

## AUB Alumni Speech – March 20<sup>th</sup>, 2017

Although our country seems to permanently struggle to maintain its institutions afloat, the external world is showing signs of support, as everybody recognizes the huge importance of the global public good provided by Lebanon as it has become by far the biggest host of displaced people per capita in the world, with about 260 displaced per 1000 inhabitants in 2016. As we speak, 530 million European citizens host 1.7 million refugees. At the same time, 4.2 million Lebanese host 1.7 million refugees.

A year ago, we had the visit of the UN Secretary General and the World Bank president, who announced their visit to Beirut right after my speech on the refugees' issue at the Annual Meetings in Lima. In addition to commending Lebanon for what it is doing on behalf of the whole world, President Kim compared the situation in Lebanon to having all of Mexico's population suddenly moving into the United States. He also warned that the Lebanon we know may be disappearing.

In this paper, I would like to summarize the diagnostic that I exposed to the IMF Managing Director Christine Lagarde in Abu Dhabi some time ago, as I believe it is still pretty much valid, and I will go into the details of one aspect, the exogenous shocks, and then focus on one of them, the impact of the Syrian war, and its consequences on Lebanon's economy and financial sector. Finally, I will summarize what my team and I are striving to do for Lebanon to come up with the proper set of actions, and how we are keeping the lines of communication open with the international community.

The first point is about our fundamentals, which are clearly on a negative although still manageable trend. As you know, Lebanon's 2017 GDP growth is estimated around 2%, up from zero in 2015. The current account deficit is close to 17% of GDP and the fiscal deficit is expected to be above 9% of GDP at year end. Lebanon's balance of payments has been in the red for more than three years, which had never happened before. In order to properly react to this situation, we need strong governance, a stable inflow of capital, and a reform agenda.

My second point is precisely governance: Finally, we have our president, a cabinet, parliamentary activity, and long-awaited appointments have taken place. Nevertheless, we are yet to have general elections based on a new law, our system suffers from rampant corruption, and headlines such as the waste issue and the telecom story remind us of the work to be done.

The third point is about exogenous shocks. As of today, I would like to highlight three of them: The impact of low oil prices, the international legislation, and the impact of the Syrian crisis on Lebanon.

The economic model that was developed since the end of the civil war presents a concentration of Lebanese jobs in the Gulf, and a concentration of financial resources from the Gulf, on top of which is the biggest share of remittances channeled through Lebanon's banking sector. Therefore, it is critical to maintain a reasonable amount of communication with Gulf countries, particularly because of the Lebanese workforce in this region of the world. On top of this, the correlation between oil prices and financial inflows has always been high.

Regarding international regulations, the critical issue there is not individuals who could be targeted, even if we need to make sure that everybody is treated on fair ground. Instead, it is the perception of the Lebanese financial sector's risk that is of utmost importance, as correspondent banks deal with a relatively tiny volume coming from Lebanon, and may find it too cumbersome to scrutinize the business and reach high levels of confidence in the compliance rates that we achieve. What is currently being done

is precisely to secure an acceptable level of trust so as to keep the channels with our correspondents safe and secure. Nevertheless, it is important to take into account the increased cost of doing business due to recent developments.

Third point: The Syrian crisis. My team, together with the World Bank and UN agencies, has estimated the economic loss in 2015 alone to \$5.6 billion due to the displaced crisis, which represent 11.3% of GDP. The cumulative overall economic loss from 2011 till 2015 amounts to more than \$15 billion.

On the labor market, unfair competition and sluggish growth due to the crisis have placed more than 190,000 Lebanese into poverty, in addition to the existing one million. The unemployment rate has doubled to more than 20%, one-third of the Lebanese youth are unemployed representing a 50 percent rise since 2011, in a labor force estimated to be 50 percent larger than pre-crisis according to the IMF in addition to an increase in informality which brought downward pressure on wages. Host communities' desperation increases as they lose jobs and as they fail to compete with Syrian labor, while they witness the deterioration of basic services and utilities. If we keep in mind the local price inflation due to direct support to the displaced that excludes host communities, they have yet another problem to deal with. Channeling money to the displaced only can trigger hostile reactions.

