

**Lebanon: Report on Performance Under the Program Supported by
Emergency Post-Conflict Assistance**

This report on Lebanon's performance under the program supported by emergency post-conflict assistance was circulated to the Executive Directors of the IMF for their information. It was prepared by a staff team of the International Monetary Fund and is based on the information available at the time it was issued on June 10, 2009. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Lebanon or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

LEBANON

**Report on Performance Under the Program Supported by
Emergency Post-Conflict Assistance**

Prepared by the Middle East and Central Asia Department
(In consultation with other departments)

Approved by Ratna Sahay and Ranil Salgado

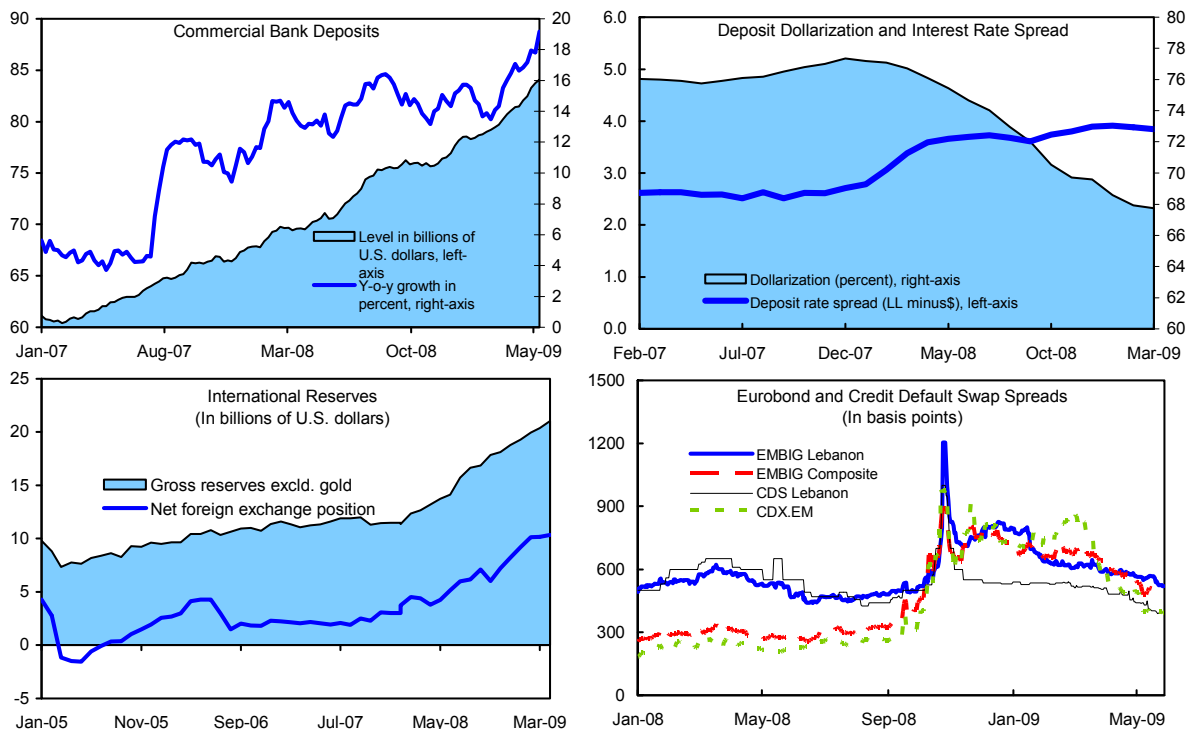
June 10, 2009

- **Emergency Post-Conflict Assistance (EPCA).** The Executive Board approved 12.5 percent of quota, or SDR 25.375 million, in November 2008. The EPCA-supported program for the period until June 2009 was designed to support the authorities' policies aimed at buttressing macroeconomic stability and financial discipline during the period until the June parliamentary elections. This report updates Executive Directors on performance under the program relative to the end-March 2009 indicative targets and monitorable actions.
- **Staff visit.** The report's findings are based on discussions held in Beirut May 13–21, 2009. The mission comprised Messrs. Fanizza (head), Finger, and Hesse (all MCD); and Messrs. Lopez Murphy (FAD) and Weisfeld (SPR). The mission met with the governor of the central bank, the minister of finance, and senior government officials.
- **Performance under EPCA.** The end-March quantitative target on international reserves was met with a wide margin. While the primary balance target was also met, the program ceiling on net government financing by the BdL was missed. The Global Income Tax law has not yet been submitted to parliament, and the planned privatization of telecom is waiting for an improvement in global conditions (both measures are end-March monitorable actions).
- **Economic outlook.** Recent cyclical indicators point to a somewhat stronger resilience of the Lebanese economy to the global recession than earlier projected. Staff projects a moderation in GDP growth to 4 percent this year, from 8½ percent in 2008, with risks to the upside if domestic political and security conditions remain calm.
