Ex-post evaluation of Macro Financial Assistance operations to Lebanon

Framework Contract DG ECFIN No ECFIN-006-2011/LOT No. 2

Client: European Commission, Directorate General Economic and Financial Affairs

Rotterdam, 2 May 2012

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Final Report

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List of abbreviations

AFD	Agence Française de Développement
BdL	Banque du Liban (Central Bank of Lebanon)
BoP	Balance of Payments
CA	Current Account
CAS	Central Administration of Statistics
CBL	Central Bank of Lebanon
CDR	Council for Development and Reconstruction
CIDA	Canadian International Development Agency
CMU	Cash Management Unit
CPI	Consumer Price Index
CPS	Country Partnership Strategy
CSP	Country Strategy Paper
DB	Doing Business
DPL	Development Policy Loan
EBRD	European Bank of Reconstruction and Development
EC	European Commission
EFC	Economic and Financial Committee
EOI	Expression of Interest
DG ECFIN	Directorate General for Economic and Financial Affairs
ECHO	European Commission Humanitarian Aid Office
EdL	Eléctricité du Liban
EFMIS	Emergency Fiscal Management Reform Implementation Support Project
EIB	European Investment Bank
EIDHR	European Instrument for Democracy and Human Rights
ENP AP	European Neighbourhood Policy Action Plan
ENPI	European Neighbourhood Policy Instrument
EOI	Expression of Interest
EPCA	Emergency Post-Conflict Assistance
ESPISP	Emergency Social Protection Implementation Support Project
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FEMIP	Facility for Euro-Mediterranean Investment and Partnership
FR	France
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GNDI	Gross National Disposable Income
GoL	Government of Lebanon
HRC	Human Rights Council
IFI	International Financial Institution
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
LBP	Lebanese Pound
LPDC	Lebanese-Palestinian Dialogue Committee
MENA	Middle East and North Africa

METAC	Middle East Technical Assistance Centre
MoF	Ministry of Finance
MTEF	Medium Term Expenditure Framework
MoU	Memorandum of Understanding
MFA	Macro Financial Assistance
NIF	Neighbourhood Investment Facility
NIP	National Indicative Programme
NPTP	National Poverty Targeting Program
NSSF	National Social Security Funds
OA	Operational Assessment
ODA	Official Development Assistance
PFM	Public Finance Management
REER	Real Effective Exchange Rate
PEFA	Public Expenditure and Financial Accountability
DG RELEX	Director-General for the External Relations
SBA	Stand-By Arrangement
SDR	Special Drawing Right
SIMC	Social Inter-Ministerial Committee
SME	Small and Medium Enterprise
STA	Single Treasury Account
TA	Technical Assistance
TFL	Trust Fund for Lebanon
TRA	Telecom Regulatory Authority
UAE	United Arab Emirates
UK	United Kingdom
UNDP	United Nations Development Program
UNRWA	United Nations Relief and Works Agency for Palestine Refugees in the Near East
US	United States
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	World Bank

Executive summary

Objective of the evaluation

This document presents the findings, conclusions and recommendations of the ex-post evaluation of Macro Financial Assistance provided to Lebanon in the period December 2007 to end 2010. The evaluation follows the *Guidelines for the Ex Post Evaluation of MFA and BoP assistance Operations*. It focuses on three core areas of effects: (i) macroeconomic effects; (ii) structural effects; and effects on the sustainability of the external financial situation. Also implications of the design of the MFA operation on its implementation are considered.

The MFA operation

Following the International Conference for Support to Lebanon, or "Paris III conference", in December 2007 the Council of the European Union approved to provide MFA to Lebanon of up to € 80 million consisting of a € 50 million medium-term loan and a € 30 million grant. The MFA assistance was divided into two tranches which were respectively conditional on the progress in the implementation of IMF programme and specific structural conditions. The MFA complemented support from the International Financial Institutions, bilateral donors, and other EU assistance provided under the European Neighbourhood and Partnership Instrument (ENPI). As the conditions for the release of the first instalment were met, the first grant (€ 15 million) and loan (€ 25 million) tranches were disbursed at the end of December 2008 and May 2009 respectively. Due to slow progress in structural reforms, however, the second tranche was cancelled.

The primary objectives of the MFA operation in Lebanon were to (i) support Lebanon's domestic efforts of post-war reconstruction and sustainable economic recovery; (ii) alleviate the financial constraints on the implementation of the government's economic programme; and (iii) support Lebanon's efforts to reduce public debt to a sustainable level. Given the nature of the operation and, consequently, the importance of fiscal consolidation and the need to address the high level of public debt, particular attention in establishing conditionalities was paid to Public Finance Management. Further importance was also given to the power sector and the social sector, which were considered important for fiscal consolidation.

The strained political situation in the run-up to the elections hampered the progress made regarding the fulfilment of conditions in 2009. To accommodate this situation, in December 2009 the Commission extended the duration of the MFA operation by one year without changes in the structural conditions for the disbursement of the second tranche. This addendum was not ratified by the Lebanese authorities. In December 2010 the Lebanese Minister of Finance requested a new extension and a review of the implementation of the MFA conditions. The request was rejected by the Commission on the grounds of poor implementation by the national authorities of key structural reform conditions, the non-existence of an ongoing IMF financial arrangement, and lack of consensus on the part of the national authorities over the activation of the previous disbursement period extension. Given the improvement of the balance of payments position, the release of the second tranche was not deemed necessary. Consequently, the second tranche was eventually cancelled.

Gross impact on macroeconomic stabilisation

Starting from 2007, the Lebanese economy has shown robust growth despite the global financial and economic crisis. The relative political stability has been a key factor determining the rebound of growth during the 2007-2010 period. One major determinant of the country's growth prospects is the size and increasing trend of current (remittances) and capital transfers, mainly from the Lebanese Diaspora. The growth prospects are inhibited by significant infrastructure problems, particularly in the power sector.

Public deficits have been close to or above 10% of GDP until 2007 and decreased gradually during the 2008-2010 period. The improvement appeared to be short lived as in 2011 a deterioration of the fiscal balances occurred. The very high debt stock resulted in interest payments amounting to more than one third of total central government expenditures, exceeding expenditures on public sector salaries and pensions.

The macroeconomic developments in Lebanon suggest an improvement in areas to which the objectives of the MFA operation were related. Specifically, Lebanon has clearly made substantial progress in post-war reconstruction and experienced economic recovery that was sustained over a period of four years, despite the particularly unfavourable global economic environment. While implementation of the government's economic programme defined before the Paris III conference faced several obstacles, financial constraints on the implementation eased. It can be concluded that the two macroeconomic objectives of the MFA assistance were largely achieved. However, since early 2011 the economy lost momentum largely owing to rising domestic political uncertainty and regional turmoil.

Gross impact on external sustainability

The origins of the major problems with Lebanon's large external and public debt stocks can be traced back to the legacy of the 1975-1991 war that weighed negatively on economic activity. It also limited the ability of the authorities to collect revenues. The post-war reconstruction during 1990s was characterised by insufficient fiscal adjustment, very limited access to international capital markets and heavy reliance on short-term bonds denominated in Lebanese pounds. As a result, gross public debt doubled from 49% of GDP in 1993 to 103% of GDP in 1997. After the Paris II donor conference in 2002 Lebanon regained access to international financing and was able to change the composition of debt financing. By 2006 gross public debt stood at 180% of GDP. The debt to GDP ratio declined gradually to 124% of GDP at the end of 2011.

While public debt is mostly held domestically, Lebanon's total external debt is very high. Total external debt has followed the same trend as the public debt, reaching almost 200% of GDP in 2006 and then declining gradually to around 160% of GDP in 2010-2011. In nominal terms, the debt grew steadily and the decline in the GDP ratio could be attributed to nominal GDP growth. The most recent government debt sustainability analysis concludes that in the baseline scenario the debt-to-GDP ratio would remain roughly unchanged from its 2011 level of about 130% of GDP until 2016, as the net effect from debt-reducing and debt-creating forces will cancel out. Projections for external sustainability foresee a current account deficit of around 14% of GDP during 2011-2012 which would decline gradually thereafter.

The high public debt in Lebanon cannot be described as sustainable. Sensitivity analysis of the baseline scenario to adverse shock confirms the existence of substantial downside risks. Slowdown in GDP growth, higher interest rates or a weaker primary government surplus would result in a quite substantial increase of the debt to GDP ratio. The risk to the public debt outlook is therefore considered to be medium.

Gross impact on structural reforms

Due to the lack of progress in the areas related to MFA structural conditions it can be concluded that the MFA operation did not have a direct impact on structural reforms in the country.

The structural conditions were informed by the IMF programme and the policy conditions attached to the other major donor programmes (i.e. France, United States, and the World Bank), the recommendations of the Operational Assessment, as well as the Government comprehensive reform programme and the Medium Term Public Financial Management Reform Action Plan. There was a dynamic process of discussion and consultation on the conditions to be included in the MoU, involving various internal and external to the EC actors. However, the consultation with the other donors was merely limited to an exchange of information rather than part of a true consultative process. Also the role of the EC Delegation was limited to providing advice on selected issues, rather than being directly part of the dialogue between the DG ECFIN and the Lebanese authorities.

During the implementation of MFA operation no progress was observed in the area of the structural conditions. During the implementation of the MFA operation none of the structural conditions had been met. The conditions were relevant to the Lebanese government philosophy on reforms and realistic from a technical point of view. It is questionable whether the conditions were realistic given the lack of consensus and frequent change of government.

Given the relative small amount of the MFA assistance it is questionable whether the MFA and its conditions could have triggered the government to undertake reform. With the benefit of the hindsight, one could argue that setting more short-term conditions (which would fit under a time-span of an "unstable" government) could have been a more effective approach. In a country with such a specific and complex political context and instability it would be difficult to expect long-term strategic commitments.

Net impact of MFA and unexpected effects

The comparative historical analysis related to the situation in Lebanon resulted in the selection of three main counterfactual scenarios (and two versions of the third scenario) to assess the net impact of the MFA operation. These are:

- *Counterfactual scenario A*: The MFA operation is not proposed at the Paris III conference and does not take place in subsequent period.
- *Counterfactual scenario B*: The MFA operation is not proposed at the Paris III conference and does not take place in subsequent period. EIB project financing is reduced relative to the actual path. Specifically, we assume that the EIB credit lines to top-tier Lebanese intermediary banks to finance investment projects carried out by private sector companies, especially SME's is cut by € 100 million in 2008 and by € 50 million in 2009.
- *Counterfactual scenario C*: The MFA operation is not proposed at the Paris III conference and does not take place in subsequent period. EIB project financing is reduced relative to the actual path. Furthermore, the IMF does not provide Emergency Post-Conflict Assistance (EPCA) programmes.

In scenarios A and B investors' and depositors' attitude would *not* be affected. Lack of the IMF programme (scenario C) would negatively weigh on assessments of prospects of the Lebanese economy by financial markets as investors and depositors would alter their behaviour. Under counterfactual scenario C1 there is no impact on the behaviour of investors and depositors in Lebanese banks. In contrast, the counterfactual sub-scenario C2 can be viewed as a particularly 'black' scenario, i.e. the one when not only the a combination of several donor assistance packages does not materialise but also when this leads to particularly negative market outcomes affecting the real economy.

Taking the counterfactual scenarios A and B and C1 as a basis the net macroeconomic effects of the operation are relatively small. This should not be surprising given the size of the operation relative to the Lebanon's economy and other financial flows to the country, including other donor assistance. At the same time, more substantial effects materialising relative to counterfactual scenario C2 (where neither MFA nor the IMF programme are agreed) highlights the key role played by the MFA instrument when it was granted to Lebanon, namely in enhancing confidence in the stability of Lebanon's economic and financial situation.

With regard to the net impact MFA on structural reforms, no or limited (gross) impact on structural reforms has been achieved as result of the MFA assistance. Given that little or no progress in structural reforms was achieved it is expected that little or no operational reinforcing effect could exist. The MFA assistance and the other assistance pledged and consequently committed as result of the Paris III Conference in 2007 were mainly of a political nature, namely to support the undertaking of the legitimate government. One of the main achievements of the MFA is, therefore, reflected by political reinforcing effects. These political reinforcing effects relate to the political signals given by the EC to Lebanese authorities, development partners and other stakeholders. The MFA operation brought the relationship between the EC and Lebanon to a different level. During the duration of the operation, however, no direct impact could be observed due to the lack of progress in the areas related to the MFA structural conditions.

Further, given the relative small size of the MFA and the minor impact of most of the conditions of the IMF programme on the progress in structural reforms, it is expected that the scenario case where no MFA would have been provided the status quo would have been maintained but not deteriorated. In case when no IMF assistance and no MFA would have been provided the net impact on structural reforms might show a different picture since the lack of an IMF programme could have changed the dynamics of other financial assistance to the country and its credibility for lenders.

Unexpected effects on structural reforms
While the assistance did not have a direct effect on structural reforms, it is believed that it played an unexpected (indirect) effect on reforms through the trust offered by the EC to Lebanon. Prior to MFA the EC provided support mainly in form of technical assistance. Provision of MFA, which was seen as a form of budget support, was seen as a signal from the EU to support Lebanon and advanced the relations between Lebanon and the EC.

Design and implementation of MFA

Specific characteristics of the MFA operation to Lebanon
In a regular MFA operation the government of the beneficiary country would normally initiate the process through sending a request for MFA. This was not the case for the MFA operation in Lebanon. Nonetheless, one may argue that the Paris III conference served implicitly as a government request for development assistance, which MFA is part of.

Delay in starting-up the MFA operation and in implementation
There was a period of one year between the Council decision to provide MFA to Lebanon on 10 December 2007 and the MoU which was signed between the EU and Lebanon on 18 December 2008. The delay was partly owed to the political paralysis of Lebanon's parliament that lasted until mid-2008. Significant amount of time was spent on negotiations of conditionalities between the EC and the Government of Lebanon.

The process of prolonged delay in further implementation of the MFA assistance led in the end to cancellation. The much improved economic situation of Lebanon and the political uncertainty in the country contributed to this. The EU did not ease its conditions for the sake of disbursement of the last tranche, while other bilateral donors, such as USAID, did that, though, without success.

Political economy considerations

The complex political situation before Paris III and the change of governments have complicated the implementation of the MFA assistance as most of the structural conditions were not fulfilled. The implementation of the World Bank, US and French budgetary support encountered similar problems. While it appears that the contextual factors did not affect the design of the MFA operation, it has seriously affected its implementation. No political economy analysis was initiated to understand how the country context may affect the implementation of MFA.

MFA as part of a comprehensive EU package

The role of the MFA needs to be seen as part of the overall EU package presented during the Paris III Conference. By including MFA in the overall EC assistance package the cooperation between the EU and Lebanon was considered as a positive signal towards the authorities and advanced the relations between Lebanon and the EC.

Conditions related to the first tranche vs. conditions related to the second tranche

The first tranche of MFA was conditioned on the progress in the implementation of the IMF EPCA Programme. Assistance of some bilateral donors was linked to the successful implementation of the IMF programme. The harmonized approach could have promoted the progress in the implementation of each actor's assistance programme. However, during the design phase there was little discussion between the EC and the French and American counterparts on how MFA conditions could be reinforced by the other's conditions. This may have ultimately affected the reinforcing effect and consequently fulfilment of the conditions related to the second tranche. Further, there was generally insufficient coordination among donors beyond sharing of information through formal and informal means.

Disbursement of the second tranche of the MFA as well as disbursement of follow-up instalments of US and French budget support did not occur as it related to overambitious conditions in terms of timing. The conditions, especially related to the power sector and in the area of PFM, could have been better designed in a stepwise manner.

Intra-EC coordination

There is a perception that the MFA operation and subsequent developments would have benefited from having a more pro-active attitude of DG ECFIN to the MFA operation, for instance through more country visits and meetings with government officials. The MFA operation has been led by DG ECFIN, who carried out also the dialogue with the Lebanese government. The EC Delegation was to a limited extent involved in the MFA operation, and was merely given an information provision and monitoring role. The full potential of the EC Delegation which had a better understanding of the political complexities within the country was not fully utilized.

Importance of MFA diminished quickly over time

The key value of MFA seems to be to provide a confidence boost and a political support message for reforms at the time of announcement. The additional EU assistance in the form of MFA came exactly at the right moment. The importance diminished quickly over time. The agreement on not so realistic conditions (and this was done quite late, once the economic situation has already changed considerably) appears to be a weakness of the design of the operation.

Value added of MFA

Two particular aspects can be mentioned, namely (i) the confidence building effect at the time of announcement of the MFA as part of the comprehensive EU package and (ii) the positive signal that was provided by inclusion of MFA in the EU package and by advancing the dialogue between the EU and the government.

Recommendations

- Take advantage of in-country knowledge of political economy considerations.
- Value the announcement effect of MFA assistance as part of larger support packages and align conditions to this by agreeing on quick disbursing conditions.
- Value the additional value MFA may have on strengthening relations with the respective country, but do not see this as an additional objective of MFA.

1 Introduction

The ECORYS consortium has been contracted to conduct an ex-post evaluation of the EC Macro Financial Assistance (MFA) provided to Lebanon in the period December 2007 to end 2010. This report presents the findings, conclusions and draft recommendations.

We would like to express our special gratitude to present and previous government officials in Beirut and other resource persons in the country, to staff members of the IMF and World Bank in Washington, D.C. and Beirut, EC officials in Brussels and Beirut, and representatives of other bilateral donor agencies for their cooperation and willingness to contribute to this evaluation by feeding us with a good understanding of the facts and events at the time of the MFA operation.

Responsibility for the opinions presented in this report is exclusively of the authors and should not be attributed to the Government of Lebanon, to the European Commission or to the other IFIs and bilateral donors.

The report is structured as follows. Chapter 2 outlines the evaluation objectives, evaluation approach, and methods that have been used in the ex-post evaluation. Chapter 3 presents a historical overview of relevant events concerning MFA and describes the background of the MFA operation. The subsequent chapters look at the main evaluation areas: impact on macroeconomic stabilisation, impact on external sustainability, and impact on structural reforms. Chapter 4 analyses macroeconomic developments in Lebanon. Chapter 5 presents a forward-looking analysis of the gross impact of MFA on external sustainability. Chapter 6 discusses the gross impact of MFA on structural reforms. Chapter 7 presents the assessment of the net impact of the MFA operation on macroeconomic, structural and external sustainability. Chapter 8 describes our findings and conclusions concerning the design and implementation of the MFA assistance and its implications on efficiency and effectiveness, and provides recommendations

In the annexes, we have documented data sources and included information has been used in this evaluation. The annexes consist of the description of the macroeconomic modelling approach, literature references and data sources, a list of interviews conducted, overviews of World Bank and IMF operations in Lebanon, and a history of events pertinent for the MFA operation in the period 2007-2010.

2 Evaluation objective and approach

2.1 Objective of the evaluation

Under the Financial Regulation (art. 27.4), the EC is legally obliged to evaluate its main programmes, including MFA. The explanatory memorandum attached to the Council Decision on Providing Community Macro-Financial Assistance to Lebanon indicates that "*an independent ex-post evaluation of the assistance is planned to be carried out by the Commission or its duly authorised representatives one to two years after the expiry of the implementation period*." The main objective of this ex-post evaluation of MFA is (a) to assess the effects of the MFA operation in Lebanon, and (b) to draw key lessons, which can be applied to future interventions and/or the possible need for a reorientation of the present approach.

This ex-post evaluation of MFA to Lebanon is both backward looking and forward looking. It will enable DG ECFIN to discharge its obligations in terms of transparency and accountability. Moreover, the evaluation will to support organisational learning by enabling the EC to draw key lessons for future MFA operations.

2.2 Evaluation approach and method

Table 2.1 summarises the main evaluation questions as stated in the *Guidelines for the Ex Post Evaluation of MFA and BoP assistance Operations*, the specific evaluation instruments used to answer these questions and the section where the corresponding questions are addressed in this report.

Table 2.1: Key evaluation questions

Nr.	Evaluation Question	Evaluation instruments	Section in this document
Q0	How would the economy of Lebanon have evolved in the absence of the MFA assistance?	Qualitative and quantitative analysis (including, desk research, stakeholder interviews - on site and telephone, macroeconomic modelling)	Sections, 7.3, 7.4, 7.5 and 7.6
Q1	To what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of Lebanon?	Logic model, qualitative and quantitative analysis, counterfactual analysis	Chapter 4, section 7.5
Q2	To what extent has the MFA assistance been effective in terms of supporting structural reform in the recipient country?	Qualitative and quantitative analysis (including desk review, stakeholder interviews - on site and telephone - and case study)	Chapters 6, section 7.7
Q3	What have been the indirect and/or unexpected effects of the MFA assistance?	Qualitative and quantitative analysis (including interviews)	Section 7.9
Q4	To what extent has the MFA assistance contributed to returning the external financial situation of	Qualitative and quantitative analysis (including desk	Chapter 5

Nr.	Evaluation Question	Evaluation instruments	Section in this document
	Lebanon to a sustainable path over the medium to longer-term?	review, interviews and macroeconomic modelling)	
Q5	How has the way in which the MFA assistance operation was designed and implemented conditioned its effectiveness and efficiency?	Qualitative assessment (including desk review, interviews)	Chapter 8
Q6	To what extent has EU added value been maximised?	Qualitative and quantitative analysis (synthesis of Q0 – Q5, interviews)	Chapter 8

2.2.1 Core areas of effects

The evaluation questions focus on three core areas of economic effects:

- Macroeconomic effects;
- Structural effects;
- Effects on the sustainability of the external financial situation.

Each area focuses on the effects over specific time horizons: macroeconomic developments are mostly assessed in the short-term horizon (up to around two years after the initial disbursement), the structural effects on the economy and institutions in the short and medium term horizon (up to four years after the initial disbursement) and effects on the external financial situation in the medium to long term horizon (three years or more after the initial disbursement). This report describes firstly the macroeconomic effects and then the effects on external sustainability, followed by the structural effects. This sequence is considered more logical from a reader's perspective.

2.2.2 The three-step approach

For the attribution of effects to the MFA assistance, we have followed the three-step approach in accordance with the *Guidelines for the Ex Post Evaluation of MFA and BoP assistance Operations*.

- The **first step** is to identify the types of short-term macroeconomic effects, short and medium structural effects on the economy and, if applicable, on institutions and identify plausible cause and effect relations between assistance and subsequent developments.

- The **second step** is to establish a counterfactual situation. This step identifies the most likely scenario in the domain of macroeconomic stabilisation and structural reform when no macro financial assistance would have been granted to Lebanon. Table 2.2 provides the basis for establishing the counterfactual situation for the evaluation of the MFA assistance. To answer these questions we took into account the precise circumstances at the time that MFA was decided upon and the role of International Financial Institutions and bilateral donors during this process. The option that other EU assistance instruments would have been used more intensively in absence of MFA has *not* been considered as a feasible counterfactual option and has therefore not been analysed.

Table 2.2: Establishing the counterfactual situation

Q0.	How would the economy of Lebanon have evolved in the absence of the assistance?
Q0.1	What are the macroeconomic and structural effects if the total assistance package (i.e. EU and IMF assistance) had not been granted?
Q0.2	What are the macroeconomic and structural effects if only EU assistance (MFA) had not been granted?

- The **third step** involves determination of effects of the operation, which, for both macroeconomic issues and structural issues amounts to the difference between observed developments and the counterfactual situation. Unexpected and indirect effects, if existing, as well as consequences of programme design have also been identified.

In addition, we have developed brief case studies for structural reform, one focussing on PFM and one on the power sector. These case studies analyse specific conditions linked to the MFA in-depth.

2.2.3 Evaluation methods

To conduct the identified steps of the evaluation approach, data and information have been collected by means of a variety of evaluation methods. Triangulation of the information collected and analyses conducted using the different evaluation methods has been applied in order to derive conclusions. Below the evaluation instruments are shortly described.

Document analysis and literature review
This instrument comprised (i) analysis of the documents available in the files of DG ECFIN; (ii) collection, processing and analysis of statistical data from the Central Bank of Lebanon, IMF and World Bank; (iii) review of documents from the main IFI's (World Bank and IMF) and two main bilateral donors (France and USAID); (iv) analysis of documents from the Central Administration of Statistics, the Ministry of Finance, and the Central Bank of Lebanon.

Interviews with key officials
Interviews with key EC officials in Brussels have been conducted. The evaluation team has conducted interviews with officials and advisors who were involved in preparing and implementing the MFA operation, representatives of the EU Delegation in Beirut, the offices of the World Bank and the IMF (in Washington DC and Beirut), and bilateral donors active in the country. All interviews were confidential and anonymously reported. Before the interviews interviewees received pre-interview questionnaires to improve the quality of the interviews, by providing the opportunity to enter into in-depth discussions during the interview, and acting as a reminder to 'refresh' the interviewee's memory before the meeting. Annex II includes an overview of interviewees.

Quantitative and qualitative approaches to the counterfactual
To estimate the net macroeconomic effects of the MFA assistance three counterfactual scenarios have been developed. One scenario comprises two sub-scenarios. To estimate the macroeconomic effects in the counterfactual situation the evaluation team has employed both a quantitative modelling approach as well as a qualitative approach based upon recent economic history of Lebanon and other countries which experienced so-called "sudden stops", i.e. sharp reductions in capital flows.

The economic model applied embodies similar characteristics to those employed in previous evaluations of MFA, but has been adjusted to take into account the peculiarities of the Lebanese economy and the availability of data, their quality and reliability and comments received from the Steering Committee. Certain specific features surrounding the MFA assistance to Lebanon include:
- Small size of disbursed MFA grants and loans relative to total foreign assistance flows to Lebanon during 2007-2010;
- Poor quality of macroeconomic statistics in Lebanon;
- The major importance of macroeconomic effects stemming from purely political developments (internal political stability).

Annex I includes a more detailed description of the macroeconomic model used to estimate the effects in two counterfactual scenarios. For the third counterfactual scenario the qualitative approach has been applied as well.

Case studies

To explore in more detail the effects of the MFA operation on the structural reforms in Lebanon, the evaluation team has considered case studies focussing on two structural conditions included in the Memorandum of Understanding, i.e. PFM and the power sector.

While in some evaluations of other MFA operations in other countries we used a Delphi questionnaire to triangulate our findings from interviews, in this evaluation the Delphi questionnaire was not used due to the relatively small and unrepresentative group of respondents willing to respond to the Delphi questionnaire.

2.3 Challenges, risks and assumptions

In the conduct of the evaluation we have relied on support from all key actors in obtaining information and getting access to sources and carriers of information. The EC has provided us with introductory letters to facilitate interviews prior to the field work.

Most of the officials that we intended to interview have changed jobs in the meantime and it has been time-consuming and difficult to identify the relevant persons and conduct interviews. Considering the preparation of the MFA assistance and the implementation, three governments have been involved. The new government was formed in June 2011. Many officials of the previous government were not anymore in place. A local economist in Beirut supported the team in getting in touch with some knowledgeable interviewees though the process proved to be more difficult than initially expect. This resulted in delays in carrying out this evaluation.

In Lebanon we encountered significant shortcomings in the quality of the available statistical data on economic developments (e.g. compilation of GDP is based on administrative data and not on the basis of economic surveys). The statistical quality has been indicated as problematic in various IMF reports. This made our work somewhat complicated and required relying on estimates provided by external sources. In addition, the uncertainty in the development of the global economy has affected the forward-looking aspects of the counterfactual analysis and the external sustainability analysis. Therefore, where necessary, additional attention was devoted to these analyses by using scenario-analysis. In this report three counterfactual scenarios have been developed to assess the net macroeconomic impact of the MFA assistance.

3 MFA Operation in Lebanon

This chapter presents the political and economic context in Lebanon covering the period before, during and after implementation of the MFA assistance. It provides also a historical overview of relevant MFA events and an overview of all financial support to Lebanon provided in the past and at present.

3.1 Political and economic context

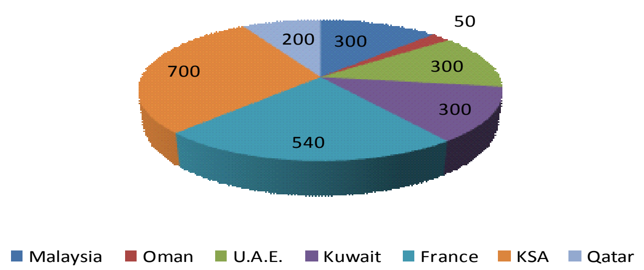
3.1.1 International and political developments

Pre-Paris III period

Financing of Lebanon's reconstruction activities at the end of the civil war between 1975-1990 led to a rapid increase of public debt in Lebanon reaching US$ 32 billion by November 2002 (185% of GDP). The Lebanese Government launched a number of fiscal policy reforms aimed at increasing the primary budget surplus and pursuing privatisation and a securitisation programme. Further measures were necessary to complement these reforms in order to change the composition of the public debt and reduce its servicing cost. Against this background the government developed an economic reform programme, for which it sought external support in the context of the Paris II Conference held on 23 November 2002.

The outcome of the conference was commitments from the donor community dedicated to debt reduction and management in the amount of US$ 3.1 billion[1]. An additional amount of US$ 1.3 billion was secured to fund projects earmarked for socio-economic development. Direct financial support (non-project financing) in the amount of US$ 2.4 billion were committed and received by the Lebanese government from seven countries (see Figure 3.1 below).These amounts corresponded to around 77% of the total pledges and were used to retire and replace maturing debt (both principal and interest). In addition, contributions were received from the Arab Monetary Fund (US$ 15 million in the form of a medium term loan for structural adjustment and extension of a US$ 40 million trade finance facility to be used for the financing of fuel imports by Eléctricité du Liban). The European Union provided a grant of € 12.25 million to be utilised for structural adjustment and fiscal reforms.

Figure 3.1: Paris II - Bilateral donor contributions to Lebanon (in millions of US$)



Source: Republic of Lebanon, Ministry of Finance, One-year progress after Paris II, 2003

[1] See Republic of Lebanon, Ministry of Finance, One year progress after Paris II, December 2003.

