# IMF's Crystal Ball

## What it saw, didn't see, and when

**Critical reading of Article IV Consultation Reports on Lebanon**

2011-2019

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# ~~Six~~ Five IMF reports on Lebanon
## 2011-2019

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Since the flare up of the multiple crises, and even before that, a lot has been analyzed and written regarding the behavior, actions, and transgressions of actors in the fiscal and financial sectors. However, almost nothing has been mentioned on what the IMF had to say since 2011, the start of the economic decline.

The IMF has been keeping a watchful eye on the economy's regress, and the accompanying decay in trust, decline in the real value of the national currency, a shaky balance at the Central Bank, challenges to the banking system, the fiscal fiasco, and the totally irresponsible destructive governance at many levels of authority.

Following each mission, dubbed Article IV Consultation, the IMF issued a comprehensive report assessing areas of strengths and weaknesses, highlighting opportunities for reform, and warning of flaws in the system. The IMF conducted six missions since 2011 but published only five reports. One contentious report (2018) was hidden from the public, a collusion between the local authorities and the Fund. It is now public knowledge what the controversy was all about.

At a time when 'fair' distribution of financial losses is being debated, and 'fair' determination of responsibilities being called for, it should be pertinent to review what this institution has been saying all along, what it saw, didn't see, and when. This is especially true on the eve of the start of advanced discussions, and perhaps negotiations, between the government and the Fund.

Observers, who are not privy to scrutiny of government affairs as granted to the IMF, had long articulated the same misgivings on how the economy was being mismanaged. But the IMF did not go further. Like most observers, it did not foresee an imminent apocalypse, or what has been hidden in plain sight.

Shouldn't the IMF also share in shouldering part of the responsibilities? Before placing the IMF on a pedestal or demonizing it, an examination of the record of that organization in regards to Lebanon would also be useful, in order to evaluate its recommendations, and hopefully negotiate with it the best deal possible.

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# Content

# Executive Summary

The International Monetary Fund (IMF) has published over the years, at the request of the Lebanese government, periodic reports on the economic, fiscal, and monetary conditions of the country, and also about the health of its financial sector. Typically, the IMF sends a mission to Lebanon which issues a fact finding and recommendation report called 'Article IV Consultation'. Usually, the published report reflects the findings of a mission conducted the previous year.

A review of the Article IV Consultation reports about Lebanon published by the IMF over the 2011-2019 period shows that the Fund's crystal ball was not functioning properly all the time. The IMF did not foresee the imminent collapse of the financial system. It had never uncovered that a large portion of the dollars at the Central Bank and the financial sector were in fact inexistent, and that they were instead a local artifact created by an internal mechanism not supported or covered by existing real funds. On the other hand, the IMF has been prescient on the damaging effects of the continuously growing debt as well as the budget deficit and negative balance in the Current Account. In each of its reports, it lamented the absence of serious reforms, especially in the fiscal and electricity sectors. It was early in detecting the havoc wrecked on the economy by the spillover of the Syrian crisis. The IMF also said that vision was blurred by the weak statistics available and called for strengthening the production of official data.


## The Central Bank

In each report, and as late as its latest 2019 report, the IMF was commending BDL for maintaining financial stability while emphasizing its need to rebuild financial strength. The Fund has continuously lauded the ability of the Central Bank to attract deposit inflows, and was specific in noting that these funds will be channeled to finance the public deficit while at the same time it was calling for curtailing the government's dependence on BDL's lending and recommending the gradual phase out of exemptions from mandatory foreign currency reserves.

The IMF didn't foresee the huge losses at the Central bank and the financial sector although it had hinted that a fall in confidence and an economic and financial crisis could happen due to the high vulnerability of the economy and the financial system.

## Peg and lira valuation

The IMF extolled the exchange rate peg as a lynchpin of stability and was constantly supportive of it although it knew that the real effective exchange rate was increasingly becoming overvalued over the years. It advised the authorities that monetary policy needs to remain geared to supporting the peg which must be backed by strengthening competitiveness and maintaining adequate foreign exchange reserves. The IMF saw that continued deposit inflows provided credibility to the peg.