- **Policy priorities.** Near-term macroeconomic policies need to focus on at least safeguarding the authorities' zero primary balance target. This would provide the basis—once a new government is in place—for swiftly implementing the Paris III fiscal and structural reform agenda to raise growth, improve living conditions, and reduce the debt overhang. Monetary policy should remain cautious in the near term, but following the formation of the new government, there could be scope for easing.
- **Safeguards assessment of the Banque du Liban (BdL).** An update assessment is underway. Preliminary findings indicate progress in implementing some of the previous recommendations, especially those included in monitorable actions of the program, but limited progress in other areas. Further actions are required to enhance the BdL's financial reporting transparency, governance, audit oversight, and the legal framework of the central bank.

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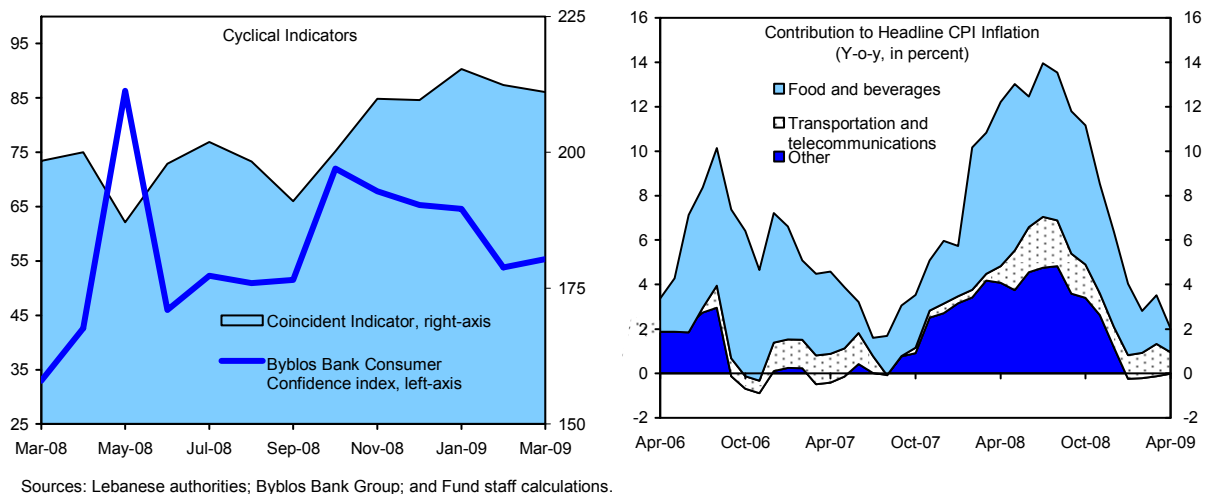
I. RECENT DEVELOPMENTS AND OUTLOOK

1. **Following the June 7, 2009 parliamentary elections, the Lebanese political parties are in the process of forming a new government.** The outgoing government, formed after the May 2008 Doha agreement, was successful in maintaining political and economic stability during the global economic and financial crisis, although it faced significant expenditure pressures in the run-up to the elections.
2. **The impact of the global financial crisis on Lebanon has so far been muted.**
 - Commercial bank deposit inflows, which are the main financing source for the large government deficit, have remained strong. Deposit dollarization has fallen, helped by stable security conditions, favorable economic developments, and a substantial interest differential between local currency and U.S. dollar denominated deposits. There have been no pressures on the peg, and the BdL has accumulated international reserves at a fast pace. Eurobond and Credit Default Swap spreads have moderated, and move in line with the emerging markets average.
 - The large banking sector has had virtually no direct impact from the global financial crisis, given limited exposure to failed foreign financial institutions or wholesale funding markets. Banks have remained liquid and well-capitalized, and there has been no need for emergency liquidity provision or other public intervention.



