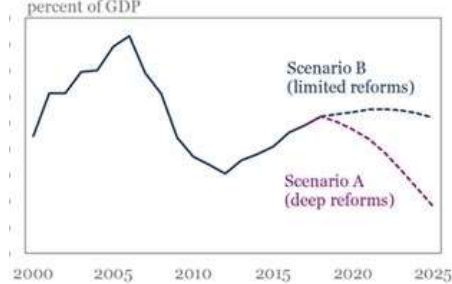


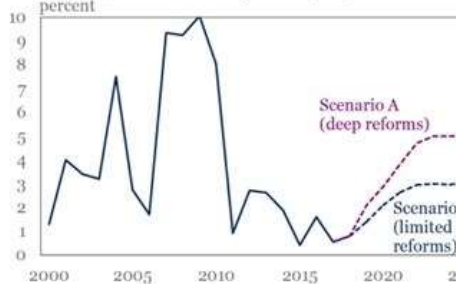
IIF: Quick reforms lead to higher GDP growth

Exhibit 1: Government debt will enter a firm downward trajectory in Scenario B.



Source: National Authorities and IIF projections

Exhibit 2: Real GDP growth could remain below 3 percent in Scenario A, but accelerate gradually to 5% in Scenario B.



Source: CAS & IIF estimate for 2018 and forecast for 2019-2025

BEIRUT: The Institute of International Finance said the new Cabinet needed to implement wide-ranging reforms and effectively combat corruption to achieve a higher GDP growth and unlock the pledged money from the CEDRE conference. The report gave two different scenarios to put Lebanon's economy on the right track.

"Given the uncertainty regarding the extent and depth of the fiscal and structural reforms, we prepared two scenarios. Scenario A assumes substantive fiscal adjustment and structural reforms (including improvement in the business climate, and addressing corruption decisively), which would unlock the funding pledged by the international community," the IIF said in its 12-page report on Lebanon following the formation of the new government.

But scenario B, according to the report, presumes that the government makes limited reforms.

"Under Scenario A, growth is expected to accelerate to 2 percent in 2019 and 5 percent by 2023, the fiscal deficit will narrow gradually from 11 percent of GDP to 8.1 percent in 2019 and 4.3 percent by 2023, debt will be placed on a firm downward trajectory, nonresident capital inflows will improve significantly, and official reserves could increase to \$54 billion by 2023. Such a scenario will help to restore confidence and support the peg."

However, the report warned the GDP growth could only rise to 3 percent in 2023 if reforms were slow.

"Under scenario B, growth could pick up gradually to 3 percent by 2023, official reserves may continue their decline (but remain adequate for the next two years), and public debt will remain around 150 percent of GDP. In this case, Lebanon may continue to be highly vulnerable to swings in investor confidence," the report said.

It added that the news of the formation of a new Cabinet on Jan. 31 after eight months of paralysis may facilitate Lebanon's access to the \$11 billion of concessional loans and grants that were pledged by the international community at the April 2018 CEDRE conference to develop the country's infrastructure.

"However, such lending is contingent on the implementation of deep fiscal and structural reforms to improve long-term fiscal sustainability, rebuild confidence, and foster higher growth," the report said.

The IIF noticed that most economic indicators in Lebanon were on the downside in 2018 due to the political paralysis and failure to form the government in a short period.

It added that real GDP growth was slightly below 1 percent last year.

"On the production side, construction and real estate activity, which were the main drivers of growth in the past, declined sharply in 2018. High volatility has been the main feature of growth over the past two decades, with downturns caused by security incidents, regional conflicts and complacency, followed by catch-up growth and implementation of structural reforms. In the context of weak domestic demand, it is surprising that average headline inflation increased to 6.1 percent in 2018."

The report also touched on the performance of the Eurobonds.

"The yield on 10-year dollar-denominated sovereign Eurobonds dropped from a peak of 12 percent on Jan. 12 to 9.3 percent on Jan. 31. At the same time, its price rallied by 10 cents to trade at 85 cents on the dollar. Markets were rattled in early January by rumors that Lebanon was planning a debt restructuring."

The IIF said as a result of this, Lebanese Eurobond prices fell, and credit default swap spreads rose sharply. "The prices of Lebanese Eurobonds bounced back after the authorities reiterated their lack of intention to restructure the public debt,

Qatar announced it would buy \$500 million worth of Lebanese sovereign bonds and following the news that Lebanese leaders reached a deal on Jan. 31 to set a new unit government.

“We expect the yield on Eurobonds to decline further in the coming months, particularly as the new government starts to undertake fiscal consolidation and structural reforms,” the IIF stressed.

It added that foreign currency assets excluding gold at BDL stood at \$39.7 billion at the end of 2018 (equivalent to 71 percent of GDP and enough to cover 13 months of imports). Gold holdings of \$11.8 billion, the second highest in the Middle East region after Saudi Arabia, provided an additional buffer.

It warned the electricity sector is still a heavy burden on the budget.

“The budgetary transfers to EDL amounted to \$1.690 billion, equivalent to 3 percent of GDP in 2018 .

“About half of EDL’s production cost are covered by the budget (technical losses due to transmission and distribution problems and the use of fuel in two power plants designed to operate on natural gas amount to 15 percent; and nontechnical losses due to illegal connections/theft and uncollected bills at 30 percent).

“How to reform the electricity sector in Lebanon is well known and has been part of the authorities’ plan for long time, but little progress has been made so far,” the IFF said.