This is why, in Amman, Jeddah and Washington DC last year, I have been emphasizing a three-level response, 1- humanitarian for hosts and displaced (not less than \$2.5 billion per year), 2- macro-financial assistance for the sustainability of the system (not less than \$420 million per year), and 3- infrastructure and developmental needs, for the stabilization of the system, as we need to bring back the services and safety nets at least to pre-crisis level. This approach was broadly accepted by our partners.

Lebanon's debt to GDP has risen for the first time in 8 years to 138% in 2015 knowing that it is already one of the highest in the world. Without the direct impact of the Syrian crisis, it would have been at 122% at year end. This alone translates into an extra burden of \$550 million every year.

As oil prices are falling, and due to their strong correlation with remittances, we have higher financing needs to face and a much higher deficit than projected without Syria's war impact.

As already stated, the fiscal deficit grew to more than 9% of GDP, with additional cumulative expenditure directly related to the Syrian displaced crisis amounting to \$0.54 billion, and lost revenues of around \$1 billion in 2015, a total of \$3.5 billion since 2011 due to numerous factors related to the Syrian crisis. In fact, for the first time since the end of Lebanon's civil war in 1990, the revenue decreased in 2015, bringing revenue to GDP to 19.3%.

The crisis has negatively affected key growth drivers, such as construction, tourism and the service sector. Exports have decreased due to the deterioration of Lebanon's only land export route which crosses Syria.

The depletion of Lebanon's environment on one hand, and of its infrastructure on the other, including public schools and hospitals, roads, and public utilities, is very quick and massive.

Although the displaced benefit from various subsidized goods like electricity, bread, medication, and others, 59% of the Syrian children between 6 and 14-years old present in Lebanon remain out of school as I already mentioned, and 41 percent of the displaced population lives in substandard shelter conditions, and around US\$20 million of due bills for the hospitalization of displaced Syrians are uncovered.

For the electricity only, and knowing that Lebanon has borne more than \$2 billion losses yearly between 2011 and 2014, and more than \$1.2 billion in 2015, the number of additional users has officially reached 1.17 million, and the cumulative cost related to Syrian displaced only has reached \$434 million. On the other hand, the incremental degradation of the environment due to the presence of the displaced population can be translated by an increase of 20% in air emissions, between 8 and 12% increase in water demand, between 8 and 14% in wastewater generation and 33% in urban densification. The yearly cost on the environment is estimated at \$3.7 billion.

Water and telecommunications' services have clearly declined, and some severe utilities problems are directly related to the massive presence of the displaced.

Generally speaking, Lebanon spends an increased amount of money on infrastructure needs, including water, electricity, and roads, to cater for development needs and for servicing the displaced.

Another important burden to be considered is security. With 1.7 million displaced, small delinquency has risen. On the other hand, and as a direct consequence of Syria's conflict, the Lebanese Armed Forces are fighting extremists on the northeastern border. Lebanon recruited 15 thousand persons in the armed forces during the past two years, which is a 20% increase in the numbers and an extra direct yearly burden of \$147 million every year. We are also substantially increasing our ammunition and maintenance military expenditure.

As the displaced may remain displaced for an average of seventeen years according to previous crises' statistics, short-term answers only are obviously not helpful. While humanitarian needs continue to exist and need to be addressed through humanitarian funding channels, additional financing needs should be leveraged to strengthen the capacities of Lebanon and its host communities to absorb the shocks on their economic and social fabric.

If the picture looks very gloomy, let us also look at the bright side, and that is the ability of this country to do wonders: Before the beginning of the Syrian conflict, the long war of 1975-1990 had already claimed two hundred thousand killed and more than a hundred thousand handicapped, in addition to the missing people and the enormous damages at all levels. We later faced two very aggressive Israeli wars in 1996 and 2006 that claimed thousands of victims and witnessed systematic demolition of Lebanon's infrastructure. This situation contributed to a very high public deficit and worrying debt dynamics, but the Lebanese people continued to finance their needs and those of refugees in Lebanon without relying on significant external assistance. We managed to keep the country going, and never defaulted, whether toward creditors or toward humanitarian responsibilities, as Palestinian refugees have been present in big numbers in Lebanon for a long time.