Sources: Lebanese authorities; Bloomberg; and Fund staff calculations.

3. **Cyclical indicators point to a soft landing of the Lebanese economy in spite of the global financial crisis and recession.** Economic activity has continued to expand robustly through the first quarter of 2009. Merchandise exports, which account for only a small share of the economy, have been negatively affected by lower external demand, but construction activity appears to hold up well, and tourism and financial services continue to expand. So far, there have not been sizeable returns of Lebanese expatriates from the Gulf, and the limited data available do not suggest a sharp drop in remittances inflows. As a result, the expected decline in economic growth will likely be milder than projected at the time of the 2009 Article IV consultations. Staff now projects real GDP growth at around 4 percent this year (instead of 3 percent), with a significant upside potential should domestic political and security conditions remain favorable. Inflation has dropped and, under the peg, is likely to remain subdued, given the benign inflation outlook in trading partner countries.



4. **Despite the global crisis, balance of payments developments remain broadly favorable.** The current account deficit will likely shrink this year, helped by the drop in oil import prices and by strong tourism inflows, which together more than compensate for a projected decline in exports (1 percent) and remittances (12 percent) in light of the global recession. Despite lower projected foreign direct investment (down 26 percent), the projected improvement in the current account, together with strong non-resident deposit flows, should allow the BdL to continue accumulating international reserves at a comfortable pace, even in the absence of government market financing from abroad. In line with the authorities' projections, donor support has further moderated in the first quarter of 2009, but could resume once a new government is in place in the second half of the year (text table).

Lebanon: Foreign Assistance to the Government
(In millions of U.S. dollars, unless otherwise specified)

	2007 Act.	2008 Est.	2009					Year Proj.	2010 Proj.
			Jan–Mar Proj. 1/	Jan–Mar Act.	Apr–Jun Proj.	Jul–Sep Proj.	Sep–Dec Proj.		
Total	773	678	83	75	72	356	465	967	598
Grants	348	257	31	21	14	64	34	133	130
Loans	425	421	52	54	58	292	431	835	468
Memorandum items:									
Paris III disbursements	572	382	56	19	40	296	318	674	484
Grants	147	144	15	12	3	53	23	91	102
Loans	425	237	41	8	37	243	295	583	382

Sources: Lebanese authorities, and Fund staff estimates.

1/ As established at the time of the 2009 Article IV consultations.

II. END-MARCH PERFORMANCE UNDER EPCA

5. Despite some slippages, performance through end-March under the EPCA-supported program remains broadly favorable.

- **International reserves exceeded the end-March indicative target by a wide margin.** Given the sustained interest rate differential, strong deposit inflows and ongoing dedollarization, the BdL has continued to accumulate international reserves at a rapid pace, surpassing the program 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 program floor.
- **Despite these favorable outcomes, government net borrowing from the BdL was higher than the program ceiling.** The target was missed by nearly 10 percent (around LL 550 billion) because the BdL temporarily acquired (a) Eurobonds in response to deleveraging from international investors, and (b) T-bills in the secondary market to manage short-term market fluctuations in the presence of binding concentration limits on some commercial banks' exposure to government. The BdL fully sterilized the monetary impact of the T-bill purchases by issuing higher-yielding Certificates of Deposit (CDs) that, however, continue to weigh on the BdL's income position.¹ The Eurobond accumulation was partly unwound in April through sales in the secondary market.

¹ In the first quarter, the BdL's T-bill holdings increased by around LL 1.3 trillion (\$850 million). The yield on three-year government T-bills is currently at 8.95 percent, and that of 5-year BdL CDs at 9.75 percent.

- **There has been limited progress on the program's monitorable actions.** The draft Global Income Tax law has been discussed by a high-level inter-ministerial committee but has not been submitted to parliament (end-March monitorable action). Following the decision in late 2008 to postpone the privatization of the two mobile phone providers in light of unfavorable global conditions, the related end-March monitorable action was not met. The BdL has already adopted formal policies for the selection, appointment, and rotation of the BdL's external auditors (end-June monitorable action).

