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IMF questions govt's ability to slash deficit

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BEIRUT: The Lebanese government is likely to carefully assess a new IMF report and recommendations, but it seems improbable that the Cabinet will endorse the fund's proposals to hike taxes. The International Monetary Fund Tuesday released a statement at the end of its 2019 consultations mission to Lebanon. It is expected to issue the executive summary and final report soon.

Like many ratings agencies, the IMF expressed skepticism that the government could succeed in lowering the deficit to 7.6 percent of gross domestic product in 2019.

The "IMF staff preliminary estimate is that the budget measures will reduce the cash-basis fiscal deficit to around 9 3/4 percent of GDP. Although the budget has not yet been approved and there is uncertainty about what form the approved budget will take, on the basis of current information, the projected deficit is likely to be well above the authorities' stated target," the report said.

"Cleary, the IMF believes that the fiscal measures included in the 2019 draft budget are insufficient and fall short of market expectations to reduce the fiscal deficit this year, which is why it called for a medium-term fiscal adjustment. It accurately highlighted the need to reform the public sector's pension system and to reduce spending, especially the public sector's wages and salaries," Nassib Ghobril, the head of economic research at Byblos Bank, said.

Marwan Barakat, the head of economic research at Bank Audi, argued that the IMF statement was more positive than the previous reports, despite its remarks.

"The new IMF report has a more positive tone than the previous ones. This is related to the new austerity environment and the launching of reforms tied to the electricity sector plan and the 2019 budget. The main lesson that we can get from the IMF report is that despite the fact that Lebanon has large imbalances, exits are still available and can ensure a soft landing for the Lebanese economy," Barakat said.

This required tough choices, he added, but if policymakers moved in that direction - and they started to do so in the budget and electricity plan - then Lebanon could avoid the worst and move into an era of gradual containment of risks and threats as a prerequisite for economic recovery in the medium to long term.

Barakat said the IMF's fiscal deficit forecast for 2019 was too conservative. He recalled that in the first four months of this year, the deficit climbed by "just" $1 billion, according to the Central Bank governor. Barakat indicated that one of the reasons behind the lower than expected rise in the deficit was the austerity measures announced by the Cabinet.

The IMF also called on the government to increase value added tax and slap a tax on gasoline to beef up the state's revenues. "The authorities will need to identify and implement additional permanent fiscal measures to achieve the necessary primary surplus. Revenue measures should include raising the value added tax and increasing fuel excises as well as efforts to increase tax compliance. The temporary increase of interest income tax in the 2019 budget could also be made permanent. Further raising revenue reliably and rapidly will require measures based on existing tax collection infrastructure, such as the VAT and fuel excises," the IMF recommended.

Ghobril was not surprised by the IMF's proposal to raise the VAT.

"The IMF admitted that the tax increases in the 2019 budget will lead to a contraction in economic activity. But, as has become the norm, the IMF could not resist calling for tax hikes, such as increasing the VAT and reinstating the excise tax on gasoline. However, it strongly called for fighting tax evasion and improving tax collection through concrete measures on the ground, and not just in text and in speeches," Ghobril said.

He said he supported the IMF's suggestion to crack down on tax evasion, which deprives the Treasury of substantial income. "On the positive side, it stated very clearly that fighting tax evasion effectively will help the government avoid raising taxes. So the fund believes that improving tax collection is a matter of political will, rather than an issue of means," Ghobril said.

The IMF emphasized that the new government had an opportunity to implement fundamental reforms to rebalance Lebanon's economy.

"The authorities have already passed a crucial plan to reform the electricity sector and are now working on a budget that will reduce the fiscal deficit. These are very welcome first steps on a long road towards sustainability and growth that will have to involve further substantial fiscal adjustment and structural reforms to improve Lebanon's business environment and governance," the report said.

Ghobril said the IMF made it clear that the two economic priorities of Lebanese authorities should be reducing the borrowing needs of the government through fiscal reforms and stimulating economic activity through structural reforms to improve the investment climate, the business environment and governance. "It said in no uncertain terms that the cause of the widening fiscal deficit in 2018 was ill-timed and poorly implemented decisions of raising taxes and enacting the public sector salary scale," he added.

The IMF repeated calls for the elimination of electricity subsidies to help the government cut the deficit substantially.

“Eliminating electricity subsidies is the most significant potential expenditure saving. The government electricity sector plan aims to switch fuel to natural gas to reduce production costs at existing plants, increase EDL’s [Electricite du Liban] capacity to meet demand, and subsequently raise tariff to eliminate electricity subsidies. The authorities need to ensure that the plan incorporates a tariff increase that is sufficient to close EDL’s deficit in the medium term under robust and realistic assumptions about the reduction of technical and nontechnical losses,” the IMF said.
It urged the Cabinet to start increasing tariffs as soon as possible to generate fiscal savings, possibly targeting the biggest consumers first.

The IMF commented on the government’s efforts to draw funds from last year’s CEDRE conference that are mainly allocated for the rehabilitation of infrastructure.
“Reforms would encourage donors to disburse $11 billion in pledged concessional funding the authorities have secured for their Capital Investment Plan at the CEDRE conference in April 2018.
“The CIP aims to upgrade Lebanon’s infrastructure while providing employment opportunities for host communities and Syrian refugees. The associated short-term growth boost can counteract the contractionary effect of the planned fiscal adjustment, especially if the authorities improve the public investment management framework early on in the CIP,” the report said.

The IMF noted that deposit inflows had virtually stopped and Banque du Liban’s foreign reserves had dropped.
“Deposit growth in 2018 was the lowest since 2005 and the BDL reserves have now decreased by around $6 billion since early 2018 despite BDL’s continued financial operations, in part because of the Eurobond principal and coupon payments it made over the same period. Bank lending to the private sector declined, nonperforming loans increased and deposit dollarization rose to over 70 percent,” the report said.
It also noted that BDL had been the linchpin of financial stability and the guardian of the currency peg, but at the cost of intensifying sovereign-bank linkages and weighing down its balance sheet.
“Over the past few years BDL’s financial operations have provided high marginal returns in Lebanese pounds on new bank U.S. dollar deposits at the BDL. These have boosted the BDL’s dollar holdings without affecting rates on older deposits at the BDL and on government debt. They have also allowed banks to offer high interest rates to their own depositors to attract new or retain existing funding while maintaining their profitability. ... BDL should gradually step back from quasi-fiscal operations and strengthen its balance sheet,” the report said.
Ghobril indicated that the IMF welcomed the Central Bank’s necessary efforts to offset the loose fiscal policy of 2018.
“More importantly, it considered that neither BDL nor commercial banks should be forced or induced to purchase Treasury bonds at nonmarket rates. I believe that this should prompt the political class to stop its ongoing pressure on the banking system to purchase such instruments. Further, the IMF encouraged banks to continue to build up their capital buffers. Commercial banks have been reinvesting about 60 percent of their profits in their capital for the past 25 years in order to reinforce their buffers,” he added.
Ghobril said the government should suspend the double taxation of the income of banks, which started in 2018, as this measure is eroding banks’ ability to reinforce their buffers in the prevailing environment and to continue to support monetary, financial and economic stability.

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