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WHAT IS AN IMF PROGRAM, AND WHY DOES LEBANON STILL NEED IT?

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ANALYSIS

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THREE YEARS INTO THE CRISIS

The last three years have been unprecedentedly difficult for Lebanon. The size of the economy declined sharply—by 37% as estimated by the World Bank—about 80% of the population is now living in poverty, and inflation has risen to mid-high triple digit levels over the past two years. At the same time, the currency has lost more than 97% of its value in the parallel market that emerged with no end in sight to its depreciation, the Banque du Liban (BdL)'s reserves have plummeted, and the government remains in default and the banking system insolvent. While the crisis has taken its toll on already weak government services and social protection mechanisms, a notable increase in emigration is depleting the country of valuable talent and skills.

The government has prepared a comprehensive plan of macroeconomic adjustment and structural reforms to lift Lebanon out of the current crisis. The plan addresses the root causes of the crisis—namely the unsustainable fiscal and monetary policies and the weaknesses in governance—and it aims to set Lebanon on a path of sustainable and inclusive growth. The plan was shared with Members of Parliament, and the government submitted to parliament draft laws in need of ratification for the plan to succeed, including the bank secrecy and capital control laws. A crucial aspect of the plan is the support that would be forthcoming with an agreement with the IMF.

Notwithstanding the government's efforts, progress in implementing the plan has been slow, not to say inexistent; presumably because of vested political interests, political will to implement reforms has been absent. Notwithstanding the difficult social and economic conditions, there seems to be little domestic pressure to move aggressively with the reform plan. The May 2022 Parliamentary elections preserved the political order despite the massive loss of people's savings and increase in poverty. Moreover, prospects for gas revenues have raised hopes that the current crisis is transitory and that it will resolve itself without difficult political and economic decisions. As a result, the urgency for reforms and the prospect for IMF support that would follow may have subsided especially within the context of the ongoing political vacuum.

The IMF has successfully helped many countries overcome their economic difficulties. Throughout the years, it has supported countries with policy advice, financial support and technical assistance. As opposed to Lebanon, countries usually approach the IMF for financial support and policy advice at the onset of their economic difficulties. The main purpose is to ease the necessary adjustment in their external imbalances. The aim is to avoid the outcomes that Lebanon has been through, including sharp contractions in the economy, financial system collapse, massive currency depreciation, high inflation and unemployment, and worsening in social conditions and poverty. These outcomes would have been largely avoided had Lebanon implemented a credible adjustment program at the beginning of the crisis. Several years into the crisis, the question being raised is whether it still makes sense for Lebanon to seek IMF support at all.

THE IMF STAFF AGREEMENT

In support of its economic recovery plan, Lebanon reached an IMF staff agreement in April 2022. The program would be implemented over a 46-month period, supported by the equivalent of around USD 3 billion from the IMF with disbursements spread over that period.¹ The program is in line with the government's economic recovery plan. The main elements of the IMF program are as follows:

- **Fiscal reforms:** One of the root causes of the crisis were the unsustainable fiscal policies, which eventually led the government to default on its debt. The program aims at strengthening public finances—including through revenue and spending measures—so that the government can deliver public services effectively, provide social protection, invest in infrastructure, and restore debt sustainability, including through a public debt restructuring. Fiscal reforms will also address deficiencies in the operations of state-owned enterprises, especially the electricity company Électricité du Liban (EdL).
- **Monetary policy reforms:** These reforms aim at strengthening Lebanon's monetary policy framework and at having a credible unified exchange rate. The central bank would be recapitalized, while the relationship between the central bank and the government would be revised, making it difficult for the central bank to finance the government.
- **Financial sector reforms:** This is perhaps the most difficult part of the reform package. It aims at restoring the solvency of the banking system so that it can resume its role of supporting the economy. It also aims at a socially responsible treatment of bank deposits. The passing of a Capital Control Law—intended to be temporary—would organize the transfer and withdrawal of funds, which has proven to be completely discretionary in the absence of such law since the beginning of the crisis.
- **Governance reforms:** The current crisis has highlighted the deficiencies in economic governance. The envisaged measures aim to strengthen the anticorruption legal framework. They would enhance transparency and accountability, including through the declaration of assets and interests owned by high-level public officials and their family members. They also aim at strengthening the integrity and independence of the judiciary. As an example, the recently approved amendments to the Banking Secrecy Law were meant to support efforts to fight tax evasion and corruption.

¹ The agreement is for SDR 2,217 million or 350% of Lebanon's quota with the IMF. This amount was equivalent to USD 2,980 billion at end-April 2022, and to USD 2,989 billion at end-January 2023. It was set on the basis of the macroeconomic framework that was prepared in April 2022. Given that the macroeconomic framework—including balance of payments needs—will need to be updated before the program is presented to the IMF Executive Board, this amount could change on the basis of these revisions.