III. POLICIES FOR 2009 AND BEYOND

6. **Lebanon's still large debt overhang calls for substantial fiscal consolidation, to build on the significant achievements of recent years in reducing the debt-to-GDP ratio.** Despite its drop since 2006, Lebanon's debt-to-GDP ratio remains among the highest in the world, substantially above conventional debt sustainability thresholds. To gradually move toward a sustainable fiscal position, a lasting and large fiscal adjustment effort is needed for many years to come.

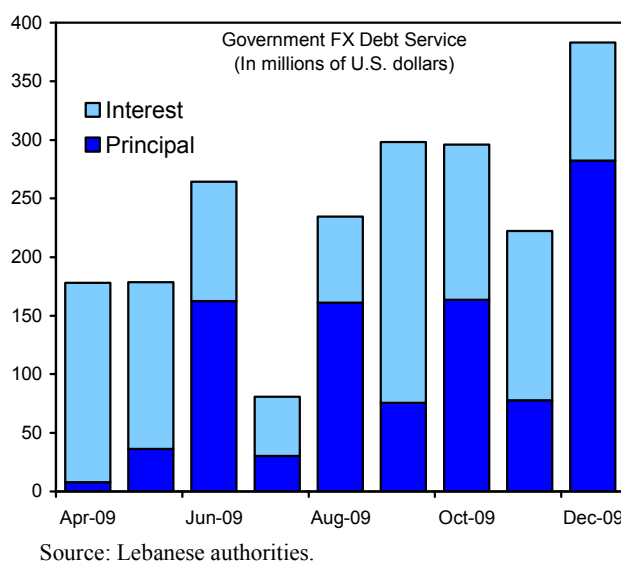
7. **Until the new government takes office, all efforts should aim at avoiding a further fiscal loosening.** Further fiscal expansion would run the risk of eroding market confidence and thus lead to heightened financing risks. It would also complicate fiscal consolidation following the formation of the new government, when decisive action will be necessary to move toward fiscal sustainability.

8. **Heightened fiscal pressures in the run-up to the elections have rendered the task of achieving the authorities' target of a zero primary balance in 2009 more difficult.** The delay in the approval of the budget proposal implies that the fiscal measures under the EPCA-supported program will not be implemented before the new administration is in place, resulting in a fiscal loss of about 0.5 percent of GDP. The recently agreed additional government funding for the Higher Relief Commission (0.6 percent of GDP) also weighs on the fiscal outlook.² Thus, fiscal measures equivalent to around 1 percent of GDP will be necessary to safeguard the government's target of a zero primary balance in 2009. This could be achieved through strict expenditure restraint and prompt implementation of the Paris III fiscal measures by the next government. Any additional savings and revenue overperformance should be locked in to bring forward as much as possible the needed fiscal consolidation. In addition, heightened spending pressures in the run-up to the elections have underscored the need for strict expenditure control to safeguard the June primary balance target under the EPCA-supported program.

² This funding is mainly for housing compensation related to the 2006 war with Israel.

9. **The new government should strive to quickly restore the fiscal consolidation agenda set out under Paris III.** Further postponement of this agenda would risk seriously undermining its credibility. Top priorities include a reduction in the need for budgetary transfers to Electricité du Liban and an increase in the VAT rate. In addition, the authorities should work toward decisive structural reform in the energy sector to spur growth, and toward the privatization of the two mobile phone providers once market conditions allow.

10. **With continued fiscal discipline, the government should be able to obtain the necessary financing from the market during 2009.** With the successful Eurobond exchange last March and strong commercial bank deposit inflows, financing conditions remain broadly favorable. Under the baseline fiscal policy plans, gross financing needs for the government in the second half of the year would amount to around LL 9.7 trillion, of which LL 1.2 trillion (US\$795 million) are amortization of foreign currency debt. Under staff's baseline scenario—which assumes deposit growth to moderate to 10 percent by end-2009—sufficient market financing would be available for the government during the remainder of this year, both in Lebanese pounds and in U.S. dollars, even if there is little rollover by foreign private investors.



