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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

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Lebanon, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 9, 2010, with the officials of Lebanon on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 15, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of July 29, 2010 updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 30, 2010 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Lebanon.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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LEBANON

Staff Report for the 2010 Article IV Consultation

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

Approved by Ratna Sahay and Thomas Dorsey

July 14, 2010

MAIN ISSUES

Background

Lebanon's economy has largely escaped the impact of the global crisis and performed remarkably well, reflecting a more stable political environment and prudent macroeconomic management. Short-term risks have declined, but there has been little progress in advancing structural reforms and the country's underlying macrofinancial vulnerabilities—especially the government debt—remain very high.

Policy challenges

The key challenges facing the authorities are managing the buoyant economy cautiously to avoid overheating risks, and taking advantage of the positive momentum to address both existing and potential emerging vulnerabilities, and advance long-delayed reforms that will entrench stability and sustain medium-term growth.

Key recommendations

- Target a primary surplus of at least 2 percent of GDP in 2010 to limit stimulus to the strongly growing economy. Accommodate within this fiscal envelope higher investments to overcome infrastructure gaps and proceed in parallel with reforms to address inefficiencies of public utilities.
- Take a cautious approach to further policy interest rate reductions to ensure a smooth deceleration of deposit inflows to a pace that can be more readily absorbed by the economy.
- Continue to aim bank supervision and regulation at preventing excessive risk-taking in light of strong credit growth and rapidly rising real estate prices, paying special attention also to the banking system's expansion outside Lebanon.
- Pursue a decisive further reduction in the public debt-to-GDP ratio over the medium term, while allowing space for permanently higher investment and social spending. This requires rationalizing public expenditures and adopting tax measures.
- Implement structural reforms, including modernizing tax administration and public financial management; creating a sound framework for public-private partnerships; and strengthening the Banque du Liban's income position.
- Further improve the coverage, quality, and timeliness of economic statistics, as data deficiencies still hamper surveillance and policy development.

Authorities' views

The authorities broadly shared the policy recommendations, although they noted that progress on major structural reforms will require consensus-building.

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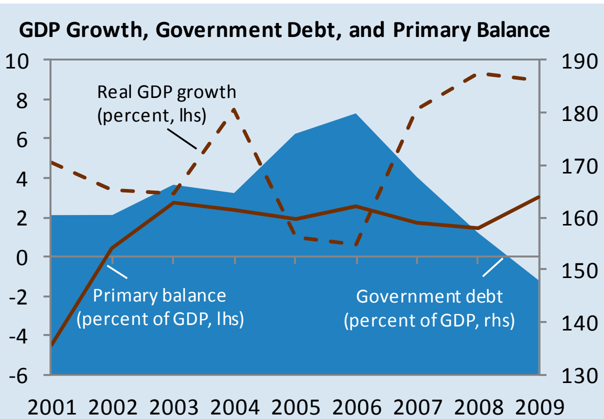
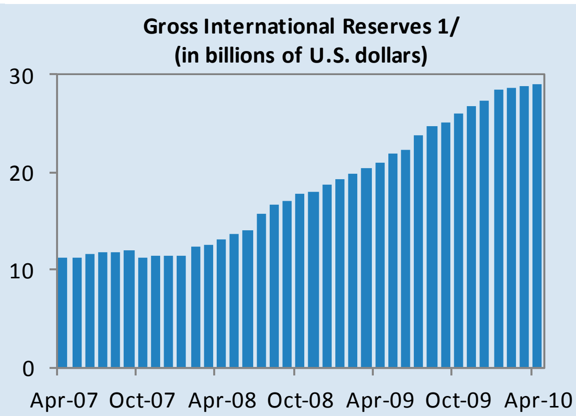
1. BACKGROUND[1]

1. **Lebanon's economic and financial performance has been remarkable in the face of the global recession.** The economy bucked international trends during the global financial crisis, maintaining strong growth momentum despite the country's large underlying vulnerabilities.

