes, depositors could withdraw part of their FX deposits in LBP at the exchange rate of 3,900. A commercial bank then had to sell the "withdrawn" FX to BdL at the same rate. The difference against the official exchange rate constituted a loss for BdL.

BdL's oversized liabilities to banks. In addition, commercial banks have themselves incurred losses due to the sharp rise in NPLs, the repayment of FX loans at non-market exchange rates, and the expected restructuring of their Eurobond holdings, which, according to market participants (and the prices the bonds are traded at) imply haircuts as high as 75 percent. While determining the exact magnitude of the overall losses in the financial system (BdL and commercial banks) requires a comprehensive bank-by-bank asset quality review and the completion of the debt restructuring, staff and the authorities estimate them at about US$70 bn (more than 300 percent of the estimated 2022 GDP).

17. The rehabilitation of Lebanon's banking system requires upfront actions to address these exceptionally large losses. While the precise formulation of measures should be decided by the authorities, the broader objectives should aim to restore banks profitability and solvency and ensure compliance with prudential requirements. These are essential for confidence in the banking system to return and for banks to be able to play their institutional role in safely intermediating resources in the economy. In this context, the roadmap ahead could include:

- Writing off capital, subordinated debt instruments, and related-party deposits.
- Internal recapitalization through a reduction of the overall deposits by a combination of: (i) write-offs; (ii) conversion into equity or long-term bonds in banks;[9] and (iii) lirafication of deposits at non-market rates.
- Protection of small FX depositors up to a certain amount in viable banks that will undergo restructuring and recapitalization based on a forward-looking analysis of their business plans.
- Fresh capital from current and/or new shareholders for viable banks to recapitalize and restructure these banks under credible and time-bound plans for each bank.
- The exit of unviable banks (by liquidation or a merger with stronger banks).

18. To better underpin an effective banking sector restructuring strategy, a bank-by-bank assessment is needed, which requires lifting bank secrecy. The assessment needs to evaluate in each bank its deposit structure and loss exposures to BdL, NPLs, and FX positions. For this assessment to be completed, the shortcomings in the new Banking Secrecy Law adopted by parliament in October 2022, should be remedied. In particular, the Law should allow the relevant institutions (BdL, BCC, and NDGI) and third parties involved in the bank-by-bank assessments to access data on individuals' transactions and deposits at the client level.

19. Any recourse to public resources should be limited and consistent with the debt sustainability objective. The authorities have argued for the establishment of a Deposit Recovery Fund (DRF), composed of state assets, and for the return on these assets to be used to pay back

[9] Such a conversion, however, might discourage new shareholders and affect banks' profitability. This would have implications for banks' potential viability after restructuring.

medium and large depositors that would be affected by the bank restructuring strategy. Staff cautioned against strategies that would allocate state assets for the benefit of a relatively small group of depositors (and likely politically connected), instead of being utilized for the rehabilitation of the economy and support the very large social and development needs. Such a strategy could also raise moral hazard concerns if state assets are used to bail out banks and large depositors in a manner that departs from good practices. Similarly, staff cautioned against sizable injection of public resources to recapitalize banks given the overarching need to restore debt sustainability. That said, staff were supportive of limited use of public resources to improve the BdL's capital position, subject to strict preconditions on BdL's governance.

20. The rehabilitation of the banking system would also require fundamental governance reforms. The institutional framework of BdL (and other banking authorities, such as the BCC, the Higher Banking Commission (HBC)), and deposit insurance agency needs to be modernized to strengthen governance, transparency and accountability, including internal controls and risk management, to prevent buildup of new vulnerabilities. The legislative changes, supported by organizational and operational changes, must aim at a minimum to:

- align BdL's mandate with best practices by prohibiting BdL's development function, its significant quasi-fiscal operations and its participations in Lebanese public utility companies or mixed national companies;
- enhance BdL's accountability through public and internal oversight by the Central Council, which should also be in charge of the BdL's internal control and risk management arrangements; introduce provisions on an Audit Committee, internal audit and external audit in line with best practices;
- ensuring effective collegial decision-making of the executive management of BdL (including a review of internal delegation procedures);
- strengthen the appointment and dismissal requirements and procedures of its officials and staff, including legal protections;
- enhance BdL's institutional, operational, and financial autonomy; notably, eliminate the Government representation on the Central Council and ensure a membership of a majority of independent non-executive Directors;
- introduce policies and procedures to mitigate conflicts of interests of BdL officials and staff;
- discontinue BdL's role in the Special Investigation Committee (SIC);
- eliminate monetary financing, and
- enhance the BCC's institutional, operational, and financial autonomy.

Authorities' Views

21. The authorities broadly agreed with the need to strengthen BdL's governance framework and the proposed strategy to rehabilitate the financial sector. They recognized that timely implementation of a credible strategy is critical to start stabilizing the system, as further delays increase banks' losses and make the strategy more costly. They also agreed on the criticality of respecting the hierarchy of claims and ensuring the consistency with debt sustainability. However, they emphasized the systemic nature of the financial crisis and the unprecedented size of losses that would have to be borne by depositors, something that has not been done in any other country before; hence, the strong opposition in Lebanon to the idea of deposits' write-off. Instead, they believe that while respecting the hierarchy of claims and debt sustainability, there are possible solutions that can provide an upside to depositors, and thus, garner the necessary political support. They argued that:

- Several modifications to the strategy (e.g., clawing back excess interest earnings, reversing some LBP-to-FX transactions, distinguishing between "eligible" and "non-eligible" deposits—including deposits that have been converted into dollars at the official exchange rate of 1,500 LBP to the dollar since October 2019—and recovering stolen and smuggled money) could improve the deposit recovery rates.[10]
- In the event that state asset management contracts (for assets including real estate, ports, SOEs, EdL, telecom, etc), are awarded to the private sector, if the government's economic and financial reform program is successfully rolled out and if the public debt reaches a level lower than the program target to maintain debt sustainability and a subject to a decent level of social and infrastructure spending, then considering earmarking some future revenues a Deposit Recovery Fund would be possible, should these exceed certain criteria when benchmarked against similar countries. The aim of such Deposit Recovery Fund would be to secure the recovery of the largest possible amount of deposits exceeding USD100,000 over time.
- Without a political decision on the final banking strategy, other related legislation, such as the draft resolution law and bank-by-bank assessments cannot be advanced and completed.

B. Monetary Policy, Exchange Rate Unification, Rebuilding Credibility

22. Finding a credible nominal anchor is critical to restore confidence and arrest inflation and exchange rate depreciation. However, given the lack of trust in the domestic currency and BdL, and weak policymaking capacity in the near term, decision about a new monetary regime would need to be taken once the large transitional processes that are pending are carried out and some degree of stabilization is achieved.

23. In the meantime, unifying the exchange rate for permitted transactions is a critical first step. Staff has identified an exchange restriction and multiple currency practices maintained by

[10] Staff are potentially open to some of these modifications, though we see their implementation as extremely challenging (Annex IV).

Lebanon and subject to approval under Article VIII, Sections 2(a) and 3.[11,12] BdL's circulars, which created a system of multiple exchange rates (Annex V.C), need to be eliminated and the exchange rate unification should be centered on:

a) *A proper trading platform (either building on the existing Sayrafa platform or otherwise)*, where price discovery takes place and large-sized trading for permitted transactions takes place.

b) *The approval and implementation of an appropriate CFMs and deposit withdrawal limits law.* Temporary withdrawal restrictions are needed for both FX and LL accounts to limit pressures at the FX market, minimize the impact on official reserves, and preserve bank deposits during the banking sector restructuring. The rules should also include repatriation requirements for exporters and money transfer companies to ensure an adequate supply of FX in the market. Removal of the CFMs should be contingent on developments in the economy. Similarly, deposit withdrawal limits should be set flexibly depending on liquidity levels in the financial sector.

c) *FX intervention policy*. FX interventions should be limited to disorderly market conditions, while not suppressing the underlying trend implied by fundamentals.

24. The exchange rate unification would need to be supported by tight monetary policy to steadily reduce inflation. Tightening would need to make use of all the available monetary policy tools, budget financing should be strictly prohibited, and BdL's decision-making structure should be strengthened (paragraph 20).

Authorities' Views

25. The authorities agreed that the current monetary regime is no longer sustainable, and that unification of the multiple official exchange rates is needed. While they would have preferred the unification of the exchange rate to be initiated in a more favorable environment to avoid an overshooting, the buildup of vulnerabilities caused by the current system calls for no further delays. BdL highlighted that such decision needs to be taken jointly with the MoF and government. They also pointed to potential risks from the exchange rate unification related to the financial system stability and liquidity. The authorities cautioned that the strategy may not yield the expected results if BdL is forced to maintain its budget deficit financing and quasi-fiscal operations,

[11] The exchange restriction arises from the central bank rationing of FX through limited and subsidized FX allocations at rates not reflective of market conditions (through setting of special official rates for selected categories of transactions and restrictions on the price determination of and transactions at the Sayrafa rate). Preventing the exchange rate from reflecting market conditions through official action, while not providing enough foreign exchange to meet all demand for current international transactions and payments, leads to rationing of FX, FX shortages and undue delays in completing payments for such transactions through the official market and channeling FX demand to the parallel market, imposing extra costs. MCPs arise from a larger than 2 percent deviation between: (i) official rate of 1,500 LBP/USD used for current account payments for priority imports where shipments were made before February 1, 2023 (ii) official rate of 15,000 LBP/USD for government transactions and medical priority imports; (iii) the Sayrafa exchange rate, and (iv) the market rate, used by FX bureaus.

[12] Given the complexity of the FX system in Lebanon, Staff is continuing to conduct an in-depth and comprehensive assessment of the Lebanese FX market for consistency with Lebanon's obligations under Article VIII, Sections 2(a) and 3. In addition, Staff is assessing the authorities' measures according to the Fund's Institutional View of liberalization and management of capital flows (IV).

which would be difficult to eliminate quickly due to social unrest concerns. BdL has started the process of transforming the Sayrafa platform into a trading one, and they are looking forward to accelerating the process that will be supported by technical assistance from the Fund.

C. Fiscal Policy and Debt Sustainability

26. The fiscal strategy should restore debt sustainability and the provision of public services while opening space for social and investment spending. This includes a gradual fiscal consolidation bringing the primary balance to a surplus of 1 percent of GDP by 2027, which together with a debt restructuring operation should reduce government debt to around 80 percent of GDP by 2027, and put it on a downward path thereafter, ensuring debt sustainability. The reforms are the opportunity to unlock the resources under the CEDRE, which together with other donors would support social and development spending.

27. Adopting promptly a credible 2023 budget is a critical first step in the stabilization process and to restore public administration. This should be achieved by incorporating an appropriate exchange rate for the computation of all taxes and inflation adjustments to specific taxes and excises including on gasoline, alcohol, tobacco, sugary drinks and private use vehicles. Tax administration should prioritize industries less impacted by the crisis and new emerging industries. Revenue mobilization measures will be critical to allow for a notable increase in wage bill, with appropriate safeguards for working employees through productivity bonuses, to sustain critical functions. Thus, targeted incentives like productivity and an increase in transportation allowance for critical share of staff could be implemented. Staff urged against general wage indexation to inflation or exchange rate under current circumstances and prior to addressing the outstanding weaknesses in public administration (see paragraph 30), as such policies will further entrench inflation, put additional pressure on exchange rate and continue weakening the fiscal position.

28. To ensure debt sustainability, and supported by financial and legal advisors, the authorities plan to engage in good faith negotiations with their private creditors to carry out the debt restructuring process. The strategy should aim to deliver a sustainable debt burden and affordable rollover risks. The current illustrative scenario suggests that this could be achieved by calibrating the restructuring to deliver an 80 percent debt to GDP ratio by 2027, and gross financing needs averaging no more than 9 percent per year in the 2024–27 period.[13] Such targets would, however, need to be tightened to the extent that the government's balance sheet is used to support the bank restructuring.

29. Beyond 2023, revenue mobilization reforms will be essential to meet medium-term fiscal objectives. Key measures should include:

- *Tax policy reforms* to broaden the tax base and move towards more efficient, and effective tax system. This includes streamlining existing exemptions and preferential treatments, gradually

[13] Calculations of GFN in 2024 are distorted by the assumed BdL recapitalization.

restoring specific excises, closing the loopholes and modernizing the CIT, introducing the simplified tax regime for small taxpayers and improving the quality of the property valuation system.

- *Tax administration reforms* to bolster effort to collect taxes. Recovery of tax arrears could be facilitated by a carefully tailored payment installment program, together with the establishment of a large debtor unit. Focus on large taxpayers would imply re-launch of the large taxpayer office (LTO) and merging VAT for large taxpayers with the LTO. The Council of Ministers should promptly operationalize broad access of Tax Administration to banking secrecy information to combat tax evasion and ensure tax compliance. Finally, integrating VAT and Revenue Directorate into a unified administration would be essential. Reforms at the custom administration should focus on developing a robust custom for Port of Beirut, implementing an Authorized Economic Operator Program and Single Window program.

30. Expenditure measures should support social and development spending and substantial recovery of wages, while restraining the overall envelope. Given the significant contraction of spending, the room for further adjustment is limited and should focus on gradual reduction of subsidies to the electricity sector underpinned by energy sector reforms. While overall spending is expected to recover from the current unsustainably low levels, it will remain considerably below the pre-crisis level due to expected interest payments savings from the debt restructuring, gradual phase out of transfers to loss making SOEs, particularly the EdL, and improved efficiency across the board. Streamlining of spending could be achieved through:

- *Public administration and civil service reforms* to address long-standing weaknesses in the management of public employment and the wage bill. It will be important to launch functional reviews in preparation for census of all government and public enterprises positions, compensation, and description of functions. This will allow to remove ghost workers from the payroll, adjust work force and salary accordingly. Reviewing the education model and addressing low efficiency will be particularly important.[14]
- *Medium-term spending reviews* across all public sectors (education, electricity, and infrastructure) to reduce expenditure from low priority, inefficient or ineffective programs.

31. Fiscal consolidation should be supported by stronger public financial management (PFM) practices. The introduction of a new, modern PFM Law is a cornerstone for the implementation of a comprehensive PFM roadmap which should include broadening the coverage of the budget, the formulation of medium-term fiscal framework, restricting the use of treasury advances, establishing a fully integrated treasury single account, and enhancing SOE oversight. It would be necessary to distinguish and clarify the responsibilities of the external control exercised by the Ministry of Finance and the Court of the Audit, extend the coverage of the internal control of the

[14] According to the World Bank data, student-teacher ratios in Lebanon at all levels of education are among the lowest in the region, ranging from 15.6 students per teacher at the pre-primary level to only 5 in tertiary education. However, despite high total spending on education (public and private) and low student-teacher ratios, Lebanon is near the bottom of the ranking of countries participating in PISA for reading, mathematics, and science. Rationalizing the number of teachers could generate savings that could be used to boost the wages remaining teachers.

Central Inspection to the public entities, review the adequacy of human and technological resources and strengthen the independence of budget control bodies. Staff welcomed the adoption of the procurement law which is in line with best international practices and called for its prompt implementation, especially regarding the full functionality of the Procurement Authority and the e-procurement platform. Moreover, a long-standing issue of expenditure arrears should be addressed, starting with careful quantification and audit, based on which a strategic plan for their clearance and future monitoring should be prepared and implemented.

Fiscal Consolidation Under the Reform Scenario 2023–27 1/
(annual, % of GDP)

	2023	2024	2025	2026	2027
Expenditure Reducing Measures	**-1.0**	**0.5**	**0.9**	**0.5**	**0.1**
Electricity sector reform	-0.8	0.5	0.9	0.5	0.1
Other	-0.2	-0.1	0.0	0.0	0.0
Expenditure Increasing Measures	**-1.7**	**-5.0**	**0.3**	**0.3**	**0.0**
Personal costs	-1.0	-0.6	-0.5	0.0	0.0
Social and reconstruction	-0.4	-1.3	0.4	0.2	0.3
Capital spending (incl. CEDRE financed)	-0.2	-3.1	0.5	0.1	-0.3
Revenue-Enhancing Measures	**2.0**	**4.9**	**0.9**	**0.7**	**0.4**
Customs (ER valuation)	0.6	1.4	-0.3	0.0	0.0
Excises (restore specific excises)	0.0	0.4	0.1	0.1	0.0
VAT (import valuation, reducing exemptions)	0.8	1.2	0.3	0.1	0.0
CIT (ER valuation/reducing incentives)	0.0	0.6	0.2	0.2	0.1
PIT (ER valuation/streamlining deductions)	0.0	0.4	0.3	0.0	0.0
Property tax (ER valuation, streamline exemptions)	0.2	0.4	0.1	0.1	0.1
Administrative fees adjustment (restore to adjust for inflation)	0.3	0.3	0.2	0.0	0.0
Revenue administration	0.1	0.2	0.1	0.2	0.1
Total Measures	**-0.7**	**0.3**	**2.0**	**1.5**	**0.5**
Macroeconomic factors (inflation) and One-offs	1.5	0.6	0.0	-0.3	-0.2
Change in PB (exl. BdL recapitalization)	**0.8**	**0.9**	**2.0**	**1.2**	**0.3**

Sources: IMF staff projections.
1/ The parameters are sensitive to macroeconomic assumptions and therefore subject to high uncertainty.

32. Considering the rapidly rising poverty, an essential component of the reform strategy should be protecting the vulnerable by expanding the social safety net through the Emergency Social Safety Net (ESSN) program. The ESSN, launched in 2022 and financed by the World Bank is expected to complement the existing National Poverty Targeting Program (NPTP), and it is designed to increase the social assistance coverage from 43,000 households to150,000 households, through targeted cash transfers and education services to eligible groups. Building on the successful implementation of the electronic registration platform IMPACT, the authorities are developing an integrated social registry. The registry will consolidate the information on beneficiaries of all social programs, and it will allow for monitoring, coordination, and identifying eventual duplications across the programs.