HOW DOES AN IMF-SUPPORTED PROGRAM WORK?

For the program to become effective, it needs to be approved by the IMF Executive Board.

A prerequisite for presenting the program to the Executive Board is the implementation of several measures, referred to as “prior actions.” It is common for IMF-supported programs to have prior actions for the approval of a program, as well as for the approval of reviews once a program is implemented. Their aim is to ensure that a program has the necessary foundations for success, including country authorities’ willingness and ability to implement the agreed measures. There has been very slow progress in implementing these measures, especially compared to other countries that experienced economic crises. While several key legislations have been approved and important cabinet decisions taken, difficult measures are yet to be taken, most notably relating to the restructuring of the financial sector and dealing with its liabilities.

The first disbursement would take place immediately after the program is approved by the IMF Executive Board, with subsequent disbursements made available contingent on satisfactory implementation of the program.

It was agreed with IMF staff that reviews would take place every three months. These reviews would assess whether program objectives are being met, whether there is a need for modifications in light of developments, and whether agreed performance quantitative performance criteria and structural benchmarks are being attained. An example of a quantitative performance criterion is a minimum level of central bank foreign reserves or a ceiling on government borrowing. Structural measures are usually measures that often are non-quantifiable, but are important for achieving program goals, for example auditing EdL. Programs could also have indicative targets, which are quantitative indicators to assess progress in meeting a program’s objectives and in Lebanon’s case, could be a minimum level of government revenues.

Failure to meet these targets does not necessarily lead to the suspension of the program as long as the program objectives are not compromised.

The IMF Executive Board could approve a waiver to a missed quantitative performance criterion if it is satisfied that the program will still succeed, either because the deviation was minor or temporary, or because the country authorities are taking the necessary corrective actions. Missed structural benchmarks and indicative targets do not require waivers, but are considered as part of overall program performance. Program reviews also provide an opportunity to assess external financial support. It is not unusual for the IMF to increase the amount of financial support after a program starts, if there is a balance of payments need and the program is on track. Along these lines, Lebanon’s current IMF staff agreement could be increased by around USD 700 million even if Lebanon’s public debt remains unsustainable. Amounts borrowed under the IMF facility being envisaged for Lebanon—the Extended Financing Facility (EFF)—are to be repaid over 4½–10 years. The longer period of EFF programs (up to 4 years) and the longer repayment period, compared with other IMF facilities, is intended to help countries implement structural reforms that often take time to implement and to yield the intended results.

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Lebanon will incur interest on the amount borrowed from the IMF. The cost of borrowing is the IMF's SDR rate (the weighted interest rate of the five currencies that make up the SDR²), which was 3.23% at the end of January 2023, plus 1-3 percentage points depending on the amount borrowed and the period of time that the credit is outstanding.³ There is also a service charge of 50 basis points on drawn amounts and a commitment fee that is refunded when the amount of the arrangement is drawn.⁴

MEASURES FOR THE IMF TO APPROVE A PROGRAM WITH LEBANON

FINANCIAL SECTOR	
MEASURES	STATUS
Cabinet approval of the bank strategy	Done
Parliamentary adoption of the emergency bank resolution legislation	Pending
Parliamentary adoption of the reform to the bank secrecy law in line with international standards	Done (possibly without some provisions envisaged by IMF staff)
Finalize and share the first phase of BdL's special audit (including foreign exchange and gold) of the end-2021 financial statements with the IMF	Done but not published
BdL and the Banking Control Commission to initiate bank-by-bank assessments with agreed terms of reference for the largest 14 banks with reputable international firms	Pending

FISCAL POLICIES	
MEASURES	STATUS
Cabinet approval of the medium-term Fiscal and Debt Sustainability Strategy	Done
Parliament approval of the 2022 Budget	Done
Cabinet approval of the Energy Strategy	Done

MONETARY FRAMEWORK	
MEASURES	STATUS
Unification of the exchange rates	Pending
Parliament approval of the capital controls and deposit withdrawal limits law	Pending

² The US Dollar, Euro, Chinese Yuan, Japanese Yen, and Pound Sterling.

³ A surcharge of 100 basis points is added to the SDR rate for loans that are up to 187.5% of quota. Loans that are above 187.5% carry a surcharge of 200 basis points, which is increased to 300 basis points if the credit remains above 187.5% after 51 months.

⁴ The commitment fee is 15 basis points for amounts up to 115% of the quota; 30 basis points for amounts from 115-575%, and 60 basis points on amounts exceeding 575%.