The financial commitment from the Paris II conference helped to improve the structure of the public debt and reduce its cost. As a result, interest payments on the debt fell sharply from 17% of GDP in 2002 to about 10% of GDP in 2005. In 2004, the macroeconomic performance exceeded all expectations, with real growth reaching more than 7%, the overall budget deficit declining to less than 8% of GDP (from 25% in 2000), and the primary budget surplus improving to 2.3% of GDP. To a large extent, the fiscal adjustment was the result of the introduction of the Value Added Tax (VAT) in 2002.[2]

Political strains and ensuing uncertainty prevented the full implementation of the structural components of the economic reform programme. As a consequence, by the end of 2004, the level of gross public debt reached 165% of GDP and by the end of 2005 even 175% of GDP.

Paris III Conference

After the conflict with Israel, almost one billion in emergency relief and early reconstruction aid was pledged to Lebanon at a donors conference in Stockholm in August 2006. At the International Conference for Support to Lebanon, or "Paris III conference", the donor community pledged in addition US$ 7,609 million for reconstruction and economic stabilisation. The pledges could be divided into four main categories: (i) government support; (ii) private sector support and other; (iii) projects underway; and (iv) funds currently being discussed.

Distinct from Paris II assistance, much of the Paris III pledges was contingent on Lebanon's meeting agreed benchmarks in implementing its proposed 5-year economic and social reform programme. The International Monetary Fund (IMF) signed an Emergency Post-Conflict Assistance (EPCA) Programme with Lebanon to support the Government of Lebanon's economic reform programme in 2007, and a second EPCA for 2008-2009, to monitor the progress of reforms and to advise donors on the timing of aid delivery.

Almost 68% of the funds aimed at supporting Lebanon's reform efforts either through budget support or project financing in the form of grants (23 % of government support) and loans (77 % of government support). Both institutions and countries pledged at the Paris III Conference. Contributions from institutions represented over 53% of the total amount pledged.

Table 3.1: Distribution of Pledges at Paris III (US$, million)

	Countries	Institutions	Total	% of Total
Arab donors	1,462	1,250	2,712	36%
European donors	1,171	1,734	2,906	38%
Other international*	9,41		941	12%
International Financial Institutions		1,050	1,050	14%
Total	**3,574**	**4,034**	**7,609**	**100%**

* Other international includes United States, Turkey, Canada, Australia, China, Japan, Brazil, Malaysia, South Korea

Source: Lebanese Republic , Ministry of Finance, First progress report on Paris III

Government Programme

The Lebanese government headed by Prime Minister Siniora prepared a comprehensive reform programme that was about to be adopted before the conflict with Israel. While the main elements of the reform programme were presented in Parliament in July 2005, the Government decided first to seek broad national consensus on the programme before holding the Beirut Conference where the programme would be officially announced. This was done to ensure ownership of the reform

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[2] Lebanese Republic, Paris III: International Conference for Support to Lebanon, January 2007.

programme and therefore its implementation, and thereby avoiding the situation that had arisen after Paris II when the government was unable to implement the full range of reforms (and specifically privatisation). The process was reaching its final stages when the conflict with Israel took place in July 2006.

The medium-term scenario under the pre-war programme envisaged an average real GDP growth of 5%, strong fiscal adjustment that should lead to an improvement of the primary surplus by 6 percentage-points of GDP during the years 2006-10, and progress in privatisation (particularly in the telecommunications sector). Without external support, the debt to GDP ratio was expected to decline from 175% at the end of 2005 to about 135% by 2010. However, with interest payments still absorbing about 50% of government revenues, the level of debt was still unsustainable over the long run. The government was dependent on sufficient external support in the form of grants and concessional loans, and financial contributions from the domestic financial sector to considerably reduce the debt to GDP ratio.

The pre-war economic reform programme had to be re-phased following the conflict with Israeli. In addition to the need for support to help Lebanon meeting the direct cost of recovery and reconstruction, the need for external support to achieve a sustainable debt scenario had further risen. The revised reform programme was structured firmly around the fact that external support was crucial for the success of the reform efforts. It was articulated around six pillars including the financial support of the international community[3]:

1. *Growth-enhancing reforms* encompassing a large number of measures and laws that would increase productivity and reduce cost, which would enhance the competitiveness of the Lebanese economy.
2. *A social sector reform agenda* to improve the social situation and strengthen (develop) social safety nets to protect the most vulnerable segments of the population.
3. *A strong phased fiscal adjustment* aimed at increasing the primary surplus through streamlining expenditures - including by reducing waste (including legalized waste), and reforming state owned enterprises, more specifically the electricity company Eléctricité du Liban (EdL), and by raising revenues in ways that would minimize the negative impact on the poor.
4. *A privatisation programme* directed primarily at increasing investment, reducing the stock of public debt, and spurring economic growth.
5. *A prudent monetary and exchange rate policy* aimed at maintaining price stability (and with it social stability), facilitating credit to the private sector, and maintaining a sound banking system.
6. *International financial assistance* to help Lebanon finance the direct and indirect cost of the July war as well as to complement the domestic adjustment efforts, primarily by reducing interest payments on public debt and creating confidence that would encourage private sector investment and ease the pain of a domestic adjustment after the war.

3.1.2 Economic developments

Bird's eye view on the Lebanese economy

The period before the MFA assistance can be characterised as one of turmoil. The mid-2006 conflict with Israel and the following blockade had a severe impact on human and economic conditions in Lebanon as well as on its political landscape. The damage to infrastructure (mostly the housing stock) was estimated by the government at US$ 2 billion. The conflict negatively affected economic growth, added to the inflationary pressures and further complicated the dramatic fiscal

[3] Lebanese Republic, Recovery, reconstruction, and reform: International Conference for Support to Lebanon, 25 January 2007, Paris.

situation. As a result, government debt reached the level of 180% of GDP at the end of 2006, one of the highest levels in the world.

As mentioned, in January 2007, the Lebanese authorities presented an ambitious five-year reform programme aiming at raising growth, improving living standards, and reducing Lebanon's large debt overhang and financial vulnerabilities, taking account of the special challenges created by the conflict with Israel in the previous year.

While political uncertainty continued through 2007 and early 2008 with eruptions of internal conflicts, macroeconomic conditions improved. GDP growth in 2007 reached 7.5%, investment rebounded, inflationary pressures moderated somewhat, and the previous upward trend of public debt reversed. By the end of 2007 the gross public debt to GDP ratio decreased by more than 10 percentage-points, largely owing to robust economic growth. Still, a combination of factors including lack of political stability, the still very high debt stock, relatively large current account deficits and lack of progress in structural reforms were contributing to high vulnerability of the Lebanese economy.

During 2008, the global surge in agricultural and energy commodity prices as well as lagged effects of the depreciation of the US dollar (to which the Lebanese pound is pegged) increased inflation to almost 11%. The current account deficit widened, reflecting commodity price increases, a recovery in domestic demand, and continued reconstruction needs. The outbreak of the global financial crisis added to potential problems affecting the domestic economy. One channel of transmission was through workers remittances. Lebanon is one of the largest recipients of remittances as a share of GDP in the world (almost 20% of GDP in 2008). With remittances outflows estimated at 8% of GDP, net remittances inflows amounted to 12% of GDP. From the second half of 2008 onwards, remittance inflows were negatively affected by the slowdown in countries where Lebanese expatriates had been working. However, this negative trend reversed already from early 2009 onwards.

In general, Lebanon has so far weathered the global financial crisis remarkably well with economic growth between 7.5% and 9.3% annually during the 2008-2010 period. This was underpinned by an improvement in the internal political climate after the Doha agreement in mid-2008, marking an end to an 18-month long political crisis in Lebanon, and the formation of the national unity government in late 2009. These developments coupled with a global low interest rate environment, and relative soundness of the banking sector boosted confidence, leading to robust capital inflows supporting activities in the construction, tourism, commerce, and financial services sectors.

The gross government debt to GDP ratio continued to improve to 137% as of the end of 2010, which nonetheless constitutes still an extraordinary high figure. The country's public finances improved slightly. Meanwhile, current account deficits have widened somewhat to above 10% of GDP in 2010 and are expected to increase in the following two years. Table 3.2 presents the main economic indicators for Lebanon.

Table 3.2: Selected economic indicators for Lebanon, 2007-2012

	2007	2008	2009	2010 (Prel.)	2011 (Proj.)	2012 (Proj.)
Macroeconomic indicators						
Nominal GDP (billion US$)	25	29.9	34.9	38.5	40.5	44.0
Real GDP growth (annual %, market prices)	7.5	9.3	8.5	7.0	1.5	3.5
Consumer Prices (period average)	4.1	10.8	1.2	4.5	5.4	5.3
Fiscal indicators						

	2007	2008	2009	2010 (Prel.)	2011 (Proj.)	2012 (Proj.)
Budget balance (% GDP)	-10.9	-9.6	-8.2	-7.5	-8.3	-8.3
Total Government gross debt (% GDP)	168	156	146	137	134	132
Balance of Payments						
Current account balance (% of GDP)	-7.1	-9.3	-9.7	-10.9	-14.7	-13.8
Total external debt (% of GDP)	194	173	175	161	158	159

Sources:
For 2007: IMF, Lebanon: 2009 Article IV Consultation and Assessment of Performance under the Program Supported by Emergency Post-Conflict Assistance;
For 2008: IMF, Lebanon: 2010 Article IV Consultation—Staff Report; Staff Statement: Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lebanon;
For 2009-2012: IMF, Lebanon: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lebanon.

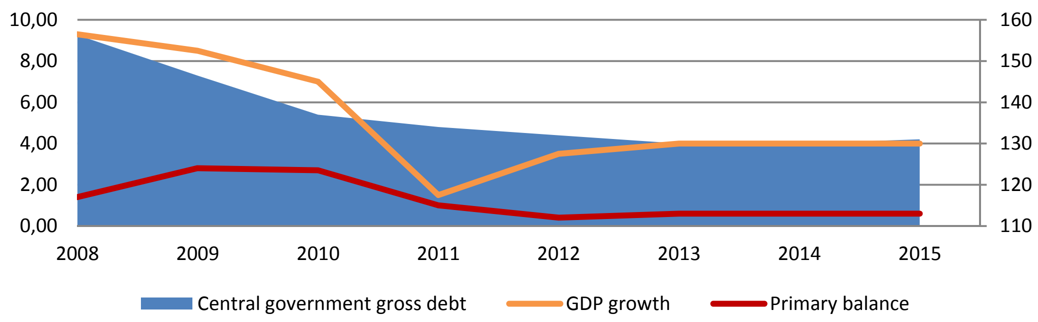
Despite the overall resilience of the Lebanese economy to global developments in 2008-2010, the economic situation remains vulnerable on several counts. In 2011, real GDP growth slowed down substantially due to the fading out of several factors that earlier supported growth, such as financial portfolio shifts and the strong surge in tourist receipts. The main causes were the collapse of the national unity government in January 2011, continuation of the turmoil in neighbouring Syria and other countries in the region and the worsening outlook for the global economy.

While Lebanon's recent macroeconomic performance was better than expected, the foundations for sustainable and resilient growth have not been strengthened much, due to the stalemate in structural reforms, and remaining bottlenecks in key infrastructure (especially, electricity, water supply, telecommunication and transport).

Debt burden

Average real GDP growth during 2008–2010 amounted to 8.4 %. Strong growth, together with an increase in the primary fiscal balance, allowed for a decline in the government's debt-to-GDP ratio to 137% by the end of 2010. The latest IMF projections estimate a limited rebound of GDP growth (3% in 2012) following a significant reduction in the growth rate to 1.5 % in 2011.

Figure 3.2: Selected economic indicators for Lebanon (% of GDP), 2008-2015



Source: IMF (2011), World Economic Outlook data, September 2011; and IMF (2012), Lebanon: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lebanon.

According to the latest External Debt Sustainability Analysis of the IMF, Lebanon's gross external debt amounted to 158% of GDP at the end of 2011. This debt comprises mostly short-term non-resident deposits in the banking sector, indicating the vulnerable debt situation of the country.

Business environment

The business environment has improved only slightly in the last few years, as measured by the country's rankings in the World Bank's Doing Business survey. In the 2012 Doing Business Lebanon is ranked 104 out of 183 countries. In the 2011 Doing Business Lebanon was ranked 103 out of 183 economies, while in 2010 the country was ranked 109. Figure 3.3 shows the rankings of Lebanon across the various areas.

Table 3.3: Business environment in Lebanon, Doing Business 2011-2012

	DB 2011	DB 2012
Ease of Doing Business - Rank	103	104
Starting a Business - Rank	104	109
Dealing with Construction Permits - Rank	157	161
Getting Electricity - Rank	52	47
Registering Property - Rank	105	105
Getting Credit - Rank	75	78
Protecting Investors - Rank	93	97
Paying Taxes - Rank	28	30
Trading Across Borders - Rank	93	93
Enforcing Contracts - Rank	120	120
Resolving Insolvency - Rank	128	125

Source: World Bank (2012), Doing Business 2012, Lebanon

In the area of 'Paying taxes', Lebanon ranks particularly good, namely 30 in Doing Business 2012 (28 in Doing Business 2011). This can be attributed to the possibility of electronic payment of taxes since 2010. Moreover, the country has made considerable improvements in the area of revenue administration in the last few years, helped by technical assistance of the IMF, the Middle East Technical Assistance Centre (METAC) and other donors.

3.2 MFA operations to Lebanon[4]

On 10 December 2007 the Council of the European Union decided to provide MFA to Lebanon of up to € 80 million in the form of a combination of a medium-term loan and grant of € 50 million and € 30 million, respectively. The MFA assistance was divided into two tranches and was conditional on progress in the implementation of IMF programmes.

The EC signed the Memorandum of Understanding (MoU) with the Government of Lebanon, one year later, on 18 December 2008. The assistance complemented support from the International Financial Institutions, bilateral donors (including EU Member States and Arab countries), and other EU assistance provided under the European Neighbourhood and Partnership Instrument (ENPI) and in the form of European Investment Bank (EIB) loans.

The condition attached to the disbursement of the first instalment of the MFA was the satisfactory implementation of the first Emergency Post-Conflict Assistance (EPCA I) programme agreed with the IMF. The specific objectives of the government reform programme for 2007 supported by EPCA are presented in the Box 3.1 below.

[4] This section is based on desk analysis of EC files on the MFA operation received from DG ECFIN, as well on two other sources: "Report on the Implementation of Macro-Financial Assistance to Third Countries in 2009, from the Commission to the European Parliament and to the Council" and "Commission staff working document accompanying the Report from the Commission on the Implementation of Macro-Financial Assistance to Third Countries in 2009".

Box 3.1: Government reform programme supported by EPCA

Under the programme, the Government committed to:

1. Fiscal
   a. Submit to Parliament a draft 2007 budget law consistent with the targeted primary balance of the central government, and including detailed HRC operations and CDR foreign-financed expenditures. The budget law should not allow budget carryovers for expenditures for which no third-part liability already exists, and treasury advances of more than one month after the fiscal year. *Target date: End-June 2007.*
   b. Issue a Cabinet of Ministers decision setting a specific floor on gasoline excise of LL 300 per litre of gasoline. *Target date: End-September 2007.*
   c. Appoint auditor for National Social Security Funds (NSSF) accounts. Auditor to prepare an audit plan of National Social Security Fund for 2001–06. *Target date: End-June 2007.*
2. Power sector
   a. Appoint auditor for Eléctricité du Liban (EdL) accounts. Auditor to prepare an audit plan of EdL for 2002-2006. Publish 2001 audit report. *Target date: End-June 2007.*
3. Privatization
   a. Submit to Parliament the draft law to authorize the sale of the mobile sector's assets and relevant operating licenses by the government. *Target date: End-June 2007.*
   b. Issue an invitation for expression of interest (EOI) in participating in the process of acquiring the licenses and assets of the two mobile telephone companies. *Target date: End-December 2007.*

Source: DG ECFIN, MFA to Lebanon - Note for the Economic and Financial Committee

As the conditions for the release of the first instalment listed above were met, the first grant (€ 15 million) and loan (€ 25 million) tranches were disbursed at the end of December 2008 and May 2009 respectively.

The primary objectives of the MFA operation in Lebanon were to support Lebanon's domestic efforts of post-war reconstruction and sustainable economic recovery; to alleviate the financial constraints on the implementation of the government's economic programme; and to support Lebanon's efforts to reduce public debt to a sustainable level. The assistance supported as well the authorities' effort of fiscal consolidation. The MoU presented the specific conditions attached to the MFA operation. Given the nature of the planned operation, particular attention was paid to Public Finance Management (PFM) because of its importance for fiscal consolidation and a sustainable solution to the high debt problem. Also, the EC focused on specific sectors that were important for fiscal consolidation, namely the power sector and the social sector. The precise structural reform measures as laid down in the MoU for the disbursement of the second tranche are presented in Box 3.2 below.

Box 3.2 Structural reform measures (conditions)

Public Finance Management

- Develop an operational mandate of the Cash Management Unit.
- The Ministry of Finance, following a Council of Ministers' decision, will identify all public entities' bank accounts held at Banque du Liban and commercial banks in preparation for the implementation of the Treasury Single Account law.
- Mandate, through a Council of Minister's decree, that opening of any new bank account for public entities falling under the remit of the STA requires approval by the Ministry of Finance.
- Approve by the Council of Ministers the project of the fiscal accountability law.

Power Sector

- Higher Council for Privatization to complete the valuation and allocation of assets for the Eléctricité du Liban (EdL) in preparation of its incorporation.

Box 3.2 Structural reform measures (conditions)
Social Sector:
• Social Inter-Ministerial Committee to approve a time based action plan that eliminates duplication of programs between Ministry of Social Affairs, Ministry of Health and Ministry of Education and Higher Education.
• Strengthen poverty focus of the social safety net programs: Establish targeting mechanism through proxy-means testing for implementing safety net programs.

Source: MoU between EC and Government of Lebanon (signed on 18 December 2008)

Disbursement of the second tranche was conditional on the fulfilment of the agreed policy conditions as stipulated in the MoU, including the existence of an ongoing IMF programme. In November 2008, the IMF Board approved a second Emergency Post-Conflict Assistance (EPCA II) package of SDR 25.375 million. The EPCA II programme expired at the end of June 2009, with the quantitative targets being met. Non-quantitative targets, such as the introduction of a single Treasury account; the reform of electricity tariffs; and the privatisation of mobile phone networks were, however, not met.

Moreover, the strained political situation in the run-up to the elections hampered the progress made regarding the fulfilment of conditions in 2009. Given the situation, in December 2009, the Commission extended the availability period of the second tranche of the MFA assistance by one year, which was until 21 December 2010. Disbursement of the second tranche was subject to the fulfilment of the agreed policy conditions. This addendum was, however, not ratified by the Lebanese authorities.

On 13 December 2010, the Lebanese Minister of Finance requested an extension of the disbursement period of the second tranche and also a review of the MFA conditions. The request was rejected by the Commission on the grounds of poor implementation by the national authorities of key structural reform conditions, the non-existence of an ongoing IMF financial arrangement, and lack of consensus on the part of the national authorities over the activation of the previous disbursement period extension. Moreover, the recent improvement of the balance of payments position rendered the release of the second tranche not necessary. The second tranche was eventually cancelled.

Annex IV presents an overview of the most important events related to the MFA operation in chronological order.

3.3 Financial support to Lebanon

3.3.1 Exceptional financial support to Lebanon

The immediate aftermath of the Lebanese-Israeli conflict of 2006 showed a slight decline of external exceptional financial support to Lebanon. This trend was subsequently reversed. Total exceptional assistance amounted to from US$ 671 million in 2007 and US$ 454 million in 2009.

Table 3.4: Lebanon: Exceptional financial assistance* to the Government (In millions of US dollars)

	2007	2008	2009	2010 Proj.
Total*	**672**	**578**	**454**	**0**
- Grants	195	133	-	-
- Loans	400	406	-	-
- IMF purchases	77	40		
Memorandum items:				

	2007	2008	2009	2010 Proj.
- MFA (grant and loan)		15	25	
- MFA as % of Total		2.60%	5.51%	

* Taken from Balance of Payments tables, Financing, Exceptional financing, in the sources mentioned below.
Sources:
IMF (2009), Lebanon: 2009 Article IV Consultation and Assessment of Performance under the Program Supported by Emergency Post-Conflict Assistance.
IMF (2010), Lebanon: 2010 Article IV Consultation—Staff Report; Staff Statement: Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lebanon.
IMF (2012), Lebanon: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lebanon.

3.3.2 Paris III conference pledges and disbursements

As mentioned, in the framework of the Paris III Conference many other donors provided financial assistance in the form of grants and/or loans for both public and private sectors. Table 3.5 provides a comprehensive overview of the most important donors, besides the EU, the European Investment Bank (EIB), the IMF and the World Bank.

Table 3.5: Paris III - Total pledges and Signed Grant and Loan Agreements by country and institution as of 31 December 2009 (above $10 million, US$ million)

Donor	Total Pledged	Grants Signed	Loans Signed	Total Signed
European Investment Bank	1,248	-	961	961
Saudi Arabia	1,100	100	-	100
World Bank Group	975	-	475	475
United States	890	770	260	1,030
Arab Fund for Economic & Social Development	750	-	442	442
France	650	-	599	599
EC	486	281	65	346
United Arab Emirates	300	-	300	300
Islamic Development Bank	250	5	245	250
Arab Monetary Fund	250	-	375	375
Italy	156	60	-	60
Germany	134	74	21	95
IMF	77	-	114	114
Spain	53	59	-	59
Egypt	44	15	-	15
UK	35	35	-	35
Belgium	26	13	13	26
Turkey	20	20	-	20
Canada	17	11	-	11
Norway	15	15	-	15
Oman	10	10	-	10
Other	47	28	-	28
Malaysia			500	500
TOTAL	**7,534**	**1,496**	**4,370**	**5,872**

Source: Republic Of Lebanon, Ministry of Finance, International Conference for Support to Lebanon - Paris III, Eleventh Progress Report, 31 December 2009.

The table shows the importance of large bilateral donors, such as the United States and France. In addition, Saudi Arabia and the Arab Fund for Economic and Social Development provide significant financial assistance. Part of the financial assistance comprised budget support. Large bilateral budget support providers included Saudi Arabia (grant of US$ 100 million), the United Arab Emirates (loan of US$ 300 million), the United States (grant of US$ 250 million) and France (loan of 488 US$ million). The emergence of these donors and the size of their financial assistance have influenced somewhat the effects of the MFA assistance on macroeconomic developments in the country, and depending to a very limited extent also the impact on structural reforms. The assistance of the US and France was conditioned on the fulfilment of certain structural reform conditions in the area of telecommunications and the power sector.

3.3.3 EU financial support

The EU is the leading donor to Lebanon. The total amount of funds committed under MEDA I (1995-1999) for bilateral assistance was € 182 million, while under MEDA II (2000-2006) the total amount allocated was € 235 million.[5]

The National Indicative Programme (NIP) 2002-2004 for Lebanon amounted to € 80 million. The NIP for 2005-2006 involved total funding of € 50 million, focusing on four main priorities:

1. support for European Neighbourhood Policy initiatives and promotion of the implementation of the Association Agreement;
2. support for the knowledge economy (vocational training, Tempus, scientific co-operation);
3. strengthening the competitiveness of the private sector; and
4. reform of the water sector and environment.

Two additional financial sources were provided. First, as part of the ongoing support to the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA), a special regional programme for Palestinian refugees was made available for an amount of € 20 million for Lebanon, Syria and Jordan. Second, DG ECHO supported the Palestinian refugees in Lebanon with an amount of € 30 million over the period 2000-2006.

In addition, the European Investment Bank provided loans for financing of venture capital and interest subsidies. The Facility for Euro-Mediterranean Investment and Partnership (FEMIP) has been operational since October 2002. In the period 2002-2006, the EIB provided lending to Lebanon for priority sectors including infrastructure (roads and ports), the private sector (SMEs) and environment (water, sewerage, solid waste and waste water). Table 3.6 provides an overview of the EIB investment projects during the 2000-2006 period.

Table 3.6: EIB lending to Lebanon, 2000-2006

Project	Sector	Date	Amount (m €)	Description
Greater Beirut Wastewater	Water, sewerage, solid waste	28/12/2005	60	Construction of wastewater treatment plant at Dora, northern Beirut, and main and secondary collectors for area served
Byblos Bank GI	Credit lines	22/12/2005	50	Financing for small and medium-scale ventures
Lebanese Highways	Transport	28/06/2005	60	Construction of a motorway section linking Beirut and Damascus and of the Tripoli West ring road (north)

5 European Neighbourhood And Partnership Instrument for the Lebanese Republic, Country Strategy Paper 2007-2013 And National Indicative Programme 2007 – 2010.

Project	Sector	Date	Amount (m €)	Description
Apex GI Multi-Sector	Credit lines	27/12/2004	60	Financing of small and medium-scale ventures
South Lebanon Waste Water	Water, sewerage, solid waste	20/07/2004	45	Upgrading and extension of sewerage networks of Saïda and Sour in southern Lebanon
Port De Tripoli	Transport	13/06/2002	45	Extension of port infrastructure in Tripoli
TOTAL			**320**	

Source: European Investment Bank, extracted from EIB website, projects financed.

EU Strategic Response 2007-2013[6]

In view of the political and economic developments, the reform agenda reflected in the Action Plan of the Lebanese Government was ambitious. Lebanon faced substantial institutional constraints and lacked internal political consensus. During the Paris III Conference the total EC support amounted to € 374 million. It consisted of grants for relief and humanitarian support in the context of the Stockholm Conference for Early Recovery (€107 million), grants in the framework of EC cooperation with Lebanon for the period 2007-2010 (€187 million), and MFA assistance (estimated then at €75 - 80 million).

The ongoing European Union-Lebanon Action Plan identifies a number of reforms in the political, social and economic areas aimed at modifying the regulatory, legislative and administrative frameworks. In this context, the main objectives of the EC strategy with Lebanon for 2007-2013 are three-fold:

- *Support for political reform:* supporting Lebanon's political reform in the areas of democracy, human rights, good governance, security and justice.
- *Support for social and economic reform*: supporting the implementation of the Action Plan, inter alia reform of the energy, improving social safety nets, improving conditions of Palestinian refugees, trade facilitation and customs reforms, environment protection, fiscal management and public finance reform.
- *Support for reconstruction and recovery*: supporting economic and social recovery and reconstruction, local development as well as de-mining and clearing unexploded ordnance.

As mentioned, a total amount of € 187 million was allocated for the first National Indicative Programme, covering the period 2007-2010, to support these three priorities. For the second NIP, covering the period 2011-2013, the assistance in the framework of the ENP Instrument amounts to €150 million. The distribution of the resources over the three objectives has differed over the NIPs as can be seen in the Table below.

Table 3.7: Allocation of NIP resources over the three objectives

Priority area	NIP 2007-2010 (in € m)	% of total allocation	NIP 2011-2013 (in € m)	% of total allocation
Support for political reform	22	11.76 %	25	16.70 %
Support for social and economic reform	86	45.99 %	91	60.70 %
Support to reconstruction and recovery	79	42.25 %	34	22.70 %

6 European Neighbourhood And Partnership Instrument for the Lebanese Republic, Country Strategy Paper 2007-2013, and National Indicative Programme 2007 – 2010.

Priority area	NIP 2007-2010 (in € m)	% of total allocation	NIP 2011-2013 (in € m)	% of total allocation
TOTAL	**187**	**100.00%**	**150**	**100.00%**

Source: EC, European Neighbourhood And Partnership Instrument for the Lebanese Republic, Country Strategy Paper 2007-2013 And National Indicative Programme 2007 – 2010, and European neighbourhood and partnership instrument Republic of Lebanon, National Indicative Programme 2011-2013.

Moreover, the EIB has committed additional € 960 million over the period 2007-2012 for the recovery, reconstruction and reform plan drawn up by the Lebanese Government by financing key projects under the Public Investment Programme, supporting both private sector activity and public investment. During the period 2007-2011, the EIB provided lending to Lebanon for numerous projects in the amount of € 428.5 million (see Table 3.8) with special focus on support to SMEs.

Table 3.8: EIB lending to Lebanon, 2007-2011

Project	Sector	Date	Amount (m €)	Description
Lebanon Growth Capital Fund	Services	21/12/2010	5	Participation in generalist private equity fund investing in Lebanese SMEs
Al Majmoua - Loan For Microfinance	Services	07/05/2010	1.5	Financing of projects carried out by small and micro-enterprises
Kesrwan Water And Wastewater Project	Water, sewerage, solid waste	03/04/2009	70	Construction of wastewater treatment plant, sewerage network and sea outfall in Tabarja, near Jounieh
Private Sector Facilities II	Credit lines	22/12/2008	20	Financing of small and medium-scale projects
Private Sector Facilities II	Credit lines	22/12/2008	7	Financing of small and medium-scale projects
Private Sector Facilities II	Credit lines	19/12/2008	25	Financing of small and medium-scale projects
Private Sector Facilities	Credit lines	27/12/2007	25	Financing of small and medium-scale projects
Private Sector Facilities	Credit lines	27/12/2007	60	Financing of small and medium-scale projects
Private Sector Facilities	Credit lines	21/12/2007	20	Financing of small and medium-scale projects
Private Sector Facilities	Credit lines	21/12/2007	30	Financing of small and medium-scale projects
Private Sector Facilities	Credit lines	20/12/2007	60	Financing of small and medium-scale projects
SME Reconstruction Facility	Credit lines	29/11/2007	100	Financing, through Banque de Liban, of investment aimed at supporting SMEs affected by recent conflict
The Building Block Equity Fund	Services	23/07/2007	5	Private equity fund specialising in supporting development of technology and services sector SMEs and traditional innovative SMEs
TOTAL			**428.5**	

Source: European Investment Bank, extracted from EIB website, projects financed.