33. Lebanon's pension system, unchanged since the 1960s, is in dire need of reform. The system is complex, has low coverage, and is inequitable. Public sector employees and military personnel generously benefit from a pay-as-you-go regime with a high replacement rate directly

provided from the budget. On the other side, formal employees in the private sector and government contractual employees are covered by an end of service indemnity scheme (EOSI) administered by the National Social Security Fund (NSSF), whose financial situation has deteriorated due to a decrease in revenues and large payment arrears from the government. A reform to the pension branch of the NSSF to transit from the EOSI scheme to a pay-as-you-go pension system is being discussed in Parliament. The government should take advantage of the momentum to complement this effort with a reform of the system for the public sector employees too.

Authorities' Views

34. The authorities broadly agreed with staff's assessment and recommendations. They concurred with the path of fiscal adjustment needed to restore debt sustainability, and recognized that a deep debt restructuring is needed to achieve debt sustainability. They, however, indicated that the fiscal reform agenda is large, and, while efforts would be needed to improve their implementation capacity, also better prioritization and sequencing would be needed. The Ministry of Finance started to adjust the exchange rate on custom and taxes gradually with the intention of using the Sayrafa rate (or the market rate once the exchange rate is unified) on all budget items in the 2023 budget. They believe that refraining from BdL financing may be difficult to achieve in the short term and stressed the urgency in addressing low pay of employees. In that respect, they are exploring the options of salary adjustment and saw a role for it to restore basic functions, awaiting a more medium-term overhaul of the salary scale. The authorities noted that targeted wage increases to core employees may be politically difficult to achieve. The authorities indicated that they have started the preparation of the 2023 Budget along the suggested reform pillars, although they underlined difficulties stemming from very high uncertainty and very weak human resources and IT capabilities.

D. State-Owned Enterprises

35. Lack of control over SOEs and large financial losses exacerbated fiscal and economic imbalances before the crisis. The governance framework is very weak, sets low professional requirements for new hires, managers and board members, does not clearly define ownership, oversight and policy functions, and does not grant boards of directors' appropriate operational tools. Transparency and reporting requirements are poorly specified and enforced and the information available on the financial performance of SOEs is minimal. As financial statements have not been audited for several years, the oversight function of the Ministry of Finance and its capacity for assessing and monitoring related fiscal risks has significantly weakened.

36. Wide-ranging SOEs reforms are needed to improve their governance, operational viability and limit fiscal risks. Emphasis should be on professionalizing the management and strengthening boards of directors, transparency, accountability, and financial oversight by the Ministry of Finance, while reducing political interference and considering capacity constraints and corruption vulnerabilities. A first step towards this objective should be to prepare a comprehensive inventory of all SOEs and start publishing financial statements on an annual basis. Conducting

financial audits by reputable international firms for the large SOEs will be critical to assess their real financial situation. Preparing and approving by the cabinet an SOE ownership strategy in line with IMF recommendations is critical. The strategy should establish key objectives, oversight, and management principles of SOEs. This will allow the government to carry out an SOE triage and decide which enterprises should be kept, privatized, or liquidated. To facilitate the reforms, a new SOE law, based on the SOE ownership strategy and in line with international standards, should be adopted.

37. Staff supported the authorities' electricity sector reform strategy adopted in 2022 to put the sector on a sustainable path but called for its timely implementation (Annex V.E). The immediate focus is on improving the operational performance and financial sustainability of EdL, enhancing transparency in EdL's financial reporting and cash management including through audited financial statements, and establishing an independent Electricity Regulatory Authority (ERA) that is essential to provide technical and economic oversight of generation and distribution sectors. These reforms are critical to mobilize donor financing to increase electricity supply and achieve cost recovery by 2026. While the November 2022 increase in electricity tariffs was an important first step, their impact on the financial sustainability of EdL remains unclear, as it depends on EdL's capacity to enforce collection, reduce non-technical losses, and increase supply. EdL could also consider introducing monthly tariff reviews through a pricing formula mechanism to reflect fluctuations in global oil prices.

Authorities' Views

38. The authorities agreed with the proposed reform plan of SOEs. They are looking forward to the findings of the IMF governance diagnostic exercise that will help identify and address main weaknesses in the sector. They plan to complement this with support of the EBRD in reviewing the legal and governance framework of SOEs which will benchmark against OECD guidelines and offer recommendations. Regarding the electricity sector, the authorities stressed that recent increase in tariffs together with the already launched campaign to address non-technical losses are already showing positive results, although they recognized that it is still early to have an assessment. They, however, noted the difficulties with billing in the environment of a very volatile exchange rate. They expected the regulatory agency to be established soon as the Ministry is in the process of reviewing applications for candidates.

E. Governance, Anticorruption and AML/CFT

39. Governance, corruption, and rule of law weaknesses underpin Lebanon's fragility and hamper the effective implementation of financial and structural reforms. The authorities' ongoing efforts, such as those under the National Anticorruption Strategy, need adjustment to tackle the severity of corruption, to align with international good practices, and to bring sustainable and credible change. Legislative amendments to ensure public access to high-level public officials' financial declarations would be an important step to strengthen transparency and accountability. Furthermore, a draft law for judicial independence has been pending for discussion in parliament,

delaying much needed reforms on judicial independence and integrity in line with international good practices.

40. At the request of the authorities, the Fund is undertaking a governance diagnostic to help prioritize and sequence recommendations to strengthen state functions most relevant to economic activity (e.g., financial sector oversight, fiscal governance, anti-corruption, rule of law, and AML/CFT). This exercise will provide a roadmap for reforms, including enhancing the independence and integrity of the judiciary, improving accountability, and reducing impunity. The publication of the diagnostic will be crucial for the authorities' ownership of the reforms, and to increase citizens' trust, as it would allow stakeholders to monitor implementation efforts.

41. Strengthening the effectiveness of the AML/CFT regime is fundamental to safeguard financial stability, and to support anticorruption efforts. The recent banking secrecy legislation reform is a step forward which should be leveraged to fight money laundering, illicit enrichment, tax evasion, corruption, and other financial crimes, and, ultimately, to recover ill-gotten assets. Other key AML/CFT efforts include the operational independence of the SIC, enhanced AML/CFT risk-based supervision of banks, targeted financial sanctions as per the United Nations Security Council Resolutions related to terrorism and proliferation financing, monitoring unusual cross-border financial flows, and easy access to accurate beneficial ownership information of legal entities. To prevent listing by the Financial Action Task Force and pressure on correspondent banking relationships, the authorities should promptly address significant deficiencies identified by the ongoing MENAFATF[15] assessment.

Authorities' Views

42. The authorities agreed that governance weaknesses and corruption vulnerabilities have been a challenge to macro-economic stability. They noted that the findings of the IMF's governance diagnostic assessment will be important to identify priorities and the sequence of reforms, and they reaffirmed their commitment to publish the report upon finalization.

F. Other

43. The ability of the authorities to collect data has been weakened by the ongoing crisis. Data provision has serious shortcomings that significantly hamper surveillance and has been further impacted by the ongoing economic crisis particularly in national accounts and fiscal sector statistics. Lack of timely, comprehensive, and reliable national accounts and fiscal data undermine accountability and economic analysis. The Fund has supported the authorities' statistical efforts through recent capacity development on government finance statistics, national accounts, and price statistics, but further assistance in these areas is needed.

[15] Middle East and North Africa Financial Action Task Force.

Authorities' Views

44. The authorities recognized the weaknesses in data provision. They highlighted that the current low levels of staff attendance in most ministries and significant budget constraints faced by CAS hamper data collection, and they expected that recent measures to support public employees would result in better data collection and provision.

STAFF APPRAISAL

45. Lebanon is at a dangerous crossroads. Further delays in implementing reforms will keep the economy depressed with irreversible consequences for the whole country, but especially low-to-middle income households. High uncertainty will further weaken the external position, and BdL will continue to lose scarce international reserves. Exchange rate depreciation and spiraling inflation will remain unabated, accelerating the already high cash dollarization of the economy. The informality of the economy will further increase, reducing the scope for tax collections and further depressing budgetary spending, while increasing the risk of illicit activities becoming entrenched in the economy. Banks will not be able to provide meaningful credit to support the economy, and small depositors will continue to incur large losses on their FX withdrawals, while medium-to-large deposits will remain indefinitely locked. Emigration, particularly of skilled workers, would accelerate, further undermining growth prospects.

46. Lebanon's political leadership needs to coalesce around a comprehensive economic recovery plan, which the government should decisively implement, to arrest the deep crisis and bring about a sustainable recovery. While the challenges have allowed to mount and implementation will be difficult, the cost of inaction will be significant for current and future generations. A reform plan can garner support from the international community, which is essential for the authorities' program to succeed, supporting it with policy advice, financing, and technical assistance. This plan should be centered on five key pillars: debt sustainability, bank rehabilitation, monetary and exchange rate policy credibility, SOE restructuring, and institutional and governance reforms. Addressing the serious data shortcomings will be important to inform policy decisions.

47. Pursuing an ambitious medium-term fiscal strategy is critical to restore debt sustainability and ensure space for social and development spending. The first step should be to adopt the 2023 Budget that uses a unified market exchange rate for customs and tax purposes, adjusts specific taxes to inflation, and makes the first steps toward restoring and reforming public administration. In subsequent years, strengthening public finances would require revenue mobilization reforms focused on broadening the tax base, closing existing loopholes, and improving tax compliance across taxpayers through strengthened and modernized tax administration. The revenue mobilization effort is critical to support a gradual scale up of priority social and development spending to more appropriate levels. The overall fiscal strategy should be supported by reforms to eliminate SOE losses and phase out transfers from the budget, particularly to the energy sector, improve public administration, and advance sustainable pension system reforms.

Gradual fiscal consolidation will be critical to complement the needed debt restructuring that should aim to reduce public debt to a sustainable level over the medium term.

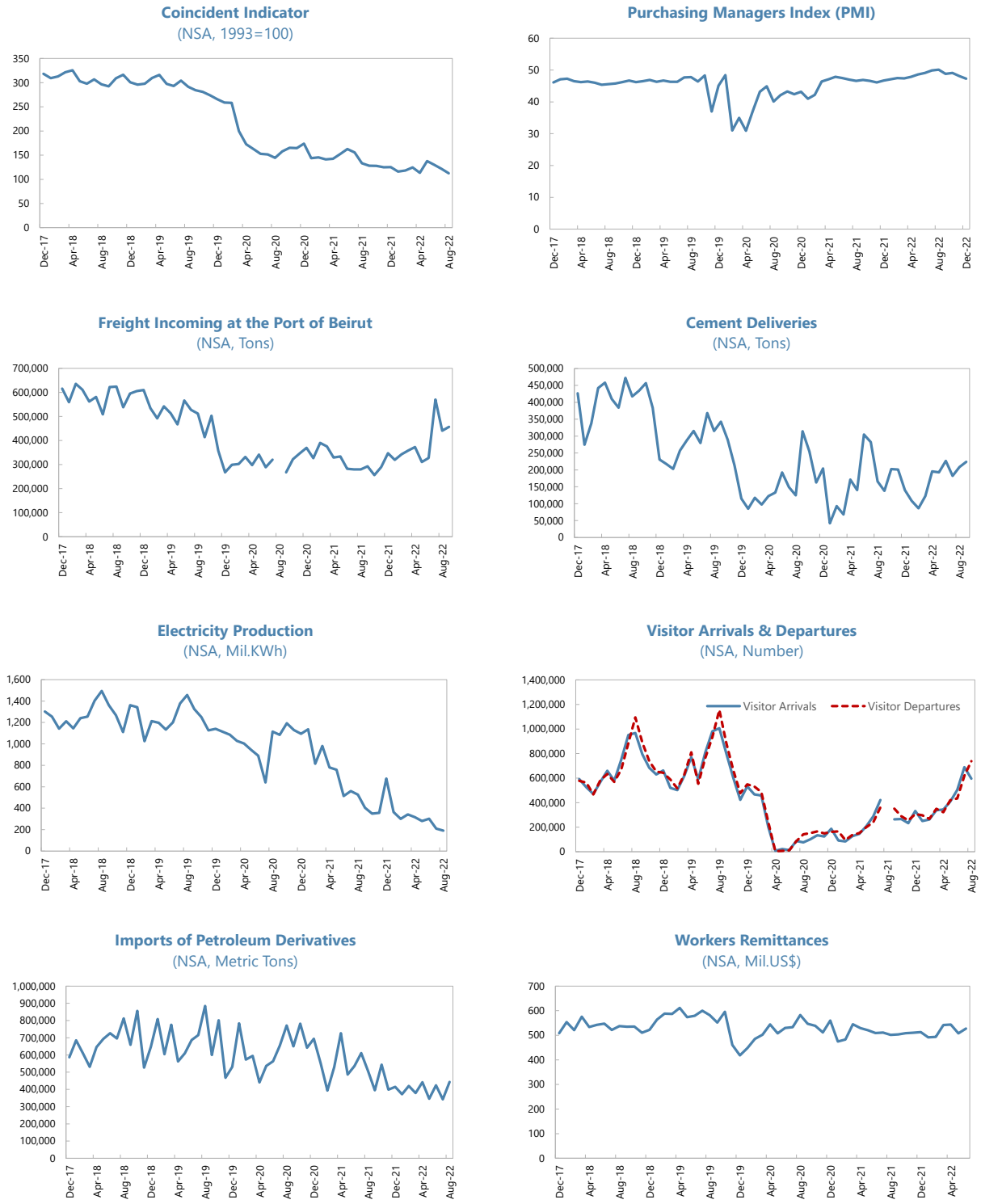
48. Credibly restructuring the financial system is necessary to restore its viability and to support economic recovery. This requires addressing upfront the large losses incurred by the central bank and commercial banks, respecting the hierarchy of claims, protecting small depositors to the extent possible, and limiting the recourse to the public sector given its current unsustainable debt position. Viable banks should be restructured and recapitalized under credible and timebound plans, and unviable banks should exit the market. To effectively restructure the banking sector, the Banking Secrecy Law should be changed to address outstanding weaknesses. In addition, the legal and institutional framework of the central bank and other banking authorities should be modernized to strengthen governance and accountability to regain public trust in these institutions.

49. Unification of the exchange rate and tight monetary policy are needed to rebuild credibility and improve the external position of the economy. Unification would remove harmful distortions, eliminate rent-seeking opportunities, reduce pressures on the central bank's FX reserves, and pave the way for a market-determined exchange rate. The process should be accompanied by temporary capital controls to help guard the limited FX resources in the financial system needed to ensure an equitable solution for depositors. To help reduce inflation following unification, tight monetary policy would need to make use of all the available tools, and central bank financing to the government should be strictly prohibited. Foreign exchange interventions will need to be very limited and only for disorderly market conditions. Staff does not recommend temporary approval of the exchange restriction and MCPs maintained by Lebanon, as the criteria for approval are not met.

50. Ambitious structural reforms will supplement economic policies and create an enabling environment for stronger growth. In that respect, strengthening the PFM framework and introducing a modern PFM law would contribute to strengthening proper oversight of public finances, enhance fiscal discipline, and improve transparency of budgetary process. Reforming SOEs should focus on good governance, transparency, financial and operational viability, better provision of services and to contain fiscal risks. Moreover, it will be critical to address long-standing issues in the electricity sector through swift implementation of sector reforms already approved by the cabinet in March 2022. Enhancing governance, anti-corruption, and anti-money laundering/combating the financing of terrorism (AML/CFT) frameworks is important to regain public trust in government policies and to promote inclusive growth.

51. It is expected that the next Article IV consultation with Lebanon will be held on the standard 12-month cycle.

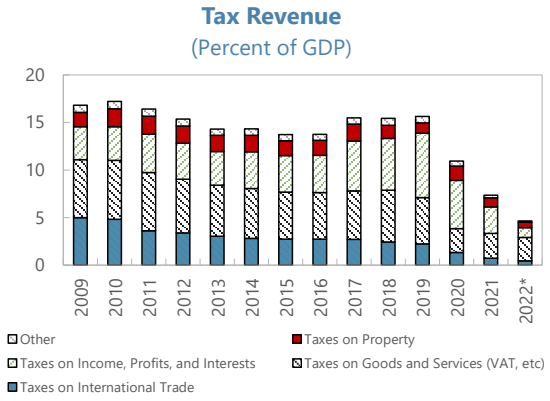
Figure 1. High-Frequency Indicators



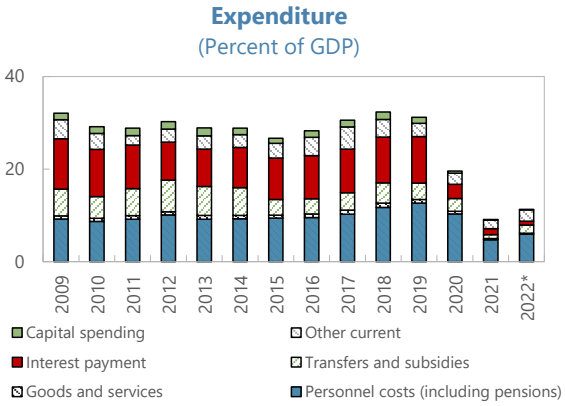
Sources: National Authorities; and IMF staff calculations.