Despite the understandable trauma, when Syria's bloody conflict began, Lebanon became a case study for the whole world: It deliberately wide-opened its borders to an immense flow of displaced, and has willingly provided relief and services to all of them, despite the very difficult circumstances. Those who feared another displaced-related conflict, or those who suspected some of the displaced to be fighters, possibly smuggling weapons into Lebanon, or those who simply wanted to avoid a very large disequilibrium between religious communities, especially at a time when the whole region is divided along sectarian lines, all of them called for closing our borders, but the displaced were not denied access into Lebanon.

In our public schools, we have introduced a two-shift system to make sure that the displaced are not denied schooling, and today, we have more Syrian students in public schools than Lebanese students. Syrian workers have been very quickly absorbed into various sectors of the economy despite the brutal slowdown that Lebanon is facing. Host communities have done everything they could to provide relief,

and it is remarkable to note that no clash has occurred at any point in time between the displaced and their host communities, knowing that the displaced are very vulnerable and could easily be manipulated.

While hoping that Syria's war will end soon and that the displaced will be able to go back home in the not-too-far future, we can all be proud of what we achieved with regards to this terrible conflict.

A country that is able to sustain a shock of this magnitude and teach the world how things can be done ought to be able to deal with its long-standing intrinsic problems. I am personally convinced that the very urgently needed reforms will never become implementable if they are part of permanent bargains.

The required changes are in the structure, and in the culture, and in the policies. Due to the issues I have just mentioned, we are in a risky zone, and postponing change should not be an option anymore. The system is stretched and has reached its limits at the political, economic and social levels.

Lebanon should ideally expect the following from its elites:

- Accept the necessity of change. The system in place is not sustainable on the long run, even though the international community has already proven ready to bail us out. It is important for the parties that benefit from the existing system to understand that the trade-off against the wealth transfer in their favor might be social instability that would jeopardize their gains on the longer term. The consequences are already massive brain drain and growing unemployment. The purchasing power of the Lebanese had its brutal corrections. The first at the beginning of the nineties through massive depreciation and inflationary pressure. The second through soaring interest rates in the mid-nineties, and a third one through higher taxes at the beginning of the 2000's, with a tax burden increasing by about 7% of GDP within three years. Then we had a correction through higher unemployment, and now through an enormous exogenous shock. It is time to wake up and reverse the deterioration trend.
- Re-discovering Constitution, laws and regulations: Law should not become meaningless. Corruption and inefficiency should not be seen as unavoidable in the system. The de-democratization of Lebanon should stop, as it leads to misusing power at all levels.

Until a few months ago, nearly nothing that lies in the Constitution was respected: No president was elected in due time, no general elections were held, no appointments nor recruitment were properly done, no policies defined to face crises, no budget voted for 11 years, no financial accounts... This has started to improve. In particular, we have reconstituted 23 years of financial accounts (millions of operations, thousands of abnormalities), which is an extremely important milestone for accountability, institutional work and memory, and credibility toward taxpayers, donors, and external agencies.

- Better redistribution: The whole world, starting with the USA, is suffering from increased concentration of wealth, and Lebanon's redistribution system is an extreme case. The wiping off of the middle class has had a very negative impact on our economy, and on our ability to introduce change and reforms. This is why we have been working on gradually introducing measures that make the system a fairer one, and this is also why I insist on targeting the loopholes in the tax system before relying on increasing the burden on taxpayers across the board. Major changes are needed in the tax system, which relies mainly on consumption, very little on labor and revenue, and not at all on wealth.
- Define the role and shape of the State: The public intervention is massive in some cases, and nonexistent in others. Citizens and businesses are insecure. At the level of utilities, there is no adequate pricing, and poor services persist.