On 17 August 2011, within the context of the European Neighbourhood Policy, the European Union announced the Annual Action Programme 2011 for Lebanon, consisting of a cooperation package of € 33 million to benefit three reform areas: municipal finance, environmental governance and justice. The Support to the Reform of Municipal Finance project (€ 20 million) aims to achieve better balanced socioeconomic development through modernized municipal administration and effective central support to local governments. The Support to the Reform of Environmental Governance (€ 8 million) aims to improve the environmental performance of the Lebanese public sector by reforming environmental governance. Training will be provided to the Ministry of Environment and to other stakeholders in the sector, to help them better plan and implement environmental policy, including law enforcement. The final component, Support to the Reform of the Judiciary (€ 5 million), aims to contributing to a more independent and better-performing judiciary system, thus increasing its legitimacy and trust among the Lebanese public.[7]

3.3.4 *IMF programmes*

The five-week conflict with Israel in 2006 and the month-long blockade that followed had a severe impact on human and economic conditions in Lebanon. On 4 May 2007, the IMF approved an amount equivalent to SDR 50.75 million (about US$76.8 million) in Emergency Post-Conflict Assistance (EPCA) to Lebanon. Discussions on EPCA were based on the Five-year Programme presented by the national authorities at the Paris III donors' conference in 2007 (see Box 3.3 below).

Box 3.3: Lebanon: The Authorities' Five-Year Reform Programme

- The authorities' reform program covering the period 2007–11 followed closely the reform agenda developed prior to the conflict.
- Fiscal adjustment and related structural reforms aimed to increase the primary surplus and reduce public debt.
- Privatisation plans included the two mobile phone operators and the fixed line telephone company.
- Monetary and exchange rate policies focussed on maintaining price stability through the exchange rate peg, relying on short-term instruments for sterilisation purposes.
- Growth-enhancing structural reforms were geared to improving the business climate and competitiveness.
- Social sector reforms seek to alleviate poverty, reduce regional income disparities, and improve education and health indicators.

In November 2008 the IMF approved an additional SDR 25.375 million covering the period until June 2009. The follow-up EPCA was designed to support the authorities' policies aimed at buttressing macroeconomic stability and financial discipline during the period until the parliamentary elections in June 2008. Table 3.9 summarises the disbursements made to Lebanon in 2007 and 2008 as well as the repayments made by the country in 2010, 2011 and 2012.

Table 3.9: Lebanon – Transactions with the Fund (in millions of SDR)

Year	Disbursements	Repayments	Charges and interest paid
2012		9,516	0.107
2011		25.375	0.750
2010		12.688	0.938
2009			1.156
2008	25.375		2.105
2007	50.750		1.537

Source: IMF, extracted from the IMF website, Lebanon country page, Transactions with the Fund

7 Ministry of Finance, "Aid Coordination Newsletter" Issue 46, September 2011.

Annex V contains a summary of the conclusions of review reports of the IMF associated to EPCA I and II.

3.3.5 World Bank assistance

At Paris III, the World Bank pledged up to US$975 million to support the Government's plan. As part of the package the World Bank envisaged two development policy-based lending operations (DPL) to advance reforms in the power and social sectors that would have an impact on the macroeconomic and fiscal balances over time. Of the US$175 million allocated, only US$100 million was disbursed. Lack of progress on the reforms supported by the first DPL prevented the finalization of the second loan. Instead of a DPL, the World Bank provided additional financing of US$69.7 million for an already approved Urban Transport Project. Table 3.9 provides a financial overview of the various World Bank projects.

Table 3.10: Lebanon and the World Bank: Total lending amounts, disbursement and repayments (in millions US$, unless otherwise indicated)

	2007	2008	2009	2010	2011
New lending amount per year		101	79.7		240
Number of projects (active)	9	9	10	8	10
Total outstanding lending amount	346.60	327.70	327.40	269.83	509.83
Net flows:					
Disbursements		151.60	36.68	13.26	41.79
Repayments		125.55	78.74	18.17	35.53

Source: World Bank, extracted from the World Bank website, Country Lending Summaries - Lebanon

The most important projects of the World Bank which were active in the period 2007 till present are presented in Annex V.

3.3.6 Support by bilateral donors

Overview of bilateral assistance to Lebanon

Traditionally, France and the United States have been the two largest bilateral donors in Lebanon. Germany, being the second largest EU member country donor disbursed approximately on average US$ 32 million over the period 2006-2009. In addition, Italy and Spain have provided the highest ODA to Lebanon in the period 2006-2009. Table 3.11 presents an overview of the gross disbursements of bilateral countries in the period 2006-2010.

Table 3.11: Bilateral donor assistance to Lebanon 2006-2010 vis-à-vis non-IFI multilateral assistance

(US$ million)	2006	2007	2008	2009	2010
TOTAL ODA	**674.52**	**607.95**	**984.90**	**615.00**	**489.38**
DAC Countries, Total	***392.61***	***474.86***	***759.37***	***404.29***	***278.89***
Australia	10.56	6.33	1.57	0.50	1.60
Austria	1.39	1.75	1.60	0.13	0.14
Belgium	2.58	5.46	4.69	5.04	4.12
Canada	13.29	3.88	11.85	13.71	5.28
Denmark	4.12	3.54	1.90	1.59	2.61
Finland	5.23	0.06	0.57	1.91	0.63
France	74.56	106.66	310.07	109.40	66.97
Germany	29.88	32.94	36.79	31.56	28.05
Greece	12.45	4.96	3.85	2.87	1.12

(US$ million)	2006	2007	2008	2009	2010
Ireland	2.04	1.47	0.49	0.16	0.61
Italy	46.60	67.21	65.43	29.77	25.04
Japan	11.29	21.77	20.60	11.00	11.17
Korea	0.68	5.82	5.07	2.85	1.82
Luxembourg	1.43	0.36	0.49	0.32	0.18
Netherlands	13.36	0.55	2.46	0.67	1.03
New Zealand	0.81	..	..	0.55	0.63
Norway	27.81	15.28	10.84	9.84	9.26
Portugal	0.43	11.52	10.18	9.66	..
Spain	15.05	36.94	51.81	24.16	23.39
Sweden	9.67	9.12	1.80	2.62	0.90
Switzerland	13.01	4.59	4.72	3.73	6.31
United Kingdom	5.08	7.52	3.02	5.40	3.96
United States	91.31	127.13	209.58	136.87	84.06
Multilateral, Total	***281.91***	***133.08***	***225.53***	***180.14***	***164.23***
AFESD	..	..	30.95	33.19	33.02
EU Institutions	226.46	77.06	130.25	74.26	53.36
GEF	..	..	0.81	1.06	0.81
UNAIDS	0.00	0.12	..	0.01	..
UNDP	1.30	1.39	1.45	0.87	2.39
UNFPA	0.76	0.46	0.55	0.63	0.64
UNICEF	2.01	2.16	0.61	0.75	0.75
UNRWA	51.36	51.89	60.90	66.98	70.97
Non-DAC Countries, Total	***..***	***..***	***..***	***30.57***	***46.26***
Kuwait	..	..	..	..	37.85
United Arab Emirates	..	..	..	30.57	8.41

Source: OECD DAC database, extracted March 2012.

France

France has been an important partner to the Lebanese government. Its support aimed to help to rebuild and stabilise the country, after many times of crisis, while contributing to socio-economic development. Since 1999 France, through the Agence Française de Développement (AFD), granted funds in excess of € 1 billion. This includes € 212 million in the form of AFD projects, € 500 million in the context of Paris II and € 375 million macro financial assistance in the context of Paris III. For the period 2008-2012 the activities of the AFD in Lebanon are concentrated in three areas[8]:

- support to the productive sector;
- infrastructure and urban development;
- water and sanitation.

Support the productive sector

General budget support in the form of a loan of € 500 million under Paris II was provided to support the restructuring of public debt. A budget support loan of € 375 million was provided in support of the economic reform agenda of the Lebanese government in the context of Paris III. Box 3.4 provides relevant details on this loan which has been provided in the same period as the EU MFA.

[8] Agence Française de Développement, "L'activité du groupe Agence Française de Développement au Liban", 2010. See http://www.afd.fr/webdav/site/afd/shared/PORTAILS/PAYS/MEDITERRANEE/Fiches-pays/AFD_LIBAN_avril2010_fr.pdf

Box 3.4: France – Features of the budget support loan in the context of Paris III

1. Total amount € 375 million.
2. Loan agreement with France signed and first tranche of € 150 million disbursed in February 2008.
3. November 2008, amendment of the loan agreement concerning the disbursement of the second tranche of € 125 million. Initial disbursement was foreseen in 2008, but postponed to 2009. Disbursement condition concerned the privatisation of the mobile phone sector. The third tranche of € 100 million was conditioned on reform in the power sector.
4. December 2009, new amendment of the loan agreement concerning the disbursement of the two remaining tranches, postponed further, not disbursed.

Infrastructure and urban development

Projects supported by the AFD in this field included: (i) enhancement of cultural heritage and urban development; (ii) capacity building of the Directorate General of Antiquities; (iii) providing technical expertise and capacity building to support the restructuring of the electricity sector; and (iv) providing technical expertise to support the reconstruction of Lebanon.

Water and sanitation

Main projects in this field included: (i) water supply in the town of Tripoli and for South Lebanon; (ii) water and sanitation for the l'Etablissement des Eaux du Liban Nord; and (iii) support renovation of water supply system of the municipality of Bkassine.

Other focal areas of the AFD in Lebanon include education (reform strategy of Lebanon in public education through the project "Education for All 2006/2015"), health (support the creation of the cluster Health Technology at Saint Joseph University) and support for local authorities (assistance to the Municipality of Beirut).

United States

In the context of Paris III the United States provided general budget support in the form of a grant of US$ 250 to support the economic reform agenda of the Lebanese government in the context of Paris III. Box 3.5 provides relevant details on this grant which has been provided in the same period as the EU MFA.

Box 3.5: USA – Features of the budget support grant in the context of Paris III

- Total amount US$ 250 million.
- Various tranches.
- US$ 125 million was aimed at reducing the country's debt and debt service to the World Bank. That amount was disbursed in various instalments:
  - US$ 14 million was provided in December 2007;
  - US$ 7 million was provided on 15 January 2008;
  - On 24 January 2008 US$ 89 million was provided;
  - US$ 3 million was provided in February 2008;
  - In March 2008 US$ 2 million was provided;
  - In April 2008 approximately US$ 4 million was provided.
  - In May/June 2008 the last US$ 6 million was disbursed.
- US$ 50 million was disbursed in May 2009 by redeeming an equivalent of Lebanon debt to the World Bank.
- Fifth and sixth tranches amounted to US$ 75 million and was conditioned on the sale of two mobile telecommunications licenses by June 2008. The deadline was postponed a number of times to May 2010 and then again through a third amendment of the grant agreement to the end of 2010.
- The condition was somewhat relaxed by requiring at least a plan towards the sale of the mobile telecommunications licenses, but was in the end not met. The grant agreement expired and no additional

Box 3.5: USA – Features of the budget support grant in the context of Paris III

money was disbursed.

USAID assistance has been aimed at advancing two primary goals:

1. strengthening the Government of Lebanon's ability to provide quality services to its citizens, including education, clean water, and good governance; and
2. enhancing economic opportunity and stabilization in the country's poorest areas, particularly areas where per capita income stands at less than US$ 4 a day.

Besides USAID assistance, other departments provided assistance to the country. The table below presents United States assistance to Lebanon in the period 2006-2010.

Table 3.12: United States economic assistance to Lebanon in the period 2007-2010, disbursements (in US$)

Funding Agency	FY2006	FY2007	FY2008	FY2009	FY2010
Department of Agriculture	13,140,191	444,200			
Department of Commerce				25,000	
Department of Defence		111,000			
Department of Energy			16,905	515,785	6,256,688
Department of Health and Human Services			358,952		
Department of State	7,101,805	35,802,859	32,740,852	18,075,464	18,106,072
Trade and Development Agency	79,240	44,830	6,850	6,800	40
USAID	40,933,527	99,737,850	200,620,834	128,641,854	58,541,558
Total	**61,254,763**	**136,140,739**	**233,744,393**	**147,264,903**	**82,904,358**

Source: USAID Foreign Assistance Database (FADB), data extracted via http://gbk.eads.usaidallnet.gov , March 2012.

4 Impact on macroeconomic stabilisation

4.1 Introduction

In this Chapter, we have analysed the first group of evaluation questions linked to the area of macroeconomic stabilisation (see Table 4.1).

Table 4.1: Evaluation question on macroeconomic stabilisation and sub questions[9]

Q1.	**To what extent has the MFA assistance been effective in terms of the macroeconomic stabilisation of Lebanon?**
Q1.1	What are the short and medium-term macroeconomic objectives* of the assistance?
Q1.2	To what extent have the short and medium-term macroeconomic objectives* of the assistance been achieved?
Q1.3	What has been the contribution of the grants and/or loans provided by the operation to the achievement of objectives?
Q3.2	What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?
Q3.3	Has the assistance given rise to any unexpected short and medium-term structural and/or macroeconomic effects? What were they and how did they occur?

* Or expected effects if explicit objectives cannot be identified

4.2 Macroeconomic objectives of the intervention

Q1.1 What are the short and medium-term macroeconomic objectives of the assistance?*

4.2.1 *Findings*

In December 2007, the Council of the European Union adopted Decision 2007/860/EC to make available to Lebanon macro-financial assistance (MFA) of up to € 80 million. The total assistance was a combination of a grant of up to € 30 million and a loan of up to € 50 million. The Council Decision explicitly states the objectives of the assistance:

"to support (…) Lebanon's domestic efforts of post-war reconstruction and sustainable economic recovery, and in this way, alleviat[e] (…) the financial constraints on the implementation of the government's economic programme"

The Decision directly refers to the *"Lebanon's high level of indebtedness"* and explains that:

"Lebanon faces substantial financing needs arising from the mounting financial constraints of the public sector, including a high level of public debt, aggravated by the July-August 2006 military conflict and a projected deterioration of the balance of payments in 2007."

The Memorandum of Understanding (MoU) signed on 18 December 2007 states that *"the objective of this assistance is to support Lebanon's efforts to reduce public debt to a sustainable level"*. The

[9] See pp. 9-11 of the "Guidelines for ex post evaluation of MFA/BoP assistance", May 2010.

MoU also specifies that the MFA is expected to support the economic reform programme agreed with the IMF by alleviating the financial constraints.

4.2.2 Conclusions

Based on the above findings we recapitulate the macroeconomic objectives of the MFA for Lebanon in Table 4.2.

Table 4.2: Macroeconomic objectives of the MFA granted to Lebanon

Objective	Sources
1. To support Lebanon's domestic efforts of post-war reconstruction and sustainable economic recovery;	Council Decision 2007/860/EC
2. To alleviate the financial constraints on the implementation of the government's economic programme;	Council Decision 2007/860/EC
3. To support Lebanon's efforts to reduce public debt to a sustainable level	MoU

4.3 Gross impact – actual macroeconomic outcomes

Q1.2 To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?*

To answer this question, we have analysed actual macroeconomic developments on the basis of relevant indicators relating to the macroeconomic objectives. While no specific benchmarks or target levels have been set for these indicators, we have analysed their general direction and accordance with the identified MFA objectives. The list of the indicators is provided in Table 4.3. They are grouped in four categories: macro economy, public finance, balance of payments, and debt sustainability.

Table 4.3: Macroeconomic indicators

Category	Effect Indicators
Macro economy	Growth rates in GDP and components Inflation Interest rate Exchange rate
Fiscal sector: Public finance	Level of government revenue Level of government expenditure General government balance Financing of the deficit
Balance of payments	Current account deficit Components of the current account: exports, imports, current transfers Inflow of foreign direct, portfolio and other investment Remittances International reserves
Debt sustainability	Public and foreign debt levels Debt service payments Debt stock composition (currency, maturity and sectors) Debt ratings

This chapter analyses the impact on the macroeconomic stabilisation with the help of the effect indicators in the area of macro economy, public finance and the balance of payments. The effect indicators related to debt sustainability are analysed in Chapter 5.

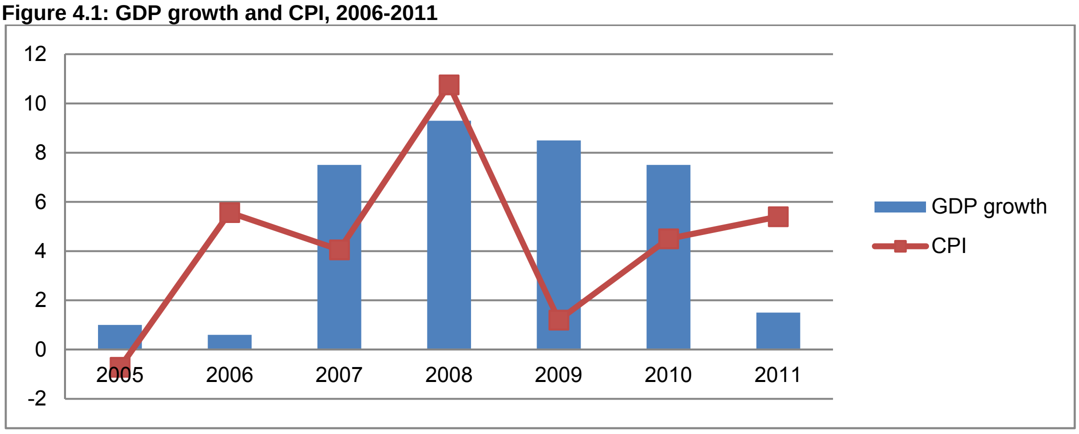
To ensure consistency, the main sources of data are the IMF, data from the Lebanese Central Administration of Statistics and the Central Bank of Lebanon.

4.3.1 Macroeconomic performance

Economic growth

Figure 4.1 depicts the GDP growth dynamics and inflation developments during 2006-2011. Starting from 2007, the economy has shown robust growth despite the global financial and economic crisis. This resilience should be seen in light of the preceding decade of slow growth (2.7% annually on average in 1998-2006) due to political unrest with frequent outbreaks of open violence, including political assassinations and armed conflict.[10] The year 2011 saw an economic downturn with sharp deceleration of growth negatively affecting fiscal balances.

Figure 4.1: GDP growth and CPI, 2006-2011

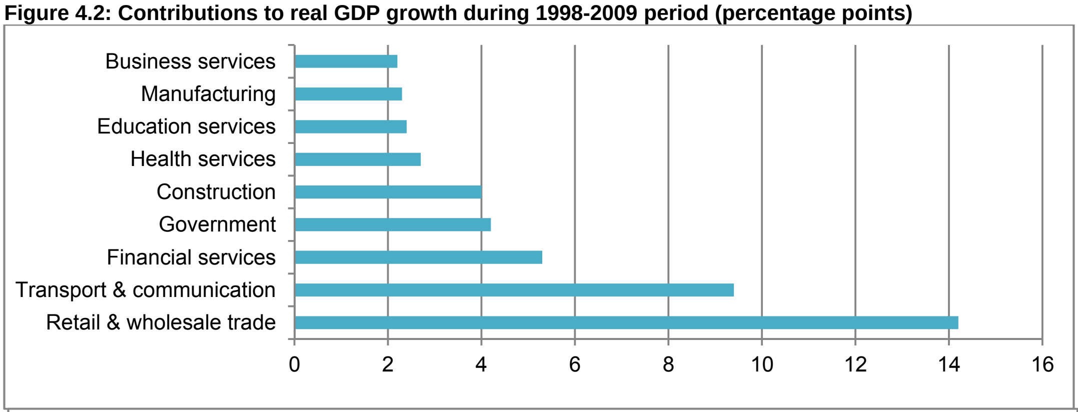


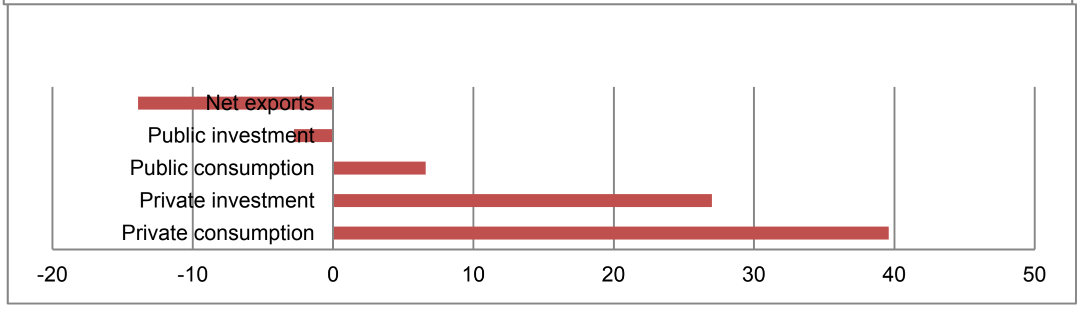
Source : IMF, World Economic Outlook database, update, September 2011; IMF Country report 12/39.

While the Lebanese economy has been relatively diversified, economic growth drivers have been concentrated on a few sectors: trade (retail and wholesale), telecommunications, and the banking sector. Overall, the services sector has been the main driver of economic growth. From the demand side, economic growth was essentially driven by private-sector consumption and investment, with negative contributions from net exports and public investment. The picture observed in 2009 was broadly similar to the cumulative growth contributions calculated over the 1998-2009 period (see Figure 4.2).

[10] This subsection draws heavily from a March 2011 presentation by Eric Mottu and Najla Nakhle, Lebanon: Real GDP Growth Analysis,1997-2009. IMF Resident Representative Office in Beirut.

Figure 4.2: Contributions to real GDP growth during 1998-2009 period (percentage points)





Source: Mottu and Nakhle (2011); based on national accounts data published by the Economic Accounts Mission at the Presidency of the Council of Ministers of Lebanon

The relative political stability has been a key factor determining the rebound of growth during the 2007-2010 period. One major determinant of the country's growth prospects is the size of current (remittances) and capital transfers, mainly from the Lebanese Diaspora. Both these categories increased considerably in recent years, starting from 2006. In 2009, total disposable income available for final demand reached almost 150% of GDP. It is therefore clear that the Lebanese economy is to a significant extent influenced by developments outside the country borders.

The investment to GDP ratio increased significantly from around 23% in 2006 up to a relatively high figure of 34% in 2009. However, from the perspective of longer term growth, the composition of investment outlays matters. In this regard, the available data point to a lack of strong long-term foundations for economic growth, as in 2009 most investment went into construction and transport equipment with small purchases of machinery and equipment (only 3.5% of GDP). This also highlights the difficulty of the manufacturing sector to enter a more dynamic growth path. The manufacturing sector's share in GDP declined from around 12.5% of GDP back in 1997 to around 7.5% in 2009.

Public investment in Lebanon has been low compared to many other countries (see Figure 4.3). During 2003-2009 it averaged below 2.5% of GDP. This has led to the emergence of substantial infrastructure gaps in areas such as electricity, telecommunication, water supply and the road network. Despite an almost 100% electrification rate, shortage of electricity generation capacity (no additions since the two combined cycle plants were installed in the 1990s) implies that electricity blackouts are a daily phenomenon for most consumers. Businesses and households have been forced to invest substantial resources in inefficient, costly and polluting back-up arrangements (i.e. diesel generators).

There are also severe development bottlenecks in other infrastructure areas, such as roads, water supply and ICT network. According to the World Economic Forum's Global Competitiveness Index

(GCI), Lebanon ranks 135 out of 142 classified countries on the overall quality of infrastructure (see box below).[11] The quality of electricity supply is particularly worrisome.

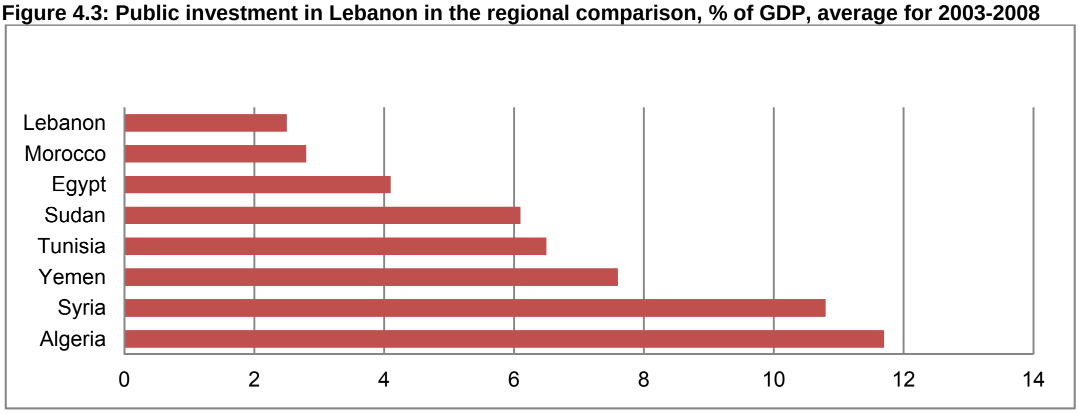
Box 4.1: Global Competiveness report 2011-2012, Lebanon, 2nd pillar – Infrastructure - country ratings	
Quality of overall infrastructure	**135**
Quality of roads	115
Quality of railroad infrastructure	122
Quality of port infrastructure	62
Quality of air transport infrastructure	43
Available airline seat kms/week, millions	70
Quality of electricity supply	141
Fixed telephone lines/100 pop	58
Mobile telephone subscriptions/100 pop.	108

Source: World Economic Forum, The Global Competitiveness Report 2011–2012, 2011.

Only in November 2011 first 3G service in mobile telecommunication were launched. These infrastructure gaps constitute a substantial drag on the country's development outlook and given the character of these gaps they are likely to continue to exert a downward pressure on economic growth for several years to come. Lebanon's internet and ICT services are also among least competitive and hence most expensive in the region[12].

Not only are the infrastructure problems inhibiting growth prospects, they also contribute to growth being less inclusive. For instance, electricity supply is relatively better in Beirut than in other parts of the country. Given the subsidies to the electricity sector this implies that social transfers are provided to the better off strata of the population, while many poor areas need to rely on expensive self- generation (using diesel) to meet their basic needs.

Figure 4.3: Public investment in Lebanon in the regional comparison, % of GDP, average for 2003-2008



Source: IMF, Country Report No. 10/306.

2011 has seen a sharp deceleration of growth, mainly due to domestic political uncertainty (Lebanon's unity government collapsed in January 2011) and ongoing unrest in neighbouring Syria and the wider region. It took five months before a new Government was formed.

Inflation and monetary policy

Lebanon implements a fixed exchange rate policy with the Lebanese's pound (LBP) pegged to the US dollar. This arrangement is seen as an essential stabilisation mechanism. There is a broad

11 See World Economic Forum, The Global Competitiveness Report 2011–2012, 2011.

12 See also IMF, Lebanon: Selected Issues, Country report 12/40, February 2012.

consensus in Lebanon as well as among the international institutions, such as the IMF, that the peg should be maintained. The importance of maintaining the peg owes to the high public and private foreign currency debt (see discussion in chapter 5) and resulting currency mismatches of corporations and households. The peg arrangement can be assessed as sustainable given its importance for interested parties – financial and non-financial sector in Lebanon. At the same time, a long term policy objective should be to gradually reduce dollarization of the Lebanese economy and existing currency mismatches.

The country can also be characterised as very much dependent on imports, which accounted to close to 50% of GDP and exceeded exports by a factor of around 3 during the 2008-2010 period. Finally, large capital inflows have posed challenges for monetary policy. These factors imply that inflation developments are largely determined by international price trends.

Following a period of moderate inflation up till 2007, the international food and energy price surges have led to a spike in the consumer price index (CPI) in 2008, comparable with the developments in several other economies in the region and beyond. A subsequent decline in food prices drove CPI down during 2009 (with a deflationary period around mid-year). Since then, inflation has increased to 4.5% at the end of 2010 and 6% in the first half of 2011. It declined to below 4% in early 2012.

Deposit interest rates have remained broadly flat from 2005 till mid-2008. Subsequent abrupt drop in international interest rates have led to a rising deposit rates premium in Lebanon, fuelling capital inflows and thereby the build-up of foreign reserves. As a result, gross official reserves more than doubled between the end of 2007 and the end of 2009. According to the IMF the reserves reached the level broadly adequate from the perspective of country's exposure to negative shocks. In this context the country's monetary policy shifted to a gradual reduction of deposit rates that continued till mid-2010. Bank deposits in both Lebanese pounds and foreign currencies continued to rise throughout 2011. International reserves also increased during 2011 and the most recent IMF assessment concludes that their level at end-2011 was sufficient to withstand even large external shocks[13].

4.3.8 *Public finance*

General government revenues have fluctuated in the 20-25% of GDP range since 2002. With total expenditures reaching up to 35% of GDP the public deficits have been close to or above 10% of GDP until 2007. A gradual decrease of the deficit could be observed during 2008-2010 but this improvement appears to be rather short lived as the provisional estimates for 2011 suggest a deterioration of the fiscal balances. Table 4.4 provides key underlying figures of the country's public finances.

Table 4.4: Central Government Overall Deficit and Financing (% of GDP)

	2006	2007	2008	2009	2010	2011
Revenue and grants	25.1	24.4	23.8	24.3	22.0	22.4
Revenues	22.1	23.0	22.9	24.0	21.9	22.2
Tax revenue	14.6	14.8	15.9	17.0	17.2	15.7
Total expenditures	36.3	35.2	33.5	32.5	29.2	30.7
Of which:						
Current primary expenditure	20.8	20.3	20.8	20.0	17.6	19.6
Interest payments	13.0	12.5	11.0	11.0	10.2	9.3

13 IMF country report 12/39. February 2012.

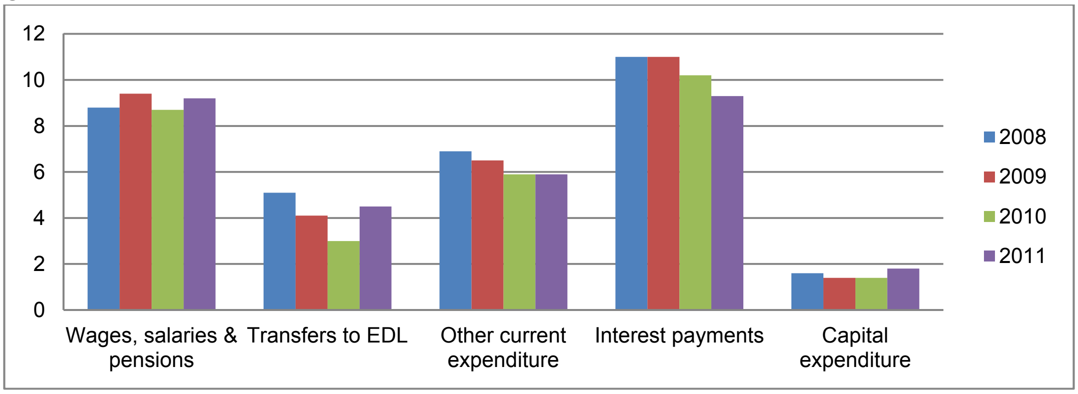
	2006	2007	2008	2009	2010	2011
Overall balance (cash basis)	-10.4	-10.9	-9.6	-8.2	-7.5	-8.3
Primary balance (cash basis)	2.6	1.7	1.4	2.8	2.7	1.0
Net financing by the banking system	5.7	-3.1	7.2	9.2	5.2	9.4
Net financing by government institutions			0.6	1.9	0.3	0.3
Net financing by other creditors			2.2	-2.9	1.5	-1.5
Memorandum: MFA loan				0.004		

Source: IMF, country reports 09/131 (2006-2007),10/306 (2008), and 12/39 (2009 and onwards). Gray shading denotes projections.