2. **This positive outcome reflected domestic and external factors.** Confidence rebounded with the political reconciliation agreement reached in Doha in 2008 and the successful, though delayed, formation of a new national unity government in late 2009, which returned the country to relative political stability. Together with a global low-interest rate environment, this unleashed a sharp acceleration in capital inflows even during the global crisis.

3. **Macroeconomic policies remained prudent during the upswing, but there was little progress on structural reforms.** Buoyant revenues, supported by the reintroduction of fuel excises, led to an increase in the government's primary surplus to 3 percent of GDP in 2009, which—together with strong growth–allowed for a marked reduction in the debt-to-GDP ratio. In addition, the Banque du Liban (BdL) took advantage of the abundant capital inflows to accumulate international reserves. While macroeconomic outcomes have been broadly consistent with the frameworks that were drawn up in the context of the 2007 Paris III donor conference and the two programs supported by the IMF's Emergency Post-Conflict Assistance (EPCA), structural reforms fell substantially short of the authorities' commitments (Box 1).





Sources: Lebanese authorities; and staff estimates and projections.

1/ Excludes gold.

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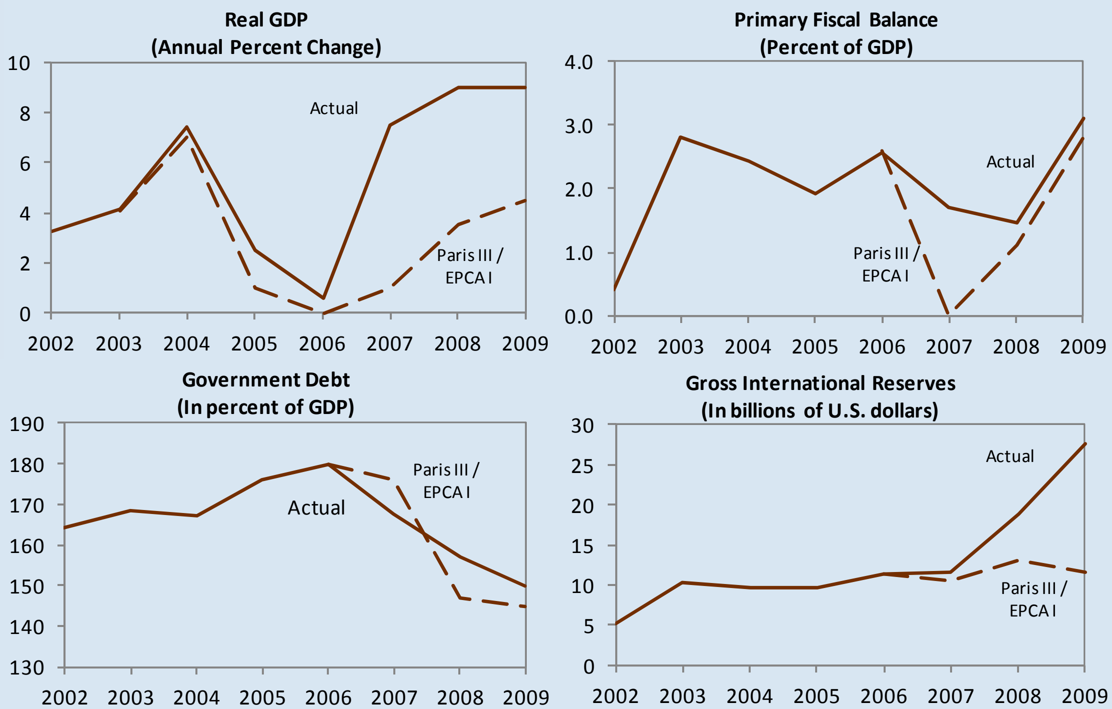
[1] This report is based on discussions held in Beirut during May 27–June 9, 2010. The staff team comprised Messrs. Bauer (head), Finger, Hesse, Mottu (Resident Representative), Sadikov (all MCD), and Lopez Murphy (FAD). Ms. Choueiri (OED) joined for some discussions. Staff met with the Minister of Finance, the Governor of the Banque du Liban (BdL), a number of other members of cabinet and officials of the administration, members of parliament, and representatives of the private sector and the academia. The mission held a joint press conference with the authorities and issued a concluding statement.