Figure 2. Fiscal Indicators

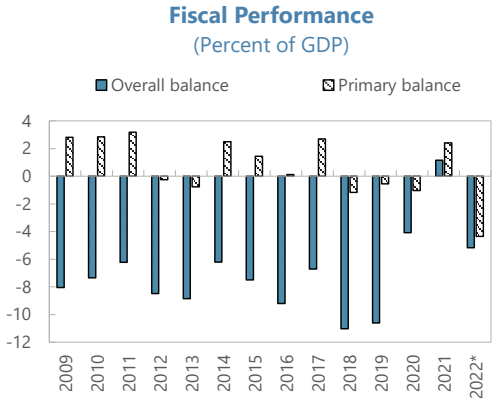
Tax revenues collapsed during the crisis…



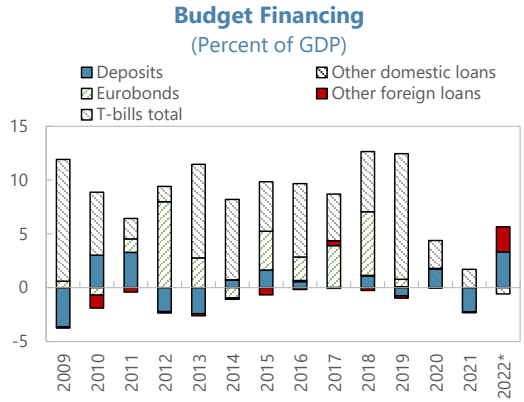
…forcing significant cuts in spending, …



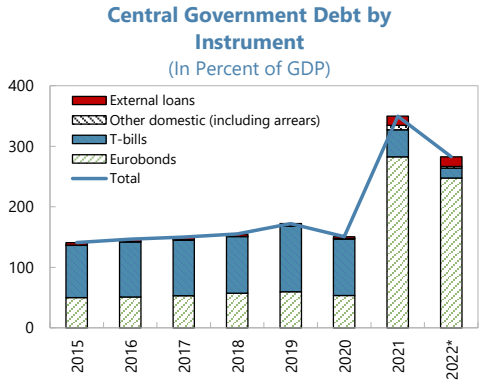
… which together with the Eurobond default and no interest payments led to a surplus in 2021.



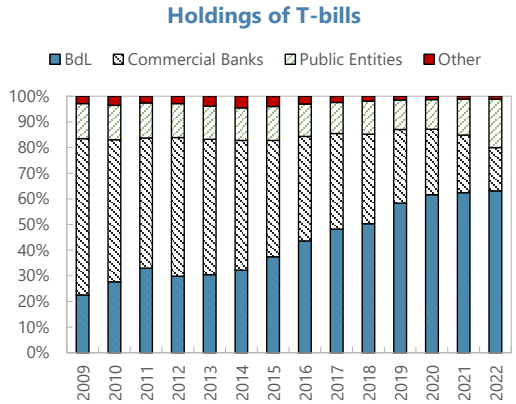
Budget financing became very limited following the default.



Large real depreciation pushed public debt up in 2021, though somewhat reversed in 2022.



Domestic financing switched from commercial banks to BdL and other public entities (NSSF)

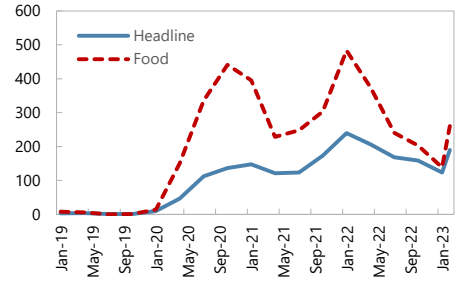


Sources: National Authorities; and IMF staff calculations.

Figure 3. Monetary Indicators

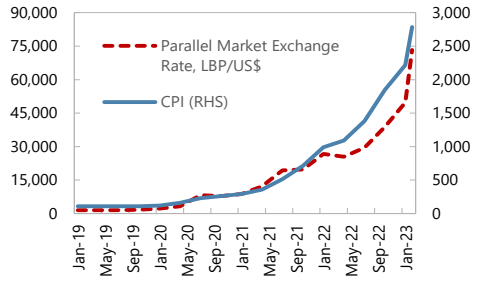
Inflation increased dramatically, especially for the food prices ...

Inflation: Headline and Food
(YoY percentage changes)



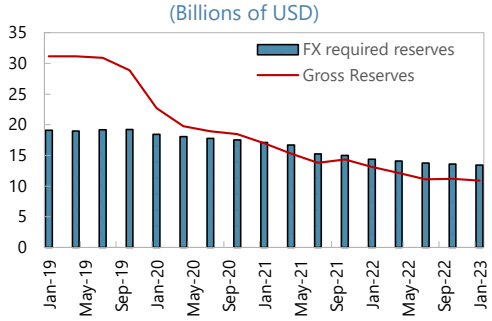
.... following the depreciation of the LBP in the parallel market.

Parallel Market Exchange Rate vs. CPI



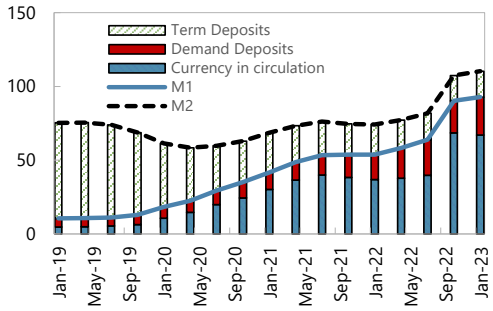
BdL has been losing the FX reserves ...

Gross Reserves vs. FX Required Reserves
(Billions of USD)



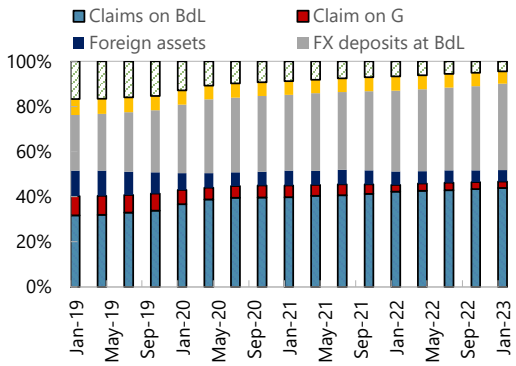
... while the currency in circulation has shot up.

M2 Composition
(Trillions of LBP)



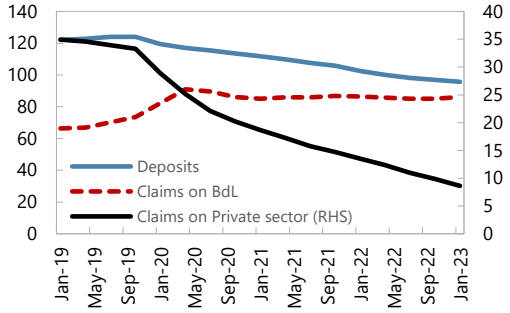
Banks' FX assets are now mostly the claims on BdL and the government.

Banks' FX Assets by Type



The stock of FX loans has decreased sharply, while the FX deposits are in multiples of GDP.

Banks' Selected FX Positions
(Billions of USD)



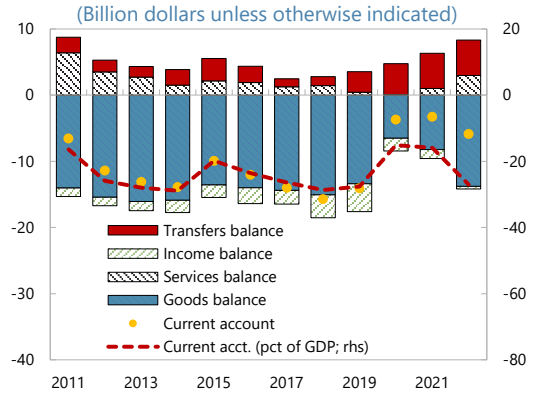
Sources: National Authorities; and IMF staff calculations.

Figure 4. The External Sector

The current account has narrowed from pre-crisis levels but remains wide...

Current Account

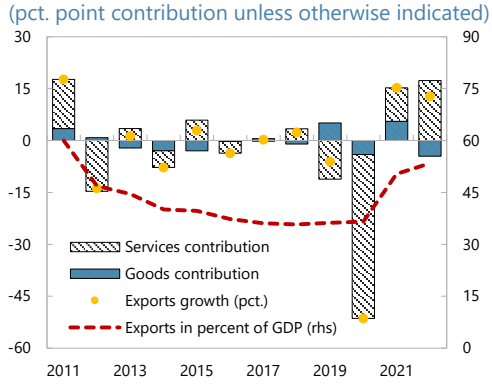
(Billion dollars unless otherwise indicated)



... though exports have begun recovering, including from the post-COVID tourism reopening...

Exports Growth

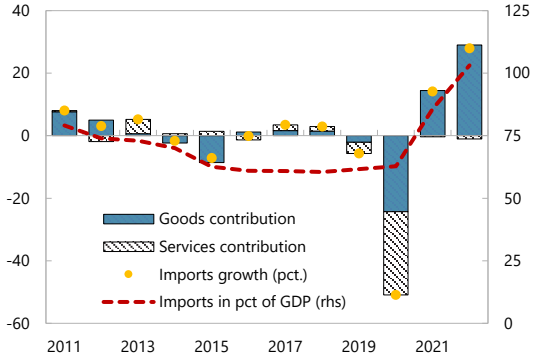
(pct. point contribution unless otherwise indicated)



Nevertheless, imports have picked up strongly...

Imports Growth

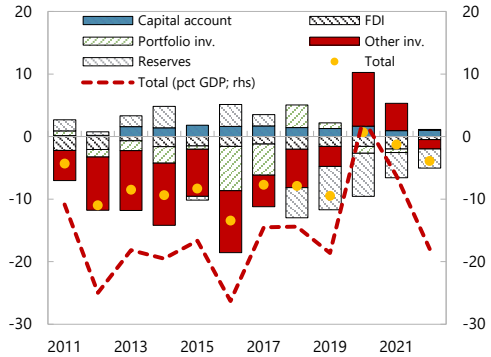
(pct. point contribution unless otherwise indicated)



...while a reserves drawdown has been an important source of current account financing...

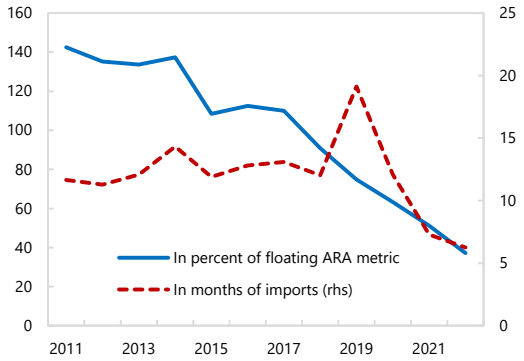
Financing

(Billion dollars unless indicated otherwise)



... sending reserves adequacy metrics downward.

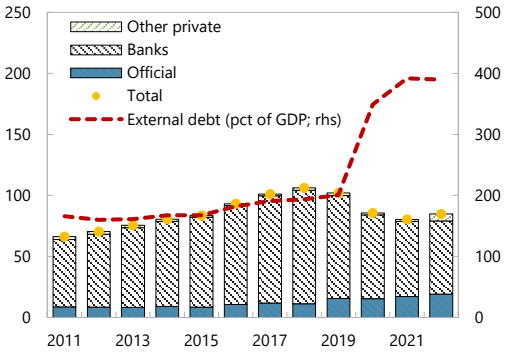
International Reserves Metrics



Meanwhile, external debt remains high.

External Debt

(Billion dollars unless otherwise indicated)



Sources: National Authorities and IMF staff calculations.

Table 1. Lebanon: Selected Economic Indicators, 2018–27

Illustrative scenario, subject to timely implementation of the reform package

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Act.	Act.	Act.	Act./Est.	Act./Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Output and prices					(Annual percentage change)					
Real GDP (market prices, actual data through 2020)	-1.9	-6.9	-25.9	-10.0	0.0	-0.5	3.9	4.5	3.2	3.0
GDP deflator	5.5	4.1	61.1	140.8	165.0	290.0	143.0	70.0	30.0	10.0
Consumer prices (end-of-period)	5.6	7.0	145.8	224.4	233.6	222.4	111.9	54.3	33.6	12.1
Consumer prices (period average)	6.1	2.9	84.9	154.8	171.2	296.1	148.7	75.1	33.6	12.1
Central government finances (cash basis)					(In percent of GDP)					
Revenue (including grants)	21.0	20.8	16.0	9.8	6.5	9.6	15.2	16.1	16.3	16.2
Expenditure	32.0	31.4	20.1	9.1	11.5	16.4	35.0	19.6	18.4	18.0
Overall balance (including grants)	-11.0	-10.6	-4.1	1.2	-5.2	-6.9	-19.9	-3.5	-2.0	-1.7
Primary balance (including grants)	-1.2	-0.5	-1.0	2.4	-4.3	-3.5	-16.3	-0.6	0.7	0.9
Primary balance excluding BdL recapitalization						-3.5	-2.6	-0.6	0.7	0.9
Total government debt	155.1	172.3	150.6	349.9	282.3	509.3	110.0	91.5	83.6	80.9
External sector					(In percent of GDP, unless otherwise indicated)					
Current account	-28.6	-27.9	-15.7	-17.3	-29.0	-12.5	-12.2	-11.0	-9.3	-6.0
Balance of goods and services	-24.8	-25.4	-26.3	-35.3	-52.9	-41.3	-39.1	-31.7	-28.2	-26.1
Exports of goods and services (in US$, percentage change)	2.4	-6.1	-51.4	15.2	21.6	7.6	9.6	15.0	7.8	6.4
Imports of goods and services (in US$, percentage change)	2.9	-5.7	-50.9	14.1	37.1	-16.2	8.6	13.4	4.3	3.5
Foreign direct investment	3.7	3.1	6.4	9.6	2.2	4.5	4.2	3.1	2.5	2.4
Total external debt 1/	194	201	135	392	391	205	204	168	165	165
Gross reserves (in billions of U.S. dollars) 2/	31.4	24.5	17.7	13.6	10.6	9.5	11.7	13.3	14.0	15.5
In months of next year imports of goods and services	12.0	19.1	12.1	6.8	6.3	5.2	5.6	6.2	6.3	6.7
In percent of ARA metric	90.9	74.8	63.2	51.2	37.1	92.4	104.9	111.2	110.9	116.9
In percent of short-term external debt 3/	35.8	30.7	27.3	23.4	17.4	46.8	56.3	62.2	63.1	67.2
Memorandum items										
Nominal GDP (in billions of U.S. dollars)	54.9	50.9	24.5	20.5	21.8	16.2	18.2	24.7	26.7	27.9
Local currency per U.S. dollar (economy-wide, average)	1,508	1,576	3,900	10,100	25,200	...	...	...	...	...
Local currency per U.S. dollar (official, average)	1,508	1,508	1,508	1,508	1,508	...	...	...	...	...
Real effective exchange rate (annual average, percent change)	2.5	1.4	-26.7	-7.0	7.8	-26.7	7.8	29.9	5.1	0.7
Real effective exchange rate (cumulative percent change since 2019)	...	...	-26.7	-31.8	-26.5	-46.1	-41.9	-24.5	-20.7	-20.2

Sources: Lebanese authorities; IMF staff estimates.

1/ Includes nonresident deposits.

2/ Excluding gold and encumbered assets.

3/ Short-term debt on a remaining maturity basis, including short-term nonresident deposits.

Table 2. Lebanon: Central Government Overall Deficit and Financing, 2018–27

Illustrative scenario, subject to timely implementation of the reform package

(In percent of GDP, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Act.	Act.	Act.	Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue and Grants	21.0	20.8	16.0	9.8	6.3	9.5	15.1	16.0	16.3	16.2
Revenue	21.0	20.8	16.0	9.8	6.3	8.6	14.0	15.0	15.9	16.2
Tax revenue	15.4	15.6	10.9	7.3	4.7	6.5	11.4	12.0	12.5	12.8
Taxes on income and profits	5.4	6.8	5.1	2.8	1.1	1.2	2.6	3.0	3.3	3.5
Taxes on property	1.4	1.1	1.5	1.0	0.6	0.7	1.0	1.1	1.2	1.3
Taxes on domestic goods and services	5.4	4.9	2.5	2.6	2.4	3.3	4.7	5.1	5.2	5.2
of which: VAT revenues	4.6	4.1	1.9	2.3	2.1	2.9	4.3	4.7	4.8	4.8
Taxes on international trade 1/	2.4	2.2	1.3	0.7	0.6	1.2	2.9	2.6	2.6	2.6
Other taxes	0.7	0.7	0.5	0.3	0.1	0.1	0.2	0.2	0.3	0.4
Nontax revenue	4.1	4.2	3.4	1.7	1.4	1.8	2.2	2.5	2.5	2.5
Other Treasury Revenue	1.5	1.0	1.7	0.7	0.2	0.3	0.4	0.6	0.9	0.9
Grants	0.0	0.0	0.0	0.0	0.0	0.9	1.1	1.0	0.5	0.1
Total Expenditure	32.0	31.4	20.1	8.6	11.5	16.4	35.0	19.6	18.4	18.0
Current primary expenditure	20.6	20.1	16.6	7.2	10.5	12.5	27.9	13.6	12.8	12.3
Personnel costs 2/	11.7	12.7	10.3	4.8	5.8	6.9	7.5	8.0	8.0	8.0
Transfers to EdL	3.2	2.8	1.5	0.4	1.1	1.9	1.4	0.6	0.1	0.0
Other current 3/	5.7	4.6	4.8	2.1	3.6	3.8	19.1	5.0	4.7	4.2
o/w social protection				0.0	1.1	1.5	1.6	1.5	1.6	1.6
o/w reconstruction post explosion spending				0.0	0.0	0.0	1.2	0.9	0.7	0.4
Interest payments	9.9	10.1	3.0	1.3	0.8	3.4	3.6	3.0	2.7	2.6
Capital expenditure	1.6	1.3	0.4	0.1	0.2	0.4	3.4	3.0	2.8	3.2
Social protection and reconstruction expenditure 4/					1.1	1.6	5.8	4.7	3.8	3.5
Overall balance	-11.0	-10.6	-4.1	1.2	-5.2	-6.9	-19.9	-3.5	-2.0	-1.7
Primary balance	-1.2	-0.5	-1.0	2.4	-4.3	-3.5	-16.3	-0.6	0.7	0.9
Primary balance excl. BdL recapitalization					-4.3	-3.5	-2.6	-0.6	0.7	0.9
Underlying Primary balance 5/	-1.2	-0.5	-1.0	2.4	-3.6	-1.9	3.1	3.8	3.9	3.7
Net financing	11.3	10.4	3.5	-0.6	5.9	8.4	19.9	3.5	2.0	1.7
Banking system	12.5	9.4	3.2	-1.8	3.9	6.7	13.6	-0.1	-0.1	-0.1
Government institutions	1.2	0.0	0.4	1.3	0.1	0.7	0.0	0.0	0.0	0.0
Other	-2.5	1.0	-0.1	-0.1	1.2	-0.5	6.3	3.7	2.1	1.7
Memorandum items:										
Total government gross debt	155.1	172.3	150.6	349.9	282.3	509.3	110.0	91.5	83.6	80.9

Sources: Lebanese authorities; and IMF staff estimates and calculations.