There are many areas in the Public Finance Management (PFM) of the country requiring improvements as will be discussed in chapter 6. Many conditions of the second MFA grant and loan instalments were related to visible PFM improvements.

On the expenditure side, the very high debt stock resulted in interest payments amounting to more than one third of total central government expenditures, exceeding expenditures on public sector salaries and pensions (see Table 4.4 and Figure 4.4). This has left little room for public investment expenditures, which are exceptionally low (amounting, for instance, to below 14% of debt-related expenditures in 2009) and contributing to worsening instead of gradual removal of infrastructure bottlenecks, as discussed above.

Figure 4.4: The role of debt-related expenditures in central government expenditures, 2008-2011, % of GDP



Note: EDL: Eléctricité du Liban.
Source : IMF, Country report 10/306 and Country report 12/39, 2011 figures are projections.

Tax policy is another weak area of Lebanon's public finances. VAT is the main source of revenues, despite a relatively low rate (10%) and several exemptions. Different income tax rates apply to various types of income. Furthermore, the weak tax administration, the complicated tax system that is perceived as unevenly affecting taxpayers and the large informal economy significantly hinder actual tax collection. As a result, tax revenues in Lebanon in relation to GDP are similar to levels in other countries in the region, despite the significantly higher GDP per capita.

There appears to be limited room for increasing government revenues. A recent IMF report has estimated the room for a revenue increase of around 3% of GDP over a five year period[14]. The focus should be on increasing uniformity, broadening tax bases, and possibly raising some tax

[14] IMF(2010), Lebanon 2010 Article IV Country report, no. 10/306.

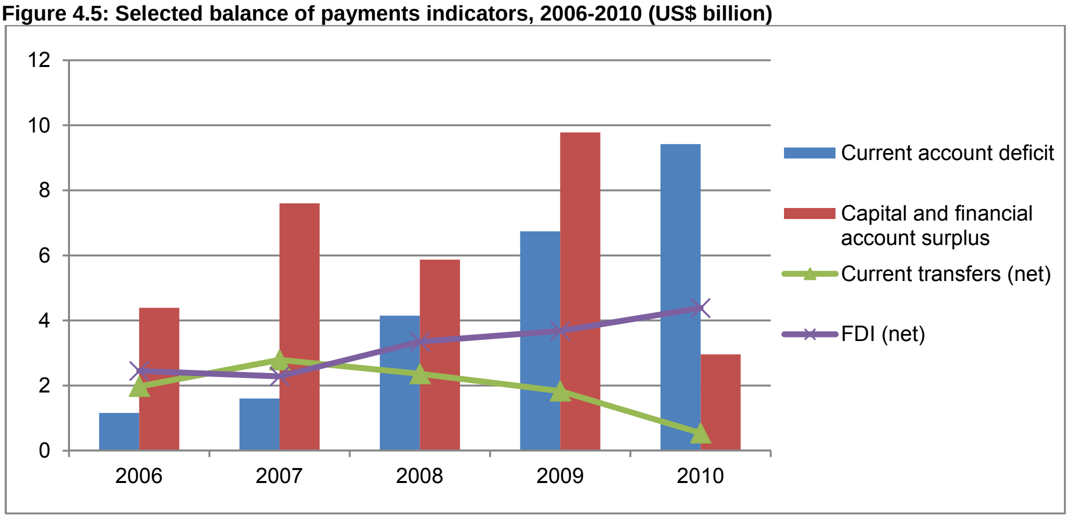
rates (both income tax and VAT) that are moderate by international standards. With regard to the income tax the IMF suggests widening the coverage to include also the capital gains for individuals. Elimination of some VAT exemptions, raising excises on alcohols and protecting the real value of excise taxes through indexation are other recommended steps. To a certain extent the draft 2012 budget contains proposals which are in accordance with these general suggestions. The draft 2012 budget includes a proposed increase of the VAT rate, increase in taxes on interest from deposits and a new tax on real estate transactions. However, similarly to the situation in previous years the proposed tax measures have already generated discontent and the draft budget has not (yet) been approved. It is noted that during 2006-2011 none of the draft budgets was approved by the Parliament.

Lebanon has kept a primary surplus oscillating around 2% of GDP since 2002 (around 1% of GDP in 2011). The financing structure of the sizeable overall deficits has been quite specific. The most part of the fiscal deficits is financed by commercial banks that have accounted for around half of local currency debt for the last several years. However, in effect commercial banks could be seen as playing an intermediation role given that the money ultimately comes from depositors, including in particular the large Lebanese Diaspora. Given the limited room for providing loans to the private sector, banks end up channelling private deposits to government financing. The Lebanese Central Bank and public institutions are other major financers of the public sector deficits. Such a structure has until now played an important role in maintaining stability in the debt market as discussed in more detail in the next chapter.

4.3.9 Balance of payments

The current account deficits of Lebanon exceeded 10% of GDP between mid-1990s and 2005. Following a brief period of lower deficits in 2006-2007, they widened again in subsequent years. The current account deficit exceeded 10% of GDP in 2010. In 2011 the situation has worsened (estimate of 14% of GDP) due to higher prices for (imported) fuel and food and decrease of tourism. Driven by robust capital inflows (especially portfolio investment), the capital and financial account surpluses have significantly exceeded the current account deficits during 2006-2009 resulting in the significant accumulation of official reserves. Figure 4.5 provides an overview of the trends of the main balance of payments indicators.

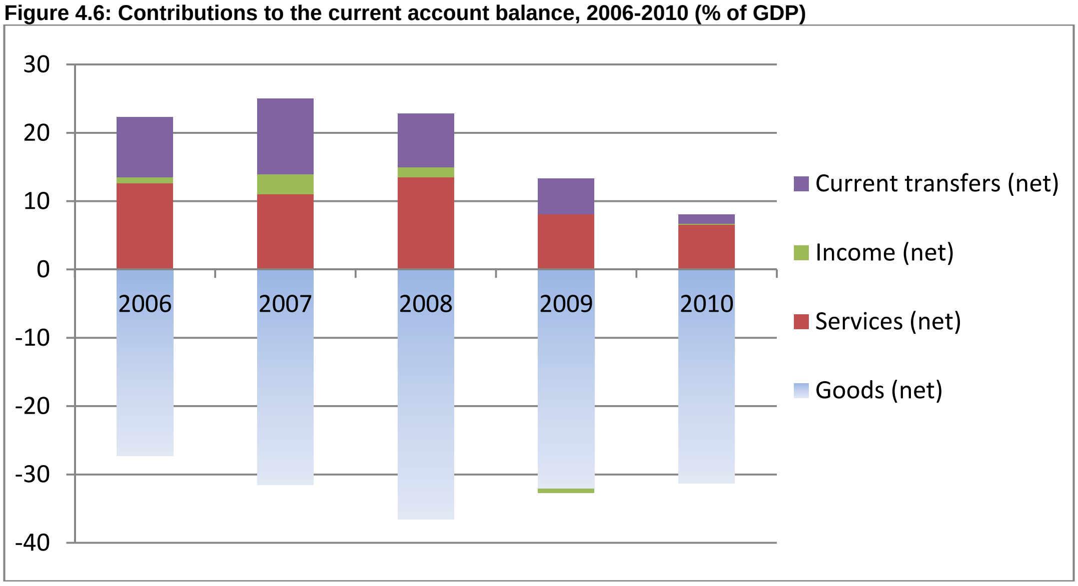
Figure 4.5: Selected balance of payments indicators, 2006-2010 (US$ billion)



Source: Banque de Liban, Statistical Annex Second Quarter 2011. Balance-of-payments data differ substantially from those reported in IMF country reports, although the trends are similar. The statistics are subject to a particularly wide margin of error. As one indication, the category 'unclassified transactions' amounted to US$ 6.46 billion in 2010.

The balance of trade in goods showed large deficits, with exports amounting to almost 50% of GDP during the 2008-2010 period and imports to below 20% of GDP. In contrast, the trade in services has shown a large surplus, with the tourism industry playing an important economic role. Current transfers, mainly representing remittances from Lebanese nationals living abroad, have been a very important element improving the balance of payments. As mentioned, Lebanon is among the countries with the largest remittance inflows relative to GDP in the world. It is estimated that up to half of all remittance inflows comes from Gulf Cooperation Council countries.[15]

Figure 4.6: Contributions to the current account balance, 2006-2010 (% of GDP)



Note: See note to Figure 4.5 for discussion of data quality.

Source : Banque du Liban, Statistical Annex Second Quarter 2011.

The country's strong capital and financial account position is determined by inflows of foreign direct (FDI) and portfolio investment, loans, and other capital, and in particular non-resident deposits in banks. The year 2010 witnessed further strengthening of FDI inflows, but a significant decrease of the 'other investment' category that explains the considerable reduction of the capital and financial position in that year. However, it should be noted that these trends should be interpreted very cautiously given the low quality of data. In particular, the distinction between resident and non-resident deposits is in practice blurred. Also, the 2010 balance of payments statistics show a positive US$ 6.46 billion flow of 'unclassified transactions'.

Preliminary 2011 data do not suggest any significant changes in the development of trade in goods. However, higher oil prices translated into higher imports value and larger trade and current account deficits. The latter was also affected by a reduction in the surplus in trade in services, partly owing to a slowdown in the inflow of tourists.

4.4 Conclusions

The above analysis of macroeconomic developments in Lebanon suggests an improvement in areas to which the objectives of the MFA operation were related, i.e. (i) to support Lebanon's domestic efforts of post-war reconstruction and sustainable economic recovery; (ii) to alleviate the

[15] For a further discussion on remittances see section 5.3.4.

financial constraints on the implementation of the government's economic programme; and to support Lebanon's efforts to reduce public debt to a sustainable level. Specifically, Lebanon has clearly made substantial progress in post-war reconstruction and experienced economic recovery that was sustained over a period of four years, despite the particularly unfavourable global economic environment. While implementation of the government's economic programme defined before the Paris III conference has faced several obstacles, financial constraints on the implementation have eased and were not among major problematic issues. Since early 2011 the economy lost momentum largely owing to rising domestic political uncertainty and regional turmoil.

Issues related to the third identified macroeconomic objective of supporting Lebanon's efforts to reduce public debt to a sustainable level are discussed in more detail in the next chapter.

We conclude that the two macroeconomic objectives of the MFA assistance were largely achieved. What remains to be assessed is the degree to which the MFA operation contributed to the achievement of objectives and to what extent progress should be rather attributed to other forces at play. These issues are touched upon in Chapter 7.

5 Impact on external sustainability

5.1 Introduction

Table 5.1 presents the second group of evaluation questions which addressed the impact of MFA on the country's external sustainability. This Chapter details our preliminary findings to these questions.

Table 5.1: Evaluation question on macroeconomic stabilisation and sub questions[16]

Q4.	**To what extent has the MFA assistance contributed to returning the external financial situation of Lebanon to a sustainable path over the medium to longer-term?**
Q4.1	How did the external financial situation of Lebanon evolve prior to and during the operation?
Q4.2	What are the main internal and external factors on which the current trend in Lebanon's external financial situation and its prolongation into the future are conditional?
Q4.3	How is the Lebanon's external financial situation likely to evolve in the 5 years following the final disbursement given the likelihood of changes to current conditions?
Q4.4	What is the MFA contribution to medium and long term external sustainability prospects of Lebanon?

The fourth sub-questions is already part of the generic evaluation questions, but based on the experience from previous evaluations we repeat it here to be better able to provide an explicit and clear answer on the impact of MFA on external sustainability and underline this key dimension of the evaluation. This sub-question is dealt with in more detail in Chapter 8.

5.2 Gross impact – actual evolution of external sustainability indicators

Q4.1 How did the external financial situation of Lebanon evolve prior to and during the operation?

5.2.1 Current account

As mentioned, the exports and imports of goods and services and remittances have been key determinants of the overall balance of payments position of Lebanon. There have been substantial fluctuations in the foreign trade dynamics in the second half of 1990s and early 2000s.

Between 2000 and 2006 the volume of imports of goods and services rose at an annual average rate of 6-7%. In contrast, the volume of exports of goods increased by as much as 26% annually. Increases in the export of services were more modest showing a combined growth of exports of goods and services of 12% annually. More recently, between 2006 and 2010, the import volume dynamics have exceeded the export volume dynamics. While imports increased by 11% on an annual basis, the volume of exports of goods have been rising by a modest 7%. This can be partly explained by the strong drop in the exports of goods in 2009.

The deficit in trade in goods has exceeded 30% of GDP since 2007 with no tendency for improvement (see section 4.3.3 above). This is a relatively large deficit by international standards. With regard to the trade in services, after reaching a peak of almost 19% of GDP in 2008, the surplus in the trade of services has been gradually shrinking, but still remained above 15% of GDP.

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16 See pp. 9-11 of the "Guidelines for ex post evaluation of MFA/BoP assistance", May 2010.

Figures 5.1 and 5.2 depict the main foreign trade partners of Lebanon. The geography of exports and imports differs significantly. Lebanon imports originated mostly from industrialised countries (US, several large EU economies, such as Italy, Germany and France) and China and other emerging economies. Imports from countries in the Middle East and North Africa (MENA) region are relatively low.

In contrast, the MENA region (especially United Arab Emirates - UAE, Iraq, Saudi Arabia and Syria) accounts to almost half of Lebanon's exports. Other African countries (e.g., South Africa) are also an important export destination, having even a higher share than the EU countries. Finally, Switzerland was the top single country export destination in 2010.

Figure 5.1: Main export partners of Lebanon in 2010 (% of total goods exports)

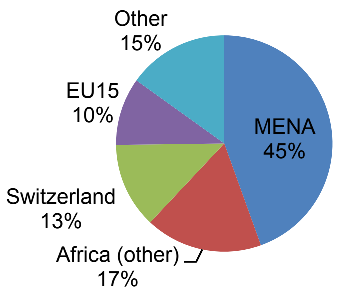
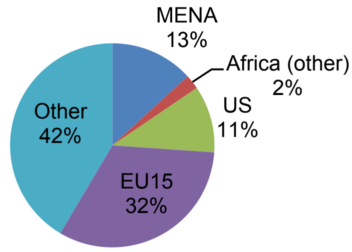


Figure 5.2: Main import partners of Lebanon in 2010 (% of total goods imports)



Sources: Ministry of Finance, Lebanon: Country profile 2011, citing Bank du Liban and Higher Council of Customs as a primary source.

These geographical differences can be better understood in view of the commodity composition of Lebanon's trade (see Figures 5.3 and 5.4).

Figure 5.3: Main export commodities of Lebanon in 2010 (% of total goods exports)

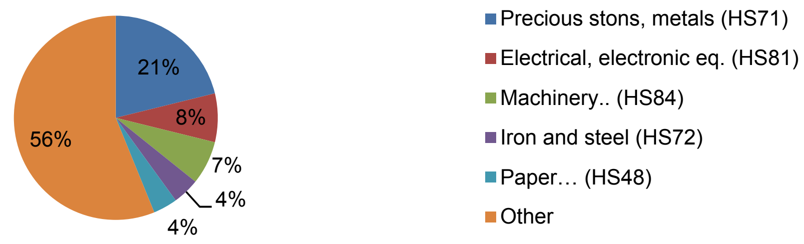
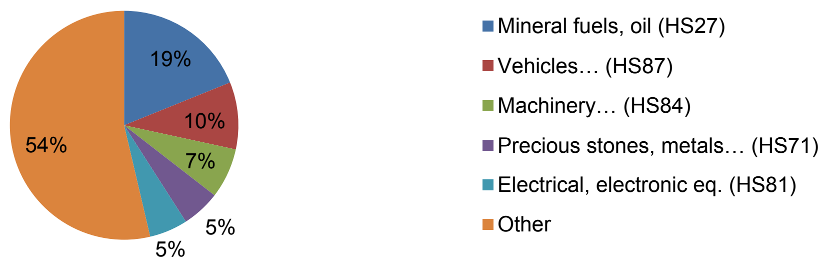


Figure 5.4: Main import commodities of Lebanon in 2010 (% of total goods imports)



Source: UN Comtrade database.

Main exports include jewellery, base metals, chemicals, miscellaneous consumer goods, fruit and vegetables, tobacco, construction minerals, and electric power machinery. At the product level, gold and other products in the category pearls, precious stones and metals accounted for close to 30% of all exports in 2010. The key destination markets were Switzerland, South Africa, UAE and Belgium. The value and share of exports of these products in total exports exhibited substantial volatility in recent years. During 2007-2008 the values were particularly low, with a share in total exports in the range of 16-17%.

Main imports include petroleum products, cars, machinery and equipment, gold and precious stones, meat and live animals, etc. Foreign trade structures have been broadly stable over the last few years.

Tourism has been a particularly important sector contributing significantly to the relatively large positive balance of trade in services. Security and stability in the country and the wider region are important factors affecting attractiveness of Lebanon as a tourist destination.

The informal peg of the Lebanese pound to the US dollar could under some circumstances lead to domestic currency overvaluation and ensuing problems with the country's international competitiveness. However, existing evidence does not indicate this to be problem. The real effective exchange rate (REER) of the Lebanese pound was depreciating for several years prior to mid-2008, in line with the weakening of the US dollar. Strengthening of the REER since mid-2008 reversed this trend. However, IMF calculations using a number of methodologies (macroeconomic balance, external sustainability, and the equilibrium real exchange rate approaches) produced mixed results suggesting a real exchange rate broadly in line with fundamentals[17].

[17] See discussion in IMF, Lebanon Country Report 10/306.

5.2.2 Debt sustainability

Concerns about debt sustainability are not new. The origins of the major problems with Lebanon's large external and public debt stocks can be traced back to the legacy of the 1975-1991 war that not only weighed negatively on economic activity but dramatically limited the ability of the authorities to collect revenues. At the same time expenditure needs have been significant. The post-war reconstruction during 1990s was characterised by insufficient fiscal adjustment, very limited access to international capital markets and heavy reliance on short-term bonds denominated in Lebanese pounds. As a result gross public debt doubled within the four-year period 1993 -1997, from 49% of GDP to 103% of GDP.[18] After the Paris II donor conference in 2002 Lebanon was able to change the composition of debt financing. It retired some high-yield short-term domestic bonds and gained again access to international financing either at concessional rates or in any case at lower international interest rates.[19]

However, by 2006 gross public debt stood at 180% of GDP, by far the highest in the entire Middle East region, with the exception of Iraq. The debt to GDP ratio has since then declined to below 150% of GDP in 2009, 137% of GDP at the end of 2010 and an estimated value of 124% of GDP a end-2011 (see Table 5.2 below).

Table 5.2: Selected indicators of external vulnerability, 2006-2011

	2006	2007	2008	2009	2010	2011
Gross public debt (US$ billion)	40.4	42.0	47.0	51.1	52.6	54.4
Gross public debt (% of government revenues)	717	698	660	602	622	600
Gross public debt (% of GDP)	180	168	156	146	137	134
Foreign currency gross public debt (% of GDP)	91	85	70	61	53	52
Gross financing need (USD billion)^	..	..	13	15	16	22
External debt (% of GDP)*	199	194	173	175	161	158
External debt-to-exports ratio (%)	325	304	229	267	249	247
Gross external financing need (USD billion)	35	37	41	45	55	58
Gross external financing need (% of GDP)	155	149	136	129	143	144
Gross official reserves(US$ billion) #	11.4	11.5	18.8	27.4	30.2	30.6
Gross official reserves (% of short term external debt) **	32	30	46	53	56	55

* The figures include estimates for public debt and banking deposits held by non-residents, and non-resident claims on the nonfinancial sector.
^ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
# Excluding gold and encumbered assets.
** Short-term debt on a remaining maturity basis, including short-term non-resident deposits.
Source: IMF, Country Reports 12/39, 10/306 and Lebanon's Ministry of Finance, Debt and Debt Markets, quarterly bulletin Q2 2011. Grey shading denotes estimates /projections.

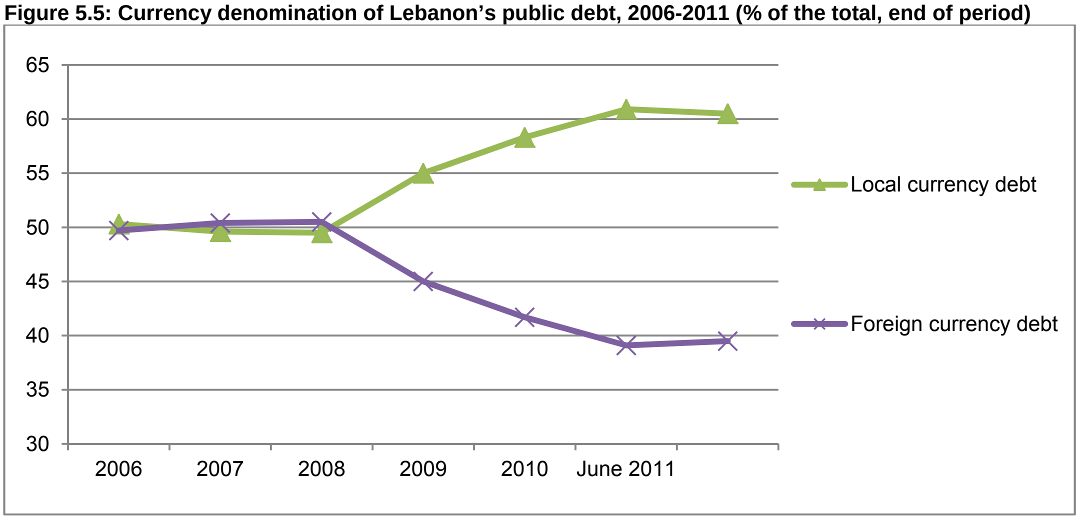
The market structure of Lebanon's public debt is quite unique. The country has limited exposure to externally held debt. Foreign currency (predominantly US$) denominated debt declined from

18 For discussion see Eken S. and T. Helbing (1999), Back to the Future: Post war Reconstruction and Stabilization in Lebanon. IMF Occasional Paper no. 176.

19 For a detailed discussion see S.Y Saab (2005), Is Lebanon's Debt Sustainable? A Closer Look at Lebanon's Debt Dynamics, mimeo, Johns Hopkins University, School of Advanced International Studies.

around 50% of the total debt during 2005-2007 to 40% in 2010-2011 (see Figure 5.5). Importantly, a large part of this foreign currency debt is held domestically.

Figure 5.5: Currency denomination of Lebanon's public debt, 2006-2011 (% of the total, end of period)



Source : Lebanon's Ministry of Finance, Debt and Debt Markets, Quarterly Bulletin Q2 2011.

Externally held public debt declined from 46% of GDP in 2006 (i.e. around a quarter of total public debt) to an estimated value of 28% of GDP in 2010. There is also a significant difference between maturities of domestic and foreign currency denominated debt. As of end-2011 the former carried an average maturity of 2.6 years (a substantial increase compared to previous period), while foreign currency debt (mainly Eurobonds) had a longer average maturity of 5.2 years and this figure was also on the rise.[20] The lengthening of maturities results from the strategy of the Lebanon's authorities that apart from this has also tried to lower the foreign currency share of its government debt.

Table 5.3: Public debt structure, 2005-2011 (US$ billion)

	Dec05	Dec06	Dec07	Dec08	Dec09	Dec10	Jun11
Gross public debt	38.5	40.4	42.0	47.1	51.2	52.6	52.5
A. Local currency	19.3	20.0	20.8	25.9	29.8	32.0	31.8
A1. Central bank*	7.8	6.4	6.0	5.8	6.9	8.7	10.6
A2. Commercial banks	9.4	10.9	11.2	16.1	18.1	18.1	16.0
A3. Other local (T-bills)	2.2	2.7	3.6	3.9	4.9	5.2	5.2
A31.o/w held by public entities	1.6	2.2	3.2	3.4	4.0	4.2	4.4
B. Foreign currency	19.1	20.3	21.2	21.2	21.3	20.6	20.7
B1. Eurobonds	16.4	17.5	18.0	17.8	18.0	17.7	17.8
B2. Loans	2.4	2.5	3.0	3.1	3.0	2.8	2.8
B21. o/w Paris III loans #	0.6	0.6	0.6	0.5	0.4	0.3	0.3

* Including REPOs and loans to Eléctricité du Liban to finance fuel purchases.
# Includes inter alia IMF and MFA loans.
Source: Lebanon's Ministry of Finance, Debt and Debt Markets, Quarterly bulletin Q2 2011.

The government debt is mainly held by commercial banks (54%), Banque du Liban (20%), and other government institutions (see also Table 5.3)[21].

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20 The data is based upon IMF, Country Report 12/39.

21 The figures reflect late-2011 IMF estimates (IMF, Lebanon Country Report 12/39). Detailed data on trends over time in domestic currency denominated debt are included in Table 5.3.

While public debt is mostly held domestically, Lebanon's total external debt is very high, among the highest in the world. Total external debt has followed similar dynamics as the public debt, reaching almost 200% of GDP in 2006 and then declining gradually to around 160% of GDP in 2010-2011. In nominal terms, the debt has been growing steadily and the decline in the GDP ratio primarily owes to nominal GDP growth. The IMF estimates suggest that around 80% of the total external debt consists of short-term non-resident deposits in the banking sector. This also implies that statistics are subject to wide error margins given the difficulties in separating resident and non-resident banking deposits and estimating other claims of non-residents (often representatives of the Lebanese Diaspora).

The large majority of external debt has been short-term of nature ever since 2006 and the share of short-term debt has been rising, reaching 84% by 2010. However, gross official reserves and commercial banks' foreign assets have been rising faster than short-term external debt. As a result the relevant ratios have been improving.

In view of the still high (even if declining) amount of foreign-denominated public debt and the currency mismatches of corporations and households, owing to widespread loan dollarization, the maintenance of the Lebanese pound's peg to the US dollar is an essential element supporting stability of the external situation.

The most recent government debt sustainability analysis from end- 2011 concludes that in the baseline scenario the debt-to-GDP ratio would remain roughly unchanged from its 2011 level of just above 130% of GDP until 2016, as the net effect from debt-reducing and debt-creating forces cancel out. While the country is expected to maintain primary surpluses over the projection horizon their size (around 0.6% of GDP) will be much lower than in the past (almost 3% of GDP during 2009-2010). After 2014 the relation between real interest rates and GDP growth is likely to start acting towards an increase of public debt, in sharp contrast to the situation during 2007-2010. Given very high debt to GDP ratio the baseline scenario can hardly be described as easily sustainable.

On the other hand, analysed negative shocks, while resulting in a substantial increase of debt to GDP ratios still do not lead to skyrocketing debt to GDP relations, at least not in comparison with historical developments in Lebanon. A combined permanent negative shock to the tune of 1/4 standard deviation shocks applied to the real interest rate, the growth rate, and the primary balance elevate public debt to GDP ratio to 146% by 2016, compared to 132% baseline. This is certainly a non-negligible increase, to levels last seen in 2009.

However, it should be noted that assessing the debt outlook and sustainability is a particularly difficult task in the case of Lebanon. Applying the standard international benchmarks to debt indicators would lead to a conclusion that the country is on the brink of a default or indeed that it should have defaulted several times in its history (Table 5.4).

Table 5.4: Typical debt-burden thresholds in international benchmarking exercises

	NPV of debt as % of exports	NPV of debt as % of GDP	NPV of debt as % of revenues	Debt service as % of exports	Debt service as % of revenues
Weak policy (IRAI ≤ 3.25)	100	30	200	15	25
Medium policy (IRAI 3.25< to < 3.75)	150	40	250	20	30
Strong policy (IRAI 3.75≤)	200	50	300	25	35
Lebanon (2010 est.)	n/a	n/a	n/a	19	42

Note: IRAI stands for IDA Resource Allocation Index (formerly known as CPIA) and is an aggregate proxy measure of the quality of policies. No IRAI data is available for Lebanon.
Source: IMF and IDA (2005), Operational framework for debt sustainability assessment in low-income countries – further considerations, 28 March and own calculations based on IMF and Bank du Liban data. The value of exports taken to calculate debt service / exports ration includes an estimate of exports of services. The ratio of debt service over exports of goods stands at 73%.

In its recent history Lebanon went through periods when debt service costs exceeded 90% of government revenues (1997), a prolonged civil war, frequent negative political and security shocks such as the assassination of the former prime minister Hariri in February 2005 and the Israel – Hezbollah war in the summer of 2006. Against the odds, none of these developments led to a debt crisis. Indeed, Lebanon belongs to a small club of countries that have never defaulted on external debt or depositors.

This apparent puzzle can be explained by a combination of factors, of which three are considered most important[22]:

- First, market participants perceive Lebanon as benefiting from and implicit guarantee from donors. This perspective is very important from the perspective of designing the counterfactual scenario when no MFA operation or no MFA and no IMF support would have been provided. We return to these issues in chapter 8.
- Second, Lebanon appears to benefit from its clear track record of having never defaulted on external debt or deposits. Consistent with some comparative cross-country literature past record of always meeting all obligations positively affects investors' perceptions[23].
- The third factor is a unique market structure for Lebanese debt with a dominant role of domestic banks and a large pool of 'dedicated' investors and depositors. As indicated above domestic banks held the major share of outstanding public debt obligations. Banks in turn, consistently show high appetite for government papers due to limited alternative options (demand for private sector credit is limited) and high deposits held by domestic and foreign investors, including the large Lebanese Diaspora. Depositor's confidence appears to be driven by similar factors as investors' confidence. Some of them have limited alternative investment options (especially local residents), others feel special ties with the country (particularly the Diaspora) and for more sophisticated investors it may provide portfolio diversification given low or negative correlation of the market with the rest of the region. Moreover, the Lebanese banking sector is generally perceived as well-regulated, providing high quality services (including secrecy) and generally

22 The following discussion draws from findings presented in A. Schimmelpfennig and E. H. Gardner (2008), Lebanon – Weathering the Perfect Storm, IMF Working Paper WP/08/17.