Box 1. Economic Performance and Policies in Context

Lebanon's macroeconomic performance has been stronger than anticipated at the time of the Paris III conference and the first program supported by Emergency Post Crisis Assistance (EPCA I) in early 2007. Average real GDP growth during 2007–09 was 8.5 percent, markedly higher than the 3 percent projected under Paris III/EPCA I. Strong growth, together with an increase in the primary fiscal balance broadly in line with expectations, allowed for a decline in the government's debt-to-GDP ratio to 148 percent by end-2009. While this decline was somewhat less than projected under Paris III/EPCA I, the latter assumed resources from privatization of the mobile phone carriers, which did not materialize. At the same time, strong capital inflows and the ongoing dedollarization of deposits allowed for a much larger than anticipated build-up of international reserves.



Sources: Lebanese authorities; and staff estimates and projections.

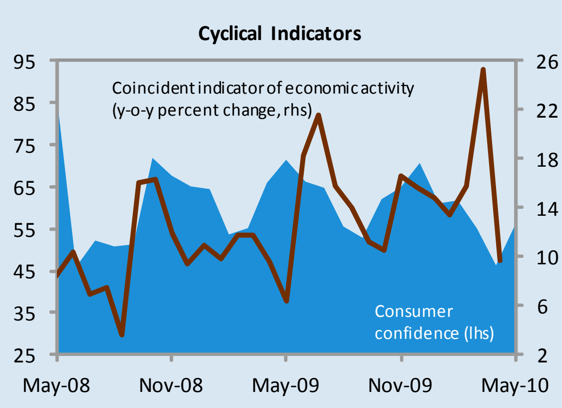
Progress toward the Paris III structural reform objectives has been much more limited. Price stability was maintained, gasoline excises were restored, and increases in capital expenditures and the tax on interest income are part of the draft 2010 budget. The authorities are also working to introduce a more uniform income tax, improve debt management and the budget process, and partially privatize the air carrier MEA. Some progress has also been made in capital market, business environment, and social sector reforms. However, the implementation of other commitments has made little headway, including raising the VAT rate; reforming the electricity sector; privatizing the mobile phone carriers; reducing the wage bill as percent of GDP; eliminating extrabudgetary funds (Fund for the Displaced and Council of the South); and reforming the pension system.

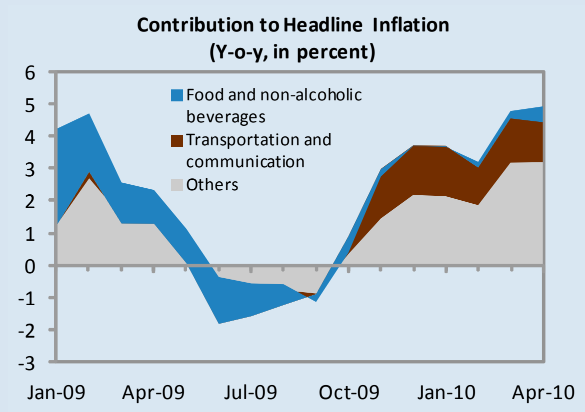
Macroeconomic policy since the last Article IV Consultations has been broadly in line with the staff's advice. The authorities implemented the 2009 budget cautiously and saved the revenue overperformance, which led to a much higher than budgeted primary surplus and a marked decline in the government's debt-to-GDP ratio. Similarly, the authorities gradually reduced interest rates—although at times somewhat slower than suggested by staff—with a view to moderating the pace of deposit inflows once it became apparent that the global crisis was virtually not affecting Lebanon and domestic political near-term risks abated.

4. **While some headway has been made in reducing short-term risks, large underlying vulnerabilities remain and new vulnerabilities could emerge in the future.** Domestic stability rests on the fragile political system that is split along confessional lines, and the country lies at the crossroads of regional tensions. The government's debt, at 148 percent of GDP, still remains among the highest in the world, and almost half of it is denominated in foreign currency. The large banking system is highly exposed to the sovereign, and dependent on short-term deposit inflows from nonresidents. Bank lending is to a large extent dollarized, which creates exposure to unhedged borrowers. In addition, unless carefully managed, new vulnerabilities could emerge in the future from rapidly rising real estate prices, plans to develop public private partnerships (PPPs), or the ongoing regionalization of local banks.