1/ Includes domestic excises, which are collected at customs and are classified as taxes on international trade.

2/ Includes wages, salaries, related benefits, and pensions.

3/ Includes transfers to the National Social Security Fund, hospitals, municipalities, Higher Relief Committee, Displaced Fund, Council of the South, bread subsidy, and the interest subsidy.

4/ Includes CEDRE financed capital spending

5/ Excludes foreign financed social, post explosion port reconstruction and capital spending, and BdL recapitalization

Table 3a. Lebanon: Balance of Payments, 2018–27

Illustrative scenario, subject to timely implementation of the reform package

(In millions of USD, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Act.	Act.	Act.	Act./Est.	Act./Est.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of U.S. dollars)									
Current account (ex. official transfers)	-15,670	-14,247	-3,832	-3,539	-6,479	-2,159	-2,427	-2,952	-2,596	-1,687
Goods (net)	-15,060	-13,378	-6,499	-8,226	-13,677	-9,107	-9,224	-10,270	-10,310	-10,547
Exports, f.o.b.	3,847	4,839	4,097	4,594	4,373	5,333	5,665	5,779	6,133	6,418
Imports, f.o.b.	-18,907	-18,218	-10,596	-12,821	-18,051	-14,440	-14,889	-16,049	-16,443	-16,966
Services (net)	1,440	440	67	990	2,164	2,436	2,113	2,449	2,764	3,277
Credit	15,770	13,579	4,856	5,724	8,178	8,166	9,130	11,239	12,220	13,108
Debit	-14,330	-13,139	-4,789	-4,733	-6,014	-5,731	-7,017	-8,790	-9,456	-9,831
Memo: Tourism (net)	2,146	2,255	682	1,319	2,118	2,449	2,740	3,171	3,456	3,957
o/w: credits	8,400	8,593	2,353	3,135	5,187	5,540	6,243	7,539	8,235	8,977
o/w: debits	6,254	6,338	1,670	1,816	3,069	3,091	3,503	4,367	4,778	5,019
Income (net)	-3,471	-4,227	-1,936	-1,363	-427	-1,365	-1,334	-1,252	-1,375	-938
Credit	2,816	3,097	1,607	373	1,500	2,318	1,969	1,755	1,505	1,476
Debit	-6,287	-7,325	-3,543	-1,736	-1,927	-3,683	-3,303	-3,007	-2,880	-2,415
o/w: Interest on government debt	-753	-743	-1,036	-1,033	-89	-96	-141	-197	-222	-241
Current transfers (net) 1/	1,366	2,962	4,520	5,067	5,624	6,022	6,218	6,367	6,445	6,536
Official (net)	-55	44	-16	6	162	146	200	247	120	14
Private (net)	1,421	2,918	4,537	5,061	5,462	5,876	6,018	6,120	6,325	6,522
Capital and financial account	5,996	4,953	-5,356	-2,963	2,762	180	740	1,013	929	770
Capital account (net)	1,449	1,298	1,666	933	1,163	1,163	1,163	1,163	1,163	1,163
Direct investment (net)	2,027	1,561	1,578	1,971	468	723	764	770	667	679
Portfolio investment, loans and other (net)	2,520	2,094	-8,601	-5,868	1,131	-1,706	-1,187	-920	-901	-1,072
Government (net)	-1,284	-145	1,154	-1,112	-1,679	-1,859	-776	-773	-775	-957
BdL	317	1,454	29	-667	-304	0	0	0	0	0
Banks (net)	1,354	2,453	-6,267	-3,090	-1,262	0	0	0	0	0
Foreign assets of banks 2/	-5,295	7,991	943	1,608	-118	0	0	0	0	0
Nonresident deposits 3/	6,649	-5,538	-7,210	-4,699	-1,145	0	0	0	0	0
Nonbank private sector (net)	2,133	-1,668	-3,517	-998	4,376	153	-412	-147	-126	-115
Errors and omissions	4,860	2,369	96	428	0	0	0	0	0	0
Overall balance	-4,814	-6,926	-9,092	-6,074	-3,716	-1,979	-1,687	-1,939	-1,667	-917
Financing	4,814	6,926	9,092	6,074	3,716	1,979	1,687	1,939	1,667	917
Official reserves (- increase)	4,814	6,926	6,871	4,036	2,990	1,094	-2,149	-1,660	-691	-1,440
Eurobond arrears and restructuring, donor support	0	0	2,221	2,038	727	885	3,836	3,599	2,358	2,357
Memorandum items										
Current account balance (ex. official transfers, in percent of GDP)	-28.5	-28.0	-15.6	-17.3	-29.7	-13.4	-13.3	-12.0	-9.7	-6.1
Goods and services balance (in percent of GDP)	-24.8	-25.4	-26.3	-35.3	-52.9	-41.3	-39.1	-31.7	-28.2	-26.1
Exports of goods (in percent of GDP)	7.0	9.5	16.7	22.4	20.1	33.0	31.1	23.4	22.9	23.0
Export value, percent change	-4.8	25.8	-15.3	12.1	-4.8	21.9	6.2	2.0	6.1	4.7
Export volume, percent change	-7.7	23.5	-21.6	3.6	-9.0	16.8	2.9	-1.2	4.0	2.8
Imports of goods (in percent of GDP)	-34.4	-35.8	-43.3	-62.6	-82.9	-89.3	-81.8	-65.0	-61.5	-60.9
Import value, percent change	2.5	-3.6	-41.8	21.0	40.8	-20.0	3.1	7.8	2.5	3.2
Import volume, percent change	-4.4	-0.4	-39.3	3.0	27.8	-19.3	2.4	7.1	1.8	2.5
Services credit (in percent of GDP)	28.7	26.7	19.8	28.0	37.5	50.5	50.1	45.5	45.7	47.0
Services debit (in percent of GDP)	-26.1	-25.8	-19.6	-23.1	-27.6	-35.4	-38.5	-35.6	-35.3	-35.3
Gross reserves (excl. gold, year-end, in millions of US$) 4/	31,447	24,521	17,650	13,614	10,624	9,531	11,680	13,339	14,030	15,470
External debt (in percent of GDP) 5/	193.6	200.6	349.1	391.7	391.2	205.3	204.2	167.8	164.8	165.0
Government external debt (residency basis, in percent of GDP)	17.3	28.3	70.1	113.3	107.2	108.8	65.6	57.4	53.4	49.1
GDP (in millions of US$)	54,901	50,880	24,494	20,476	21,780	16,168	18,209	24,677	26,749	27,874

Sources: Lebanese authorities; BIS; and IMF staff estimates and projections.

1/ Excluding official budgetary transfers.

2/ Net of non-deposit foreign liabilities.

3/ Differs from banks' reported data, to include estimated deposit flows by Lebanese nationals living abroad but classified as residents.

4/ Excludes Lebanese Eurobonds and encumbered reserves.

5/ Includes all banking deposits held by nonresidents, including estimated deposits of Lebanese nationals living abroad but classified as residents.

Table 3b. Lebanon: Balance of Payments, 2018–27

Illustrative scenario, subject to timely implementation of the reform package

(In percent of GDP, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Act.	Act.	Est.	Act./Est.	Act./Est.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In percent of GDP)									
Current account (ex. official transfers)	-28.5	-28.0	-15.6	-17.3	-29.7	-13.4	-13.3	-12.0	-9.7	-6.1
Goods (net)	-27.4	-26.3	-26.5	-40.2	-62.8	-56.3	-50.7	-41.6	-38.5	-37.8
Exports, f.o.b.	7.0	9.5	16.7	22.4	20.1	33.0	31.1	23.4	22.9	23.0
Imports, f.o.b.	-34.4	-35.8	-43.3	-62.6	-82.9	-89.3	-81.8	-65.0	-61.5	-60.9
Services (net)	2.6	0.9	0.3	4.8	9.9	15.1	11.6	9.9	10.3	11.8
Credit	28.7	26.7	19.8	28.0	37.5	50.5	50.1	45.5	45.7	47.0
Debit	-26.1	-25.8	-19.6	-23.1	-27.6	-35.4	-38.5	-35.6	-35.3	-35.3
Memo: Tourism (net)	3.9	4.4	2.8	6.4	9.7	15.1	15.0	12.9	12.9	14.2
o/w: credits	15.3	16.9	9.6	15.3	23.8	34.3	34.3	30.5	30.8	32.2
o/w: debits	11.4	12.5	6.8	8.9	14.1	19.1	19.2	17.7	17.9	18.0
Income (net)	-6.3	-8.3	-7.9	-6.7	-2.0	-8.4	-7.3	-5.1	-5.1	-3.4
Credit	5.1	6.1	6.6	1.8	6.9	14.3	10.8	7.1	5.6	5.3
Debit	-11.5	-14.4	-14.5	-8.5	-8.8	-22.8	-18.1	-12.2	-10.8	-8.7
o/w: Interest on government debt	-1.4	-1.5	-4.2	-5.0	-0.4	-0.6	-0.8	-0.8	-0.8	-0.9
Current transfers (net) 1/	2.5	5.8	18.5	24.7	25.8	37.2	34.1	25.8	24.1	23.4
Official (net)	-0.1	0.1	-0.1	0.0	0.7	0.9	1.1	1.0	0.5	0.1
Private (net)	2.6	5.7	18.5	24.7	25.1	36.3	33.0	24.8	23.6	23.4
Capital and financial account	10.9	9.7	-21.9	-14.5	12.7	1.1	4.1	4.1	3.5	2.8
Capital account (net)	2.6	2.6	6.8	4.6	5.3	7.2	6.4	4.7	4.3	4.2
Direct investment (net)	3.7	3.1	6.4	9.6	2.2	4.5	4.2	3.1	2.5	2.4
Portfolio investment, loans and other (net)	4.6	4.1	-35.1	-28.7	5.2	-10.6	-6.5	-3.7	-3.4	-3.8
Government (net)	-2.3	-0.3	4.7	-5.4	-7.7	-11.5	-4.3	-3.1	-2.9	-3.4
BdL	0.6	2.9	0.1	-3.3	-1.4	0.0	0.0	0.0	0.0	0.0
Banks (net)	2.5	4.8	-25.6	-15.1	-5.8	0.0	0.0	0.0	0.0	0.0
Foreign assets of banks 2/	-9.6	15.7	3.9	7.9	-0.5	0.0	0.0	0.0	0.0	0.0
Nonresident deposits 3/	12.1	-10.9	-29.4	-22.9	-5.3	0.0	0.0	0.0	0.0	0.0
Nonbank private sector (net)	3.9	-3.3	-14.4	-4.9	20.1	0.9	-2.3	-0.6	-0.5	-0.4
Errors and omissions	8.9	4.7	0.4	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-8.8	-13.6	-37.1	-29.7	-17.1	-12.2	-9.3	-7.9	-6.2	-3.3
Financing	8.8	13.6	37.1	29.7	17.1	12.2	9.3	7.9	6.2	3.3
Official reserves (- increase)	8.8	13.6	28.1	19.7	13.7	6.8	-11.8	-6.7	-2.6	-5.2
Eurobond arrears and restructuring, donor support	0.0	0.0	9.1	10.0	3.3	5.5	21.1	14.6	8.8	8.5

Sources: Lebanese authorities; BIS; and IMF staff estimates and projections.

1/ Excluding official budgetary transfers.

2/ Net of non-deposit foreign liabilities.

3/ Differs from banks' reported data, to include estimated deposit flows by Lebanese nationals living abroad but classified as residents.

Table 4. Lebanon: Money and Banking, 2018–27

Illustrative scenario, subject to timely implementation of the reform package

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Act.	Act.	Act.	Act./Est.	Act./Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Reserve Money (percent of GDP)	99.8	66.4	66.2	37.9	19.8	4.1	3.0	2.9	2.9	2.9
Currency (percent of GDP)	7.1	13.2	32.3	22.1	14.6	3.8	2.7	2.7	2.7	2.7
Required LL Reserves (percent of GDP)	6.3	4.3	3.1	2.2	1.3	0.4	0.2	0.2	0.2	0.2
Excess LL Reserves (percent of GDP)	86.5	48.9	30.8	13.6	3.88	0.005	0.002	0.001	0.001	0.001
M1 (percent of GDP)	14.4	21.1	42.0	28.0	17.9	4.6	3.3	3.1	3.1	3.1
M2 (percent of GDP)	91.5	77.9	70.0	37.9	21.1	5.5	3.8	3.5	3.4	3.5
Broad Money (percent of GDP) 1/ 2/	327.6	315.9	253.6	115.8	48.5	521.4	275.9	212.5	191.7	183.2
Currency In circulation (percent of GDP)	6.1	12.2	30.6	20.0	13.4	3.5	2.5	2.5	2.5	2.5
Deposits in Lebanese pounds (percent of GDP)	95.1	73.5	44.2	20.1	8.6	2.3	1.5	1.1	1.1	1.1
Deposits in FX (percent of GDP) 2/	226.5	230.2	178.8	75.7	26.5	515.7	271.9	208.8	188.1	179.6
Credit to private sector (billions of USD) 3/	52.3	43.2	22.5	15.0	9.3	67.3	9.9	13.6	15.3	16.6
Commercial banks total assets (in billions of U.S. dollars) 3/	249	207	140	122	112	55	56	60	59	60
Share of foreign currency private deposits in total (percent)	70.7	76.1	80.4	79.5	76.1	99.6	99.4	99.4	99.4	99.4
Net foreign exchange position of BdL (billions of USD) 4/	-40.1	-63.6	-75.5	-78.0	-79.2	-150.4	-19.7	-13.3	-7.4	-4.2
Gross international reserves (including gold, billions of USD) 5/	46.7	40.7	36.9	46.5	27.9	26.8	28.9	30.6	31.3	32.7
Gross international reserves (excluding gold, billions of USD) 6/	31.4	24.5	17.7	13.6	10.6	9.5	11.7	13.3	14.0	15.5
in percent of banking system foreign currency deposits	25.4	20.3	15.8	13.2	11.1	23.1	26.9	29.5	30.1	32.0
in percent of total banking system deposits	18.0	15.4	12.7	10.5	8.5	23.0	26.8	29.4	30.0	31.8
in percent of commercial banks' required FX reserves	165	131	102	94	79	163	191	209	251	266

Sources: Banque du Liban; and Fund staff estimates and projections.

1/ Broad money (M5) is defined as M3 (currency + resident deposits) + nonresident deposits.

2/ An increase in 2023 is reflective of a revaluation of FX deposits that were previously valued at the 1,500 LBP/USD exchange rate.

3/ With the FX component recalculated at the economy-wide average rate.

4/ Defined by currency (not by residency), as official foreign currency assets, including gold and SDR, less foreign currency liabilities. Liabilities include the exceptional deposits by GCC governments.

5/ Defined as all official foreign currency assets, less encumbered foreign assets.

6/ Defined as all official foreign currency assets, less encumbered foreign assets and gold.

Annex I. Risk Assessment Matrix[1]

Risks	Likelihood	Possible Impact	Policy Recommendation
External Risks			
Intensification of regional conflict(s). Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade, remittances, refugee flows, FDI and financial flows, and payment systems.	**High**	**High.** The impact would be mainly through high food and fuel prices, pushing inflation further up and hurting the most vulnerable households, while making pressures on already low foreign reserves.	Strengthen revenue mobilization to create space for well targeted social spending. Refrain from general subsidies through differentiated exchange rate. Establish a credible monetary and exchange rate system and conduct tight monetary policy. Re-build grain silos to ensure food security. Conduct a comprehensive reform policy that would unlock donors' financial support.
Commodity price volatility. A succession of supply disruptions and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	**Medium**	**High**. Lebanon is highly dependent on food and energy import, and higher prices would have a significant negative impact, as explained above, further adding to economic instability.	
Abrupt global slowdown or recession. Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and markets fragmentation.	**Medium**	**Medium.** It could lead to lower tourism activity and lower inflow of remittances, adding pressures to external balances and exchange rate. On the other hand, downward pressures on some commodity prices may provide an offset to the adverse effects.	Preserve international reserves and maintain greater exchange rate flexibility to absorb external shocks. Reprioritize spending and mobilize donor support.
Domestic Risks			
Lack of progress on reforms. Government unable to implement the needed reform to decisively tackle the crisis.	**High**	**High.** It would lead to increased uncertainty and higher emigration rates, accelerate informality, illicit flows, depreciation and inflation, deplete the FX reserves, and depress the economy even further. Fiscal risks from EdL and other SOEs would start to materialize with additional pressure on budget spending.	Pursue implementation of a comprehensive set of reforms (as agreed under the SLA).
Widespread social discontent and political instability. Deepening economic crisis, lack of public trust deepened by corruption charges and investigations, and unresolved political vacuum amplifies social unrest and political instability.	**High**	**Medium.** It could disrupt economic activity and further weaken confidence, amplify exchange rate pressures, and accelerate the FX reserves decline.	Accelerate implementation of a comprehensive set of reforms to arrest the ongoing crisis and allow economy to recover (as agreed under the SLA).