23 Reinhart, C. M., K. S. Rogoff and M. A. Savastano. "Debt Intolerance," Brookings Papers on Economic Activity, 34, 2003-1 (2003): pp. 1-74 argue that countries' default histories affect the present tolerance to debt. Countries that have often defaulted may subsequently experience problems managing even relatively low debt levels.

sound. All this contributes to depositors' showing remarkable resilience to bad news and providing a steady deposit inflow.

As a results, a self-reinforcing equilibrium emerges where the large majority of domestic stakeholders (predominantly the government itself and the domestic financial sector) is vitally interested in avoiding the risk of default. The default is no topic in domestic fierce political debates for the simple reason that it would be extremely costly for domestic depositors and Lebanese Diaspora.

These special features of the Lebanon's situation clearly limit the relevance of standard debt sustainability analysis.

5.3 Identification of major risks

Q4.2 What are the main internal and external factors on which the current trend in Lebanon's external financial situation and its prolongation into the future are conditional?

In this section we present our analysis of the key risk factors to Lebanon's external sustainability. We have identified the following five major risks:
- domestic political developments;
- political and security developments in the wider region;
- sudden stop or reversal of deposits and capital inflows;
- remittances; and
- export performance.

The first two risks are strongly inter-related to the last three risks factors.

5.3.1 Domestic political developments

Political instability, including frequent outbreaks of open violence, have been a major factor determining Lebanon's economic and social development and indeed the very existence of the country since it gained independence in 1943.[24] Clearly, political stability is also a key determinant of the outlook for the country's external financial situation. The recent period of relative political stability ended in January 2011 with the collapse of the national unity government. A new government has been formed in June 2011. Nonetheless, given a range of domestic and external factors, as will be discussed below, it is unlikely that a sustainable political constellation emerges in the country in the medium-term perspective. Hence, one should expect continued risks to the external financial situation from:
- The possible rapid deterioration of political situation and outbreak of violence;
- The continued deterioration of the status-quo, where, inter alia, political decisions important from the perspective of external sustainability are not taken due to a stalemate between major political actors.[25] This in particular applies to external sustainability effects from delays in introducing fiscal and other structural reforms.

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[24] See e.g. discussion in K. Höckel (2007), Beyond Beirut: Why Reconstruction in Lebanon Did Not Contribute to State-Making and Stability, Crisis States Occasional Paper no. 4.

[25] For a discussion of the situation of Lebanon in terms of the "deteriorating status quo" see S. Colombo (2011), Syria and Lebanon: Diverging paths of state unsustainability, MEDPRO Technical Report No. 6, June, see www.medpro-foresight.eu

5.3.2 Political and security developments in the wider region

There is an important international dimension to the lack of internal political stability as discussed above. In particular, it is widely believed that a normalisation of the situation in Lebanon would require some resolution of the Arab-Israeli conflict. Also, crucially important are developments in Syria, that has substantial economic links with Lebanon and that has continued to exercise substantial influence over Lebanon after the end of a more direct political and military control that lasted until 2005.[26] In addition, although Lebanon's direct trade exposure (in terms of exports and imports) to Syria is relatively low, this country plays an important transit role for trade and tourism flows with the Gulf Cooperation Countries, Jordan, and Turkey. The ensuing internal conflict in Syria that has been escalating since early 2011 worsens the risks in this area. Similarly, the uncertain developments in Egypt – another very important regional partner – also weigh negatively on the prospects of the Lebanon’s economy.

Although it is very difficult to quantify the impact of this risk factor, an impression can be made by looking at the most recent IMF projections of financial flows in the Middle East and North Africa (MENA) (see Table 5.5), showing significant unfavourable projections for 2011 and 2012.

Table 5.5: Middle East and North Africa economies: Net financial flows[27]

	2007	2008	2009	2010	2011p	2012p
Private Financial Flows, net	63.5	31.1	62.1	10.5	-20.0	17.1
- Private Direct Investment, net	48.9	58.1	64.1	43.2	36.4	43.8
- Private Portfolio Flows, net	-43.7	-3.9	10.0	3.2	-29.6	-17.8
- Other Private Flows, net	58.3	-23.1	-12.0	-35.9	-26.8	-8.9
Official Flows, net[28]	-76.3	-102.6	-44.2	-43.0	-144.1	-135.5
Change in Reserves[29]	-231.0	-185.2	21.5	-102.8	-145.0	-122.1

Source: IMF, World Economic Outlook, September 2011.

5.3.3 Bank deposits and capital inflows

As it was discussed above, continued inflow of resident and non-resident bank depositor is the key factor determining the commercial banks’ demand for government debt. With the short-term character of most deposits the inflow observed for the last years can very rapidly come to a stop or be reversed. The likelihood of a prolonged change in the sentiment of domestic and foreign depositors is limited but some forces as discussed above may change the experience so far with the previous confidence crises. For instance, after both the 2005 prime minister Hariri assassination and the 2006 war with Israel the drop of deposits proved limited and short-lived. Also, according to the central bank data 2011 has seen an acceleration of both resident and non-resident deposits compared to 2010, despite the insecure political situation and slowdown of the economy. However, a scenario with a more persistent fall in depositors’ confidence cannot be ruled out. This could create serious risks to the sustainability of the debt situation in Lebanon.

According to the IMF, the risk of a relapse by opposing party blocks into political deadlock or spillovers from a sudden spike in regional tensions remains latent, and exposes Lebanon to the

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26 See discussion in S. Colombo (2011) op cit.

27 Net financial flows comprise net direct investment, net portfolio investment, other net official and private financial flows, and changes in reserves.

28 Excludes grants and includes transactions in external assets and liabilities of official agencies.

29 A minus sign indicates an increase.

possibility of a sudden negative confidence shock. In addition, falling interest rates are putting pressure on bank profits, challenging the traditional business model that relies on intermediation of private deposits to the government and the Central Bank of Lebanon.

5.3.4 Remittances

As discussed above, the remittance inflows have been a relatively stable element of the country's balance of payment. This is in line with trends observed in other countries, and may additionally be supported by the hypothesis that a substantial share of remittance senders are well educated professionals (the emigration rate of the tertiary educated population was estimated at 39% in 2000[30]) who may be at lower risk of losing employment in the event of adverse economic shocks in their host countries. The stock of emigrants as percentage of the population is estimated at 15.6%.[31] Still, given the size of the remittance flows we include this issue among risk factors as even relatively mild fluctuations on remittance flows could have a substantial impact on the balance of payments. The high local and regional tensions affect the size of remittances given that it is estimated that up to two thirds of all remittance inflows comes from the MENA region[32]. Table 5.6 shows the dynamics of remittances over the period 2003-2010 illustrating a rising trend of inward remittances since 2007.

Table 5.6: Dynamics of remittances in Lebanon, 2003-2010 (in US$ millions or as % of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010 est.
Inward remittance flows (US$ mln)	**4,743**	**5,591**	**4,924**	**5,202**	**5,769**	**7,181**	**7,558**	**8,177**
Of which:								
Workers' remittances	3,964	5,183	4,257	4,623	5,022	5,775	6,385	-
Compensation of employees	779	409	667	579	747	1,405	1,173	-
Outward remittance flows (US$ mln)	**4,081**	**4,233**	**4,012**	**3,445**	**2,967**	**4,366**	**5,749**	**-**
Of which:								
Workers' remittances	3,694	3,573	3,281	2,783	2,370	3,576	4,71	-
Compensation of employees	387	660	731	661	597	790	1,034	-
As % of GDP								
Net Workers' remittances	**1.3**	**7.4**	**4.5**	**8.2**	**10.6**	**7.3**	**4.8**	**1.3**
Inflows	19.7	23.8	19.5	20.6	20.0	19.2	18.3	n.a.
Outflows	-18.4	-16.4	-15.0	-12.4	-9.4	-11.9	-13.5	n.a.

Sources: World Bank (2011), Migration and Remittances Fact book 2011, second edition – for nominal figures; World Bank (2012), Using Lebanon's Large Capital Inflows to Foster Sustainable Long-Term Growth, January 2012 – for % of GDP figures.

Based on existing data and views of interviewed experts we do not identify declines in remittances in the first half of 2011. However, such risk remains in place and the likelihood of materialisation of the negative scenario may increase if the weakness of the global economy continues as well as the negative political scenarios in the MENA region materialise. This would affect both balance of payment sustainability and the debt sustainability prospects[33].

[30] See World Bank (2011), Migration and Remittances Fact book 2011, second edition, p. 159

[31] See World Bank (2011), Migration and Remittances Fact book 2011, second edition, p. 159

[32] IMF, country report 12/39.

[33] M. T. Gapen, Y.Abdih, A. Mati and R. Chami (2009). 'Fiscal Sustainability in Remittance-Dependent Economies'. IMF Working Papers WP/09/190 highlight the importance of remittances' inflow on public debt sustainability.

5.3.5 *Export performance*

Despite substantial gains in recent years, Lebanese exports remain relatively low as a share of the country's GDP and relative to the level of imports. Geographical concentration of exports to the Middle East and North Africa region may be also viewed as a risk factor given the political unrest or uncertainty in a number of countries and ensuing drag on economic activity there. Given the large import dependence, the continued and accelerated development in the export sectors is a necessary condition for ensuring macroeconomic stability in the longer term. Hence, there remain risks of a deterioration of export performance, including exports of services. Of the latter, roughly one third is accounted for by tourism services.[34] A dynamic rebound of this particular sector observed in recent years may not continue unless the domestic and regional stability and security situation improve. The situation in 2011 provides an illustration. Provisional data from the United Nations World Tourism Organization suggest a decline in tourist arrivals to Lebanon by around 24% compared to 2010, the sixth steepest decline globally[35].

5.4 Projections for external sustainability

Q4.3 How is the Lebanon's external financial situation likely to evolve in the 5 years following the final disbursement given the likelihood of changes to current conditions?

Balance of payments outlook

The current account deficit is expected to remain at an aggravated level in 2012, comparable to the 2011 value and above levels observed until 2010. This will be driven by the higher oil import bill and weaker exports of services, especially due to lower performance of the tourism sector that in turn reflects a combination of regional security and stability considerations and weaker economic prospects in home countries of potential tourists.

The dynamics of remittances is practically impossible to forecast, but it is unlikely that Lebanon will see a strong growth of inward remittances in the coming two years or so. The most recent IMF projections from end- 2011 foresee a current account deficit of around 14% of GDP during 2011-2012 and very gradually declining thereafter.

Debt projections

With the present existing data, the external sustainability has been further analysed, based also upon the Public Sector Debt Sustainability analysis carried by the IMF. The most recent update was published in end-2011. The figures from the scenarios presented in this version are commented based on the recent developments in the Lebanon's, regional and global economy.

The baseline scenario assumes 3.5% GDP growth in 2012 followed by 4% growth in subsequent years (until 2016). This scenario results in stabilisation of the gross domestic debt at just above 130% of GDP (see Figure 5.6). It is worth noting that these values are below earlier debt projections despite much weaker actual GDP growth during 2011 than projected in the previous IMF debt sustainability analysis exercise from October 2010.

Even at these lower levels, such high public debt cannot really be described as sustainable and it certainly amplifies several risks. It still constitutes a drag on the development prospects of the

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34 See discussion in IMF, Lebanon Country Report 09/131.

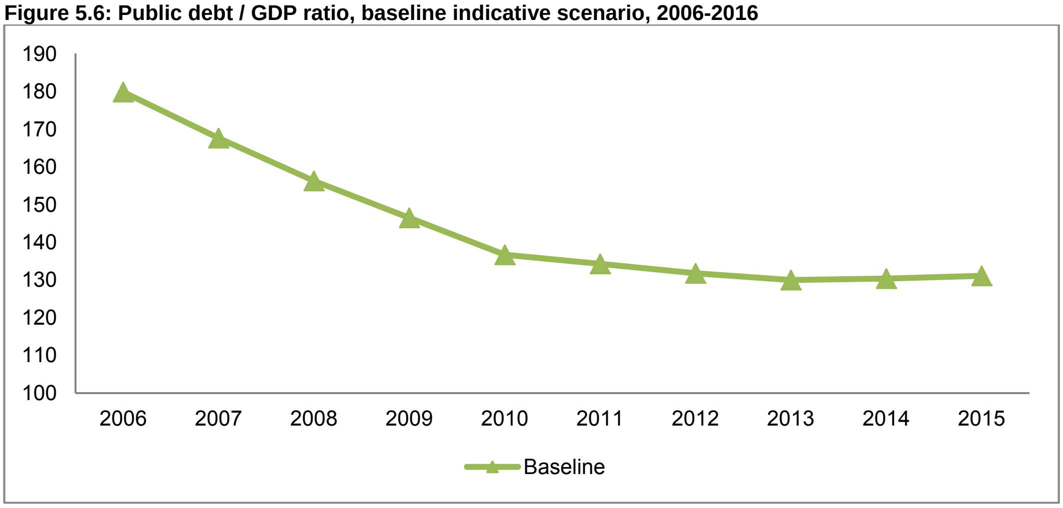
35 Cited by Byblos Bank, Lebanon this week, issue 249, 3 February 2012.

country. Sensitivity analysis of the baseline scenario to some adverse shock confirms the existence of substantial downside risks. Slowdown in GDP growth, higher interest rates or a weaker primary government surplus would all result in a quite substantial increase of the debt to GDP ratio, although this increase does not yet look alarming given the levels observed in very recent Lebanon's history.

It should be once again noted that the special features of the Lebanon's debt situation as discussed above limit the relevance of standard debt sustainability analysis.

In summary, based on the information currently available we assess the risks to the public debt outlook as *medium.*

Figure 5.6: Public debt / GDP ratio, baseline indicative scenario, 2006-2016



Source : IMF Country report 12/39, February 2012.

6 Impact on structural reforms

6.1 Introduction

Table 6.1 shows the third core of evaluation questions which focus on the effectiveness of MFA assistance in terms of supporting structural reforms. The main analysis of the impact of MFA on structural reforms focuses to a large extent on this question and its sub-questions.

Table 6.1: Evaluation question on structural reform and sub questions[36]

Q2.	**To what extent has the MFA assistance been effective in terms of supporting structural reform in Lebanon?**
Q2.1	What are the short and medium-term expected structural effects* of the assistance to Lebanon?
Q2.2	How relevant are the short and medium-term expected structural effects of the assistance to the needs of Lebanon?
Q2.3	To what extent have the short and medium-term expected structural effects* of the assistance to Lebanon occurred as envisaged?
Q2.4	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
Q2.5	To what extent have structural effects been enhanced, if at all, by complementarities between the MFA assistance and other EU instruments?

* Or explicit objectives if there have been identified.

In this chapter we describe the MFA operation in the context of structural reforms and present our preliminary findings along with issues which will need more detailed investigation during the last phase of the evaluation. Note that in addition to the core questions related to the impact on structural reforms, there are a number of other evaluation questions (i.e. Q 0.1; 0.2; 3.1; 3.2; 3.3 in Table 6.2) which also reflect the effectiveness of the MFA operation in terms of supporting structural reforms. These will be dealt with in Chapter 7.

6.2 Overview and background to structural conditions

6.2.1 Historical background

Available documentation in the MFA files of the EC reveals that there was some discussion on a possible MFA operation in Lebanon in the context of a very fragile macro-economic position back to 2001. This discussion was, however ,at a very infant stage and did not reach the point of considering areas for structural conditionalities. This was confirmed by various interviewees and therefore the focus of this evaluation will be on the time period starting from 2007.

As known, the MFA is also supposed to underpin the implementation of structural reform measures. In the case of Lebanon these were designed to support the fiscal consolidation effort aimed at reducing public debt to a sustainable level, the third identified macroeconomic objective of the MFA assistance. In this respect, it is important to recall that the Lebanese public debt levels were reaching the highest in the Middle East region in 2006 while no fiscal reforms which could stabilise the debt situation were being implemented. Further, according to an EC note

[36] See page 10 of the "Guidelines for ex post evaluation of MFA/BoP assistance", May 2010.

(ECFIN/D3/AS/REP50433) because of weak implementation of the structural components of the reform programme, the full benefits of Paris II could not be materialised leading again to an increased debt-to-GDP ratio by the end of 2005.

At the International Conference in Paris in 2007 the EC emphasized that a potential "*MFA operation would be part of the EC contribution to a broad international effort in support of the government's programme of socio-economic reforms, and to ease the mounting financial constraints aggravated by the military conflict in summer 2006*". The EC decision to proceed with an MFA operation was announced to be dependent on the success of negotiations of an IMF Emergency Post-Conflict Assistance (EPCA) programme which would support reinforcing the credibility of the government's programme, provide a means for close monitoring of its implementation and act as a catalyst for external assistance, particularly budget support.

According to the files, the IMF believed that for stabilising public debt there was a need to clearly identify fiscal measures and include stronger up-front actions and structural reforms. Apparently, while the government expressed its commitment to continue fiscal consolidation this was not supported by clear measures. While the Lebanese authorities announced to rely on privatisation and measures to improve the business environment, they were reluctant to support these with appropriate monetary and fiscal measures.

At the beginning of 2007 the possibility of a formal IMF programme was seriously being considered by the IMF and the Lebanese authorities. Support for such a programme was explicitly expressed by the United Kingdom, France, US and the EC. The political instability, lack of consensus on necessary reforms and a weak track record in implementing reforms, however, were the main downside risks underlying the programme. Nevertheless, there existed broad agreement that in the absence of a comprehensive reform package the situation would worsen considerably. Fiscal measures were considered very crucial in that respect. According to a note to the Economic and Financial Committee - EFC (ECFIN/D/3(2007)REP/53096): "*given the nature of the planned operation, in defining the conditionality in the area of structural policies, particular attention will be paid to PFM with a view to strengthening efficiency, transparency and accountability, and because of its importance for fiscal consolidation and a sustainable solution to the debt problem.*"

With the new government in place at that time and its expressed commitment to reforms and financial stabilisation there were expectations that structural reforms would receive more attention and would eventually lead to success. The political consensus and government commitment was one of the determinant factors for reaching a formal agreement on the IMF programme and consequently on the decision and design of the MFA operation, focussing on the set of structural conditions in particular.

The IMF programme (EPCA I) was approved in April 2007 and the follow-up programme (EPCA II) was approved in November 2008. The programme provided an anchor for the implementation of reforms and included series of monitorable actions (see Box 6.1 below).

Box 6.1: EPCA monitorable actions

Fiscal

- Submit to parliament a draft 2007 budget consistent with the targeted primary balance, including HRC and CDR foreign-financed expenditure and limit the allowance for carryovers and treasury advances;
- Appoint auditor for National Social Security Funds (NSSF) accounts and prepare audit plans for 2001-2006;
- Issue a Cabinet of Ministers decision for setting a floor on gasoline excise;
- **Submit to parliament the Global Income Tax draft law;**
- **Establish a Treasury Single Account.**

Banque du Liban (BdL)

- **Establish an investment committee and draft formal guidelines for foreign reserve management;**
- **Adopt formal policies for the selection, appointment, and rotation of the BdL's external auditors.**

Power sector

- Appoint auditor for EdL accounts and prepare audit plan for 2002-2006; publish 2001 audit report.
- **Revise electricity tariff structure consistent with program objectives.**

Privatization

- Submit to parliament the draft law to authorise the sale of mobile sector's assets and relevant operating licences by the government;
- **Issue Request for Application in participating in the process of acquiring the licenses and assets of the two mobile telephone companies**.

Note: Actions in bold were part of EPCA II, the others part of EPCA I.

As mentioned previously, the first tranche of MFA would be released on the basis of a satisfactory implementation of the Emergency Post-Conflict Assistance (EPCA) programme agreed with the IMF.

Further, prior to finalising the decision on MFA, the EC commissioned in October 2007 an Operational Assessment (OA) of administrative procedures and financial circuits of organisations/processes involved in the MFA in order to ensure that Lebanon would maintain a sufficient control environment for a sound PFM. It is noted that the OA is a pre-requisite for providing MFA. The OA concluded that "*the framework for sound financial management of the Ministry of Finance is effective with regard to budgetary processes, but needs to be strengthened and developed with regard to treasury and cash management as well as internal and external audit*". The assessment provided 19 recommendations emphasising the degree of their priority (high/medium) and timeframe. All four recommendations labelled as "high priority" were integrally incorporated into the MoU.

6.2.2 Structural conditions for MFA Lebanon

Besides the IMF programme and the Operational Assessment, in determining the structural conditions in the MoU the EC was guided by the following inputs:

- the Government comprehensive reform programme;
- the Medium Term Public Financial Management Reform Action Plan;
- consultation of major donors programmes (i.e. France, United States, and the World Bank) and the reform conditions they would attach to their budget support.

The final list of structural conditions included in the MoU, determining disbursement of the second MFA tranche, is presented in Table 6.2. The table also identifies the origin of the specific conditions and presents some background information which is relevant for understanding their relevance and expected impact.

Table 6.2: Structural conditions included in the MoU

Conditions in the MoU for the second tranche	Origin and comments
1. Public Finance Management	
a. Develop an operational mandate of the Cash Management Unit.	High priority recommendations from the Operational Assessment. Establishing a cash management unit was a condition proposed by the MoF for the 2nd MFA tranche. A Cash Management Unit was created by a ministerial decree in August 2007 but its effectiveness was being questioned. Consequently the final condition on cash management has been adjusted to motivate further steps.
b. The Ministry of Finance, following a Council of Ministers' decision, will identify all public entities' bank accounts held at Banque du Liban and commercial banks in preparation for the implementation of the Treasury Single Account law.	High priority recommendations from the Operational Assessment used to prepare the ground for the implementation of the Single Treasury Account (STA).
c. Mandate, through a Council of Minister's decree, that opening of any new bank account for public entities falling under the remit of the STA requires approval by the Ministry of Finance.	High priority recommendations from the Operational Assessment used to prepare the ground for the implementation of the STA.
d. Approve by the Council of Ministers the project of the fiscal accountability law.	High priority recommendations from the Operational Assessment.
2. Power Sector	
a. Higher Council for Privatization to complete the valuation and allocation of assets for the Eléctricité du Liban (EdL) in preparation of its incorporation.	Measures in power sector were subject for discussion for long time and were included in the assistance of various donors incl. France, WB (through a Development Policy Loan), EIB, etc. More specifically, the EIB was considering contributing to the rehabilitation of the energy sector. As part of the Paris III there were discussions between DG ECFIN and EIB on complementing assistance to the energy sector through an Enterprise Facility Support project. Also the CSP underlines the importance of complementarity with EC assistance for a comprehensive action towards the restructuring of the energy sector, including in particular electricity.
3. Social Sector	
a. Social Inter-Ministerial Committee (SIMC) to approve a time based action plan that eliminates duplication of programs between Ministry of Social Affairs, Ministry of Health and Ministry of Education and Higher Education.	This condition appears to emanate from the proposal of the MoF related to formalisation and activation of the SIMC which was implemented by the time of signature of the MoU. However. during some interviews it was suggested that the conditionalities in the social sector were proposed by the EU Delegation in Beirut.
b. Strengthen poverty focus of the social safety net programs: Establish targeting mechanism through proxy-means testing for implementing safety net programs.	Improving social safety net was part of the Government Reform programme, i.e. Social Action Plan. The CSP included provisions for strengthening of the social safety nets which was in line with the ENP AP. Analysis of findings suggests that this condition was proposed by the MoF and mutually

Conditions in the MoU for the second tranche	Origin and comments
	agreed with the EC. The new targeting system is being developed with support from the WB.

The discussion on possible conditions for the MFA started in 2007. According to the EC files, in July 2007 the Lebanese Ministry of Finance (MoF) submitted to the EC a proposal of possible conditions for the first and second trance for consideration. The initial set of conditions proposed by the Lebanese MoF for consideration to the EC included measures in the three areas (PFM, privatisation and social sector reform). Some interviewees, however, report that it was the EC that proposed the conditionalities and not the government.

In the area of PFM the proposed conditions mainly focused on improving the budget process, in particular preparing the ground for the introduction of a Medium Term Expenditure Framework (MTEF), issuance of a Budget Circular for 2008 with a MTEF and formalisation of the approval of budget ceilings by the Cabinet, piloting of the MTEF in a sector ministry and preparation of a shadow budget reflecting the MTEF. These conditions were dropped in the final MoU. Only one condition related to improvement of cash management was maintained in the final set of conditions as proposed by the MoF. Some of the conditions have been implemented by the time of signing the MoU, while the others were replaced with recommendations from the OA which were considered to have higher priority. The Lebanese authorities have informally expressed their concerns on the formulation of one of the conditions in the draft MoU which emanates from the OA, particularly on mapping of all bank accounts hold by public entities. The ground for these concerns was originating from the Lebanese legal framework, i.e. Law on Banking Secrecy, which did not allow the disclosure of this information. Various alternative proposals were considered during the negotiations.

In the *area of privatisation* the conditions proposed by the MoF were related to the telecommunication sector. Specifically they included the set up of the Telecom Regulatory Authority (TRA), complete corporatisation of Liban Telecom and transfer of all regulatory functions to TRA. None of these conditions were included in the final MoU. It has to be noted though that one of the monitorable actions of the IMF programme related to the privatisation of the telecom sector. Therefore, a possible reason for excluding this as a MFA condition could have been to avoid overlap with both the IMF programme and the American budget support. Therefore, duplication appeared not to be necessary for reinforcing the effects of the IMF and American financial assistance.

In the *area of social sector reform* the MoF proposed to formalise and activate the Inter-Ministerial Committee for Social Policy, to adopt new standards and criteria for care Program Service Providers and their contracting, to pilot a new targeting system and revisit the safety net programmes in the Social Action Plan. In the end two of the four proposed conditions by the MoF were incorporated in to the MoU, one of which was rephrased to reflect the progress already achieved.

The evidence collected points to a broad and inclusive process concerning the discussion and consultation on the conditions to be included in the MoU, involving various Directorates within the EC but also actors outside, i.e. Lebanese Government, EIB and to certain extent other development partners.

During the design phase there was little (at least direct or explicit) discussion on the MFA conditions and their coordination with the French and American counterparts. All parties expressed being aware of each other’s conditionalities, but more as result of information sharing rather than as part of a true consultative process. Also the EC Delegation played a minor role in these consultations. They provided advice on selected issues ,but were not part of the direct dialogue between the EC (represented by DG ECFIN) and the Lebanese authorities. As it will be discussed in the next section, this may be one factor that affected the implementation of the MFA to a certain degree.

6.3 Gross impact – actual structural reform outcomes

This section focuses on aspects relevant to the structural reforms in the context of the following evaluation questions:

Q2.1. What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)?
Q2.2. How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country?
Q2.3 To what extent have the short and medium-term expected structural effects of the assistance to Lebanon occurred as envisaged?*

While the short and medium-term expected structural effects are not articulated in the formal documents (Loan/Grant Agreement, MoU), the expected structural effects were subject of discussion in various internal EC documents and consultations as well as during the discussions with other stakeholders. The MFA assistance aimed at supporting the fiscal consolidation effort to reduce public debt to a sustainable level. The conditions therefore put emphasis on measures aiming to contribute to bringing fiscal discipline to a sustainable level while reducing the country's debt burden through improving PFM.

The rationale for PFM conditions in terms of their contribution to fiscal consolidation and sustainability of public debt is apparent. Measures to improve cash management and implementing a Single Treasury Account (STA) would decrease the short-term borrowing needs and consequently borrowing costs of the government. According to the EC, the fiscal accountability law was expected to "*provide a self-reinforcing mechanism of fiscal adjustment and debt reduction that reduced the risk of back-tracking*". Given the nature of the problems and respectively conditions in the power and social sector there are sufficient reasons to justify their relevance to the achievement of the proposed aim. Specifically, by addressing losses of the EdL, which was heavily dependent on public funds, it was expected that it would contribute to fiscal sustainability. Also the conditions in the social sector were expected to "*build public support for reforms by compensating for the inevitable difficulties of fiscal adjustment*".

In terms of relevance of MFA structural conditions, the review of the economic and fiscal situation prior to the MFA operation suggest that the proposed conditions were relevant and in line with the government philosophy on reforms. However, given the fragility of the political situation and the very slow progress of implementing the reforms prior to the MFA operation one might question the extent to which:
- the conditions were not overambitious;
- their timing/sequencing was appropriate; and
- it was realistic to expect progress in the political and structural reforms at the time of establishing the MFA operation.

It is clear that the intention of the EC was to set realistic and achievable conditions. Given the historical development, however, it appears that the conditions were realistic under the leadership of the government in place at that time; however, it is questionable whether they were realistic when taking into account the political economy environment of Lebanon and its reputation for frequently changing governments. Some interviewees suggest, however, that it was impossible to foresee the fragility and the instability of the government. While in Lebanon there remains a general consensus within (various) governments on the need for reforms in the areas of the MFA structural conditions, there was no common agreement across governments on specificities of implementation, a fact that continues to undermine the pace and progress of reforms.

The progress reports on implementation of MFA conditions emphasise that **no progress in the area of the structural conditions have been observed during the implementation of the MFA**. Also the ECPA reviews of the IMF emphasised the limited progress on the programme's structural reform measures (see the Table 6.3).

