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It is time to save Lebanon

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As protestors take to the streets across the country, Lebanon appears to be heading towards an **economic meltdown** with severe consequences for Lebanese citizens of all walks of life. We are concerned that failure to tackle current problems immediately and comprehensively could result in spiraling unemployment, uncontrollable inflation, more social unrest, civil strife and a severe deterioration in public health services and other basic resources.

The challenges include a large and increasing debt load, spiraling fiscal and current account deficits, waning investment confidence, increasing political gridlock and external liquidity shortages. While we remain resolutely apolitical and non-sectarian, based on our collective expertise and global experience, LIFE has warned repeatedly and explicitly over the last two years that the situation was becoming untenable and has provided specific recommendations to policy makers to address the worsening economic and financial situation.

Those warnings were captured in an economic paper (included herein by reference) distributed to key policy makers where we called for immediate action and mentioned that Lebanon's famed "resilience" was at a breaking point. Although the gravity of the economic situation was apparent to most, **the policy response has been insufficient to stop the country from sliding into a full-blown crisis.**

This week's announcement by Prime Minister Hariri does signal a willingness to accelerate some austerity measures but **does not represent a realistic and sustainable fiscal consolidation plan**. It also falls short of sufficient details and does not include the structural reforms required to put the country back on track. In particular, it fails to provide a comprehensive and detailed plan for the electricity sector enabling the government to fully eliminate subsidies. Furthermore, it continues to use the coffers of the Central Bank as well as the banking sector to fund government spending, this time in a form that is unsustainable and counterproductive. It is also unclear to us whether the Banque du Liban ("BdL") fiscal "transfer" can even be considered as revenue for budget accounting.

We remain convinced that the country requires a broader set of urgent and more comprehensive steps to restore confidence. Before we lay these out, we thought we would first list some **misconceptions** which continue to circulate among policy makers even in this critical juncture which in our opinion need to be dispelled:

- Lebanon's economy is **beyond easy solutions** and the way out of a crisis will require substantial economic pain on most stakeholders. While this sounds harsh, the alternative is far harsher. As such, a new and clear political mandate based on **political consensus** and expert economic leadership will be required with all stakeholders expected to carry a share of the burden for Lebanon's economic stabilization.

- Lebanon's **fiscal consolidation needs to be front loaded and particularly focused on reducing the size of the public sector**. Without comprehensive fiscal reforms, neither the one-time bank tax, nor the 1% annual fiscal adjustment target agreed during the CEDRE conference will restore confidence or put Lebanon on a sustainable debt trajectory. Empirical studies strongly suggest that a **primary surplus of around 5% is needed** to reduce Lebanon's relative debt ratios and hence should be the target for 2020/2021.

- **Lebanon will not be able to grow its way out of its large debt burden**. In other terms, no realistic growth trajectory allows Lebanon to deleverage as the race between economic growth and debt formation is already mathematically lost.

- Lebanon's crisis **cannot be averted by relying on oil and gas** reserves as these will take many years at best to exploit. Buying time hoping that future gas revenues will help Lebanon deleverage is therefore ill-advised.

- Although Lebanon is in desperate need for infrastructure investment, **CEDRE**-related grants and concessionary loans can't be used for budgetary purposes and **will not solve the current economic crisis**. It is also worth highlighting that, as we have seen over the last 18 months, financial assistance from friendly countries will provide only temporary relief.

- Lebanon's famed economic resilience and competitiveness based on services and remittances will no longer apply even in a fiscal consolidation scenario. In order to address the chronic current account deficit and leverage on the country's relative advantages, **a new economic model is required.**

- A front-loaded debt restructuring or **Eurobond haircut will only serve to weaken the capital formation engine** of the country and further delay the more important and sustainable fiscal austerity measures that are required.

- We also believe that, although it may be inevitable, a currency **devaluation at this juncture in Lebanon is not advisable** as it will lead to potentially uncontrollable levels of inflation without sufficiently addressing the gaping current account deficit nor improving the debt service outlook.

Avoiding a worsening economic crisis and restoring confidence will require a well-orchestrated series of **immediate and radical measures across five primary areas**:

1. Create Fiscal Space

Lebanon's public finances are dominated by the three-headed monster of (i) public wages and government transfers, (ii) persistent subsidies to Electricité du Liban ("EdL") and (iii) the cost of servicing the ballooning sovereign debt. Simply put, **progress needs to be made on all three fronts**. The current strategy of soft fiscal consolidation, which essentially consists of incremental steps and hiding future deficits by accumulating arrears will not be successful.