[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex II. Public Debt Sustainability Analysis

Lebanon: Risk of Sovereign Stress			
Horizon	**Mechanical signal**	**Final assessment**	**Comments**
Overall	...	**High**	The crisis in Lebanon is without precedent and resolving it will require comprehensive and fundamental reforms on multiple fronts, with sustained momentum over multiple years. Given the extremely delicate state of the economy, high domestic and global volatility, and risks of reform slippages, the overall risk is high.
Near term 1/	n.a.	n.a.	A sovereign stress event was triggered by the loss of market access in 2019. With sovereign default that began in 2020 remaining unresolved, Lebanon is still in sovereign stress and the near-term risk assessment is not applicable.
Medium term	**High**	**High**	Given the unprecedented nature of the current crisis, the expected reforms will produce impacts that complicate the interpretation of the standard tools. Nevertheless, staff agrees with the mechanical signal of high risk. Addressing the current unsustainable debt situation will require a wide ranging package of complex reforms that will need to be steadfastly implemented over the medium-run.
Fanchart	**High**	...	
GFN	**Low**	...	
Stress test	...	...	
Long term	...	**Moderate**	Upon delivery of the multi-year reform agenda, Lebanon would be in a more comfortable long-run position. Additionally, offshore natural gas reserves are at an early stage of exploration. A determination of their viability for investment constitutes a potential upside risk.
Sustainability assessment 2/	Not required for surveillance countries	Not required for surveillance countries	The baseine internalizes that the authorities will complete their debt restructuring strategy to deliver debt sustainability. Without restructuring and comprehensive reforms, debt would remain unsustainable.
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Lebanon is currently experiencing unsustainable debt. However, the authorities have committed to a wide-ranging reform package, which underpins the baseline. The authorities' measures include fiscal adjustment, debt restructuring (for illustrative purposes assumed to be completed in 2024), a unified exchange system, banking system restructuring, repairing the BdL's balance sheet, and other structural reforms (including in the energy sector) to enable the economy to begin recovering. Prompt and full implementation of this reform agenda would deliver a significant near-term reduction of debt, a downward debt trajectory over the medium term, and manageable financing needs. **If implemented as assumed, the debt stabilization and acceptable rollover risk conditions under the Fund's definition of debt sustainability would be expected to be met, which would allow for an assessment that debt is sustainable but not with high probability**. However, if the status quo were to persist, then debt would remain unsustainable.

Source: Fund staff.
Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.
1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.
2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Lebanon: Debt Coverage and Disclosures

	CG	GG	NFPS	CPS	Other	Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					Yes	

2. Subsectors included in the chosen coverage in (1) above:

		Subsectors captured in the baseline	Inclusion	Comments
CPS / NFPS / GG: expected / CG	1	Budgetary central government	Yes	
	2	Extra budgetary funds (EBFs)	No	
	3	Social security funds (SSFs)	No	NSSF is not consolidated
	4	State governments	No	
	5	Local governments	No	
	6	Public nonfinancial corporations	No	
	7	Central bank	No	Expected BOP support is included
	8	Other public financial corporations	No	

	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/
3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

	Basis of recording		Valuation of debt stock		
4. Accounting principles:	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

	Consolidated	Non-consolidated
5. Debt consolidation across sectors:	Consolidated	Non-consolidated

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on Intra-Government Debt Holdings

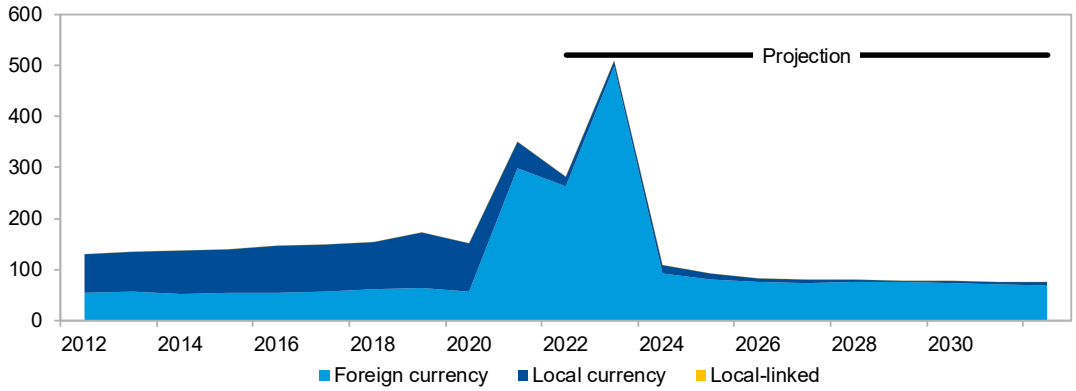
	Issuer \ Holder	Budget. central govt	Extra-budget. funds (EBFs)	Social security funds (SSFs)	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1 Budget. central govt									0
	2 Extra-budget. funds									0
	3 Social security funds									0
	4 State govt.									0
	5 Local govt.									0
	6 Nonfin pub. corp.									0
	7 Central bank									0
	8 Oth. pub. fin. corp									0
	Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

The DSA perimeter is the central government, with the inclusion of expected BOP support, which while being on the central bank's balance sheet, is ultimately the liability of the government. State-owned enterprises are only reflected through direct transfers to EdL, certain transfers to SOEs for salaries (both on the spending side), and through non-tax revenues transferred from SOEs to the budget. In addition, the framework assumes clearance of accumulated arrears of which the largest part is related to NSSF. The envisaged SOEs and PFM reforms should help prevent additional fiscal costs.

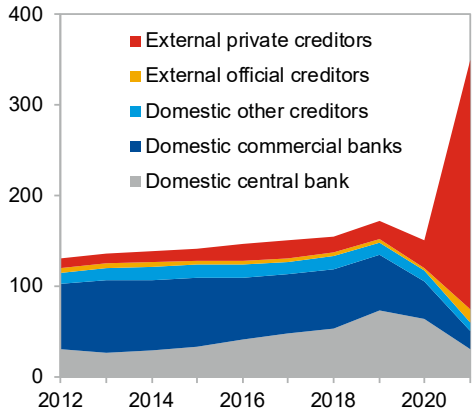
Lebanon: Public Debt Structure Indicators

Debt by Currency (percent of GDP)



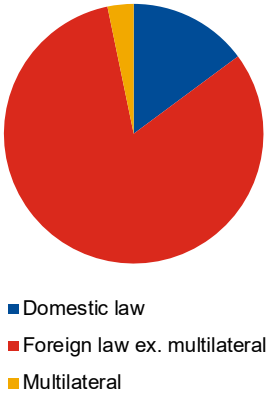
Note: The perimeter shown is central government.

Public Debt by Holder (percent of GDP)



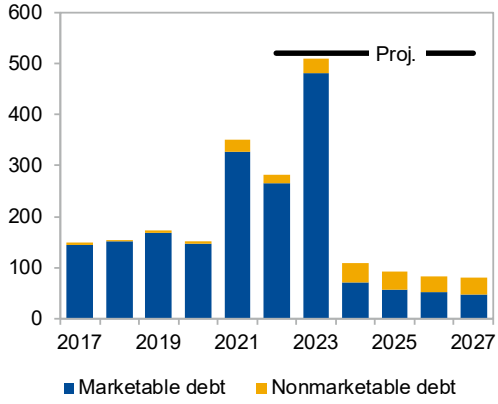
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2021 (percent)



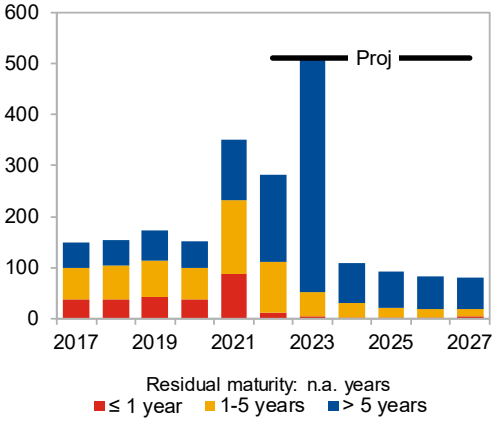
Note: The perimeter shown is general government.

Debt by Instruments (percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (percent of GDP)



Note: The perimeter shown is general government.

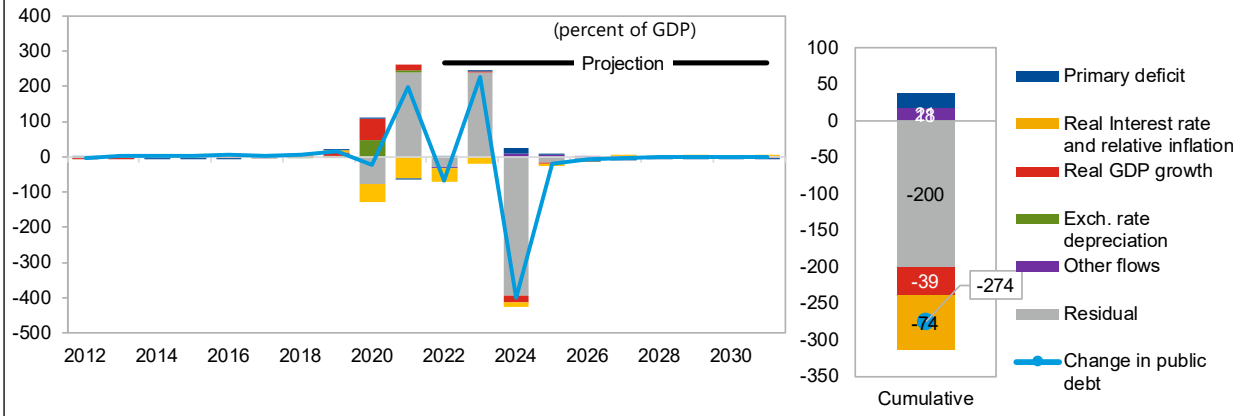
The drastic exchange rate depreciation that coincided with the onset of the crisis has led to an explosion of debt from valuation effects of the government's foreign currency liabilities (particularly Eurobonds). As a result, public debt is mainly in foreign currency, held by foreign creditors, and subject to foreign law. Over the forecast horizon, debt will be largely composed of concessional borrowing and the (non-market) BdL recap bond, which will tilt debt toward non-marketable and longer-term instruments.

Lebanon: Baseline Scenario

(based on the reform scenario assumptions, percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection				
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	349.9	282.3	509.3	110.0	91.5	83.6	80.9	79.7	79.2	77.5	77.0	75.8
Change in public debt	199.3	-67.5	227.0	-399.3	-18.5	-7.9	-2.7	-1.2	-0.6	-1.7	-0.6	-1.1
Contribution of identified flows	-39.6	-38.5	-14.1	-6.9	-3.4	-1.3	0.4	-1.8	-2.2	-2.4	-2.0	-1.8
Primary deficit	-1.9	4.3	3.5	16.3	0.6	-0.7	-0.9	-0.4	-0.6	-0.6	-0.3	-0.4
Noninterest revenues	9.8	6.3	9.5	15.1	16.0	16.3	16.4	16.5	16.5	16.6	16.6	16.6
Noninterest expenditures	7.9	10.7	13.0	31.4	16.6	15.7	15.4	16.1	15.9	15.9	16.2	16.2
Automatic debt dynamics	-37.7	-39.5	-16.5	-32.6	-10.7	-4.0	-1.9	-1.5	-1.6	-1.8	-1.6	-1.4
Real interest rate and relative inflatio	-61.9	-39.5	-17.9	-13.6	-6.0	-1.2	0.6	0.9	0.7	0.6	0.7	0.8
Real interest rate	-96.6	-217.0	-207.6	-284.9	-40.4	-17.8	-4.8	0.2	0.1	-0.1	0.0	0.2
Relative inflation	34.7	177.5	189.8	271.4	34.4	16.6	5.3	0.7	0.7	0.7	0.7	0.7
Real growth rate	16.7	0.0	1.4	-19.0	-4.7	-2.8	-2.5	-2.4	-2.3	-2.3	-2.3	-2.3
Real exchange rate	7.4	…	…	…	…	…	…	…	…	…	…	…
Other identified flows	0.0	-3.3	-1.2	9.4	6.8	3.3	3.2	0.0	0.0	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	0.0	-3.3	-1.2	9.4	6.8	3.3	3.2	0.0	0.0	0.0	0.0	0.0
Contribution of residual	238.9	-29.1	241.1	-392.5	-15.1	-6.6	-3.1	0.6	1.6	0.8	1.4	0.7
Gross financing needs	6.1	7.7	9.8	21.9	4.9	3.2	2.8	6.5	6.6	5.3	5.6	5.7
of which: debt service	7.9	3.4	6.3	5.6	4.3	3.9	3.7	6.8	7.1	5.9	5.9	6.1
Local currency	7.8	2.6	3.5	2.5	1.4	1.0	0.9	0.9	0.8	0.3	0.2	0.4
Foreign currency	0.2	0.8	2.8	3.1	2.9	2.9	2.8	5.9	6.4	5.6	5.7	5.7
Memo:												
Real GDP growth (percent)	-10.0	0.0	-0.5	3.9	4.5	3.2	3.0	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator; percent)	140.8	165.0	290.0	143.0	70.0	30.0	10.0	2.9	2.9	2.9	2.9	2.9
Nominal GDP growth (percent)	116.7	165.0	288.0	152.4	77.7	34.2	13.4	6.0	6.0	6.0	6.0	6.1
Effective interest rate (percent)	1.8	0.6	4.6	1.8	4.8	3.9	3.5	3.2	3.0	2.7	2.9	3.2

Contribution to Change in Public Debt



Under the baseline, key elements of the authorities would be implemented in 2024, with sizable impacts on the outlook. First, the authorities would complete their debt restructuring in 2024, causing a sizable reduction in public debt. In the same year, gross financing needs would be elevated by a high primary deficit that is highly distorted by the issuance of a large recapitalization bond to the central bank, and which does not bear market risk. Thereafeter, debt would be on a downward trend, reflecting fiscal adjustment, improved growth, more orderly exchange rate dynamics, and more concessional financing.

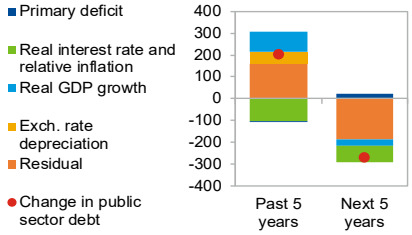
Lebanon: Realism of Baseline Assumptions

Forecast track Record 1/	t+1	t+3	t+5
Public debt to GDP			
Primary deficit			
r - g			
Exchange rate depreciaton			
SFA			
	real-time	t+3	t+5
Historical output gap revisions 2/			

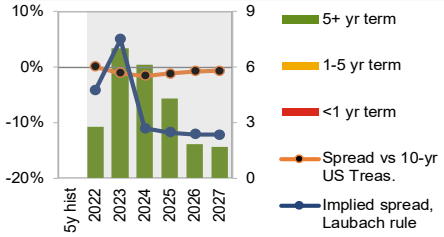
Comparator group:
Emerging Markets, Non-Commodity Exporter, Surveillance

Color code:
Optimistic: > 75th percentile; 50-75th percentile
Pessimistic: 25-50th percentile; < 25th percentile

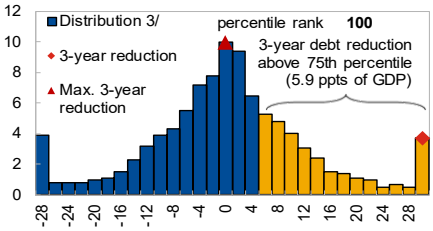
Public Debt Creating Flows
(Percent of GDP)



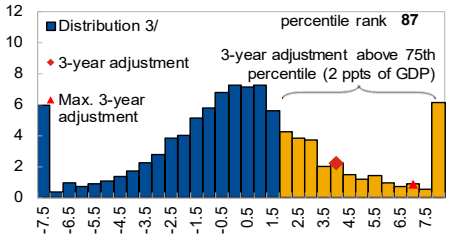
Bond Issuances (bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))



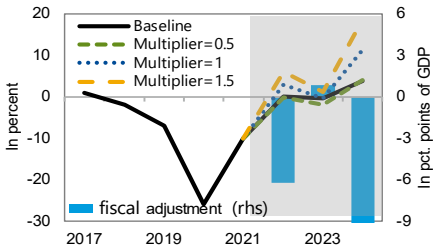
3-Year Debt Reduction
(Percent of GDP)



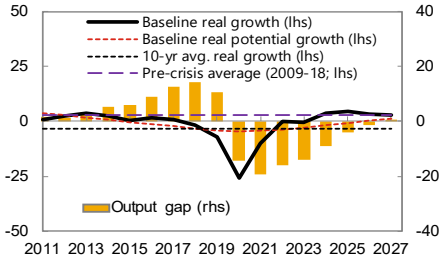
3-Year Adjustment in Cyclically-Adjusted Primary Balance (percent of GDP)



Fiscal Adjustment and Possible Growth Paths
(lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS)



Real GDP Growth
(in percent)



The realism tools flag some signs of potential optimism, though the unprecedented nature of the crisis and the long period of unsustainable policies that preceeded the outbreak of stress may make cross-country and historical comparisons difficult. The forecast track record suggests some pattern of misses, particularly as regards the real interest-growth differential and the output gap. The debt restructuring will lead to unusual behavior of debt drivers and a large reduction in debt by comparison with peers and Lebanon's own history. The fiscal reforms that will coincide with the restructuring will constitute an adjustment over 2023-25 in the top quartile of past fiscal adjustments. Given the restructuring, debt issuance will be in the form of concessional financing, with some medum-term domestic issuance for arrears clearance. Fiscal multiplier analysis is broadly in line with the baseline growth. However, growth is projected above its 10-year average, although this comparison should be interpreted with caution. Recent growth has been distorted by the current crisis, which began in 2019, and staff's medium-term growth projection is in line with the pre-crisis average.