Table 6.3: Progress in implementing EPCA monitorable actions

IMF EPCA monitorable actions	Deadline	Status of completion
Fiscal		
Submit to parliament a draft 2007 budget consistent with the targeted primary balance, including HRC and CDR foreign-financed expenditure and limit the allowance for carryovers and treasury advances.	End-June 2007	Submitted to Parliament on June 13, 2007.
Appoint auditor for National Social Security Funds (NSSF) accounts and prepare audit plans for 2001-2006	End-June 2007	Auditor appointed on June 12, 2007. Audit plan finalized on August 6.
Issue a Cabinet of Ministers decision for setting a floor on gasoline excise;	End-September 2007	Not implemented.
Submit to parliament the Global Income Tax draft law	End-March 2009	Not met.
Establish a Treasury Single Account.	End-June 2009	Not met.
Banque du Liban		
Establish an investment committee and draft formal guidelines for foreign reserve management.	End-December 2008	Done on January 28, 2009.
Adopt formal policies for the selection, appointment, and rotation of the BdL's external auditors.	End-June 2009	Done on January 28, 2009.
Power sector		
Appoint auditor for EdL accounts. Auditor to prepare an audit plan of EdL for 2002–06. Publish 2001 audit report.	End-June 2007	Done by August 2007.
Revise electricity tariff structure consistent with program objectives.	End-December 2008	Not met.
Privatization		
Submit to parliament the draft law to authorize the sale of the mobile sector's assets and relevant operating licenses by the government.	End-June 2007	Based on legal opinion from the Ministry of Justice, the law is not necessary to proceed with the privatization.
Issue an invitation for expression of interest (EOI) in participating in the process of acquiring the licenses and assets of the two mobile telephone companies (MIC1 and MIC2).	End-December 2007	Applications with pre-auction bids had been requested for February 1, 2008, but the auction has been delayed.
Issue a Request for Application in participating in the process of acquiring the licenses and assets of the two mobile telephone companies (MIC1 and MIC2).	End-March 2009	Not met. Privatization has been postponed due to unfavourable international

IMF EPCA monitorable actions	Deadline	Status of completion
		capital markets.

Source: Authors' summary based on IMF reports.

According to the IMF, the introduction of a Treasury Single Account was postponed because of political tensions, but most important because of the resistance from the telecommunications sector. Measures related to Banque du Liban had been met, i.e. an investment committee was established and audits were carried out. However, as of now the external audit report is not yet made public. Furthermore, there was little progress in the power sector because of the difficult political environment in the run-up to the elections. The government promised citizens to revise the tariffs only after an improvement in the delivery of services will be observed. A comprehensive Action Plan was developed and approved by the Council of Ministers and was expected to be adopted by the Parliament soon. Only in September 2011 the Lebanese parliament approved a funding bill for investments in the sector (amounting to about 3% of GDP). The electricity sector contingency plan involves the construction of additional power plant, resulting in expansion of capacity with 700 MW per day before the end of 2014.

During the implementation of the MFA operation none of the structural conditionalities have been met. The status of completion of MFA conditionalitiesat the time of writing this report is summarised in Table 6.4. Interviews' findings suggest that most of the conditions were relevant to the Lebanese developmental objectives (as reflected in their action plans) and realistic from a technical point of view. However, as reflected above, it is questionable whether the conditions were realistic given the political commitment needed to push forward such reform measures and the unstable political situation and frequently change of governments, which would need to act as the guarantor of such political commitment.

Table 6.4: Structural conditions included in the MoU

Conditions in the MoU for the 2nd tranche	Relevance and status of completion
1. Public Finance Management	
a. Develop an operational mandate of the Cash Management Unit.	Has been accomplished in the last 6 months. The cash management unit was created in 2007 and is now fully fledged. It is a regular department within the Treasury with dedicated staff and reporting responsibilities. The realisation of this conditionality can be mainly attributed to a combination of political, technical and administration factors. Firstly, there was support provided through the World Bank IFMIS project, through international experts working with the MoF. Secondly, the authorities got a better appreciation of the importance of proper cash management for a strong PFM. Nevertheless, the effectiveness of cash management may be questioned given the challenges in cooperation with some line ministries, the challenges in the treasury management and the lack of a proper budget in place.
b. The Ministry of Finance, following a Council of Ministers' decision, will identify all public entities' bank accounts held at Banque du Liban and commercial banks in preparation for the implementation of the Treasury Single Account law.	Even though quite challenging, this exercise is still on-going and actually done by the Cash Management Unit of MoF in cooperation with other entities of the MoF. The Middle East Technical Assistance Centre (METAC) is currently discussing with the authorities several ideas on TSA. With the benefit of the hindsight it would have been easier to redefine this conditionality by splitting it in more realistically sequenced actions.

Conditions in the MoU for the 2nd tranche	Relevance and status of completion
c. Mandate, through a Council of Minister's decree, that opening of any new bank account for public entities falling under the remit of the STA requires approval by the Ministry of Finance.	This measure has been achieved for central government, i.e. for public entities which are on the budget but not yet for other independent government entities.
d. Approve by the Council of Ministers the project of the fiscal accountability law.	Not yet met. A number of interviewees questioned the realistic character of this conditionality. It is also premature to raise this fiscal accountability law when there is no authorised budget in place. It could be questioned though whether at the time of Paris II anybody could have anticipated that there will be no formally approved budget for 5 years.
2. Power Sector	
a. Higher Council for Privatization to complete the valuation and allocation of assets for the Eléctricité du Liban (EdL) in preparation of its incorporation.	Some interviewees consider this conditionality too ambitious and almost impossible to achieve. There was little progress in this sector during the last years. There were a lot of promises done at Paris III but not much realised in practice. It wouldn't be fair to blame the government since probably their intention and commitment was sincere but the implementation of this conditionality and reforms in the power sector were not feasible due to the political instability. Further there was also no (political) consensus in the country on how to advance energy sector reforms. Although in 2010 the Cabinet approved a reform strategy for the electricity sector, only in September 2011 the Lebanese parliament passed a funding bill for investments in the sector (amounting to about 3% of GDP[37]). The electricity sector contingency plan involves expansion of capacity with 700 MW per day before the end of 2014.
3. Social Sector	
a. Social Inter-Ministerial Committee (SIMC) to approve a time based action plan that eliminates duplication of programs between Ministry of Social Affairs, Ministry of Health and Ministry of Education and Higher Education.	Partly met with delay. In 2010 draft National Social Development Strategy for Lebanon was prepared and discussed in workshops. In 2011 the National Social Development Strategy was finalised. The strategy was prepared by various ministries (including a/o Education, Health, Labour, Interior, Justice and Social Affairs) and coordinated by the SIMC. The objectives of the strategy include: (i) achieving better health; (ii) strengthening social protection; (iii) providing quality education; (iv) improving opportunities for equitable and safe employment; and (v) revitalizing communities and developing the social capital. Document does not contain time-based action plan.[38]
b. Strengthen poverty focus of the social safety net programs: Establish targeting mechanism through proxy-means testing for implementing safety net programs.	Partly met with delay. As part of (draft) National Social Development Strategy –see above. Proxy means-testing is not indicated in the strategy, but mentioned are, for instance, "efficiently targeting them at the poor and low-income population". A National Poverty Targeting Programme (NPTP)

[37] See IMF (2012), Country report 12/39.
[38] Ministry of Social Affairs (2011), National Social Development Strategy of Lebanon.

Conditions in the MoU for the 2nd tranche	Relevance and status of completion
	was adopted in October 2011 in the context of the International Day of Poverty. The NPTP aims to establish a national targeting system in order to improve the delivery of social transfers and services to particularly the poor and vulnerable through, for instance, introduction of proxy-means testing. The World Bank supports the Government through the (restructured) Second Emergency Social Protection, involving a grant of US$ 6 million, adding to US$ 28 million of committed Government resources.[39] The main output of the NPTP will be an automated database on the poor and vulnerable that will include over 150,000 households. This will enable a more objective assessment of the households welfare and their ranking. A pilot had been conducted in 2009 covering 25,000 people. A household survey is being implemented together with the Central Administration of Statistics in order to improve the means-testing approach and to set a baseline for measuring the impact of the programme. The database would be completed by the beginning of 2012 and the first package of targeted benefits would be disbursed by mid 2012. The benefits would include: (i) comprehensive health coverage for beneficiaries in public and private hospitals; (ii) coverage of chronic disease prescription medications through the Ministry of Public Health centres; (iii) registration fee waivers and free books for students in primary and secondary public schools; and (iv) discounts on the electricity bills submitted to the Eléctricité du Liban.[40]

Given the relative small amount of the MFA assistance it is questionable whether the MFA and its conditions could be a sufficient trigger for the government to fulfil them and whether the conditions were not too ambitious. Note that the conditions of the French and Americans were linked to relatively higher amounts, the latter being a grant. The corresponding agreements have been even more flexible in terms of fulfilment of conditions and the corresponding disbursements. With the benefit of the hindsight, one could argue that setting more short-term conditions (which would fit under a time-span of a “unstable” government) would be a more effective approach. In a country with such a specific and complex political context and instability it would be difficult to expect long-term strategic commitments.

Further, there is a perception that the MFA operation and corresponding developments would have benefited from having a more pro-active attitude of DG ECFIN to the MFA operation, for instance through more country visits and meetings with government officials. The MFA has been orchestrated by ECFIN and the dialogue was carried out merely between ECFIN and the Lebanese government. The EC Delegation was to a limited extent involved in the MFA operation and could have played a more prominent role in the policy dialogue which was linked to the MFA operation (through representing ECFIN and generally the EC interests). It would allow the EC to better

39 Support to the NPTP is also provided by CIDA and Italy.

40 See World Bank (2011), Restructuring Paper on a Proposed Project Restructuring of Grant (Approved September 5, 2008) to the Republic of Lebanon, 28 September 2011; World Bank (2012), Social Promotion And Protection Project, Project Information Document – Concept Stage, January 2012; and Republic of Lebanon, Ministry of Finance, Aid Coordination Newsletter, November 2011, Issue 248.

understand the political difficulties the country was facing and forming a stronger, consistent and homogeneous front with the other donors.

Given the complex political context and lack of consensus in Lebanon on how to implement reform measures, one interviewee argued that it may be beneficial to first facilitate the dialogue on various options and then to build consensus on potential solutions. For example, in 2008 the EC Delegation made an attempt to promote an inclusive dialogue by bringing together various political parties and experts. The discussions were focused on various reforms in the social sector, power and telecommunication sectors. This initiative was appreciated and welcomed by many stakeholders. It led to some (implicit) consensus building around people with various backgrounds/interests.

6.4 Case study

As discussed in the previous chapter, the MFA conditions cover three areas: PFM, power sector and social sector. These conditions have a potential impact on the achievement of the objectives of the MFA operation, namely alleviation of the financial constraints and debt sustainability.

Given that the conditionality related to the social sector has a weaker link to the direct objectives of the MFA it was not further investigated in more detail. The following case studies were investigated in more detail:

- *PFM:* The Ministry of Finance, following a Council of Ministers' decision, will identify all public entities' bank accounts held at Banque du Liban and commercial banks in preparation for the implementation of the Treasury Single Account law;
- *Power Sector:* Higher Council for Privatization to complete the valuation and allocation of assets for the Eléctricité du Liban (EdL) in preparation of its incorporation.

Table 6.5. below specifies the characteristics of these conditionalities.

Table 6.5: Characteristics of selected conditions

Characteristic	PFM	Power Sector
MFA condition	The Ministry of Finance, following a Council of Ministers' decision, will identify all public entities' bank accounts held at Banque du Liban and commercial banks in preparation for the implementation of the Treasury Single Account law	Higher Council for Privatization to complete the valuation and allocation of assets for the Eléctricité du Liban (EdL) in preparation of its incorporation
Origin and overall rationale	This condition was included as result of the Operational Assessment. There were extensive negotiation about its inclusion and precise formulation. The Lebanese government had reservations on the possibility to implement the condition given the existing legal restriction. In addition, this case study is interesting from the point of view of involvement of multiple stakeholders on which the implementation of the conditionality depends as well as its relevance in terms of sequencing of PFM reforms.	CSP underlines the importance of complementarity with EC assistance for a comprehensive action towards the restructuring of the energy sector. Furthermore, it underscores that the energy sector will be a potential sector for EC interventions as well as the readiness of the EIB to contribute to the rehabilitation of the energy sector. Expected result in this area would be the reorganisation of the electricity sector (including addressing the debts of Eléctricité du Liban). Review of evidence suggests that this conditionality could have had a reinforcing

Characteristic	PFM	Power Sector
		effect for other EC assistance and eventually with the French budgetary assistance. Also the WB provided a Development Policy Loan (DPL) to the power sector conditional on implementation of reforms in the sector, reform of the social protection system and modernisation of the PFM.
Cross-conditions	This is a EC specific conditionality although other donors were having a dialogue in the same area of PFM reform concerning the Single Treasury Account (STA)	WB Policy Development Loan French Assistance
Complementarity with other EC assistance	PFM reforms were part of the CSP. During the MFA operation, however, no specific assistance in the area of PFM was provided.	CSP EIB
Complementarity with assistance from other donors	IMF Middle East Technical Assistance Centre (METAC) WB IFMIS project French assistance	French Assistance

The following sections discuss in more detail on the case studies.

6.4.1 *PFM case study*

One of the conditions in the area of PFM was related to establishment of the Treasury Single Account. The rationale is rooted in various discussions, in which various stakeholders, including the government, raised their concerns. At the request of the Lebanese Government the IMF reviewed the cash management process in Lebanon in March 2007. The review included recommendations and an action plan for improvement of cash management. A key issue was the reconsideration of the implications of the proposed draft Treasury Single Account (TSA) law on cash management. The review suggested that the implementation of the recommendations would require assistance from development partners. This review and action plan informed the government's reforms action in the area of PFM which was prepared in the context of Paris III.

At the same time as part of the preparation of the MFA operation the EC launched an Operation Assessment (OA) of the Public Financial Management system in Lebanon, which is a prerequisite of any MFA assistance. The OA was carried out in October 2007. One of the main recommendations of the OA was to map all public entities' bank accounts held at Banque du Liban and commercial banks in preparation for the implementation of the Single Treasury Account law. This recommendation was considered as a high priority and was included as a conditionality for the disbursement of the second tranche of the MFA.

The Government of Lebanon committed during the Paris III Conference to implement structural reforms in public financial management. One of the intentions was to improve cash-flow forecasting by launching the process to establish the Single Treasury Account, reducing idle balances by streamlining payments and receipts, and improving cash management practices across all government entities. The improvement in the accuracy of intra-year forecasts for cash positions was expected to result in overall fiscal savings and a reduction in debt and debt servicing.

The government has embarked on PFM reforms before and within the context of its Paris III reform programme. With respect to the creation of a Single Treasury Account the Ministry of Finance' vision emphasised the following:

> *"Treasury Single Account (TSA): The Parliament has finalized the review of draft law # 13796 (presented to the Parliament on December 18, 2004) that would restore the Treasury Single Account. According to the Public Accounting Law dated 1963 (article 242), all public funds have to be deposited at the Treasury Single Account (TSA) at the Banque du Liban (BDL). During the years of war, and specifically in 1987, Law Number 78/49 (Article 3) modified the above by allowing public agencies with an annex budget, public institutions, and municipalities to open special accounts at the BDL. The new draft law # 13796 proposes to amend Article 3 of the existing 1987 Law through the re-creation of a Treasury Single Account. The only exception is made for municipalities. Public institutions and public agencies that have previously opened special accounts at the BDL are to be given a period of six months to close these accounts and transfer the residuals to the TSA."*
> *Source: Ministry of Finance, Reforms at the Ministry of Finance, A clear vision leading the way, 2005-2008 and beyond.*

A key measure of the reform plan was to prepare the introduction of a Treasury Single Account (TSA) through working on the necessary legislation and decrees required for managing the TSA by the end of December 2008. The OA indicated that no specific implementation plan was developed and formalised to define schedule, responsibilities, deadline, phases and supervisory authority for setting up the TSA.

Other developments partners included in their programmes also conditions related to the creation of the TSA. The establishment of the Single Treasury Account was one of the measurable actions of the EPCA programme. The IMF condition was more ambitious than the MFA conditionality. The MFA conditionality could be considered as a bridge which was meant to prepare the implementation of a TSA through identification of all public entities' bank accounts held at Banque du Liban and commercial banks.

Given the findings and recommendations of various assessments prior to Paris III as well as taking into consideration the vision and actions included in the Government's PFM reform plan we conclude that the MFA conditionality related to the preparation for creation of a TSA was adequate and relevant from a technical point of view. When considering the progress in that respect since then little has been achieved so far. A major explaining factor for the delay in the creation of a TSA is the country's political economy context. Therefore, with the benefit of hindsight the question is to what extent the political economy context has received due attention when designing the MFA and more particularly defining the structural reform conditions. Some interviewees argue that the time period between approval of EPCA and MFA the political context changed significantly and the actions which seemed feasible at the time of designing the programmes, were unfortunately unfeasible during the implementation of the programmes. With the benefit of hindsight the implementation of the MFA might have been easier in terms of its implementation if the conditionality was formulated by splitting it in a number of sequenced short-term measures which accomplishment would prepare the ground for the creation of a TSA.

Various stakeholders declare that even though the Paris III reforms were endorsed by the government and there was overall commitment to PFM reforms, there was little progress made due to the difficult political environment. The Treasury Single Account is one of the areas where little success has been achieved due to conflicting interests and respective resistance of some key players.

The Wold Bank provided a grant from the Trust Fund for Lebanon (TFL) for the Emergency Fiscal Management Reform Implementation Support Project (EFMIS). The project supports the implementation of the reforms in the public expenditure and debt management system. One of the five components of the project includes assistance to improve the management of public expenditure. As part of this project international and local advisory services as well as training and capacity building is directed to the envisaged reform measures. The Middle East Technical Assistance Centre (METAC) has also provided technical assistance in the area of budget reform, cash management and treasury single account (TSA).

From the evidence collected, some progress in the last year has been achieved, supported by the above mentioned assistance. Some progress has been achieved in terms of operationalisation of the Cash Management Unit (CMU). As part of their activity the CMU started an inventory of the existing bank accounts. The telecommunication sector is seen as an obstacle in the creation of a TSA. Among other issues, there is an on-going discussion on whether the telecommunication sector should be included under the TSA arrangement or not. IMF and METAC have been discussing with the authorities several ideas on the future of the TSA. In its latest report, reporting on the situation in November 2011, the IMF indicates that implementation of the TSA has been stalled.[41] Nonetheless, recently some progress has been made to strengthen cash management. At the beginning of February 2012, the Ministry of Finance, notified spending agencies of new procedures to register cash grants in the General Budget, including the obligation to channel cash grants into the treasury accounts. The recent change is another step forward in consolidating public accounts and eventually in establishing the TSA.

6.4.2 Power sector case study

Implementation of the condition related to the power sector has also posed enormous challenges. The sector generated enormous losses, affecting fiscal sustainability as significant government transfers were provided to EdL. Especially with the recent hike in fuel oil and gasoil prices, transfers to EDL between January and November 2011 soared to LL1.598 trillion.[42] For whole 2911 transfers to EDL amounted to LL1.797 trillion.[43] As mentioned earlier, the supply of electricity was problematic. The condition asked for the Higher Council for Privatization to complete the valuation and allocation of assets for the state-owned monopoly Eléctricité du Liban (EdL) in preparation of its incorporation. Corporatisation was seen as necessary to ensure longer term improvement in EdL's financial performance and management efficiency.

The EPCA condition to revise the electricity tariff structure was not met. According to the IMF report the pressure to adjust electricity tariffs was reduced due to lower oil prices resulting in the non-observance of the IMF monitorable action.[44] In its progress report on the implementation of MFA of March 2010 the Government indicated that a reputed accounting firm was selected to conduct the valuation of the assets, but further approval was awaited.[45]

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41 IMF (2012), Country report 39/12, p.5.

42 Albawaba Business, Lebanon: Energy Ministry to issue tenders for $1.2 billion electricity projects, 12 March 2012, available on www.albawaba.com.

4343 EECOY, Economy and Ecology Online 3 April 2012, available on www.eecoy.com.

44 IMF (2009), Country Report 9/131.

45 Document "Summary of Achievements on Conditionality EC Macro Financial Assistance, March 2010, included in EC files.

In the EU's 2007-2013 Country Strategy Paper for Lebanon it was stated that a long-term energy strategy was under development aimed to restructure the sector. Plans would include the creation of an energy authority NERA, introduction of natural gas in the economy and the privatisation of the electricity provider, EdL. The National indicative Programme 2007-2010 prioritised the restructuring and progressive opening up of the sector, as well as supporting the creation of a regulatory authority. It mentioned the support of the EIB to contribute to the rehabilitation of the energy sector. In the National indicative Programme 2011-2013 specific reference to the sector was not made anymore, except referring to the general state of infrastructure bottlenecks in a number of sectors in the country and the possibility to provide support in one of these sectors.

Corporatisation of EdL was included as one of the actions of the World Bank support to the energy sector. The WB prepared a detailed Electricity Sector Public Expenditure Review in 2008.[46] The World Bank's Development Policy Loan of US$ 100 million focused on the power, telecommunications and social sectors. Actions in the sector policy matrix included (i) EDL corporatization including decrees issued; and (ii) asset registration and valuation completed. As such, the MFA condition would reinforce the World Bank assistance. In the end the performance indicator concerning the plan for EdL's incorporation and restructuring was not achieved as agreement between different energy stakeholders on corporatization and restructuring of EdL was lacking. In its completion report the World Bank stated that "*the consensus that seemed to exist before the Paris III program, especially on electricity sector reform, did not last. That had major negative impact on advancing sector reform*." Although, a draft corporatization plan was developed, it was not implemented, due to lack of consensus among different stakeholders on the final model and objectives of EdL corporatization. From its side, the World Bank admitted that its programme and the related actions generally were too ambitious.[47] Not only in the MFA period, but already much earlier, there has been for many years no (political) consensus in the country on how to advance energy sector reforms.

Box 6.2: Recent history of reform of the electricity sector[48]

The restructuring of the electricity sector has been on the Lebanese government's agenda since 1998 when a first draft of a new Electricity Decree was proposed. The Cabinet of Ministers approved the draft Electricity Decree in 2000. Two years later the Parliament approved the Decree, which included main elements of electricity sector reform, including restructuring of EDL, corporatization, unbundling of its activities, partial privatization, and creation of a regulatory authority. The agreement, on the principles of EDL privatization and unbundling was not strong enough to guarantee implementation. Agreement on the measures to achieve EDL's restructuring has proved to be challenging in the Lebanese context.

In the framework of the Paris III conference, the government re-affirmed its commitment to reform of the sector according to the principles outlined in the 2002 Electricity Sector Law. The government committed to the creation of a regulatory authority, the unbundling of EDL and the incorporation of new entities under commercial law. Also the need for new investment was recognized. The ambitious agenda agreed upon in Paris III did not proceed as planned. The difficult political context in 2007-2008 contributed to the lack of implementation. In 2010 a Policy Paper for the Electricity Sector in 2010 was prepared and adopted by the

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[46] World Bank, Republic of Lebanon: Electricity Sector Public Expenditure Review, Report No. 41421-LB, January 31, 2008.

[47] In its completion report, the World Bank indicated that "while implementable in other political economies, in the case of Lebanon these actions proven to be very ambitious. The Bank underestimated the potentially negative impact of the fragile political environment on implementation of the reforms included in the RIDPL. The Bank decided to take a calculated risk and proceed with the RIDPL, believing that there was a window of opportunity which, in the end, did not materialize" (pp. 15-16).
It also indicated as lesson that "the window of opportunity turned out to be quite small, and it would have been better to set more modest targets that could have been achieved in a relatively short span of time" (p. 17).

[48] Based on a detailed analysis of the political economy and history of the power sector: Katarina Uherova Hasbani (2011), Electricity Sector Reform in Lebanon: Political Consensus in Waiting, December 2011.

Box 6.2: Recent history of reform of the electricity sector[48]

Council of Ministers, but the financing required for implementation was delayed. As of July 2011, the new government has taken the reform of the sector forward.

The development of a road map for corporatization of EdL has continued to receive attention. The Policy Paper for the Electricity Sector of 2010 has included corporatization of EdL as one of the main proposed measures. The development of a roadmap would still include, among others, asset registration and valuation. The present status is that World Bank assistance is being provided to recruit a consultant to develop a roadmap for Corporatization of EdL that would result in an approved roadmap by the end of 2012. [49]

In 2010 the Cabinet approved a reform strategy for the electricity sector. Only in September 2011 the Lebanese parliament passed a funding bill for investments in the sector (amounting to about 3% of GDP or US$1.18 billion). Half of the resources would come from the government and the remainder from Arab countries. The financing would be spread over four years. The contingency plan represents one phase of a larger $ 4.87 billion comprehensive reform plan prepared by the Ministry of Energy. The plan would require funding in the amount of around US$5 billion. The government would cover about US$1.55 billion; the private sector about US$2.32 billion; and the international donor community about US$1 billion.[50]

6.5 Conclusions

The selection and formulation of structural conditions played a prominent role in the design of the MFA operation. The decision making was informed in particular by the government reform philosophy, the challenges identified in a number of reviews which were carried out prior to MFA, as well as, consultations with various stakeholders.

A number of elements has characterised this process:

- the MFA conditions were consistent with the areas of conditions in the programmes of other development partners;
- the selection and definition of structural conditions was mainly orchestrated by the EC headquarters, but also other EC entities were consulted during the process;
- other development partners were consulted, although the consultation had more an informative character rather than served as basis for real consultations.

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There are various opinions on the origins of the structural conditionalities. The files point out that the government made a preliminary proposal for structural conditionalities. During the interviews, however, various stakeholders representing both EC and the Lebanese side suggested that the conditions were merely the initiative of the EC. In any way, the process was inclusive and all stakeholders were involved.

During the duration of the operation **no direct impact has been observed due to the lack of progress in the areas related to MFA structural conditions. The two case studies**

49 See World Bank, Restructuring Paper On A Proposed Project Restructuring Of LB-Emergency Power Sector Reform Capacity Reinforcement Project Grant No. Tf058084-Le, Board Approval Date: March 19, 2007 To The Lebanese Republic, 29 December 2010; And Implementation Status & Results Lebanon LB-Emergency Power Sector Reform Capacity Reinforcement (P104774), December 2011.

50 The Daily Star, Blominvest: Lebanon power sector in urgent need for reform, 15 August 2011.

demonstrate that actions which seem to be realistic in other countries, proved to be very ambitious given the specific context in Lebanon.

7 Net impact of MFA and unexpected effects

7.1 Evaluation questions

The counterfactual is determined by answering the following questions:

- *What arrangement would have been implemented if the MFA had not been granted?*
- *What are the structural and macroeconomic effects of the most likely implementation scenario(s)?*

This would allow analysing the net macroeconomic and structural impact of MFA respectively, through the evaluation sub-questions:

Q1.3 What has been the contribution of the grants and/or loans provided by the operation to the achievement of objectives?

Q2.4. What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?

7.2 Approach to the counterfactual

Answering the question on the most likely counterfactual scenarios required educated guesses on the side of the evaluation team. Our approach is based on consultations with stakeholders in Lebanon, European Commission, IMF, World Bank and other institutions as well as on the analysis of existing data, documents and reports. It is reiterated that only one grant and one loan tranche was disbursed. In money terms the MFA assistance was not large, i.e. not large enough to expect some quantifiable effects. Therefore, we have also undertaken a comparative historical analysis related to the situation in Lebanon, as well as to other countries. This analysis contributed to construction of a realistic counterfactual scenario. In summary, the counterfactual analysis is supported by a modelling approach, combined with a more qualitative approach focussing on the possible risks of not having the MFA assistance on certain economic and financial indicators based upon empirical comparative historical analysis.

7.3 Macroeconomic counterfactual

This section constructs and analyses the macroeconomic aspects of the main counterfactual scenarios analysed.

The following factors emerge as particularly important in determining the counterfactual:
- The MFA operation was designed and implemented as part of the large multi-donor effort to support the bold government policy plan, going beyond simple reconstruction after the Israel-Hezbollah conflict of summer 2006.
- The MFA operation was small relative to the total support pledged at the Paris III conference. It amounted to some 6% of total (loans and grants combined) budget support pledged as

estimated in September 2007[51]. When budget support and project financing pledges are considered together the MFA share declines to 2% of this total.

- The MFA assistance was an element of the broader EU support that also included project financing grant pledges of up to € 187 million in the framework of EC cooperation with Lebanon for the period 2007-2010 and EIB loans in excess of € 2,000 million for waste water and power sector projects.
- Partial disbursement of the MFA resources (half of the planned grant and loan components) is not atypical among other Paris III pledges.
- A delay in MFA disbursement relative to original plans / expectations also was not atypical.
- During 2007-2009 the actual EIB lending to projects in Lebanon exceeded the original pledges with signed projects valued at € 422 million. The bulk of these went into private sector facilities, SME reconstruction and water treatment projects[52].
- The size of the IMF balance of payment support (EPCA) pledge was yet smaller than the MFA. However, the disbursement of the full amount of the IMF loan took place already in April 2007.
- The IMF programme was perceived (at least by some stakeholders) as providing the overall macroeconomic framework to the government's reform programme and donor assistance agreed on during the Paris III conference.
- Market perception of implicit donor guarantees to Lebanon is a very important factor supporting debt sustainability of Lebanon.

Based on the assumptions on potential interactions between various donor support instruments and in order to gain the range of estimates for plausible counterfactuals we consider the following three main counterfactual scenarios (and two versions of the third scenario) in terms of donors' actions.

Counterfactual scenario A

The MFA operation is not proposed at the Paris III conference and does not take place in subsequent period. Actions by all other donors are unaffected.

Counterfactual scenario B

The MFA operation is not proposed at the Paris III conference and does not take place in subsequent period. EIB project financing is reduced relative to the actual path. Specifically, we assume that the EIB credit lines to top-tier Lebanese intermediary banks to finance investment projects carried out by private sector companies, especially SME's is cut by € 100 million in 2008 and by € 50 million in 2009. Actions by all other donors are unaffected.

Counterfactual scenario C

The MFA operation is not proposed at the Paris III conference and does not take place in subsequent period. EIB project financing is reduced relative to the actual path. Specifically, we assume that the EIB credit lines to top-tier Lebanese intermediary banks to finance investment projects carried out by private sector companies, especially SMEs is cut by € 100 million in 2008 and by € 50 million in 2009. Furthermore, the IMF does not provide its 2007 Emergency Post-Conflict Assistance (EPCA) programme. As a consequence also the 2008 EPCA II support from the IMF does not materialise. Actions by all other donors are unaffected, including France and the United States.

