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Slashing the deficit, sending strong signals

The Lebanese government’s plan to cut the budget deficit to 7.5 percent of GDP from more than 11 percent in 2018 is supposed to send a strong message to the international community that Lebanon is determined to implement long-overdue reforms. Information Minister Jamal Jarrah told reporters Wednesday at the Grand Serail that the Cabinet had decided to cut the deficit to 7.5 percent instead of the original 7.65 percent, after some ministers suggested more cuts to the budget.But he said that due to the numerous suggestions from Cabinet members, Prime Minister Saad Hariri had agreed to postpone the final approval of the draft budget to Friday.Observers and international donors will be closely monitoring the progress of the government’s work and scrutinizing all measures to determine whether Lebanon is on the path of recovery.Hariri is also particularly keen to speed up the approval of the budget to encourage countries that took part in last year’s CEDRE conference in Paris to gradually release money set aside for the reconstruction of Lebanon’s aging infrastructure.The previous government failed to implement the necessary reforms despite constant warnings from the World Bank, the International Monetary Fund and other international financial institutions.As a result of this gross negligence, the budget deficit in 2018 soared to more than 11 percent of the gross domestic product in 2018.Government spending increased to alarming levels while revenues dwindled in 2018. Most ministers were fully aware of the magnitude of waste and corruption in most of the government institutions, but apparently no one had the courage to demand an end to the chaos.Against this backdrop, Hariri and Finance Minister Ali Hasan Khalil urged all the ministers to drastically cut the ministries’ budgets.The size of the cuts in the new budget is still not clear, although there are indications that the Cabinet wants to cut spending by around $1 billion a year and boost revenues through specific taxes and fees.The first copy of the 2019 bill has set the total budget at LL25.7 trillion ($17.13 billion). This includes projected revenues and spending for this year. But this figure may drop if the proposed cuts in spending are approved by all the ministers.The proposal calls for reducing the budget deficit from $6.5 billion to $4.6 billion in 2019. The government wants to reduce spending by $1.1 billion and increase revenues by $1.2 billion.The Cabinet plans to cut the wages and benefits of ministers, MPs, former MPs, civil servants, army personnel and government retirees.There will also be major cuts in the budget allocated to ministries.

The Cabinet has given its approval to increase the taxes on interest rates on deposits to 10 percent from the current 7 percent.It will also increase the revenues of the telecommunications sector to over $125 million a year.The government Tuesday approved slapping a 2 percent tax on most imported items, with the exception of medicine and environmentally friendly cars. This tax is supposed to generate around $266 million a year and will be effective immediately once Cabinet and Parliament have endorsed the budget.Marwan Barakat, the head of economic research at Bank Audi, commended the efforts of the government to cut the budget deficit to 7.5 percent and even lower.“These measures are required. We should stop criticizing everything in this country. Lowering the deficit to GDP to 7.6 percent from 11 percent in 2018 is an achievement,” Barakat said. He added that the government’s new target was even better than the previous commitment to CEDRE, where the previous Cabinet pledged to cut the deficit by 1 percent only.“This commitment to CEDRE has been accomplished this year. The government has even adopted brave measures to increase revenues and reduce spending,” he added.Barakat argued that the goals set by the Cabinet were achievable.He said lowering spending could have a temporary effect on GDP growth this year. “There is nothing wrong with slapping a 2 percent tax on imported goods especially since we import $20 billion worth of goods and we only export $3 billion. The 2 percent tax on imports should generate $400 million a year for the Treasury. This step could reduce imports and decrease the balance of payments deficit,” Barakat said.Apart from the budget, the Central Bank will help the Treasury by replacing a chunk of sovereign bonds with bonds carrying lower interest rates. Khalil had previously said that he planned to issue LL11 trillion of bonds at 1 percent interest. But this must be executed in coordination with the Central Bank and Lebanese commercial banks.“The Lebanese banks were not too happy about increasing the tax on interest rates on deposits to 10 percent. But nevertheless, the banks are willing to help the Cabinet in cutting the deficit if they see clear indications to reduce spending and implement reforms,” one economist told The Daily Star.International investment bank Morgan Stanley said one of the key factors for the success of Cabinet reforms was the flow of deposits and capital to Lebanon.“We have argued before that we needed to see either a strong pickup in deposit growth rates in the banking sector which amplifies their ability to roll over sovereign debt or else a sharp fiscal consolidation which reduces the sovereign funding need itself for us to increase exposure to Lebanon. With the sovereign aiming for a steep fiscal consolidation in the 2019 budget, we think that the concerns will likely be partially addressed,” the bank said in a report released Wednesday.It added that significant execution risk would persist but should the targeted fiscal consolidation lead to disbursements of CEDRE funding commitments, it should at least lead to a relief rally in the near term.“As such we prefer to add duration exposure to low cash price long-end bonds than increasing notional exposure to high cash price front-end bonds. The low cash price bonds should provide a better buffer should the geopolitical noise in the Gulf remain high," Morgan Stanley said.The investment bank noted large cash outflows in January following media headlines about a public finance reform plan that included debt restructuring. "The deposit outflows turned to inflows since February as government formation took place at end-January," it added."However, the growth rate has remained subpar at 1.9 percent versus 3.5 percent in 2018 and 4.5 percent in 2017. We think that a deposit growth rate in excess of 5 percent is required for banks to be in a comfortable position to fund the sovereign deficits. That said, the moderation in the deposit growth rate was accompanied by a rise in deposit rates on offer to attract inflows," the report said.However, it noted a stabilization in deposit rates in both Lebanese pound and dollar deposits. "If this trend continues, we think that it will be a positive as stabilization of the deposit rate means that the hurdle yield rate for banks to buy Eurobonds also stabilizes, even if this proves to be temporary," it said.On the fiscal side, the report said that the government was aiming to target a deficit of less than 9 percent of GDP versus an 11.2 percent deficit in 2018. "The targeted level is still higher than the debt-stabilizing levels, and the prolonged budget approval process indicates that there will be execution risks in implementation of the budget proposals. Even the EDL [Electricite du Liban] reforms are unlikely to yield fiscal savings in 2019," it added."That said, the reform trajectory is now in the right direction."More importantly, should the targeted budget proposals pave the way for disbursements of some of the $11 billion CEDRE funding commitments, it would be seen positively by the markets."The report said that the funding commitments from donors should help to finance Lebanon's capital investment program and will be a medium-term positive as the program seeks to address the infrastructure shortfalls in crucial sectors like electricity and water, and should help to boost GDP growth and job creation during the implementation.But Morgan Stanley warned that the geopolitics was an important factor that could affect the future of Lebanon. "The ongoing tensions in the Gulf pose a tail risk for Lebanon as it is a net hydrocarbon importer. A significant share of its remittances, a key source of BoP [balance of payments] inflows, also originates from the Gulf states. Should geopolitical tensions escalate further from here, markets may also start to differentiate among the Middle East sovereign credits based on their foreign policy orientation," the report said.