THE USEFULNESS OF AN IMF PROGRAM FOR LEBANON

The difficulties in, and slow pace of, implementing the measures agreed with IMF staff, the seeming resilience of the population, and gas production prospects have raised doubts about proceeding rapidly with the government's recovery plan and IMF involvement. There are hopes that gas revenues will lift the country and the financial system from the current crisis, thereby avoiding the politically difficult decisions on the treatment of bank deposits and the recapitalization of the financial sector. However, there are several problems in relying on gas revenues as a solution to the crisis. There is no certainty on the amount or timing of these revenues, especially as exploration has not started yet. In most forecasts, gas revenues will be a small fraction of the government debt and are many years away. Irrespective of the amount of gas revenues, there is also a need to strengthen governance so that these revenues are not mismanaged. With regard to the resilience of Lebanon's population, even though the population is adapting to the new economic and social realities, there is a need for measures to reverse the massive and sudden increase in poverty rates. There is also an immediate need to improve access to decent social services—including health and education—that large segments of the population no longer have access to.

Lebanon badly needs to undertake reforms with - or without the IMF. The program that was agreed with IMF staff does not impose any measures that are not already included in the government recovery plan and that the IMF does not consider to be in the interest of Lebanon. There is an urgent need for wide ranging measures to address the imbalances in the public sector and the balance of payments, restore debt sustainability, provide effective social protection, restore credibility in the currency and strengthen economic governance. These measures should be taken with or without an agreement with the IMF.

The most important aspect of an IMF-supported program is the credibility that it would give to Lebanon's economic policies, and this is the key argument. This single consideration is more important than the amount of IMF lending. Lebanon could implement a reform program without IMF involvement. However, the IMF's participation—by helping to formulate the program, monitoring its implementation, and providing an independent assessment of the appropriateness of policies—would give Lebanon's reform program the credibility it needs that appropriate policies are being taken to address its macroeconomic imbalances and structural weaknesses.

Lebanon would also receive substantial additional financial support for implementing an IMF program. While the funding to be provided by the IMF is significantly below Lebanon's needs, an agreement with the IMF would lead donors and creditors to provide significant assistance to Lebanon. International financial institutions, like the World Bank, and other bilateral creditors and donors, would provide financial support to Lebanon once the IMF Executive Board approves the program. This aspect of IMF programs is quite common, and it is referred to as the IMF's catalytic role. Irrespective of the amount to be provided by the IMF, an IMF program would not be approved by the IMF Executive Board without assurances from donors and creditors that Lebanon's external financing needs will be met. This additional support is estimated at about USD 8-10 billion over the four-year duration of the program.

An arrangement with the IMF would also facilitate negotiations with bond holders. Bond holders have made an agreement on the restructuring of the public debt contingent on an IMF program, as they have done with other countries before. Bond holders need assurances that the

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Lebanon will be able to honor the renegotiated terms of the bond contracts, and an IMF program would help provide these assurances.

Lebanon may receive additional financial support from the IMF once program implementation begins. Under IMF policy, lending to Lebanon is limited to specific multiples of its quota with the IMF given that the Lebanese government is currently in default. IMF lending to countries whose public debt is assessed to be unsustainable is limited to 145% of their quota per year, or a cumulative of 435% at any time. Lebanon's quota is SDR 633.5 million, equivalent to about USD 840 million. This lending limit translates to about USD 1.2 billion per year, subject to a ceiling of about USD 3.6 billion for total lending. Amounts in excess of these limits are considered exceptional and are subject to additional criteria related to the need for higher financing, debt sustainability, the ability to regain market access, and prospects for the program's success. The IMF may therefore have some room to increase lending to Lebanon, even if Lebanon's debt is assessed as unsustainable, in the event that there is a balance of payments need and the program is on track.

An IMF program will give priority to technical assistance requests. The IMF provides technical assistance in several economic and financial areas. This assistance is provided free of charge to most countries, including to Lebanon. Country requests for technical assistance exceed the capacity of the IMF to deliver it, so the IMF prioritizes this assistance. Typically, countries with current IMF programs get priority, especially for measures that are key to the success of the program. This assistance covers a wide range of areas related to central banking, fiscal measures and development of statistics, all which could be very useful for Lebanon as it rebuilds its public institutions.

True, there is sometimes a stigma in having to resort to the IMF. IMF programs are usually an indication that country authorities have messed up the management of the economy (except in the event of an unforeseen external shock) and are in need of outside advice and financial support to get them out of their difficulties, subjecting their policies to intense scrutiny by IMF staff. However, these considerations pale in comparison to the benefits stemming from an IMF program, assuming a country is truly serious about economic and financial reform.



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