Source : IMF Staff.

1/ Projections made in the October and April WEO vintage.

2/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

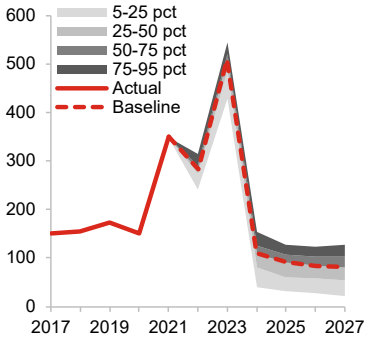
3/ Starting point reflects the team's assessment of the initial overvaluation from EBA (or EBA-Lite).

4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

5/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates and final estimates in the latest October WEO) in the total distribution of revisions across the data sample.

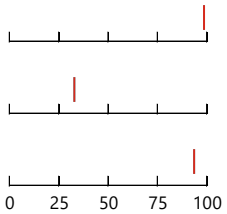
Lebanon: Medium-Term Risk Assessment

Final Fanchart (percent of GDP)

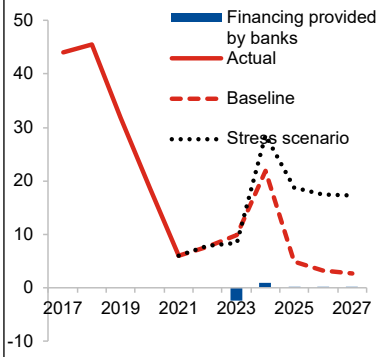


Debt Fanchart Module

	Value	Contrib [1/]	Percentile in peer group [2/]
Fanchart width *(percent of GDP)*	106.5	1.5	
Probability of debt non-stabilizaiton *(percent)*	4.3	0.0	
Terminal debt-to-GDP x institutions index	71.4	1.6	
Debt fanchart index (DFI)		3.1	
Risk signal: [3/]		High	

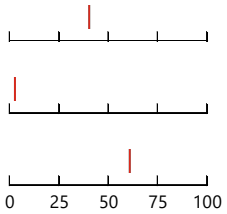


Gross Financing Needs (percent of GDP)

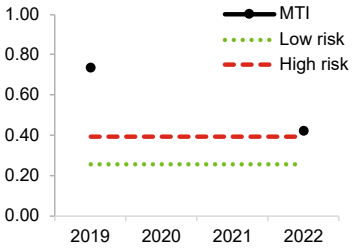


Gross Financing Needs (GFN) Module

Average baseline GFN *(percent of GDP)*	8.4	2.9	
Banks' claims on the gen. govt *(pct bank assets)*	1.7	0.6	
Chg. In banks' claims in stress *(pct banks' assets)*	12.3	4.1	
GFN financeability index (GFI)		7.5	
Risk signal: [4/]		Low	



Medium-Term Index (MTI; index number)



Medium-Term Risk Analysis

	Value	Weight	Contribution
Debt fanchart index (normalized)	0.7	0.5	0.3
GFN finaceability index (normalized)	0.1	0.5	0.1
Medium-term index	0.4		
Risk signal: 5/	High		
Final assessment:	High		

Prob. of missed crisis, 2022-2027, if stress not predicted: 54.5 pct.

Prob. of false alarms, 2022-2027, if stress predicted: 8.0 pct.

The mechanical signal for the medium term assessment is high. This result largely reflects the debt fanchart, which is heavily distorted by the crisis and the expected debt restructuring. The magnitude of the shocks in recent years is causing the fanchart to be very wide. However, if the restructuring is completed and deep reforms are implemented, actual medium-term risks in Lebanon may be lower than signaled by the tool. The gross financing needs module, which emits a borderline low-risk signal, further supports a view that medium-term risks may be more contained. Several adjustments consistent with the guidance on the SRDSF have been implemented to reflect Lebanon's special circumstances. First, the debt fanchart's historical sample ends in 2019 as subsequent observations are contaminated by the default, restructuring process, and structural break induced by the collapse of the pegged exchange rate regime. An exit clause is activated for the adjusted fanchart as sharp drop in public debt is induced by the deep debt restructuring to meet sustainability objectives. In the GFN module, the change in bank claims is calculated on a measure of bank assets that decreases as a percent of GDP, in line with the expected evolution of the banking sector.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.

2/ The comparison group is non-commodity exporter, emerging markets, surveillance.

3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.

4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.

5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

Annex III. External Sector Assessment

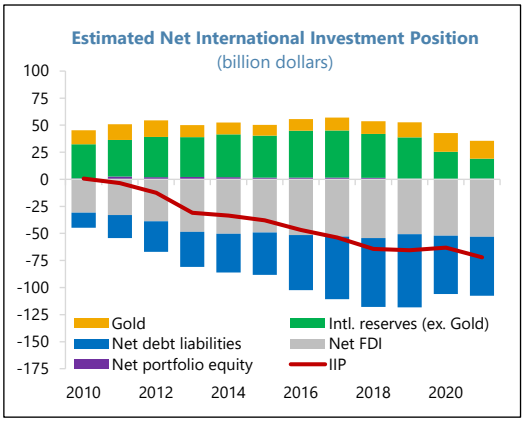
Overall Assessment: *The unprecedented nature of the ongoing crisis complicates analysis of the external position of Lebanon in 2022. Market-based measures of the exchange rate show sharp nominal depreciation, and while complicated by the multiplicity of exchange rates and the very high inflation, staff estimate that real depreciation has occurred over the past two years. Still, Lebanon's external debt continues being unsustainable, amid an ongoing sovereign default, which along with the severe stress in the banking system has led to abnormal financial account flows. The current account deficit continues to be wide, but has shown some limited evidence of external adjustment as of 2022. However, reserves are well short of adequate levels.*

Consequently, the overall external position of Lebanon in 2022 is assessed as weaker than warranted by fundamentals and desirable policies*.*

Potential Policy Responses: *Addressing the crisis will require a wide-ranging package of comprehensive reforms including moving to a credible and transparent exchange rate system; fiscal adjustment and a decisive restoration of debt sustainability; restructuring the banking system to return it to health; and broader reforms to boost the economy, including in the energy sector, which should contribute to external adjustment.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Lebanon does not produce official statistics on the international investment position (IIP), although available information points to continued deterioration over the last few years from an already weak starting point. According to a staff estimate derived from international databases, the net IIP was close to -$72 billion or about -350 percent of GDP in 2021, steadily worsening over the past five years from -$54 billion or 101 percent of GDP in 2017.[1] Lebanon has a very high degree of indebtedness (gross liabilities of nearly $150 billion or about 730 percent of GDP). Of the external debt that amounted to 392 percent of GDP, slightly more than three quarters were banking sector liabilities, and about 20 percent was owed by the public sector. Foreign assets have plunged in recent years largely due to the steep drop in in BdL's international reserves (gross assets estimated at $77 billion or 378 percent of GDP).

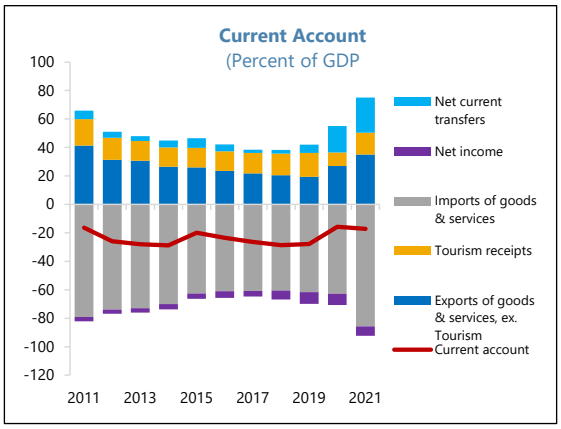


Assessment. The risks associated with Lebanon's unsustainable external debt burden and insufficient reserves have already crystallized and exacerbated the current crisis. The government is in default on its sovereign Eurobonds and has accumulated arrears with several official creditors. Resolving this situation will require the authorities to follow through on key elements of their reform program including as regards the exchange rate regime, fiscal reforms and their external debt restructuring proposal, and the banking sector restructuring.

2021 Estimate (% GDP)	NIIP: -352	Gross Assets: 378	Debt Assets: 125	Gross Liab.: 730	Debt Liab.: 392

Current Account

Background. The current account deficit is estimated at 15.9 percent of GDP in 2021.[2] While it represents a narrowing from deficits averaging nearly 24 percent of GDP over the last 5 years, it remained very wide. The large deficits have been reflective of very high levels of imports, which is partly financed through remittances, which have risen in recent years. Additionally, the large tourism sector has started to partially recover after collapsing due to both the COVID-19 shutdowns as well as the Port of Beirut explosion in 2020. Balance-of-payments data are not yet available for 2022 but staff estimates a deficit of 29 percent of GDP, as imports remained high, likely reflecting opportunistic transactions to take advantage of favorable (official) exchange rate valuations for taxation purposes.



Lebanon: EBA-lite Model Results, 2022
(in percent of GDP)

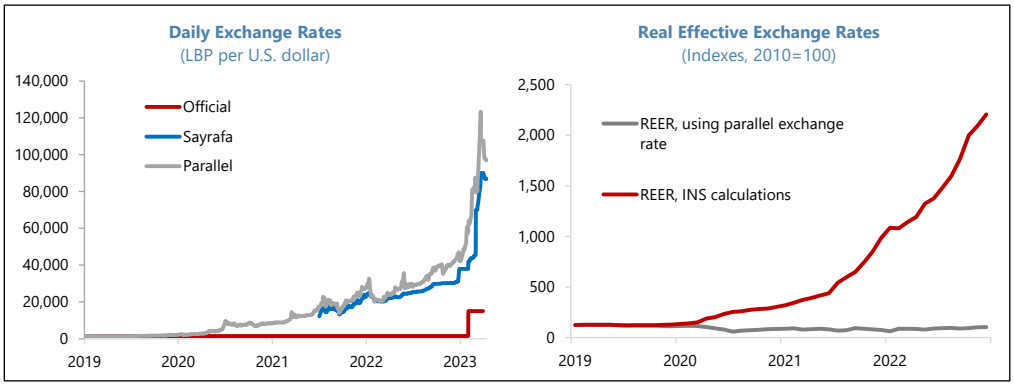
	CA model 1/	REER model 1/ w/ BdL Exch. Rate	REER model 1/ w/ Average Exch. Rate 2/
CA-Actual	**-29.0**		
Cyclical contributions (from model) (-)	2.6		
COVID-19 adjustors (-) 3/	-0.7		
Additional temporary/statistical factors (-)	0.0		
Natural disasters and conflicts (-)	0.1		
Adjusted CA	**-31.0**		
CA Norm (from model) 4/	**-23.3**		
Adjustments to the norm (-)	0.0		
Adjusted CA Norm	**-23.3**		
CA Gap	**-7.7**	**-100.0**	**28.5**
o/w Relative policy gap	1.0		
Elasticity	-0.5		
REER Gap (in percent)	**17.1**	**220.6**	**-62.9**

1/ Based on the EBA-lite 3.0 methodology
2/ Staff's calculations of the weighted average of various exchange rates used in Lebanon.
3/ Additional cyclical adjustment to account for the temporary impact of the pandemic on (-0.7 percent of GDP). 100 percent of the shock to tourism is assumed temporary.
4/ Cyclically adjusted, including multilateral consistency adjustments.

Assessment. Under the EBA-Lite current account model, after applying cyclical adjustments, the cyclically adjusted current account rises to -31 percent of GDP, against the norm of -23.3 percent of GDP. This implies a current account gap -7.7 percent of GDP, or a REER gap of about 17 percent. This gap is consistent with an external position that is substantially weaker than implied by fundamentals and desirable policies.
The overall result appears intuitive given the strong external pressures currently evident in Lebanon.
The contribution to the gap that is attributable to differences between actual policy settings and their desirable medium-term levels is particularly notable and reflects sizable deviations of the fiscal balance and change in reserves from their desirable levels.

Real Exchange Rate

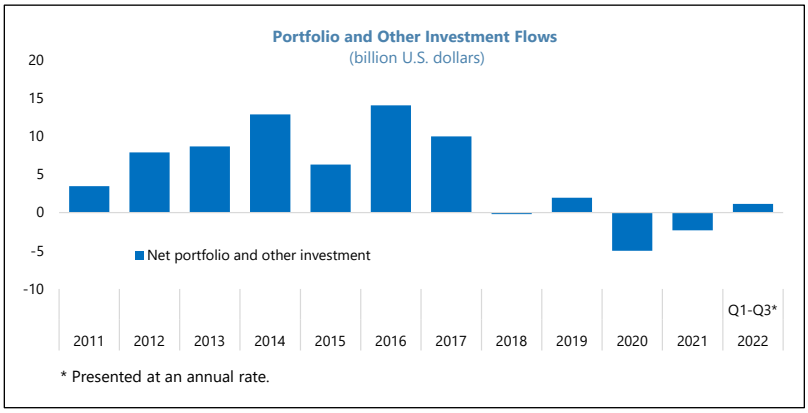
Background. Analysis of the real exchange rate is complicated by the multiple nominal exchange rates at which transactions take place in the Lebanese Economy. BdL posted an official exchange of 1,507.5 LBP per dollar, which is significantly below other rates. The Sayrafa rate (for authorized transactions) averaged about 35,625 LBP per dollar in 2022 and depreciated about 35 percent from 2021. Additionally, the daily average parallel rate depreciated almost 48 percent in 2022, to almost 47,700 LBP per dollar. The multiple nominal exchange rates imply different real effective exchange rates (REER). Using the Fund's standard INS index, which uses BdL's rate, the average REER in 2021 appreciated 144 percent in 2021 and a further 152 percent in 2022. In comparison, in a REER computed with the parallel rate, a real depreciation of about 7 percent took place in 2021, followed by an appreciation of 7.8 percent in 2022. Additionally, so far in 2023, exchange rate dynamics have been large, with the official rate rising to 15,000 LBP per dollar in February 2023 and the parallel and Sayrafa rates showing sharp depreciations in March, which have been partially reversed, at least partly reflecting BdL's efforts to limit the depreciation.



Assessment. Reflecting the extremely diverging behavior of the different REER indexes, the EBA-Lite REER model has been applied to both the INS and parallel exchange rate REER indexes. With the severe appreciation of the INS REER measure, the standard model gives a REER gap of 221 percent in 2022, which implies a current account gap of about -100 percent of GDP and is consistent with an overall external position that is substantially weaker than implied by fundamentals and desirable policies. When repeated on the REER computed with the parallel market exchange rate, which shows less dramatic behavior, the REER gap is about -63 percent, which implies a current account gap of 28½ percent of GDP—a position that is stronger than warranted by fundamentals and desirable policies. Overall, staff does not view the REER computed with the official exchange rate as a reliable measure of the real exchange rate as only a limited set of transactions occur at that rate. Similarly, measuring international transactions amid the crisis is extremely difficult, warranting some caution in interpreting the current account model. The REER model using staff's estimate of the average REER reflects the adjustment that has already taken place, although its result is subject to considerable uncertainty also.

Capital and Financial Accounts: Flows and Policy Measures

Background. The large net outflows observed in 2020 appeared to have reduced in 2021 and eased further in the first half of 2022. However, this slowdown has coincided with highly distressed conditions: Given the government's unsustainable debt burden and ongoing default, international bond issuance has halted in recent years. Lebanese banks' non-resident deposit and non-deposit liabilities have decreased at slower rates in the context of withdraw limits. Outside of the government and banks, economic activity continues being depressed, limiting scope for more sizable investment flows in those sectors.



Assessment. A return to normal capital flows will require decisive action on unifying the exchange rate system, achieving public debt sustainability, and restoring the health of the banking system. The early implementation phases of these reforms may require the implementation of formal capital controls. However, these measures would be expected to be temporary. Their relaxation, along with the broader reform package—including energy sector reforms to allow the broader economy to expand—should help to strengthen Lebanon's attractiveness as an investment destination over a longer horizon. Once this occurs, both inward and outward capital flows can pick up again in the context of a more stable economy.

FX Intervention and Reserves Level

Background. Since reaching a peak of $36.8 billion in October 2017 (69 percent of GDP), usable international reserves have dropped to $10.4 billion as of December 2022 (44 percent of GDP) or about 6.3 months of projected 2023 imports); gold reserves amounted to an additional $15 billion, though their use requires parliamentary approval. The plunge in international reserves over the past several years reflected BdL's efforts to support the exchange rate peg as the crisis began to unfold, triggering deposit and capital outflows. The pegged regime has since given way and a multiplicity of exchange rates has emerged—both official exchange rates, including several ad hoc facilities established by BdL for transactions at less depreciated rates as well as the Sayrafa and parallel exchange rates. Additionally, BdL has supported subsides for certain imports. Given this, the reserve loss has continued, although the pace in 2022 appears less than in recent years.

Assessment. The current level of reserves amounts to about 37 percent of the Assessing Reserve Adequacy (ARA) metric for floating rate regimes—well below the recommended 100–150 percent range. In line with BdL's balance sheet weaknesses, reserves are also below 100 percent of commercial banks' foreign currency reserve requirements. The authorities' package of comprehensive reforms—particularly with respect to the exchange system—would lead to significant external adjustment and relieve pressures on reserves. Prospective new official financing that may coincide with such a reform program could also contribute to a re-accumulation of reserves.

[1] In estimating the IIP, staff has taken the External Wealth of Nations data through 2018 as a starting point, and appended estimates from the Coordinated Portfolio Investment Survey (CPIS) on portfolio investment; UNCTAD's World Investment Report and BdL's Balance of Payments Flows for foreign direct investment; WEO estimates for external debt liabilities; and BIS Locational Banking Statistics for external debt assets.