11. **Nonetheless, the global recession and the still impaired international financial market conditions continue to pose downside risks to government financing.** The need for the BdL to temporarily absorb government paper from the secondary market, including from international investors, in the first quarter has shown that Lebanon's financing conditions have not been completely decoupled from the global financial market environment. Moreover, a pronounced slowdown in commercial bank deposit growth, which can not be ruled out if global conditions deteriorate further, could tighten financing conditions in the period ahead, particularly if fiscal discipline were relaxed further. To minimize these risks, the government should contain financing needs through strict expenditure control. Moreover, contingency plans for the case of financing shortfalls should be updated in line with evolving conditions, including a combination of (i) further fiscal adjustment, (ii) efforts to mobilize additional donor support, (iii) temporarily lower international reserves accumulation, and (iv) higher interest rates.

12. **Monetary policy should remain cautious in the near term, but following the formation of the next government, there could be room for reducing interest rates.**

Given strong deposit growth, dedollarization and the build-up of international reserves, staff supports the recent decision to reduce interest rates on five-year CDs by 25 bps. Going forward, the BdL should strive to reverse its first quarter government debt purchases with a view to meeting the June program target on government net borrowing from the BdL. Moreover, interest rate policy should remain very cautious in the near term, given the heightened uncertainties during the period of formation of the next government. If deposit growth holds up at comfortable levels beyond that period, we see room for further reductions in interest rates. Lower domestic currency interest rates would also reduce the need to encourage local currency bank lending via exemptions from BdL reserve requirements.

13. **Going forward, consideration should also be given to a change in the use of monetary policy instruments.** The current policy of sterilizing excess liquidity mainly by issuing 5-year CDs at a substantially higher yield than that of 3-year government T-bills shifts part of the cost of government financing to the BdL and conceals the true interest cost inherent in the government's fiscal position. With commercial banks now strongly preferring CDs over T-bills and beginning to on-sell BdL CDs to their clients, after the new government has been formed the BdL should consider changing its monetary policy instruments. For the purpose of liquidity absorption, the BdL should then increasingly shift to selling parts of its large T-bill portfolio and phase out the use of long-term CDs, consistent with banks' concentration limits on exposure to government. This would reduce the quasi-fiscal costs for the BdL, remove the distortion in local-currency interest rates between T-bills and CDs, and ensure that the true interest cost is borne by the budget.

Table 1. Lebanon: Selected Economic Indicators, 2006–09

	Prel. Act. 2006	Prel. Act. 2007	Est. 2008	Proj. 2009
Output and prices	(Annual percentage change)			
Real GDP (market price)	0.6	7.5	8.5	4.0
GDP deflator	2.1	3.8	8.0	4.0
Consumer prices (end-of- period)	7.2	6.0	6.4	2.2
Consumer prices (period average)	5.6	4.1	10.8	2.0
Investment and saving	(In percent of GDP)			
Gross capital formation	22.7	27.4	28.6	23.3
Government	2.5	2.4	1.6	2.8
Nongovernment	20.2	25.0	26.9	20.5
Gross national savings	17.4	20.6	17.8	15.0
Government	-7.8	-8.5	-8.1	-10.3
Nongovernment	25.3	29.1	25.9	25.3
Public finances (cash basis)	(In percent of GDP)			
Revenue (including grants)	25.1	24.4	24.4	24.9
<i>of which: grants</i>	2.9	1.4	0.9	0.4
Expenditure	35.5	35.3	34.2	36.9
Budget balance (including grants)	-10.4	-10.9	-9.7	-12.0
Primary balance (including grants)	2.6	1.7	1.5	0.4
Primary balance (excluding grants)	-0.4	0.3	0.6	0.0
Total government debt	180	168	160	160
Monetary sector	Annual percentage change, unless otherwise indicated			
Credit to the private sector 1/	-5.7	15.8	18.5	10.0
Reserve money	-1.9	9.6	19.1	14.5
Broad money 2/	6.4	10.9	15.5	10.0
Velocity of broad money (level)	0.4	0.4	0.4	0.4
Interest rates (period average, in percent)				
Three-month treasury bill yield	5.2	5.2	5.2	...
Two-year treasury bill yield	8.7	8.7	8.6	8.2
External sector	(In percent of GDP, unless otherwise indicated)			
Exports of goods (in US\$, percentage change)	40.8	26.8	25.3	-1.0
Imports of goods (in US\$, percentage change)	11.3	27.6	36.7	-8.0
Balance of goods and services	-13.5	-18.2	-18.7	-12.6
Current account excluding official transfers	-6.5	-7.6	-11.2	-8.5
Current account including official transfers	-5.3	-6.8	-10.8	-8.3
Foreign direct investment	11.9	7.5	8.9	6.1
Total external debt	199	194	186	178
Gross reserves (in billions of U.S. dollars)	11.4	11.5	18.8	22.1
In months of next year imports of goods and services	6.6	4.9	8.1	9.1
In percent of short-term external debt 3/	31.7	29.7	41.7	46.4
In percent of banking system foreign currency deposits	30.1	26.5	42.8	51.0
In percent of total banking system deposits	21.9	19.7	28.2	30.2
Memorandum items:				
Nominal GDP (in billions of U.S. dollars)	22.4	25.0	29.3	31.7
Net imports of petroleum products (in millions of U.S. dollars)	-2,247	-2,554	-3,875	-2,160
Local currency per U.S. dollar (period average)	1,508	1,508	1,508	...
Real effective exchange rate (annual average, percent change)	2.2	-4.6	1.3	...
Stock market index	1,184	1,454	1,182	...