Expenditures

Tangibly, on the expenditures front, **subsidies to EdL need to cease**. Given that power outages will increase dramatically and spending on alternative power sources will soar, this decision may seem politically unbearable. The reality is that Lebanon has run out of less drastic options. Cutting subsidies to EdL will reduce government expenditures dramatically, reduce hard currency outflows which are exacerbating Lebanon's external vulnerabilities, and more importantly, force the immediate **implementation of a credible electricity reform plan**.

The size of Lebanon's government, by most metrics, is large and in need of optimization. A first step to **streamline the public sector** is to conduct a thorough census of employees to determine the type and importance of the service they provide and address the problem of "ghost" employees as well as those who are unproductive. This seems to be ongoing and needs to be completed by the end of this year and implemented promptly. The next steps should include a re-assessment of the bloated number of government agencies, a freeze on some of the costly services and the **widespread introduction of digital government services** which will have the triple benefit of **reducing corruption**, enhancing the level service and lowering costs.

Revenues

While a number of new taxes are being discussed, as **tax evasion is rampant**, the focus should be first and foremost on better tax administration and collection. We believe additional taxes will only serve to weigh on the sluggish economic growth and increase tax evasion rather than achieve the desired outcome of higher revenues. In other word, t**here's no point in increasing taxes when the existing ones are not well collected.**

Specifically, tax administration should be improved by **focusing on improving efficiency and collection** on VAT, personal and corporate income taxes, and especially customs duties. Here too, the government should increase the use of electronic services, by automating customs clearance and applying e-government services where appropriate. Another area to focus on is real estate taxes whereby property including land should be properly assessed and taxed accordingly.

Additional taxes can be considered provided that they are not overly regressive (such as VAT) and that they are applied in a targeted manner in line with an economic vision for Lebanon, which should include the improvement of public health and the preservation of the environment. As such, taxes on cigarettes and duties and activities that are harmful to the environment, such as seashore violations and quarries, can be increased significantly.

Pension Reform

The initiation of pension plan reform by the government is encouraging. To be clear, current and retired government workers who were hired and worked under a set of terms and conditions should have their rights respected. However, moving forward, government hiring should be more selective, based on a sustainable pension that also rewards employee role and performance rather than just simply years of "service". In addition, the **retirement age should be raised**, benefits must be linked to price inflation, the rate of social contribution should be tiered and capped, and public pension investments should be diversified away from Lebanese sovereign bonds. Deeper reforms including a unified social security system should also be considered.

Privatisation

A comprehensive privatisation programme should be launched immediately. The substantial state assets, including the Rafic Hariri Beirut Airport, the Beirut maritime port, the National Lottery, the Middle East Airlines, the Casino du Liban, the Telecom operators and eventually EDL should all be considered for privatisation. This process should start with, as appropriate and required, corporatisation, setting up and activation of independent regulatory bodies as well as new management teams should be actioned. Enhancing governance, management and operational efficiency in line with the private sector would result in significant valuation gains and service improvements. Eventually, potential partial stock listing of those state assets and bonds issued should be used to bolster the local capital markets. In order to optimise valuation, full privatisation should be sequenced after confidence is restored by implementing the required reforms and reinforcing the rule of law discussed below in order to avoid any irregularities in the asset transfers as we have seen in other countries.

II. Reinstate Transparency and Reinforce the Rule of Law

Enforcing the rule of law will play an essential role in Lebanon's economic revival and is a pre-condition to reinstating investor confidence. It is widespread knowledge that Lebanon suffers from widespread corruption and fiscal leakages at many levels. For instance, Lebanon's Transparency International ranked Lebanon 138th out of 180 countries assessed. As such, the recent adoption of the Anti-Corruption National Strategy is a welcome development and the government's seriousness in its enforcement will be of utmost importance. This can only happen if there is a programme in place which aims to reinforce the independence of the judiciary which has eroded over the last few years.

Such enforcement requires the introduction of **mandatory asset disclosure for public officials**, independent audits, formal procedures to recover embezzled public funds and **steep penalties and fines to be applied** regardless of political backing or seniority. Improving tax collection combined with enforcing a strict code of conduct can rapidly and meaningfully increase government revenues. This point is of particular importance in light of the ongoing oil and gas exploration and drilling contracts and related potentially lucrative windfalls. We would also encourage the establishment of a digital citizen grievance and feedback system on all aspects of government service delivery to enhance accountability and align motivations.

We also call for the establishment of an independent commission to implement a "Stolen Asset Recovery Initiative" in order to return the proceeds of corruption to the state. This should achieve the dual benefit of increasing government revenues as well as discouraging future corruption.

III. Review Debt Service and Implement Liability Management Plan

Debt servicing costs in Lebanon are among the highest in the world. While there have been discussions about debt restructuring, debt rescheduling or some form of liability management exercise, this debate needs to be handled with extreme care and **should not be initiated before the implementation of the fiscal and reform measures** described above. Any debt liability management needs to occur with a backdrop of sound economic leadership and serious austerity measures.