[2] The analysis using the EBA-Lite current account model uses the total current account balance rather than the current account excluding official transfers, which is cited elsewhere in this report.

Annex IV. Financial Sector Restructuring

This annex presents a set of issues related to the restructuring of the financial sector and allocation of its losses.

The Losses and the Central Bank

1. **The losses in the commercial banks and BdL stem from four main sources:** (i) the exchange rate depreciation; (ii) expected restructuring of the public debt (Eurobond holdings and LBP-denominated debt, whose value has collapsed with the ongoing depreciation); (iii) non-performing loans held by commercial banks; and (iv) losses incurred by BdL.

Select Assets and Liabilities, as of January 2023

Holder of Liability (Creditor) → Issuer of Liability (Debtor) ↓	G	BdL	Banks	Private
Government (T-bills and Eurobonds)				
LBP trln	-	59.1	12.7	-
US$ bn at the official rate of 1,507.5	-	4.2	5.8	-
Banque du Liban (deposits, CDs, overdraft)				
LBP trln	43.2	-	32.0	-
US$ bn at the official rate of 1,507.5	-14.6	-	86.2	-
Banks (deposits)				
LBP trln	7.5	-	-	45.8
US$ bn at the official rate of 1,507.5	-	-	-	95.8
Private Sector (loans)				
LBP trln	-	-	13.8	-
US$ bn at the official rate of 1,507.5	-	-	8.6	-

Sources: BdL and IMF staff calculations.

2. **Estimating these losses as well as the ultimate capital and FX position precisely is not possible** without completing first an asset quality review for the banks and knowing the parameters of the public debt restructuring. However, approximate calculations using aggregate banking sector data and assuming a Eurobond haircut of 75 percent (in line with market commentaries and the prices the bonds are traded at) suggest that BdL will end up with negative equity of some US$60bn and a net open FX position of a similar magnitude.

3. **Eliminating BdL's losses and bringing BdL to zero net worth,** thereby not compromising its ability to attain its policy objectives in the future and maintaining its financial independence, requires writing off a similar amount of commercial banks' claims against BdL (out of the total of US$86 billion of deposits and CDs banks hold at BdL), as the sovereign is unable to recapitalize it on such a scale, given its own unsustainable debt position.

4. This large transfer of BdL losses to banks' balance sheet implies that banks will become severely undercapitalized. As current shareholders or other investors are unlikely to inject the capital needed to recapitalize the banks, rehabilitating them will require the use of internal recapitalization mechanisms.

The Banks and the Deposits

5. One upfront solution, which the authorities floated initially, is for a partial write down, on a bank-by-bank basis, of deposits held at banks, above a minimum socially acceptable threshold, to bring banks' capital to zero. This would be done only following the bail-in of shareholders, subordinated debt, and related deposits. For banks to be viable, current shareholders or new investors will have to commit new capital to bring the bank's capital above the required minimum with some timebound use of regulatory forbearance until the full capital is restored. Banks that fail to meet this criterion would exit the market.

6. Banks currently hold almost US$100 bn worth of FX deposit accounts. Preliminary illustrative calculations suggest that despite the size of the write-off, it might be feasible to fully protect deposits up to US$100,000.

FX Deposits by Tranches as of December 31, 2022
(Preliminary and illustrative calculations)

Tranches	Number of Accounts	Deposit Values, US$ mn	Percent of Accounts	Percent of Deposits	Cost of protecting up to 100K, US$ mn
Less than US$100,000	1,246,741	16,761	88%	18%	16,761
US$100,000 to US$ 1 mn	152,527	40,795	11%	44%	15,253
US$1 mn to US$10 mn	10,790	24,416	1%	26%	1,079
More than US$10 mn	443	10,234	0.03%	11%	44
Total	**1,410,501**	**92,206**			**33,136.7**

Sources: BCC and IMF staff calculations. Data are reported on solo basis (i.e., without data of branches abroad, subsidiaries in Lebanon and subsidiaries abroad)

7. However, there may be other large depositors that warrant protection as well due to their social relevance (such as, accounts of pension funds, insurers, and other public interest institutions) and expanding protection to such deposits will inevitably lead to a lower deposit protection threshold for everyone else. Evaluating this impact is not feasible at this stage since the exact ownership structure of many deposit accounts is unclear due to the current bank secrecy law.

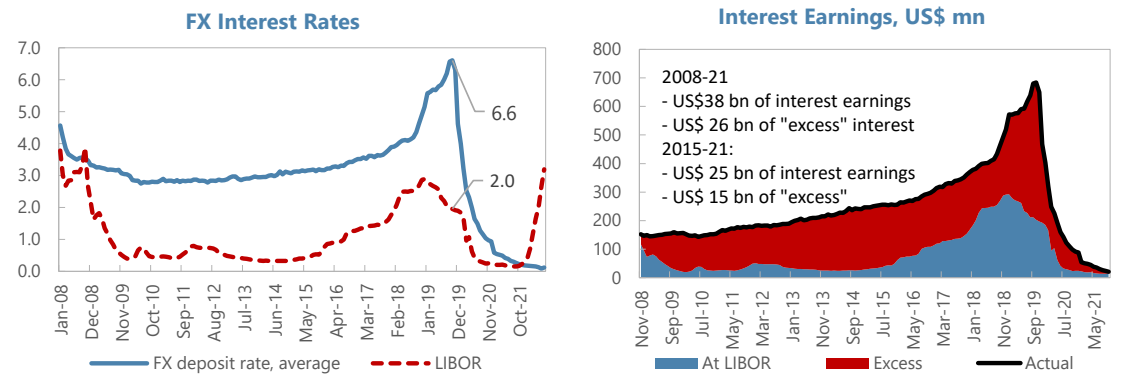
Modifications to Find Political Consensus

8. It has proved difficult for the government and parliament to form a consensus (let alone convince depositors and the general public) on an upfront banking strategy that writes down depositors on such a scale due to the implications for depositors. Several modifications have been

proposed to mitigate the impact and therefore facilitate progress toward a bank restructuring strategy. These include:

- *"Eligible" vs "non-eligible" deposits*. Allegedly, well-connected large depositors were allowed to convert their LBP holdings into US$ at the official exchange rate even after the parallel exchange rates substantially diverged from it. They also were offered top-ups to their "lollar" deposits in exchange for new "fresh" dollar deposits (see Annex V.C). There seems to be popular support for such "ineligible" deposits to either incur a higher haircut or to be lirafied at non-market exchange rates. Some estimates suggest that the share of such deposits could be some 25 percent of total FX deposits. However, determining the exact amount requires very granular and time-consuming analysis, involving examination of all transactions since October 2019. Such analysis would also be difficult to independently verify given the current banking secrecy law.

- *Treating "excess" interest differently*. Since the interest rates on deposits were excessively high during the financial engineering years, it is argued that depositors could be convinced to forego their interest earnings if principal amounts are untouched. Staff estimate that the interest amount over the LIBOR rate during 2015–21 could amount to about US$15 bn, while total interest earnings during that period were about US$26 bn.



Sources: BdL and IMF staff calculations.

- *Recapitalizing BdL*. Under the proposed SLA banking sector restructuring strategy, the government would issue a marketable bond to recapitalize BdL and reduce the write-off of BdL's FX liabilities to commercial banks. In turn, banks would reduce the write-off of their customers' FX deposits. BdL's recapitalization would benefit the whole pool of depositors, and thus would be equitable. However, such an approach could only work if the size and terms of the bond do not jeopardize the debt sustainability. This approach would also require that certain strict preconditions for BdL's governance and internal controls are met.

- *Use of state assets*. Selling existing state assets (land and SOEs) or redirecting part of their income stream could help significantly improve the prospect of compensating depositors. However, pricing these assets accurately under the current circumstances will be near impossible and selling them would be undesirable under the current governance and transparency practices. Moreover, such a use of state assets would complicate discussions with external

creditors. At the same time, use of the revenue streams generated by reformed and revamped state assets (possibly after entrusting their management to the private sector) could be appropriate to recapitalize BdL, thereby reducing the losses to commercial banks and depositors, as long as this is done in a structure that includes very strict preconditions on BdL's governance and internal controls and is consistent with the debt sustainability objectives.

- *Protecting per depositor per system rather than per depositor per bank*. Many, including the authorities, argue that the crisis is systemic, driven by failures of the government and the central bank, and therefore the protection ceiling should be set per depositor throughout the banking system rather than per depositor per bank. However, some banks may have been more prudent in their investment strategies than others; thus, their depositors deserve to be treated differently. Moreover, multiple deposit accounts per depositor would be operationally difficult to evaluate, even more so under the current unhelpful bank secrecy law. Even if that were possible, deciding which accounts, for what amount, and in which bank should be protected will have complex implications for individual banks' viability assessments and for the recovery rates for the large depositors. This will make having a transparent, fair, and legally sound strategy very complex and difficult to execute.

- *A minimum deposit protection threshold for everyone, regardless of the viability of the banks*. If the crisis is systemic in nature, then, all small depositors should be protected in full, regardless of the bank where their deposits are held. It is unclear who would ultimately bear the cost of this top-up, however; and if it becomes the government's obligation, whether it would not jeopardize the debt sustainability prospects.

- *Recourse to future budget surpluses*. Some have suggested using a part of future budget surpluses to compensate depositors if certain conditions are met (e.g., growth rates and primary surpluses above those agreed upon within the IMF program framework). However, the introduction of state contingent payouts could complicate discussions with external creditors, not to mention that such benchmarks could be easily manipulated. In addition, links to budget surpluses could incentivize policymakers to scale back on much needed social and infrastructure spending in order to "deliver" higher surpluses. Moreover, this ultimately implies transfer of wealth from the Lebanese citizens at large (current and future generations) to a relatively small group of depositors (potentially including non-residents and non-citizens).

- *Deposit recovery fund*. Many interlocutors and observers argue that for the banking sector restructuring strategy to be accepted, depositors need to be "given hope," i.e., an upside to recover over time. It is argued that the best way for that would be through creation of a dedicated fund that would be funded from a number of sources (e.g., proceeds from operating and privatizing state assets, recovery of stolen assets, future oil and gas revenues, etc.). However, a fund that explicitly or implicitly guarantees depositors constitutes a contingent claim on government resources, undermining the debt sustainability objectives and placing constraints on the fiscal policy. Moreover, the credibility of many of these funding sources is questionable, while large competing demands, including for social and development needs, cannot be ignored.

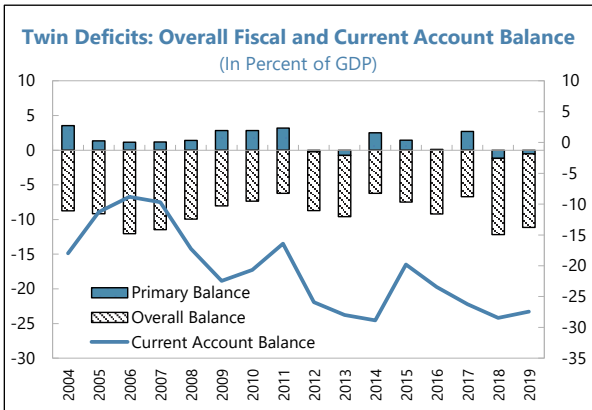
Annex V. Supporting Analytical Materials

A. The Origins of the Crisis

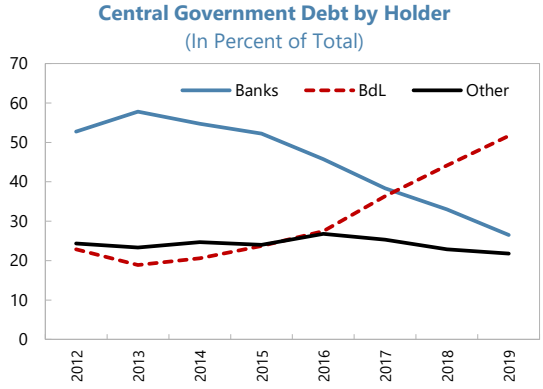
1. Over the past two decades, Lebanon built up unsustainable fiscal and external imbalances. Large fiscal and current account deficits—in the context of high dollarization, an increasingly overvalued exchange rate, and lack of structural reforms—resulted in very high public debt and financing needs.

2. Large external borrowing needs were met through deposit inflows and Eurobonds. Deposit inflows increased significantly during the global financial crisis of 2008–10, helping to finance the twin deficits and an increase in international reserves. However, inflows slowed down after the start of the Syrian war, and the central bank stepped in to provide government financing. The share of government debt held by BdL increased from 23 percent of total debt in 2012 to 52 percent in 2019, with a mirror decline in the share of public debt held by banks.

3. Starting in 2015, BdL undertook complex financial operations to attract inflows by offering unsustainable high interest rates on BdL deposits. This "financial engineering" led banks to massively increase their foreign currency exposure to BdL allowing them to offer high interest rates on retail deposits in a context of low global interest rates and increasing profits. However, it eventually led to unprecedented losses to the central bank (see Annex IV).



Sources: National Authorities and IMF staff calculations.



Sources: National Authorities and IMF staff calculations.

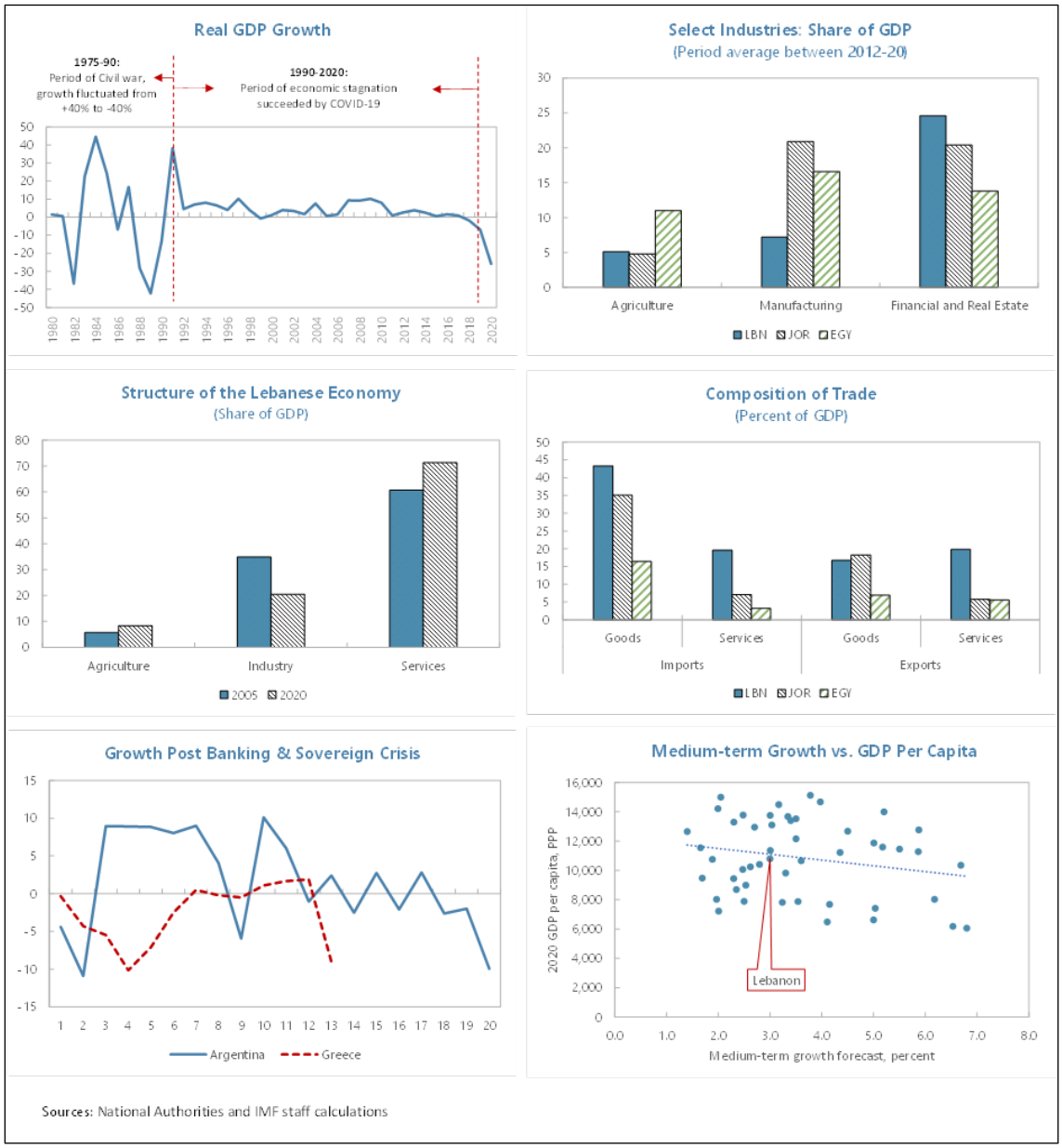
4. Amid weakening confidence, Lebanon was hit by a sudden stop, amplified by sovereign-bank linkages and the Eurobond default in March 2020, and resulting in an economic collapse of historical proportions. Deposit inflows reversed in 2018, amid concerns about an over-leveraged banking sector and political tensions. The liquidity crunch continued in 2019, leading to large capital outflows, breaking the local currency peg to the U.S. dollar, and escalating to large-scale social protests in October 2019. The large FX exposure of banks to the central bank have made them unable to service their clients' FX deposits.

5. Inadequate policies, the COVID pandemic and the August 2020 Beirut port blast have prolonged and amplified the crisis. Vested interest groups and distrust among political parties,

banks and other stakeholders have negatively impacted policy decisions to deal with crisis, including adopting a capital controls law, abiding by mandatory budget timelines, and restructuring the banking sector. The crisis has also been worsened by the COVID pandemic, which resulted in nearly 11,000 deaths so far, and the Beirut port blast.