A key question pertaining to the above counterfactual scenarios is on the extent to which their realisation would have affected market confidence and in particular the sentiment of investors and

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[51] Republic Of Lebanon, Ministry Of Finance, International Conference for Support to Lebanon - Paris III, Third Progress Report, 28 September 2007.

[52] Based on data provided by the EIB on its website.

depositors. Based on the available information and collected opinions on the market perceptions of the three analysed operations (MFA, EIB lending and the IMF programme) we believe it is plausible to assume that in scenarios A and B investors' and depositors' attitude would *not* be affected. The rationale for this stems from the observation that the EC was offering other support instruments (larger in size) at the Paris III conference and hence even the absence of the MFA would not be interpreted as lack of the strong EU/EC support for the Lebanon's economic programme. In turn, EIB lending operations mainly materialised in sectors different from the ones originally discussed in Paris, the total volume of EIB lending was substantially higher than pledged in Paris and the specific loan agreements considered affected the credit market, particularly for the Lebanese SMEs, but were not major news changing the perceptions of the Lebanon's overall financial situation.

In turn, lack of the IMF programme (counterfactual scenario C) would not only exclude the possibility for the EC to provide the macro financial assistance to Lebanon but could also be interpreted as lack of support for the ambitious economic programme of the Lebanon's government from one of the key global players. The IMF support, while limited in size, was considered as a 'catalytic part of the overall financial assistance package of Paris III'[53]. Hence, lack of the IMF programme could negatively weigh on assessments of prospects of the Lebanese economy by financial markets. Investors and depositors could then alter their behaviour. We assess that such a drop of confidence is the most likely outcome in a counterfactual scenario without IMF assistance. However, for completeness we consider two versions of the counterfactual scenario C (C1 and C2).

Under counterfactual scenario C1 there is no impact on the behaviour of investors and depositors in Lebanese banks. Thus, we only consider the effects of the lack of an IMF loan on the balance of payments, international reserves and other macroeconomic indicators. This sub-scenario should be seen as a sub-scenario which will provide the lower bound of MFA effects within the counterfactual scenario C.

In contrast, the counterfactual sub-scenario C2 can be viewed as a particularly 'black' scenario, i.e. the one when not only the a combination of several donor assistance packages does not materialise but also when this leads to particularly negative market outcomes affecting the real economy.

In all scenarios (A, B, C1, C2) we have assumed that other aid providers, either international institutions or bilateral donors, would not change their assistance due to their own rationale for supporting Lebanon, be it from economic, political, security or historical perspectives. In particular France would continue playing an important role during the Paris III conference.

7.4 Effects of the macroeconomic counterfactual scenarios

Below, the macroeconomic consequences of the three scenarios are determined based on a combination of the quantitative and qualitative approaches.

The behaviour of macroeconomic variables in counterfactual scenarios A and B and C1 is determined by relying on the applied macroeconomic model similar to the one employed in previous MFA evaluations (evaluation of MFA in Moldova, the Former Yugoslav Republic of Macedonia, Romania, and Tajikistan, Serbia and Montenegro and Albania), though adapted to the specifics of

[53] Lebanon: Use of Fund Resources - Request for Emergency Post-Conflict Assistance - Staff Report; and Press Release on the Executive Board Discussion, IMF Country Report no. 07/177.

Lebanon's economy. Annex A provides details on the model. Given the particularly low quality of Lebanon's economic data, the small size of the MFA operation relative to other external financial flows and the somewhat speculative character of necessary assumptions on the macroeconomic effects of the EIB loan to commercial banks (the pass through to private sector investment activity in Lebanon, particularly by SMEs) the results of this quantitative exercise should be interpreted with caution.

We do not relay on simulations using the macroeconomic consistency framework for the analysis of the macroeconomic developments under the counterfactual scenario C2, where the most significant effects materialise due to negative changes in investors' and depositors' sentiment. Based on our experience and opinions of consulted experts (e.g. from the IMF) quantification of such effects could be close to impossible or rather any such attempt would be subject to extremely wide uncertainty margin. Instead, the analysis of our counterfactual scenario C2 primarily relies on two sources: the literature on the effects of 'sudden stops' (i.e. rapid negative changes in trends in international capital flows) and the analysis of historical economic data for Lebanon during two recent episodes that share some common features with counterfactual scenario C2.

The main results of the counterfactual scenarios are as follows:

- Macroeconomic developments under **counterfactual scenario A** exhibit negligible deviations from the actual historical path. This is due to the relatively small size of the MFA assistance and lack of any stronger reinforcing mechanisms. In view of this we have aimed at estimating the maximum size of potential effects, and set up the model parameters accordingly. Without MFA assistance, government expenditures are scaled down, primarily with regard to public investment expenditure. There is no effect on the government balance and government debt as all the adjustment is assumed to happen on the expenditure side. In the balance of payment the adjustment appears partly in the international reserves and partly through current account (marginally lower imports and exports).

- In **counterfactual scenario B**, the mechanisms described above are still at play, but at the aggregate level they are dominated by a drag on private investment activity caused by scarcity of resources at major Lebanese intermediary banks. Specifically, we assume that the commercial banks would limit their credit to the private sector by the full amount of the EIB loan. We do not have information on the actual pace with which the EIB loans were transmitted into financing investment projects by banks. Therefore, the assumption has been made that the whole amount of the loans was used for private sector credit by the end of 2011, i.e. there is was gradual intermediation process during 2008-2011. This implies that in the assumed counterfactual scenario, private sector credit decreases throughout 2008-2011. Lower investments would reduce import demand and lead to a somewhat lower current account deficit. The overall level of economic activity is lower (mainly driven by weaker private investment and a smaller public investment decline during 2008-2009). The adjustment in public finances occurs on the expenditure side, and hence effects on public debt are minimal. The somewhat weaker GDP leads to minimally higher public debt to GDP ratio.

- In **counterfactual scenario C1** the mechanisms relevant for counterfactual scenario B are still at play and indeed they remain the key driving forces for macroeconomic outcomes. Without IMF loans the international reserves of Banque du Liban would decline slightly. The willingness of the central bank to finance fiscal deficit declines and fiscal adjustment is assumed to happen on the expenditure side. In the balance of payments, adjustment appears mostly in the international reserves and partly through the current account (marginally lower imports and exports).

- The key problem with deriving the probable path of key macroeconomic variables of interest under **counterfactual sub-scenario C2** rests with the fact that there is hardly any guidance for making plausible assumptions on the strength and consequences of negative confidence effects.

  The prominent paper by Eichengreen et al (2008) documents the potential role of IMF programmes in limiting the risk of sharp reductions in capital flows ('sudden stops')[54]. It finds evidence suggesting that the presence of IMF programmes reduces the likelihood of sudden stops and in this sense can be seen as providing justification for the construction of sub-scenario C2 (see Annex I for a detailed description). However, the events classified as sudden stops are defined using time series properties of financial account data. This does not provide guidance as to the magnitude of capital and financial account effects potentially materialising in Lebanon.

  Eichengreen et al (2008) is nevertheless useful in that for a given definition of a sudden stop it provides an indicative range of effects observed in countries undergoing sudden stop episodes. In the year of a sudden stop occurrence total net financial inflows on average turn to a negative of 4.6% of GDP, compared to a positive 4.2% of GDP observed in the three years prior to the event occurrence. The bulk of this change occurs for the category 'net other capital flows' with portfolio investment less affected and having only minor effects on foreign direct investment (FDI). Corresponding current account adjustment (reduction of a deficit) amounts to around 4% of GDP, and economic growth rate declines by some 3 percentage points in the first year to recover to pre-event level soon thereafter. This mainly owes to the fall of fixed capital formation to the tune of around 3% of GDP.

  In Lebanon, the fall in market confidence would likely materialise primarily in the form of lower non-resident and resident bank deposit inflows. The two relatively recent episodes that could provide some indication of the possible scope and duration of this decline are the February 2005 assassination of the former prime minister Hariri and the outbreak of the Israel-Hezbollah war in mid-2006. Then, the cumulative drop of deposits amounted to around US$ 2 billion and US$ 3 billion, respectively. The return to pre-crisis levels took around half a year in both cases. These two years witnessed a significant slowdown of growth relative to the 2002-2004 trend, some reduction of the current account deficit, and a significant increase of public debt. However, it is impossible to attribute a share of these effects to the negative confidence shock itself. Especially the 2006 war also had a profound direct impact on economic activity.

  The above examples from international and Lebanon's own recent economic history could serve as an approximation of an upper bound of negative effects materialising in the counterfactual scenario C. We consider that under particularly unfavourable circumstances its realisation could cost Lebanon another half a year of lacklustre growth with a cumulative GDP effect of up to around 3%, and a further build-up of public debt by some 5% of GDP. We stress once again that such magnitudes should be seen as an assumed *upper bound* of potential effects and in any case their establishing is subject to very large uncertainty margin.

The table below summarises the effects of the counterfactual scenarios distinguished.

Table 7.1: Macroeconomic developments without the MFA operation (changes relative to actual path), by counterfactual scenario

[54] See B. Eichengreen, P. Gupta and A. Mody, (2008). "Sudden Stops and IMF-Supported Programs," NBER Chapters, in: Financial Markets Volatility and Performance in Emerging Markets, pages 219-266 National Bureau of Economic Research, Inc.

	Counterfactual scenario A	Counterfactual scenario B	Counterfactual scenario C	
			Sub-scenario C1	Sub-scenario C2
Brief description of the counterfactual scenario	No MFA. Other donor support unaffected.	No MFA and no EIB loans (in the amount of EUR 150 million) for private sector development.	No MFA, no EIB loans and no IMF programme (2007 and 2008 EPCA). No confidence effects.	No MFA, no EIB loans and no IMF programme (2007 and 2008 EPCA). Fall in investors and depositors confidence.
Key driver of counterfactual developments	Negative one-off fiscal shock.	A drag on access to capital and private investment activity.	A drag on access to capital and private investment activity.	Fall in private sector capital inflows and deposits.
Economic growth	Almost unchanged. Decline of up to a cumulative 0.1% of GDP, mostly materialising during 2008-2009.	Decline by around cumulative 0.2-0.3% over the 2008-2011 period. Up to around cumulative 0.5%.	Decline by around cumulative 0.3-0.4% over the 2007-2011 period. Up to around cumulative 0.6%.	Upper bound of negative effects assessed as cumulative 3% of GDP materialising during 2007.
Inflation	Almost unchanged.	Almost unchanged.	Almost unchanged.	-*
Investment	Almost unchanged. Investment/GDP ratio decreasing by up to 0.05 percentage points during 2008-2009.	Decreasing investment GDP share by around 0.2-0.3 percentage points on average during 2008-2011.	Decreasing investment GDP share minimally in 2007 and by around 0.2-0.3 percentage points on average during 2008-2011.	Qualitative estimate of an upper bound of negative effects of some 2% of GDP materialising during 2007.
Current account	Almost unchanged.	Marginally lower current account deficit – around 0.1% of GDP during 2009-2010 and 0.2% of GDP in 2011.	Marginally lower current account deficit – around 0.1% of GDP during 2008-2010 and 0.2% of GDP in 2011.	Lower current account deficit in 2007.*
Public debt	Almost unchanged.	Minimal increase of public debt/GDP ratio.	Minimal increase of public debt/GDP ratio.	An upward permanent shift in the public debt / GDP ratio by up to 5 percentage points.*

* Eichengreen et al. does not provide quantitative point-estimates, but provide a qualitative assessment.

7.5 Net impact on macroeconomic stabilisation

Comparing the actual developments with counterfactual results presented above allows indicative estimation of the net macroeconomic impact of the MFA operation to Lebanon.

The section above has described in quantitative and qualitative manner the key differences between macroeconomic performance in the three analysed counterfactual scenarios. Table 7.2 below presents the estimated net effects of the MFA against each of the three counterfactual scenarios based on the macroeconomic consistency framework and the comparative analysis introduced above (see Annex I for details). The results are reported as ranges or upper bounds rather than specific point estimates reflecting inherent uncertainty in macroeconomic modelling and applied sensitivity analysis (modifications of key parameters of the model).

Table 7.2: Indicative estimates of net effect of the MFA operation, by counterfactual scenario

	Net effect of MFA in case of counterfactual scenario A	Net effect of MFA in case of counterfactual scenario B	Net effect of MFA in case of counterfactual C	
			Counterfactual sub-scenario C1	Counterfactual sub-scenario C2
Brief description of counterfactual scenario	No MFA. Other donor support unaffected.	No MFA and no EIB loans (EUR 150 million) for private sector development.	No MFA, no EIB loans and no IMF programme (2007 and 2008 EPCA). No confidence effects.	No MFA, no EIB loans and no IMF programme (2007 and 2008 EPCA). Fall in investors and depositors confidence.
Principal mechanism of MFA effects	Positive one-off fiscal shock.	Preventing a drag on access to capital and private investment activity.	Preventing a drag on access to capital and private investment activity.	Supporting private sector inflows and deposits.
Economic growth	Around zero. Up to a cumulative 0.1% of GDP, mostly materialising during 2008-2009.	Around cumulative 0.2-0.3% over the 2008-2011 period. Up to around cumulative 0.5%.	Around cumulative 0.3-0.4 %over the 2007-2011 period. Up to around cumulative 0.6%.	Upper bound of positive effects assessed as cumulative 3% of GDP materialising during 2007.
Inflation	Around zero.	Around zero.	Around zero.	-*
Investment	Around zero. Investment/GDP ratio increasing by up to 0.05 percentage points during 2008-2009.	Increasing investment/GDP share by around 0.2-0.3 percentage points on average during 2008-2011.	Increasing investment/GDP share minimally in 2007 and by around 0.2-0.3 percentage points on average during 2008-2011.	Estimate of an upper bound of positive effects of some 2% of GDP materialising during 2007.*
Current account	Around zero.	Marginally higher current account deficit – around 0.1% of GDP during 2009-2010 and 0.2% of GDP in 2011.	Marginally higher current account deficit – around 0.1% of GDP during 2008-2010 and 0.2% of GDP in 2011.	Assessment of a higher current account deficit in 2007.*
Public debt	Around zero.	Minimal reduction of public debt/GDP ratio.	Minimal reduction of public debt GDP ratio.	Assessment of a downward permanent shift in the public debt/GDP ratio by up to 5 percentage points.

* As mentioned, Eichengreen et al. does not provide qualitative point-estimates, but provide a qualitative assessment.

As Table 7.2 makes clear the range of estimated effects is quite wide, indicating substantial uncertainty on the shape of the counterfactual scenario. It can be concluded that taking the counterfactual scenarios A and B and C1 as a basis (i.e. where only the MFA and MFA and some part of EIB borrowing does not materialise) the net macroeconomic effects of the operation is relatively small. This should not be surprising given the size of the operation relative to the Lebanon's economy and other financial flows to the country, including other donor assistance. At the same time, more substantial effects materialising relative to counterfactual scenario C2 (where neither MFA nor the IMF programme are agreed) highlights the key role played by the MFA instrument when it was granted to Lebanon, namely in enhancing confidence in the stability of Lebanon's economic and financial situation.

7.6 Counterfactual for structural reforms

In this section we consider the possible scenarios for the dynamics of structural reforms in case the MFA to Lebanon would have not been provided. The analysis is structured around the two mentioned generic evaluation aspects with particular emphasis on structural conditions.

0.1. What arrangement would have been implemented if the MFA had not been granted?
0.2. What are the structural and macroeconomic effects of the most likely implementation scenario(s)?

As mentioned two separate counterfactuals have been constructed and analysed:
- one referring to the lack of the total assistance package (EU and IMF assistance);
- the other one where the IMF package is in place but it is not accompanied by the MFA assistance.

It is worth reiterating that a key problem in devising MFA counterfactuals is the overlapping of the MFA conditions with the structural reform conditions in the framework of the IMF EPCA programme. Also the triggers/conditions of policy loan(s) and budgetary assistance of other IFI's and/or donors have to be considered. Of particular importance it will be crucial to consider the Development Policy Loan to the power sector of the World Bank as well as the budgetary assistance by the French and US governments. The importance of cross-conditions required interviews with relevant stakeholders to acquire a deeper understanding, not only of net outcomes, but in terms of the process as well.

Starting with one distinctive counterfactual scenario, the likely structural developments will be constructed on the basis of *'what if'* questions during the interviews with officials and in the later stage of the evaluation also the questionnaire. In order to verify the possible effects of this counterfactual scenario, the constructed effects are as much as possible discussed with academics, independent economists and verified with EC, IMF and WB officials as well as other relevant donors.

The analysis and review of the operation suggest that no or limited (gross) impact on structural reforms have been achieved as result of the MFA assistance. Further, given the relative small size of the MFA and the minor impact of most of the conditions of the IMF programme on the progress in structural reforms, it is expected that the scenario case where no MFA would have been provided the status quo would have been maintained but not deteriorated.

As such MFA didn't play a significant role (at least in quantitative terms) and presumably without it the situation would not evolve differently since in principle all structural conditionalities under MFA were part of the government reform plan. As mentioned in other parts of the report, the government at the time of operation was committed to reforms but commitment alone is not sufficient for achieving real progress. However, in the perspective of MFA as a part of the overall package of the overall pledges and commitments (which one can see as a risk buffer) from the international community one could say that MFA was an element of the overall confidence provided by the Paris III pledges.

In case when no IMF assistance and no MFA would have been provided the net impact might show a different picture since the lack of an IMF programme could have changed the dynamics of other financial assistance to the country and its credibility for lenders, as has been discussed under the macroeconomic counterfactual analysis.

7.7 Net impact on structural reforms

The following generic questions guided our analysis of the net impact of structural reforms:

Q2.4. What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
Q3.1 What, if any, has been the contribution of the political signalling, i.e. confidence boosting effects, of the assistance?

Question 3.1 is addressed as part of question 2.4.

This evaluation of net impact has been be made through a triangulation of sources using documentary evidence from the document analysis and results from the interviews with key stakeholders. The analysis focuses on possible MFA 'reinforcing effects' on structural reforms at two levels of analysis:

- *political reinforcing effect:* all relevant actors were familiar with the MFA conditions and perceived them as an incentive to continue their reform efforts (an overall increase of chances of happening);
- *operational reinforcing effect:* the reinforcing effect led to a verifiable speeding up of reform implementation or improved the quality of the reforms (the lack of pre-emptive effects of other instruments).

Based on interviews and available information and on the fact that little or no progress in structural reforms was achieved it is expected that little or no operational reinforcing effect could exist. The MFA assistance and the other assistance pledged and consequently committed as result of the Paris III Conference in 2007 was mainly of a political nature, namely to support the undertaking of the legitimate government.

One of the main achievements is reflected by political reinforcing affects. These political reinforcing effects relate mainly to the political signals given by the EC to Lebanese authorities, development partners and other stakeholders. The MFA operation brought the relationship between the EC and Lebanon to a different level (see also section below). During the duration of the operation, however, no direct impact has been observed due to the lack of progress in the areas related to MFA structural conditions.

With the benefit of hindsight and given the progress of structural reforms in the country and the factors explaining it, one could question whether the political economy context should have been paid more due attention.

7.8 Impact of complementarity with other EU instruments

The discussion in this section is built around the following generic evaluation question:

Q2.5. To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?

As presented in Chapter 3, the EC assistance to Lebanon was and is provided through various financial instruments including instruments which are part of the normal programming cycle as well as exceptional/ad-hoc assistance. Being exceptional in its nature, the MFA is not part of the regular financial support framework for structural changes or more generally the economic and social development of the beneficiary countries. Other financial and thematic instruments which were employed by the EC to address in particular structural reforms included the following[55]:

- ENP EU-Lebanon Action Plan which guides the CSP (2007-2013) and NIP (2007-2010) in the framework of the European Neighbourhood Partnership Instrument;
- Thematic Regional (ENPI) programmes;
- Neighbourhood Investment Facility (NIF) which promotes investments by European financial institutions, in particular in the transport, energy, and environment areas.

Furthermore, the EC has a special instrument for assistance which was employed in Lebanon. The EC considered providing subsidies to EIB loans in form of grants.

Most of the EC assistance was channelled through the CSP/NIP. As indicated in section 3.3.4 one of the priority areas of the CSP 2007-2013 is the support to social and economic reform (accounting for about 46% of the total NIP allocation). Aspects which are linked to the structural conditions of the MFA are reform of the energy sector, improving social safety nets, trade facilitation and customs reforms, fiscal management and public finance reform.

It is noted that an internal note in the EC files for the preparation of the International Conference in Paris emphasized that the 2007 programme would be processed through EC fast-track procedures being launched before the Paris Conference. This procedure appears not to be used and therefore has not influenced design or operation of the MFA assistance.

The NIP 2007-2010 included ENPI funds supplemented by a joint operation with the EIB to provide access to credit for SMEs affected by war with the aim to assist with reconstruction, recovery and socio-economic and political reforms in the context of the EU-Lebanon Action Plan. It was expected that the MFA assistance would complement the ENPI and EIB funds[56]. As part of the Paris III there were discussions between ECFIN and EIB on complementing assistance to the energy sector through an Enterprise Facility Support project. As part of this an EIB loan of €150 million was foreseen. However, while a formal decision on this loan was taken, the EIB didn't succeed to sign the Financing Agreement within the legally predetermined timeframe i.e. 3 years and possibilities for redirecting this assistance are being considered.

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55 EC assistance to Lebanon was provided also through other instruments (e.g Reconstruction Assistance Facility, EIDHR, Tempus and Erasmus Mundus, thematic budget lines like ECHO etc) but these were not related to structural reform efforts and therefore are left in principle outside the scope of this evaluation.

56 Lebanon: Note on the possibility of future MFA, Note for the EFC, Brussels 17.01.2007, ECFIN/D3/AS/REP50433

7.9 Unexpected effects on structural reforms

This section focuses on the unexpected impact of MFA operation on structural reforms and is guided by the following generic evaluation question:

Q3.2. Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur?

Most interviewees consider that MFA had a low profile in Lebanon, not only for its relatively small amount of assistance, but also for the less assertive and visible dialogue between the EC and the Lebanese authorities. While the assistance did not have a direct effect on structural reforms, it is believed that it played an unexpected (indirect) effect on reforms through the trust offered by the EC to Lebanon. Prior to the MFA the EC was providing support mainly in form of technical assistance. Provision of MFA, which was considered as a form of budget support, was seen as a signal of willingness from the EU to support Lebanon. It took the relations between Lebanon and the EC to a “different level”.

8 Design and implementation of MFA

8.1 Introduction

Table 8.1 shows the fifth set of evaluation questions. This question focuses on the influence of the decision-making process in the design and implementation of the MFA assistance as well on the impact of the design and implementation of the MFA assistance operation on its performance in terms of efficiency and effectiveness.

Table 8.1: Evaluation question on design and implementation effectiveness and efficiency and sub-questions

Q5.	How has the way in which the MFA assistance operation was designed and implemented conditioned its effectiveness and efficiency?
Q5.1	What was the influence of the decision-making process in the design and implementation of the MFA assistance?
Q5.2	In what way has the design and implementation of the MFA assistance conditioned the performance of the operation in respect to its cost and its objectives?

8.2 Main findings and conclusions

Specific characteristics of the MFA operation to Lebanon

MFA (untied balance of payments, or budget support, in the form of medium long term loans or grants, or a combination thereof) is provided on an ad-hoc basis to non-member States (countries with which the Community maintains close political and economic links) on the basis of a unanimous decision of the Council, on a Commission proposal and after consultation with the Parliament. While there are no fixed rules or regulations concerning the decision-making criteria, MFA generally respects the strict eligibility and conditionality criteria reflected in the so-called "Genval Principles". Basically the Genval criteria were met. In a regular MFA operation the government of the beneficiary country would normally initiate the process through sending a request for MFA. This was not the case in Lebanon. Nonetheless, one may argue that through the process of the Paris III conference implicitly a request was made. In Lebanon case it was clear that the political proximity criterion was substantially met notably taking into account the progress made towards signing an Association Agreement. Prior to the MFA operation Lebanon was not following an IMF programme, although it was running large macro-economic imbalances, which made the economic situation very fragile. It was clear that the economic situation could deteriorate fairly quickly.

Delay in starting-up the MFA operation and implementation

DG ECFIN provided a note to the EFC on MFA to Lebanon in June 2007 shortly after the EPCA I was approved by the IMF. The Council decided on providing MFA to Lebanon on 10 December 2007. [57]The MoU between the EU and Lebanon was signed only on 18 December 2008. The delay partly owed to political paralysis of Lebanon's parliament that lasted until mid-2008. Significant amount of time was spent on negotiations of structural conditions between the EC and the Government of Lebanon. According to an interviewee of the IMF both EC and IMF agreed to

[57] According to the revised procedures, MFA operations would be decided upon by the European Parliament upon proposal of the Council.

whatever was initially proposed without realising sufficiently the conditions were impossible to fulfil. Nonetheless EC discussions with the Government touched to a certain extent on the practicality of implementation. Less time was needed for discussions between the EC and the IMF. Discussions with the IMF were to ensure complementarity with the IMF programme and to ensure that there was a reinforcing effect of the MFA operation on the IMF programme.

The process of prolonged delay in further implementation of the MFA assistance led in the end to cancellation. The much improved economic situation of Lebanon and the political uncertainty in the country contributed to this. The EU did not ease its conditions for the sake of disbursement of the last tranche, while other bilateral donors, such as USAID, did (be it without success).

Political economy considerations

The complex political situation before Paris III and the change of governments have complicated the implementation of the MFA assistance. As mentioned in chapter 6, structural conditions have largely not been fulfilled. Furthermore, the implementation of the US and French budgetary support encountered similar problems. While it appears that the contextual factors did not affect the design of the MFA operation, it has seriously affected its implementation. No political economy analysis was initiated to understand how the country context may affect the implementation of MFA.

MFA as part of a comprehensive EU package

The role of MFA needs to be seen as part of the whole EU package presented during the Paris III Conference. Including MFA in the package the cooperation between the EU and Lebanon was considered as a positive signal towards the authorities and took the relations between Lebanon and the EC to a “different level”.

Conditions related to the first tranche vs. conditions related to the second tranche

The first tranche of MFA was conditioned on the progress in the implementation of EPCA. Assistance of some bilateral donors was also related to the IMF programme. The harmonized approach could potentially promote the progress in the implementation of each actor’s assistance programme. On the other hand, during the design phase there was little (at least direct or explicit) discussion on the MFA conditions and their coordination with the French and American counterparts and this may have affected the fulfilment of the conditions related to the second tranche.

Disbursement of the second tranche of the MFA, as well as disbursement of follow-up instalments of US and French budget support, did not realise as it related to perhaps overambitious conditions. Some interviewees argued that some conditions, especially related to the power sector and in the area of PFM, could have better be designed stepwise, taking into account the time horizon focus of the conditions to deliver ‘results’ (in short term, medium term or long term).

No particular leading role among donors could be identified. Interviewees in Beirut have commented on the insufficient coordination among donors, though applauded the sharing of information through formal and informal means.

Intra-EC coordination

As mentioned, there is a perception that the MFA operation and subsequent developments would have benefited from having a more pro-active attitude of DG ECFIN to the MFA operation, for instance through more country visits and meetings with government officials.

The MFA operation has been led by DG ECFIN, who carried out also the dialogue with the Lebanese government. The EC Delegation was to a limited extent involved in the MFA operation, and was merely given an information provision and monitoring role. The full potential of the EC Delegation which has a better understanding of the political complexities within the country was not fully utilized.

Importance of MFA diminished quickly over time

The key value of MFA seems to be to provide a confidence boost and a political support message for reforms at the time of announcement. The additional EU assistance in the form of MFA came exactly at the right moment. The importance diminished quickly over time. The selection of not so realistic conditions (and this was done quite late, once the economic situation has already changed considerably) appears to be a weakness of the design of the operation. The prolonged negotiations could be seen as a signal that given the internal political situation, etc. disbursements were by no means guaranteed.

8.3 Value added of MFA

The sixth evaluation question refers to the added value of the MFA. As mentioned in the previous section, two particular aspects can be emphasised, namely (i) the confidence building effect at the time of announcement of the MFA as part of the comprehensive EU package, and (ii) the positive signal that was provided by inclusion of MFA in the EU package which advanced the dialogue between the EU and the government.

8.4 Recommendations

The conclusions mentioned above point to a number of recommendations to strengthen the design and implementation of the MFA instrument, although the emphasis will be on strengthening the preparation of the MFA operation. We focus on two main recommendations, and additionally emphasize the need to stay at the core of the MFA instrument, i.e. not changing objectives.

- **Take advantage of in-country knowledge of political economy considerations.**
  The Meta-evaluation of MFA has indicated the importance of paying more attention to the political-economic situation in the respective country. In a very complex environment good analysis of the political economy in a country will improve the design, particularly the number of tranches and the selection of conditions. Such analysis does not need much time, as knowledge exists in-country, i.e. for instance at the EU Delegations.

- **Value the announcement effect of MFA assistance as part of larger support packages and align conditions to this by agreeing on quick disbursing conditions.**
  The MFA assistance was a welcome addition to the EU assistance package to the country, which together with the support of other donors have provided a signal that boosted at time of announcement the support and credibility of the country towards third parties. MFA was relatively the only option for the EU to add additional EU resources. The announcement effect needs to be followed by actual action, i.e. disbursement. The selection of conditions on structural reforms, which may need to be agreed upon first with all Lebanese actors involved, is not conducive to this. In such circumstances it may be sensible to select conditions which may directly impact on macro-fiscal variables without too much delay or further negotiation, either with the provider of the assistance or among Lebanese stakeholders. Where the scope and context of the MFA is different from a ‘traditional’ operation, the tool should allow to deviate from the default model in order to avoid delays in implementation.

- **Appreciate the additional value MFA may have on strengthening relations with the respective country, but do not see this as an objective of MFA**.
  Including MFA in the package the cooperation between the EU and Lebanon was considered as a positive signal towards the authorities and advanced the relations between Lebanon and the EC. While this can be seen as a positive element of the MFA operation which was not so successful, it should not be seen as an argument to decide on MFA operations. Other instruments may be better geared to this.