- **Controlling the deficit:** The government should define clear priorities. Government spending consists of a long list assigned to satisfy everybody at all time. Therefore, important expenditure does not necessarily come first. We waste the value of time, thus we have a soaring debt. Current expenditure comes before capital expenditure and is sometimes borne forever before related projects take place. Accommodating everybody means that no clear work program is ever defined, and therefore, no performance assessment is possible. We start twenty projects at a time, and we finish none, so we spend plenty of money with no return on public investment. My team and I have developed a medium term expenditure and budget framework, which provides a clear prioritized agenda.
- **Growth agenda:** Our economy needs diversification. We want growth that creates employment for the skilled labor force to increase the local added-value. Construction creates jobs for foreign workers, and tourism creates short-term employment. We have niches in which investment can be very profitable, and this is why, from the Treasury which provides the money, and from the central bank's board where I sit, I have been promoting and supporting various initiatives that boost new sectors with high potential. The induced competitiveness will allow Lebanon to open up the market and consumers to enjoy better terms and quality. The state will have to secure honest competition, protection of rights, efficient courts of justice, and a fair treatment to all.
- **Education:** It has traditionally been a very big investment for households (more than 12% of GDP, compared to 5% in France). This means that it requires high returns, with no adequacy with the labor market needs and no sizeable demand for highly skilled labor. Conclusion: the skilled labor goes abroad and seeks higher returns. With the Syrian displaced now, the system needs to be stabilized very quickly.
- **Labor market:** The rigidity of the Lebanese labor market was obvious to all players before the extraordinary concentration of workforce that we are witnessing now. We are currently putting in place a mechanism that allows Lebanon to benefit from this workforce in its traditional areas, such as heavy infrastructure works and agriculture.
- **Social safety nets:** Any correction in our economy will be very tough on the less privileged, which calls for effective social safety nets. Access to education, health services and retirement pensions are the minimum a state can provide for that part of the population. It is a fact that we would save money by having proper safety nets compared to the current situation, as most of those who benefit from State subsidies do not really need it, whereas the poorest are often not on the screen.
- **Attract FDI:** We are too short-term oriented, with quick profit in mind, probably due to the permanently unstable environment. Investors are eager to find long term opportunities, stability, and institutions. At the General Directorate of Finance, we are increasing trust and reliability with the public, whether through procedures and services or through technical improvement and automation, not only for transparency purposes, but also for reinstating the image of an institution that is solid and reliable.
- **Credibility toward donors and financial institutions:** Lebanon needs the support of the international community for some time. This is why credibility is of utmost importance.
- **Environment:** It overlaps with many other items. Just bear in mind the cost of deterioration I mentioned earlier. It is very costly on tourism, public health, living standards, etc. And the cost of reversing the trend is far too high. This is an area where postponing solutions is simply unacceptable.
- **Asset management:** My General Directorate is trying to establish a proper asset-liability management for Lebanon. Under the same topic lies the issue of petroleum. My team has produced the petroleum law, and finalized the draft tax law that is necessary for petroleum operations. Another critical issue is the way we intend to use those resources. If we treat them as income and spend them massively on debt servicing and reduction, or on various other inefficient expenditures, we would be triggering a Dutch

disease phenomenon, with lower productivity and accelerated brain drain. We would also be depriving future generations from those assets, after having piled up the debt. Alternatively, treating them as assets and wisely using the income they generate will be a very positive game changer.

- Given the impact of the Syrian crisis, Lebanon's response should include trade facilitation and direct investment incentives. This is of utmost importance to be able to deal with the displaced issue. Clearly, our European partners have a big role to play in this regard.
- Consolidating the financial sector: If we do not manage to come up with the proper answers for the displaced issue, Lebanon will be in trouble on the long run. And if we do, our already strained financial sector will come under extra pressure due to increased consumption and financing demand. This is why we have put in place an ongoing assessment for the sector. Our new medium-term debt strategy takes into consideration the banking sector's needs in order to secure the smoothest cooperation among all players. The markets have greeted our work with very low rates compared to our peers, and the ability to issue dollar-denominated Eurobonds over a 20-year maturity, in addition to an unprecedented peak in demand in 1Q2017.

Those are the headlines. A quick and well-coordinated action is needed. The world is impressed with our resilience in front of the Syrian earthquake. It is high time to show that we are not resilient to positive change.

**Alain Bifani**