B. Lebanon's Growth Prospects

6. Lebanon's growth outlook is likely to remain subdued given the current economic and political climate and the structure of its economy. The Lebanese economy faces structural bottlenecks that need to be addressed to reach a strong trajectory in the medium to long term. Until those have been addressed, staff foresee even in the reform scenario medium-term growth of around 3 percent.



7. Growth in Lebanon has been rather volatile, with average growth of about 3.5 percent between 1980 and 2017 but with large deviations (reaching at times ±40 percent). This reflects a volatile geopolitical situation but also the structure of its economy. Unlike peers, such as Egypt and Jordan, Lebanon is heavily dependent on the service sector, with real estate & financial services alone accounting for as much as 25 percent of GDP, and agriculture and industry, on the other hand, having minimal presence. Similar patterns were in place already two decades ago and over time this imbalance has only increased. This dichotomy is evident in the composition of external trade as well: among the three countries, Lebanon has the highest shares of exports of services and imports of both goods and services. A quick structural transformation of such a historically service-oriented economy may not be easy.

8. A number of additional considerations should be factored in. The recovery in Lebanon could be buoyed by competitiveness gains stemming from the sizable real depreciation and presence of highly skilled and entrepreneurial population and diaspora.[1] However, as the experience of countries like Argentina and Greece show, a robust and meaningful growth trajectory is not easy to reach in the aftermath of a crisis of such proportions. A growth of 3 percent is in line with that for the comparable peers as the October 2022 WEO database demonstrates.

9. Moreover, Lebanon's growth potential is held back by several structural deficiencies. It has poor infrastructure, an unfriendly business environment, and a sub-par judicial system. While it is home to some high-quality tertiary education institutions, quality of primary and secondary education has weakened. Removing these constraints will require time and effort.

10. At the same time, Lebanon has a number of sectors that, under the right circumstances, could support higher growth. Several pre-crisis studies have worked on identifying avenues for lifting growth potential and identified the following:[2]

- Agriculture: while currently a highly informal sector, dominated by low-value crops, it has a potential to become a major supplier in the region thanks to abundance of water, were modern methods and technologies adopted to produce higher value crops and products.

- Industry: a few sub-segments—such as food processing, high-end design, and pharmaceuticals—were identified as having a high potential, if accompanied by improvements in infrastructure and regulatory frameworks. Improved competitiveness and reliable and price-efficient energy provision would also be among the necessary prerequisites for a successful transformation.

- Tourism: while an already well-known industry, its share of GDP was estimated to be just in low single percentage points prior to crisis. Limited flight connectivity and high prices, as well as

[1] Estimates of the diaspora can be as high as 14 million people, twice that of the inland population.

[2] E.g., a study undertaken in 2018-19 by McKinsey & Company, https://www.economy.gov.lb/media/11893/20181022-1228full-report-en.pdf

high fragmentation of the industry were seen as key deficiencies. Meeting and incentives travel is seen as a particularly promising sub-segment.

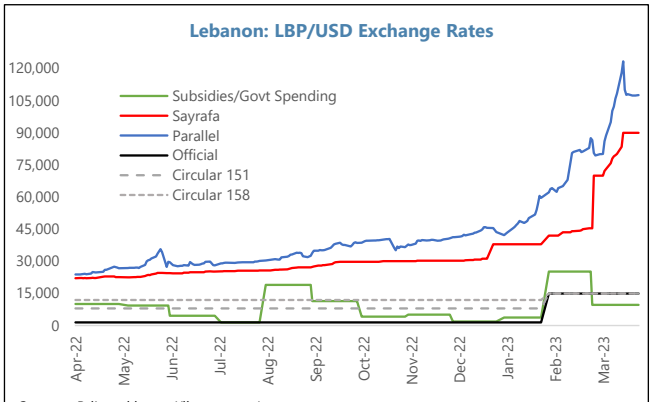
- Knowledge economy: in particular, software development and IT services were an emerging and diversified segment of the economy already before the crisis.

C. Currencies and Exchange Rates in Lebanon

11. Following the crisis, informal and ad hoc capital controls and deposit withdrawal limits have created a distinction between the so called "fresh dollars" and "lollars." The former refers to post-October 17, 2019 FX deposits and international transfers, which are not subject to the same restrictions as "lollars" (Lebanese dollars) that are FX deposits that either had existed prior to this cut-off date or have emerged after it as LBP deposits were converted into FX.

12. These restrictions have also led to an emergence of a parallel market for bank checks and a premium for cash payments. The checks can be traded for cash or used to settle "lollar" bank loans and although they traded at around 90 cents on the dollar at the start of the crisis, their value has steadily declined to around 16 cents. It may fall further as the demand for settling "lollar" loans is now close to being exhausted. Similarly, LBP cash withdrawal restrictions have created a premium for the LBP banknotes over electronic transactions (that use "bira," a bank lira). As a result, many retailers restrict LBP card payments to 50 percent or less of the overall bill amount or refuse card payments altogether.

13. In this environment, several LBP/US$ exchange rates have emerged. In addition to the official peg, these include a parallel FX market, exchange rates for specific transactions and trade in subsidized goods, as well as an exchange rate determined at the BdL-run platform Sayrafa, the purpose of which was to draw trading away from the parallel market and to provide an official reference point for the "depreciated" LBP. The platform is also used by BdL for FXI operations. The gap between the Sayrafa and parallel market has at times been as low as 10 percent, but recently has increased to 35 percent. Given this gap, the Sayrafa rate is effectively an untargeted FX subsidy that creates rent-seeking opportunities and large accounting losses for the central bank. Finally, there is a so-called "custom dollar," an exchange rate used for valuation of imports for tax purposes. This rate was set at 1,500 LBP/US$ till December 2022, at 15,000 till March 2023, at 45,000 till mid-April, and 60,000 LBP/US$ since April 19.



Sources: BdL and https://lirarate.org/
Note: The green line shows the monthly, value-weighted average exchange rate at which the BdL provided FX for transactions relating to subsidies (fuel, wheat, medicine) and public sector spending.

14. Currently, uses of these "currencies" and exchange rates as well as deposit withdrawals are governed by several BdL circulars. These include:

- Circular 148 (April–October, 2020) allowed small depositors, whose total net deposits did not exceed LBP 5 million and/or US$3,000, to withdraw the entire amount in LBP banknotes at the official rate.
- Circular 150 (April 9, 2020) allows for "fresh dollar" accounts to be used for cross-border transactions, card payments, or withdrawals without limits, and exempts them from mandatory reserves at BdL.
- Circular 151 (April 21, 2020), allows FX account holders to withdraw 1,600 per month in LBP and up to US$3,000 per month in LBP initially at a rate of 3,900, later changed to 8,000 and now 15,000.
- Circular 158 (June 8, 2021), allows depositors who had FX accounts before October 31, 2019 to withdraw up to US$800 per month: US$400 in USD, US$200 in LBP at the rate of 12,000 (later 15,000), and US$200 through card payments. Participation in Circular 158 is voluntary but precludes participation in Circular 151.
- Circular 161 (December 16, 2021) permits banks to sell US$ to clients at the Sayrafa rate, subject to monthly quotas (around US$300 per month per account).

15. Unification of exchange rates in itself is unlikely to prevent further nominal depreciation. The latter ultimately reflects mistrust towards the financial system, leading to agents hoarding FX, as well as the overall macroeconomic situation that results in a current account deficit with limited and unstable external financing amidst the scarce FX reserves. These factors will remain in place until the restructuring of the financial sector and broader reforms are firmly underway.

16. Unification may, however, reduce the pace of nominal depreciation and loss of FX reserves as it would eliminate currency speculations by those who have access to cheap FX and would reduce excessive imports that reflect expectations of future tax valuations happening at a more depreciated exchange rate. These positive effects could be strengthened further by introduction of formal capital controls and deposit withdrawal limits and by improvements in the fiscal/monetary policy mix as well as implementation of structural reforms.

D. The Refugee Crisis in Lebanon

17. Half of the population in Lebanon is vulnerable according to the UN. The crisis hit low and middle-income households particularly hard, and 1.5 million Lebanese citizens are now considered vulnerable. Lebanon also hosts one of the largest number of refugees in the world, including 1.5 million Syrians—of which 814,715 are registered as refugees—and 257,000

Palestinians.[3] The living conditions of these vulnerable groups have declined dramatically due to high unemployment, rising inflation, collapsing public services, and the financial crisis.

18. Refugees struggle with poor living and working conditions.[4] Most refugees do not have legal residency and are unable to access basic rights and services. Many work informal jobs with low pay and little job security, earning an average household income of less than US$2.5 per day (excluding humanitarian assistance). Under financial strain, households reduce their spending on food—two-thirds are severely or moderately food insecure—and half are unable to pay rent on time. Average household debt is equivalent to over six months of expenditure. Women have limited access to reproductive health, like menstrual products, while 40 percent of children aged 6 to 14 years old do not attend school due to transportation costs, lack of education materials, or pressure to work.

19. The Syrian conflict has had a significant economic impact on Lebanon, especially in its poorest regions. The World Bank estimated that during 2012–14 the conflict decreased GDP growth by 2.9 percent per year while doubling the unemployment rate to 20 percent.[5] The influx of refugees also put pressure on infrastructure, government services, and created a direct cost on the budget and central bank reserves due to untargeted subsidies that benefit all residents. Lebanon's poorest regions, which took in the majority of refugees while already having the largest infrastructure gaps, are the most impacted. In response, donors have increased aid to Lebanon, with over US$12 billion disbursed through the Lebanon Crisis Response Plan since 2013.

20. Lebanese perceptions of refugees have worsened over time. According to a UN survey, more than 80 percent of Lebanese citizens believe there is aid bias towards Syrian refugees and that their presence strains Lebanon's resources, a perception that has become more widely shared in recent years.[6] As of February 2023, 46 percent felt that the relations between Lebanese and Syrians were negative (was 37 percent in August 2022), with 60 percent citing competition for jobs as a reason.

E. Recent Developments in the Energy Sector

21. Lebanon's electricity sector suffers from chronic mismanagement, weak governance, and an inadequate regulatory framework. Government subsidies to the sector averaged US$1.7 billion (around 3.6 percent of GDP) per year before the crisis, reflecting limited collection, distribution losses, underinvestment, and low tariffs, which deteriorated to below US$0.01 per kWh until last year due to currency depreciation. In last several years there has been a decline in government transfers reflecting reduced electricity generation. Currently, Electricité du Liban (EdL) provides less than 3–4 hours of electricity a day to most clients.

[3] 2022 UN Lebanon Crisis Response Plan and UNHCR Q4 2022 Operational Fact Sheet.

[4] 2022 Vulnerability Assessment of Syrian Refugees in Lebanon.

[5] Lebanon: Economic and Social Impact Assessment of the Syrian Conflict, World Bank, September 2013.

[6] UNDP Tension and Monitoring System, February 2023.

22. Users rely on expensive private diesel generators. The government's guideline retail pricing of 45–50 U.S. cents per kWh, well above the world average of 16 cents per kWh, reflects the high cost of small-scale generation. Together with low reliability of supply, this restricts access to electricity, creates substantial costs for businesses, and disrupts public services—for example, the shutdown of water treatment facilities contributed to the 2022 cholera outbreak, the first since 1993.

23. Many have turned to small-scale solar to reduce costs and stabilize energy supply. Solar panel imports rose sharply, with an estimated increase in installed capacity from 79MW in 2019 to 690MW in 2022. However, high capital costs, financing constraints, and an incomplete regulatory framework limit the ability to deploy renewable energy sources at scale.

24. Cabinet adopted a new strategy in April 2022 to restore financial sustainability and improve service delivery. The strategy rests on four pillars: i) increasing generation and raising supply hours; ii) improving network performance, reducing losses, and enhancing collection; iii) strengthening the regulatory and legislative framework, and iv) updating electricity tariffs. The latter was implemented in November by raising tariffs to US$0.10 per kWh for the first 100 kWh and US$0.27 per kWh thereafter, plus a fixed monthly tariff of US$0.21 per Amp. The new tariffs are priced in US$ but collected in local currency at Sayrafa rate. However, their impact on EdL revenue depends on its ability to enforce collection, increase electricity supply and hedge exchange rate risk arising from the different timings of fuel purchases and tariff collection.

25. Despite this, the budget continued to finance EdL by US$0.5 billion in 2022. This amount was partly financed by the SDR allocation that Lebanon received in August 2021 and includes the July 2021 agreement with Iraq to purchase one million tons of fuel partly in exchange for health care, education and other services for Iraqi citizens (though the exact terms are unclear). The deal was extended in February 2023 to cover an additional 40,000 tons of diesel per month

Annex VI. Recommendations of the 2017 FSAP[1]

Financial Sector Supervision	
1. Develop and implement integrated risk profiles for all banks; ensure that banks' capital planning is fully aligned with their risk profile, corporate governance and risk management.	Near term (1 year)
2. Strengthen supervisory autonomy and capacity by (i) introducing legal protection for staff of supervisory authorities; (ii) reviewing the adequacy of supervisory resources; and (iii) reconsidering the practice of the Association of Banks of proposing one of the board members of the BCC and HBC.	Near term
3. Enhance the regulatory framework for banks by (i) aligning the regulatory treatment of restructured loans with international good practice; (ii) formalizing the LCR as a mandatory standard for liquidity risk management; and (iii) adjusting the risk weight on foreign currency denominated BdL instruments in accordance with the Basel Capital Accord, as financing needs and risks abate.	Near term
4. Develop capability for undertaking top-down stress tests and require banks to periodically submit bottom-up multi-factor stress tests.	Medium term (2–3 years)
5. Introduce recovery planning requirements for banks.	Medium term
6. Improve nonbank regulation by (i) finalizing and implementing new capital market regulations; (ii) modernizing the insurance law; and (iii) developing a unified regulatory framework for the microfinance sector.	Medium term
Financial Integrity	
7. Ensure that the ML offense includes all elements in the international standard, including acquisition, possession or use of illicit funds.	Near term
8. Establish a comprehensive mechanism to implement United Nations Security Council resolutions' TF-related targeted financial sanctions	Near term
9. Adjust the allocation of AML/CFT supervisory resources and action in line with actual ML/TF risks.	Near term
Macroprudential Policy	
10. Create, or build on current structures to form, a financial stability advisory committee, including external members and a formal mandate and procedures.	Medium term
Crisis Management and Preparedness	
11. Develop plans to enable the orderly resolution of systemically important banks; discontinue policy measures that [rely on regulatory forbearance and BdL financial assistance to] support mergers between sound banks.	Medium term
12. Consider reforms, as macro financial conditions improve, to better align the bank resolution regime and deposit insurance scheme with international best practice.	Medium term
Financial Development and Access to Finance	
13. Collect data and analyze the implications of withdrawal of correspondent banking services on Lebanese banks and end-users of financial services, and take mitigating actions as needed.	Near term
14. Develop a National Access to Finance Strategy.	Medium term

[1] The authorities did not submit a self-assessment about their progress in implementing the FSAP recommendations.

Annex VII. Past Article IV Recommendations

1. The last Article IV consultation took place in August of 2019. Staff pointed to a very difficult economic position, characterized by very low growth, high public debt, and large twin deficits. At that time, deposit inflows, critical to financing the budget and external deficits and underpinning financial stability, had started to slow down, reducing the authorities' room for maneuver.

2. To reduce the exceptional imbalances and reverse the unsustainable trends, staff recommended a medium-term fiscal adjustment, targeting a primary surplus of 4–5 percent of GDP and based on significant revenue (e.g., a higher and broader VAT) and expenditure measures (e.g., elimination of electricity subsidies); structural reforms aiming at unlocking growth potential and helping improve Lebanon's external position (including improving governance and reducing corruption); building buffers in the country's financial system via increasing banks' capital buffers; gradually reducing the support from BdL to the government and strengthening its balance sheet; and strong donor support, as committed under the CEDRE conference. These reforms did not materialize as the crisis unfolded just a few months later.

Annex VIII. Key Objectives of the 2022 Staff-Level Agreement

1. To address the imbalances and structural problems, the authorities requested Fund support. In April 2022 the authorities and IMF reached a staff-level agreement (SLA) on comprehensive economic policies that could be supported by an Extended Fund Facility (EFF). The reform program aimed at rebuilding the economy, restoring financial and fiscal sustainability, strengthening governance and transparency, removing impediments to job-creating growth, and increasing social and reconstruction spending. The main pillars of the program included:

- Restructuring the financial sector to restore banks' viability and their ability to efficiently allocate resources to support the recovery;
- Implementing fiscal reforms that coupled with the restructuring of external public debt will ensure debt sustainability and create space to invest in social spending, reconstruction and infrastructure;
- Reforming state-owned enterprises, particularly in the energy sector, to provide quality services without draining public resources;
- Strengthening governance, anti-corruption, and anti-money laundering/combating the financing of terrorism (AML/CFT) frameworks to enhance transparency and accountability, including by modernizing the central bank legal framework and governance and accountability arrangements; and
- Establishing a credible and transparent monetary and exchange rate system.

2. Given the size and complexity of the crisis, the approval of the program was made conditional on implementation of the following prior actions:

1) Cabinet approval of the appropriate bank restructuring strategy that recognizes and addresses upfront the large losses in the sector, while protecting small depositors and limiting recourse to public resources;
2) Parliamentary adoption of the emergency bank resolution legislation to be able to implement the bank restructuring strategy;
3) Parliamentary adoption of the reform to the bank secrecy law in line with international standards;
4) Completion and sharing with the Fund of the first phase of BdL special audit (focusing on the net international reserves) as of end-2021;
5) Initiation of bank-by-bank assessment, by signing agreed ToRs for the largest 14 banks with reputable international firms;
6) Cabinet approval of the medium-term fiscal and debt sustainability strategy;
7) Parliament approval of the 2022 budget;
8) Unification of the exchange rates;
9) Parliamentary approval of the capital controls and deposit withdrawal limits law;
10) Cabinet approval of the energy strategy.