Sources: Lebanese authorities; and Fund staff estimates.

1/ For 2007, the low headline growth reflects a change in reporting of non-performing loans.

Underlying private sector credit growth has trended above 10 percent in 2007.

2/ Defined as currency in circulation plus resident and non-resident deposits.

3/ Short-term debt on a remaining maturity basis.

Table 2. Lebanon: Quantitative Indicative Targets Under the Program Supported by Emergency Post-Conflict Assistance, December 2008–June 2009
(In billions of Lebanese pounds unless otherwise indicated; end-of-period) 1/

	2008			2009			
	Prog.	Adj. Prog.	Est.	March			
				Prog.	Adj. Prog.	Prog.	
						June	
						Prog.	
I. Gross reserves of the Banque du Liban (stocks) 2/	24,718	24,510	26,793	24,867	24,980	28,871	25,436
II. Primary balance of the government, before grants (cumulative flows)	79	134	279	-346	-337	-284	314
III. Government net borrowing from the Banque du Liban (stocks)	5,905	5,984	4,428	5,700	5,777	6,331	5,700
IV. Accumulation of government gross arrears (cumulative flows, continuous)	0	0	0	0	0	0	0
V. Accumulation of external arrears by the government and the Banque du Liban (cumulative flows, continuous)	0	0	0	0	0	0	0
Memorandum items:							
Outstanding letters of credit contracted by Electricité du Liban (stock, millions of U.S. dollars)	1,046		997	766		503	733
Disbursements of official grants and loans to government (cumulative flows)	1,304		1,022	222		113	365
Banque du Liban's holdings of Republic of Lebanon Eurobonds (stock)	1,187		1,155	1,187		1,749	1,187
Disbursements of grants to the government (cumulative flows)	522		387	39		32	113
Of which: disbursements of project grants (cumulative flows)	242		187	39		30	56
Transfers of gold valuation gains from Banque du Liban to government (cumulative flows)	0		0	0		0	0
Projection of revenue from companies slated for privatization (cumulative flows)	415		331	830

Source: Lebanese authorities.

1/ AI program (end-December 2007) exchange rates.

2/ In millions of U.S. dollars. Defined as Banque du Liban's foreign exchange deposits abroad, foreign exchange holdings (including SDRs), gold and holdings of liquid foreign currency-denominated securities, less encumbered foreign assets.

Table 3. Lebanon: Monitorable Actions, December 2008–June 2009

Measure	Target Date	Implementation
Fiscal		
Submit to parliament the Global Income Tax draft law	End-March 2009	Not met.
Establish a Treasury Single Account	End-June 2009	
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		
Revise electricity tariff structure consistent with program objectives.	End-December 2008	Not met.
Privatization		
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 unfavorable international capital markets.