## Borrowing in FX

The Fund welcomed Parliament's approval of public borrowing in foreign currencies. It said that foreign currency borrowing reduces the government's reliance on BDL reserves and enables it to tap the banks' ample foreign exchange liquidity and benefit from low interest rates on the global market.

## Interest rates

The IMF was encouraging higher interest rates and foreign currency borrowing despite the fact that the main funding sources were erratic deposit inflows. It supported increasing interest rates instead of resorting to financial engineering.

### Financial Engineering

The Fund said that BDL has skillfully maintained financial stability in difficult circumstances, often with unconventional measures. It said that BDL's several financial engineering operations carried out starting in 2016 has successfully bolstered its foreign exchange reserves, supported the peg, strengthened bank capital, lowered the government's borrowing cost, and provided liquidity for domestic lending. It advised against the immediate cessation of these operations as this would increase risks. The IMF said that the financial engineering operations are not a sustainable solution but are unconventional stop-gap measures done out of necessity. In its 2019 report the IMF said that BDL should gradually revert to conventional monetary policy. These operations have added to BDL's foreign exchange liabilities and associated carry costs.

### Banking resilience

The IMF has continuously assessed the banking system, except in its 2019 report where it gave it little attention. In no case, it foresaw a scenario that would lead to a collapse that would result in depriving depositors from accessing their money and in a more than 90 percent fall in the exchange rate of the local currency, nor did it forecast the inability of the Central Bank to function as a financier of last resort. The banking system is perceived by the IMF as a resilient sector that follows a conservative policy. It said that the banking system remains a critical pillar of Lebanese resilience.

### Current Account deficit

Contrary to IMF's expectations reiterated in its various reports that the Current Account deficit would narrow over the medium term, the deficit kept on widening. The Fund was counting on a rebound in exports that would improve the Current Account balance.

### Fiscal deficit

The IMF persistently advised the authorities to carry out fiscal consolidation (fiscal adjustment). It emphasized the importance of a credible and balanced fiscal adjustment strategy to prevent further fiscal deterioration, reestablish primary surpluses, and put public debt on a sustainable path. The Fund was not in favor of increasing public wages – especially without additional fiscal revenues. It advocated improving the fiscal deficit by increasing revenues, rather than cutting costs.

### Rise in debt

The IMF continually stressed the need to address the escalating public debt. Early in 2011, it called for an ambitious fiscal strategy that could bring the debt ratio to below 100 percent of GDP by 2020 by achieving sizeable primary surpluses. It said that there was no substitute for upfront adjustment. Neither donor assistance, resolution of the Syrian conflict, nor any prospective revenue from oil and gas would, in itself, sustainably resolve the debt dynamics.

### Electricity reforms

The IMF has recognized that vested interests and general lack of governance have prevented progress in the electricity sector. Increasing electricity supply would eliminate one of the biggest constraints to doing business in Lebanon, in addition to its positive effects on income distribution, the balance of payments, the environment and fiscal deficit. The Fund called for an immediate increase of the tariff and for eliminating electricity subsidies.

### Spillovers of the Syrian crisis

Very early, the IMF sensed the huge risks that Lebanon would be exposed to because of the Syrian crisis. The spillover from the crisis presented the most serious risk to the economy. It said that the Syrian crisis had negatively affected investor confidence, disrupted tourism, increased costs of bilateral and transit trade, and forced local banks to reduce their exposure to Syria. The Fund lauded Lebanon for its efforts in hosting a number of refugees disproportional to its population and recommended international budget support to Lebanon.

### Serious statistical flaws

The IMF was relentless in highlighting that data provision has serious shortcomings, especially national accounts and external sector statistics. The Fund said that there is an immediate need to develop regular and timely statistics. It warned that fiscal reporting was lagging and that irregular Treasury inflows and outflows were weakening data compilation. It has also noted that BDL does not publish externally-audited financial statements.

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