9 Annex I - Modelling approach to the counterfactual

9.1 Objectives

This annex describes the basic framework of the macroeconomic modelling approach used in quantification of the counterfactual scenarios and hence forming the basis for the assessment of the net effect of the MFA assistance. The aim of the quantitative modelling approach is to construct a realistic and internally consistent counterfactual scenario (two alternative scenarios in the case of Lebanon) for short-term macroeconomic outcomes in the absence of the MFA intervention, compare this counterfactual to an actual outcome (and partly a baseline forecast) and therefore to establish an indicative estimate of the net effect of the MFA intervention.

9.2 General description

The model takes the key assumptions on the counterfactual scenarios as an input. It then uses these assumptions to construct a consistent counterfactual path for other macroeconomic variables of interest. This allows comparing actual with counterfactual outcomes of selected variables (such as GDP growth, price, fiscal developments, etc.) and providing a quantitative estimate of the net effect of an MFA operation.

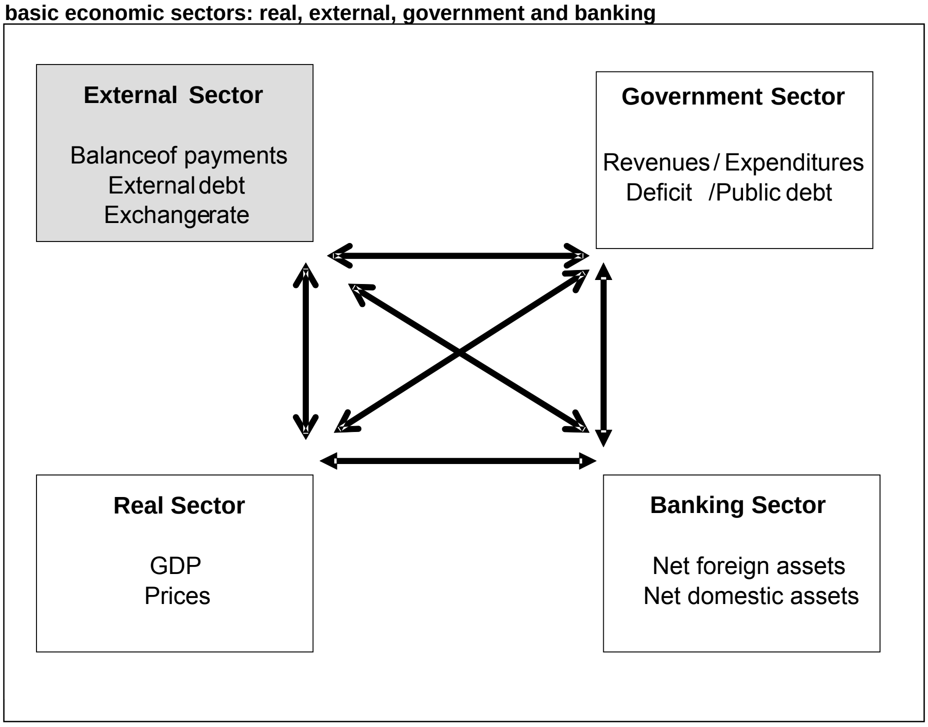
An important requirement for the model to yield a meaningful counterfactual is its macroeconomic consistency, i.e. ensuring that budget constraint is observed for all participants in the economy. The model is built from four basic blocks, corresponding to the basic economic sectors: real, external, government and monetary/banking. The corresponding key macroeconomic identities will tell that valued added in domestic production equals total expenditure (*national account identity*), that any government expenditure in excess of government revenues equals public sector borrowing and money creation (*fiscal identity*), that excess of foreign exchange expenditure over earnings equals foreign borrowing and changes in reserves (*BoP identity*) and that the increase in the money supply corresponds to the increase in domestic credit and foreign reserves (*monetary identity*).[58] Figure 10.1 provides a graphical illustration of the model logic.

Given that the MFA is an instrument that addresses the financing gap in the balance of payment (BoP), counterfactual scenarios are constructed starting from relevant changes in BoP entries related to MFA tranches (and IMF disbursements in a scenario of lack of the entire IMF and EU assistance package) and then possibly also other international financial flows (e.g., World Bank programmes, other multilateral and bilateral assistance, such as French and US assistance). The external sector is at the centre of the quantitative analysis.

This model is calibrated mostly relying on IMF data available in recent IMF country reports. Additional data sources (IMF's World Economic Outlook Database, Central Bank of Lebanon) are used in some specific cases.

[58] See also William Easterly (1989), A consistency framework for macroeconomic analysis, WPS 234, World Bank.

Figure 11.1: Basic structure of the model, which recognises links and ensures consistency among four basic economic sectors: real, external, government and banking



This modelling approach corresponds to macroeconomic consistency frameworks used by international financial institutions (especially the IMF). An important advantage is related to modest data needs and no computational problems. The quantitative results can be immediately compared with conclusions of qualitative analysis.

9.3 Structure of the model

9.3.1 Model basics

The model is linear and primarily works on differences between the analysed scenarios. Most equations used in the model describe the difference between counterfactual and actual values of variables. The difference in the values of a variable of interest X is explained by a function F of differenced explanatory variables (e.g. Y, Z):

$$DIF(X) = F[DIF(Y), DIF(Z)] \qquad (1)$$

where DIF (…) denotes the difference between counterfactual and actual values of a variable, F[…] is a function (identity or behavioural equation as discussed below). The advantage of such specification is the strong focus on variability related to the MFA assistance and the straightforward interpretation of obtained results in terms of net impact of the intervention. Also, it allows for overcoming problems related to breaks in the historical macroeconomic series making the comparison of levels of variables infeasible. Finally, it allows for carrying out a meaningful analysis in a situation when forecasts rather than actual data need to be considered as the basis for the actual scenario. This last feature is important as the last disbursement of the MFA operation in Lebanon took place in mid-2009 and the operation as such lasted till end-2010. Given its timing this evaluation only has access to actual historical data (annual frequency) up till the end of 2010 (till end-2011 for some series).

9.3.2 Identities and behavioural equations

Two major types of equations are used in the model: identities and behavioural relations.

Identities are equations that must hold by definition to ensure accounting consistency (e.g., balancing balance of payment, financing budget deficit, equating assets and liabilities of the banking sector). The only necessary assumption in simulating the counterfactual in case of identities is the determination of size of adjustment of each of the variables entering the identity in response to a given shock. Often this choice is conditional on the policy response or external factors and assumptions in this respect is based on information gathered during interviews with policy makers and analysts in Beirut, Washington and Brussels.

In case of *behavioural relations* (e.g. inflation and import equations), their functional forms are designed to best reflects the economic impact that should take place according to the economic policy realities at the time of the MFA operation, economic theory, ideally confirmed by available statistical evidence and taking into account limitations in data availability and quality. The modelling assumption involves the choice of the variables that are best in explaining dynamics of an independent variable and in quantification of the size (elasticity) of the impact. The elasticities are usually assumed based on available evidence from Lebanon and other similar economies and also taking into account the objectives of the quantitative exercise – in case of very small effects materialising in counterfactual scenarios A and B it is more informative to concentrate on values leading to maximum effects, i.e. estimating upper bounds of MFA impact.

BoP equations

The first essential equation necessary for establishing the counterfactual is the identity describing the balance of payment.

$$\text{DIF (MFA grant + other CA items) + DIF (MFA loan + other KA items) =}$$
$$\text{= DIF (IMF loan + other international reserves)} \qquad (2)$$

where DIF is the difference between counterfactual and actual value as defined above, CA is current account and KA is capital and financial account. The absence of the disbursement of the MFA grant is reflected as a drop in current account.

Based on gathered evidence and opinions specific assumptions are taken concerning the adjustment of particular elements of the balance of payments (e.g. imports, change in reserves, etc.). Hence, for example we consider a specification where import adjustment is driven by falling domestic demand (for simplicity we consider effects only changes in investment demand), and other BoP elements adjust accordingly:

$$\text{DIF (imports) = III * DIFF (domestic public \& private investment)} \qquad (3)$$
$$\text{\%DIF(exports) = A * \%DIF (imports)} \qquad (4)$$
$$\text{DIF (reserve accumulation) = DIF (MFA loan + other KA items)}$$
$$\text{+ DIF(MFA grant) – DIF (imports),} \qquad (5)$$

where %DIF denotes a percentage change, the coefficient A is set at 1 (and other values are tested as part of the sensitivity analysis). The simple export equation is motivated by the assumption of constant import content of exports between counterfactual and actual scenarios.

Furthermore, the III parameter (import intensity of investment) is set at 0.3 and other values analysed as part of the sensitivity analysis[59].

Fiscal accounts

The second core identity used in the formulation of the counterfactual describes budgetary accounts. The stylised version of this equation is given by

DIF (government expenditures) – DIF(MFA grant & other government revenues) =
= DIF (MFA loans + domestic bank financing + domestic non-bank financing + other foreign financing) (6)

From the perspective of the budgetary identity the counterfactual scenario without the MFA grant assistance implies lower government revenues (due to lack of the MFA grant). In order to balance its books, the government needs to adjust its expenditures program and/or revenue collections and/or identify alternative sources of deficit financing (taking into account the absence of the MFA loan). The counterfactual is determined by availability of alternative sources of financing and policy decisions about fiscal tightening. Specifically, in order to assess an upper bound of effects on economic activity variables in counterfactual scenarios A and B it is assumed that full adjustment takes place on the side of government expenditures, i.e.

DIF (government expenditures) = DIF(MFA loans) + DIF(MFA grant) (7)

Monetary sector

The third core identity describes the accounts of the banking sector. This stylised presentation illustrates key linkages with balance of payment situation that determines through a series of auxiliary identities the net foreign assets (NFA), and budgetary accounts that determine the size of credit to the government (NDC government), the private sector (NDC private) with adjustment in other items of net domestic assets (NDA) determining the change in money supply.

DIF (NFA) + DIF (NDC government) + DIF (NDC private) + DIF (NDA other) =
= DIF (Money Supply) (8)

In the counterfactual scenario B an important element is the link between NFA and NDC private. In order to assess an upper bound of effects on economic activity variables it is assumed that 100% of the change (increase) in international liabilities (the EIB loan) is reflected in the change in credit to the private sector[60]. To preserve a realistic timeframe of this intermediation it is specifically assumed that the share of the EIB loan intermediated in the form of credit to the private sector takes values 0.2, 0.4, 0.7 and 1 respectively during 2008-2011.

Real sector

Counterfactual inflation rates is typically based on the standard theory of inflation, where inflation changes are related to changes in money stock and real incomes. The channel of imported inflation (due to a fixed exchange rate) clearly plays a very important role in determining inflation levels, but

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59 The value of total investment good imports accounts for some 40% of total imports and corresponds to around 70% of total investment expenditure. See http://research.banqueaudi.com/documents/EconomicReports/lebanon_economic_report.pdf for an indicative classification of investment vs. consumption goods imports. Hence, a value of around 0.3 appears to be a realistic approximation of the parameter III.

60 This in particular assumes no crowding out, i.e. that in the absence of EIB Global Loan mechanism Lebanese banks would not be able to finance any of the SME projects actually funded with the help of EIB money from other resources. The rationale for taking specific assumptions in the simulations is to arrive at an estimate of an upper bound of effects.

given that our modelling framework is tailored to analysing the deviation of the counterfactual scenario from the actual developments imported inflation does not enter the equation as the MFA operation can be safely assumed to have no effect on global price trends. Given the very low magnitude of changes in the real income dynamics and M5 for simplicity we assume a fixed inflation elasticity of M5 (IEM) and set it at one[61].

DIF (inflation rate) = IEM * DIF (money growth rate) (9)

Other values have been tried as part of the sensitivity analysis exercise.

GDP deflator in the counterfactual scenarios is assumed to be driven by identical forces that determine the CPI, i.e. changes in GDP deflator between counterfactual and actual scenarios are identical to changes in CPI between these scenarios:

DIF(GDP deflator) = DIF (inflation rate) (10)

Counterfactual investment expenditure is simulated as a sum of public and private investments, where a change in public investment is assumed to be equal to the total adjustment of fiscal spending:

DIF (public investment) = DIF(government expenditures) (11)

Counterfactual changes in private investment expenditure are driven by changes in dynamics of private sector credit and a crowding-out effect between private and public investments. The latter effect can be justified by the structure of financing of fiscal deficits (with a large role of domestic banks)[62]. We assume a value of COC parameter at -0.2 and have tested other values as part of sensitivity analysis.

DIF (private investment) = DIF (NDC private) + COC * DIF (public investment) (12)

The GDP identity calculates a change in nominal GDP resulting from diverging paths of public and private investment, consumption and net exports.

DIF (nominal GDP) = DIF (government expenditures) + DIF (private consumption expenditure) + +DIF (private investment expenditure) + DIF (net exports) (13)

Finally, counterfactual real GDP growth dynamics is derived from the nominal and price change figures:

GDP growth rate = nominal GDP growth / GDP deflator (14)

9.3.3 *Sensitivity analysis*

Given the features of counterfactual scenarios A and B and the assumptions on model parameters discussed above the values reported in the main report body text can be seen as approximating

61 The deviation between counterfactual and actual M5 levels are below 0.2%, where broad money (M5) is defined as M3 (currency + resident deposits) + non-resident deposits).

62 For discussion focusing on an earlier period see e.g. V. Y. Naïmy (2005), Measuring The Effects Of Financial Liberalization On The Supply Of Credit To The Private Sector: The Case Of Lebanon, International Business & Economics Research Journal, Vol. 4 No. 5. IMF country report no. 12/40 suggests the role of credit supply for private sector credit growth and also highlights the role of crowding out between sovereign debt instruments and lending to the private sector.

upper bounds of MFA effects. This is justified given the intrinsic uncertainty related to the model and data that in any case suggest that interpretation of results should be concentrated on signs and relative size of effects, rather than on particular numerical values. Modifications of parameter values within the reasonable range do not lead to any sizeable changes in estimated effects.

9.4 Sudden stop hypothesis

In this section we provide a summary of the approach taken by Eichengreen et al (2008) and their results that are used in constructing the counterfactual scenario C2.[63]

The Eichengreen paper documents the potential role of IMF programmes in limiting the risk of sharp reductions in capital flows ('sudden stops') . It finds evidence suggesting that the presence of IMF programmes reduces the likelihood of sudden stops. In this sense it provides the rationale for the construction of scenario C2.

The authors measure capital flows by the financial account balance, a summary measure of net capital flows that includes net foreign direct investment, net portfolio investment, and other investments. It is thus a broader measure than applied in some other studies of this topic. The countries included in the analysis are those involved with international financial markets. Annual data are used, so a sudden stop episode concerns both a country and a particular year.

Sudden stops episodes are identified by time series properties of capital flows, taking into account both first and the second moments. This is done in two steps. First, the authors identify the years where the financial account balance exhibited a large decline relative to its long-term average. This needs to be a large discrete drop and not merely a correction of a large temporary inflow. Financial balance needs to be negative. In the second step the mean and one-standard-deviation band of the financial account balance are calculated using the data up to the years identified in the first stage. Sudden stops are then identified when there is a sharp increase in the capital outflow, defined as an increase equal to at least one standard deviation from the country's own history.

The analysis of thirty five episodes identified by the above procedure leads to the following conclusions:

- Typically, countries experience a net capital outflow on the order of 5 % of GDP in the first year of a sudden stop episode. FDI is usually little affected and net capital outflows consist mostly of other forms of capital, such as funds channelled through the banking system, commercial credits, etc.
- Typically, countries experiencing a sudden stop also experience an improvement in the current account balance on the order of 4 % of GDP. Given that the current account equals the domestic saving-investment balance it is interesting to see that most of the adjustment falls on the investment side with a sharp decline in capital formation.
- Sudden stops can sometimes be accompanied by a currency crisis, but this happens only in one-third of the analysed episodes.
- Export growth is not affected during sudden stops episodes
- GDP growth in a year of a sudden stop is on average 3.3 percentage point lower than the average during the three years preceding a sudden stop episode

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[63] B. Eichengreen, P. Gupta and A. Mody, (2008). "Sudden Stops and IMF-Supported Programs," NBER Chapters, in: S. Edwards and M. G. P. Garcia (eds) Financial Markets Volatility and Performance in Emerging Markets, National Bureau of Economic Research, Inc.

In our analysis of counterfactual scenario C2 for Lebanon the above results are taken as a possible indication of a potential size of negative effects should scenario C2 materialise.

With regard to the role of IMF programmes in limiting the risk of sudden stops occurrence Eichengreen et al conclude that while the unconditional probability of a sudden stop in the sample is 5.5 %, the probability of a sudden stop is about 1 percentage point lower if an IMF program was in place. They also observe that this differential in probability of sudden stops with and without IMF programmes is more pronounced if one limits the analysis to data for the more recent period (i.e. after 1989) .

This finding is confirmed by multivariate regression analyses where the authors have used a variety of approaches to check robustness including the potential endogeneity of IMF programmes (i.e. that they may be driven by conditions increasing the likelihood of sudden stops) modifying the sample of countries, etc. The basic finding that the presence of a new IMF negatively influences the probability of a sudden stop appears quite robust. It has been used to provide a rationale for the counterfactual scenario C2.

10 Annex II - Key persons contacted/interviewed

Name	Role / involvement in the MFA operation
Andreas Papodopolous	Member, Inter-Service group reviewing MFA programmes, DG ECFIN
Agnieszka Skuratowicz	Desk officer, DG ECFIN
Ronald Albers	Former Desk officer for Lebanon
Jan Hofmokl (interviewed in Warsaw)	Desk officer for Lebanon, 2009. Now seconded to Polish Ministry of Foreign Affairs
Charles Abdallah	Economist, EU Delegation to Lebanon. Currently at the Delegation.
Diego Escalona Paturel	Second Secretary, head of Cooperation Section, EUD to Lebanon
Peter Christiaens	Attaché, Programme Manager
Najla Nakhle	Local economist for IMF in Lebanon
Chadi Bou Habib	Senior Economist on Lebanon and Syria, World Bank office in Beirut
Rima Koteiche	Senior financial management specialist, World Bank office in Beirut
Wael Mansour	Economist, Poverty reduction and economic management MENA region, World Bank office in Beirut
Riwa Nasreddine	Senior Economic officer, UNDP-Project of the Ministry of Finance
Lena Jammal	Senior program officer, USAID Lebanon
Jim Barnhart	Mission director, USAID Lebanon
Timothy Alexander	Director, Program office, USAID Lebanon
Mazen Hanna	Former Economic advisor under former Prime Minister Hariri
Hazar Caracalla	Former Senior economist under former Prime Minister Hariri
Nabil Yamout	Former Advisor under former Prime Minister Hariri
Kristna Kostial	Assistant Director Middle East and Central Asia (MECA), IMF Washington D.C.
Harald Finger	Assistant to the Director MECA, , IMF Washington D.C.
Eric Mottu	Former ResRep Beirut, now Egypt desk, IMF Washington D.C.
Azim Sadikov	Economist MECA, IMF Washington D.C.
Alina Luca	Economist MECA, IMF Washington D.C.
Annette Jacqueline Kyobe	IMF Washington D.C.
Joseph P. Saba	World Bank, former Country Director, Iran, Iraq, Jordan, Lebanon, Syria
Alain A. Bifani	Director General Ministry of Finance

11 Annex III - History of events 2005 – 2010

Table 15.1: History of political events (numbers in circles refer to date of the month when the event took place)

Year	Date	Political events
2005	January	
		14 Assassination of former Prime Minister Rafiq Hariri
	March	
		26 Withdrawal of all Syrian troops in Lebanon; 15 New government led by PM Najib Mikati
	May	29 Parliamentary elections
		19 New government led by Prime Minister Fuad Siniora
	July	
	September	
	November	
2006	January	
	March	
	May	
	July	12 Israel's offensive in Lebanon against Hezbollah
		14 UN-negotiated cease-fire between Israel and Lebanon
	September	
	November	21 Internal conflict
2007	January	
	March	
	May	
	July	
	September	
	November	
2008	January	
	March	
	May	21 Doha Agreement concluded, ending 18-month long political crisis in Lebanon

Year	Date	Political events
	July	11 Formation of a new national unity government led by Prime Minister Fuad Siniora
	September	
	November	
2009	January	
	March	
	May	
		7 Parliamentary elections
	July	
	September	
	November	
		10 New national unity cabinet headed by PM Sa'ad Hariri
2010	January	
	March	31 Summary of achievements on MFA conditionality from MoF Lebanon and UNDP
	May	
	July	
	September	
	November	
2011	January	12 Resignation of the national unity government

Table 15.2: History of donor activities (numbers in circles refer to date of the month when the event took place)

	Date	Donor activities
2007	January	25 Paris III Conference; DG ECFIN to EFC on the possibility of future MFA to Lebanon
	March	
	May	14 IMF EPCA I approved; 4 Emergency Post-Conflict Assistance to Lebanon
		21 DG ECFIN note for the EFC on MFA to Lebanon
	July	EFC approved MFA to Lebanon; 9 Ex-ante evaluation of MFA to Lebanon
	September	
		27 Briefing note for Commissioner Alumnia on MFA; Operational Assessment
	November	10 Council Decision providing MFA to Lebanon 18 Grant agreement and MoU between EC and the Lebanese Republic; 30 Report on performance under EPCA to Lebanon
		17 Report on performance under EPCA to Lebanon
2008	January	
	March	
	May	5 Report on performance under EPCA to Lebanon
	July	
		18 EC report to Council and EP on MFA implementation to third countries in 2007
	September	
	November	14 IMF approves EPCA II; 25 Emergency Post-Conflict Assistance to Lebanon
		18 Grant, MoU and 19 Loan agreement between the EC and the Lebanon signed;
	December	18 Disbursement of first MFA grant tranche
2009	January	
	March	
	May	
		4 Disbursement of first MFA loan tranche
	July	15 Report on performance under EPCA to Lebanon
	September	
		4 MFA to Lebanon Briefing note for Commission Aluminia
	November	12 Report on performance under EPCA to Lebanon
		18 EC decision for extension of the availability period of MFA to Lebanon by one year
2010	January	
	March	
	May	
	July	14 Public Finance Assessment of Lebanon based on PEFA Framework

	Date	Donor activities
	September November	Expiry of the MFA agreement
2011	January	

12 Annex IV - List of World Bank projects

The Table below presents a comprehensive overview of the World Bank programmes and project in which were or are still active in the period 2006 till the present.

Table 15.1: Active projects of the World Bank in Lebanon

Project	Principal	Available	Disbursed	Approval Date	Closing Date
Urban Transport Development Project	65,000,000	399,983	64,600,016	13-jun-02	31-dec-11
	69,700,000	47,875,100	21,824,898	13-jun-02	31-dec-11
	478,000	-	457,029	13-jun-02	31-dec-11
Education Development Project	56,570,000	-	42,567,464	30-Mar-00	31-dec-09
	450,000	-	439,988	30-Mar-00	31-dec-09
Cultural Heritage and Urban Dev.	31,500,000	8,960,866	22,539,134	17-apr-03	30-jun-11
	350,000	-	302,866	17-apr-03	30-jun-11
First Municipal Infrastructure	80,000,000	-	75,301,984	22-jun-00	31-dec-08
	376,310	-	224,280	22-jun-00	31-dec-08
Community Development Project	20,000,000	-	19,992,726	26-jun-01	29-feb-08
Ba'albeck Water and Wastewater	43,530,000	8,121,977	35,408,024	4-jun-02	15-jun-11
Strengthening LB HIVAIDS M&E System	350,000	-	348,233	12-nov-04	10-nov-08
Reform Implementation DPL	100,000,000	-	100,000,000	2-aug-07	31-jan-09
Environmental Legislation	327,000	-	312,317	2-feb-06	5-jul-10
Greater Beirut Water Supply	200,000,000	200,000,000	-	16-dec-10	30-jun-16
Est. of Fund for National Reconstruction	1,025,000	-	980,216	22-sep-06	03-May-09
Municipal Infrastructure	99,300	-	88,602	3-nov-06	30-jun-11
	30,000,000	8,148,775	21,851,224	3-nov-06	30-jun-11
Bekaa Emergency Water Supply	15,000,000	7,058,314	7,941,687	20-Mar-07	20-nov-11
Emergency Pwr Reform Capacity Reinf	5,000,000	1,578,383	3,421,617	19-Mar-07	31-dec-12
Dev Cap Bldg Tools Sust. Governance	338,000	4,766	333,234	12-apr-07	13-dec-10
Statistical Master Plan	51,000	-	51,000	8-dec-05	31-dec-08
Nahr al-Barid Post-Conflict Emerg.	2,025,000	355,778	1,669,222	18-feb-08	31-dec-10
Emergency Fiscal Management Reform	4,000,000	3,024,475	975,526	12-Mar-09	30-sep-11
ESPISP 2	6,000,000	4,378,338	1,621,662	5-sep-08	31-Mar-12
Lebanon- Al Fayhaa Sust.Dev Strategy	345,190	95,190	250,000	21-feb-08	31-dec-11
MDTF for Conflict-Affected Areas	8,500,000	-	9,275,000	10-Mar-09	31-dec-13
Telecommunications Regulatory Cap Bld	492,300	392,300	100,000	04-Mar-10	28-sep-13
Education Development Project II	40,000,000	40,000,000	-	30-nov-10	31-dec-16
NABC Policy Research Grant	90,000	-	90,000	20-jul-09	31-dec-10
Urban Transport Development	65,000,000	399,983	64,600,016	13-jun-02	31-dec-11

Project	Principal	Available	Disbursed	Approval Date	Closing Date
Project					
	69,700,000	47,875,100	21,824,898	13-jun-02	31-dec-11
				13-jun-02	31-dec-11
	478,000	-	457,029		
Education Development Project	56,570,000	-	42,567,464	30-Mar-00	31-dec-09
	450,000	-	439,988	30-Mar-00	31-dec-09
Cultural Heritage and Urban Dev.	31,500,000	8,960,866	22,539,134	17-apr-03	30-jun-11

Source: World Bank, extracted from the World Bank website, Country Lending Summaries - Lebanon

13 Annex V – The IMF programmes

Annex V presents an overview of all review missions that took place under the IMF Emergency Post-Conflict Assistance (EPCA) to Lebanon between May 2007 and November 2009. Lebanon managed to make progress in reforms and maintain macroeconomic stability throughout the 2007-2009 period. The main points of attention were that the government net borrowing from the BdL remained higher than the programme ceiling and there had been limited progress with respect to the programme's structural reform measures.

Date	Activity	Amount	Selection of IMF review objectives / conclusions
April 2007	Emergency Post-Conflict Assistance to Lebanon	US$ 76.7 million	The objectives of the IMF supported programme were to protect financial stability, contain the budget deficit, and to initiate structural reforms that are crucial to the success of the authorities' medium-term reform programme for 2007-2011. The EPCA would provide an appropriate support for the transitional challenges of moving from post-conflict situation to a programme of fiscal adjustment starting in 2008.
November 2007	Report on performance under EPCA to Lebanon		All the quantitative targets for the first and second quarters of 2007 were observed, with the exception of the end-March ceiling on government borrowing from the Banque du Liban (BdL). Difficult market conditions in the first months of 2007, with commercial banks reluctant to roll over maturing securities, led the government to rely more on financing from the BdL, thus exceeding the end-March target, albeit by a small margin—the outcome was LL 106 billion ($70 million) above the LL 903 billion ($602 million) flow targeted for the first quarter. All end-June targets (reserves, primary fiscal balance, net government debt, central bank credit to government) were met by ample margins.
December 2007	Report on performance under EPCA to Lebanon		The primary balance and net debt targets for end-September 2007 were met with significant margins. The primary balance (cash basis, excluding grants as defined in the programme) posted a small surplus of 0.3 percent of GDP, compared with a projected deficit of 2.8 percent of GDP. The programme targets on international reserves and government net borrowing from the BdL were also met comfortably. Given the continued deposit inflows, and in the absence of foreign exchange market pressures, the BdL was able to increase its gross international reserves (excluding gold) by $400 million during the third quarter to $12 billion by end-September 2007, somewhat higher than expected. The government did not introduce a floor (of $0.20 per liter) on gasoline excises by end-September as previously envisaged. Progress has also been made on structural reforms.

Date	Activity	Amount	Selection of IMF review objectives / conclusions
May 2008	Report on performance under EPCA to Lebanon		The primary balance and net debt targets for end-December 2007 were met with significant margins. The authorities achieved a primary surplus excluding grants of ½ percent of GDP, compared to a target of –3.7 percent. The programme targets on international reserves and government net borrowing from the BdL were also met comfortably. With strong deposit inflows, and in the absence of foreign exchange market pressures, gross international reserves of the BdL rose to $11.5 billion, despite the shortfall in donor financing. Some progress has been made on the structural reform agenda. Preparations for the privatization of the two mobile phone operators are near completion.
November 2008	Emergency Post-Conflict Assistance to Lebanon	US$ 37.6 million	This amount adds to the US$ 76.7 million in EPCA provided to Lebanon in April 2007.
July 2009	Report on performance under EPCA to Lebanon		Despite some slippages, performance through end-March under the EPCA-supported programme remains broadly favourable. International reserves exceeded the end-March indicative target by a wide margin. The primary balance target was also met. Buoyant tax revenues, particularly from excises, and lower-than-projected wage and transfer payments compensated for lower telecom receipts and heightened election-related spending pressures in the housing compensation scheme and in domestically-financed capital expenditures, resulting in a primary balance just above the programme floor. Despite these favourable outcomes, government net borrowing from the BdL was higher than the programme ceiling. There has been limited progress on the programme's monitorable actions.
November 2009	Report on performance under EPCA to Lebanon		Performance under the EPCA-supported programme has remained broadly favorable, despite a few slippages. International reserves exceeded the end-June indicative target by a wide margin. Strong deposit inflows and ongoing dedollarization enabled the BdL to accumulate international reserves at a rapid pace, easily surpassing the programme target. The primary surplus target was also met. Strong growth and the reintroduction of gasoline excises boosted tax revenues. Despite these favourable outcomes, government net borrowing from the BdL was substantially higher than the programme ceiling, although the BdL's monetary interventions more than offset the impact on reserve money. There has been limited progress on the programme's structural reform measures.

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