We do believe that the banking sector needs to contribute to Lebanon's fiscal consolidation efforts. However, artificially and simplistically reducing the interest rate on the government's debt will distort a market already heavily distorted by unconventional BdL monetary policies and will do little to put Lebanon's public finances on a sustainable path. The banks' reluctance to engage in this discussion at this stage is based on their legitimate desire to protect their commercial interests, as well as well as the principle that debt alleviation must not be offered when public management remains extremely poor and public finances continue to deteriorate. Past experience domestically and previous banking "packages" around the world substantiate that view.

Instead, **Lebanon's banks should play a key role in the debt management review plan**. This can potentially include front loading some of the financial assistance to alleviate short term government budgetary pressures (as of 2020) including the possibility of a local "Brady" plan. Given that the banks and the sovereign are now joint at the hip, coordination is imperative and discussions should result, as required, in a voluntary debt service or debt re-profiling plan which, together with fiscal austerity measures and structural reforms will **demonstrate a clear path to sustainable debt management**.

On the monetary front, BdL has adopted a more interventionist stance to protect the country's macro financial stability. This advanced form of monetary policy experimentation, which was deemed necessary initially, increases systemic risks longer term and reduces hard currency liquidity in the system. Besides burdening the BdL with a budget financing mandate it exacerbates the eroding confidence in the financial system. Following fiscal consolidation steps, we would like to see in due course an unwinding of these measures. The fact the recently announced measures include another such fiscal "transfer from the BdL is cause for concern.

IV. Enhance Communication and Strengthen Governmental Coordination

When confidence is eroding, **policy makers need to communicate more frequently and more clearly** in order to inject confidence among stakeholders that remedial actions are being taken. The key stakeholders include bond holders, local and international banks, credit rating agencies, the World Bank, the IMF, other multilateral agencies, research institutes and most importantly, the general public. For instance, taking more than seven months to ratify a budget should be a cause for consternation not celebration. Delayed disclosure of Ministry of Finance statements, including key figures such as the budget deficit, only increases nervousness.

Of equal importance is the need to address Lebanon's persistent political stasis. **The country is in desperate need for better coordination among all state branches** and particularly within its executive arm to enable various government bodies to act in unison especially at a time of crisis where quick and often painful decisions are required. This will require a new governance framework to enable faster decision making while maintain checks and balances in place. Tangibly, the government needs to establish an **economic**

management team, which meets frequently and discloses progress in a timely fashion. Having such sound communication plan also enhances discipline and accountability.

V. Adopt Structural Reform and a New Economic Model

On the structural reform front, as discussed in our paper of 2017, and as highlighted in the McKinsey report, **Lebanon is in dire need of a new economic model**. Lebanon's current model is underpinned by the consumption-centered nature of its economy, with low domestic savings and persistent reliance on external resources to compensate for the country's large trade deficit. More significantly, the Lebanese economy has traditionally been dominated by the public sector, construction, tourism, financial services and small retail-oriented trades. With the exception of financial services, those sectors operate with medium and low skilled workers, creating limited opportunities for the country's traditionally skilled labour force thereby aggravating Lebanon's competitiveness gap. Most of those sectors are also inward looking, endogenously contributing to persistent large trade deficits and the continuous need for hard currency inflows.

The fiscal consolidation plan needs to go hand in hand with a new economic vision for Lebanon which addresses its persistent current account deficit. Lebanon's economic model, which essentially consists of exporting its most talented labour force, so that it can repatriate remittances and sustain this vicious balance of payment circle is deeply flawed.

The government-sponsored McKinsey report in 2018 identified a number of growth areas. Among those, the tourism sector, the business and outsourcing services, as well as a select number of high value add industrial (pharmaceuticals, wine, artisanal products, fashion and cosmetics) and agricultural (higher value crops, medicinal cannabis) segments deserve special attention. All of those growth measures have the triple benefit of stimulating growth, attracting inflows, and creating fiscal receipts.

This area has been well covered in our paper of 2017 and remains relevant specially to boost growth and reduce chronic current account deficits by boosting cross-border services receipts.

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While Lebanon's challenges seem insurmountable and the corrective measures quite drastic, it is difficult to overestimate the existential threat a full-blown economic crisis represents. **Lebanon's economy will be revived only if strong political and economic leadership are re-established and substantial reforms and a comprehensive fiscal program are adopted and implemented.** Such a backdrop will restore confidence, increase investment and lead to better growth prospects.

In the absence of such reforms, Lebanon's famed resilience, its social fabric, its proud history and future are at risk:

It is time to save Lebanon.