2. THE CURRENT STATE OF LEBANON'S ECONOMY

5. **The expansion of the economy continues at a fast pace**. Real GDP rose 9 percent in 2009 backed by a confidence rebound and large capital inflows, which fueled activity in the construction, tourism, commerce, and financial services sectors. The output gap has substantially narrowed or even closed and momentum carried into 2010, with growth now expected to reach at least 8 percent (Appendix 1). Inflation has risen since the fall of 2009, driven partly by energy prices. Real estate prices have also increased at a rapid pace. In view of the Lebanese pound's peg to the U.S. dollar, the weak euro should help keep inflation in check in the coming months provided that there is no further build-up of price pressures in the non-tradable sector, which could be a risk if the economy accelerates further.



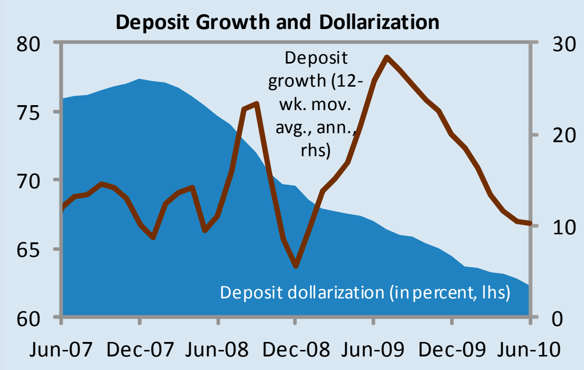


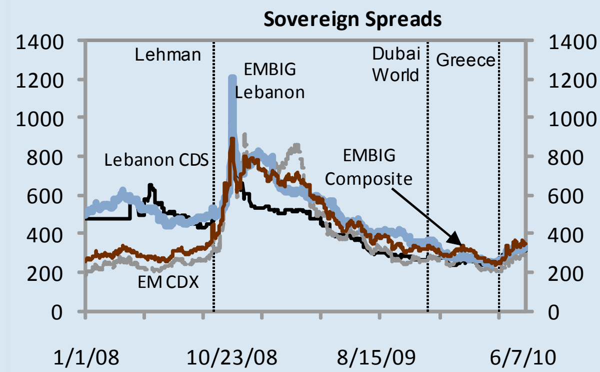
Sources: Lebanese authorities; Byblos Bank Group; and staff estimates and projections.

6. **The current account deficit is set to widen in 2010, mainly reflecting domestic-demand driven growth.** The current account deficit remained stable in 2009, as rebounding tourism inflows and lower prices for energy imports helped offset the effects of rising domestic demand. The current account will likely deteriorate this year as imports receive an additional boost from buoyant domestic demand and a partial rebound of oil prices.

7. **Capital inflows remain robust despite some moderation in recent months.** Non-resident inflows surged last year as political and security risks declined and the authorities kept domestic interest rates high while global rates dropped. As a result, commercial bank deposits grew by more than 23 percent in 2009 and deposit dollarization declined. This allowed the BdL to increase international reserves to over $29 billion, while sterilizing much of the impact on the domestic money supply through the issuance of CDs. Deposit inflows moderated in the

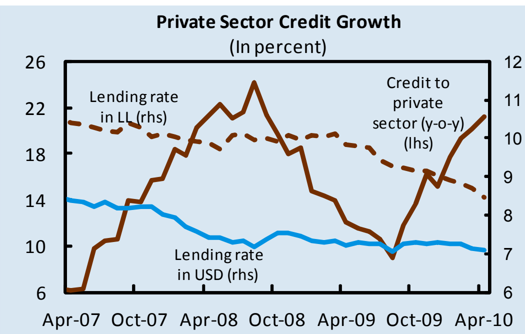
first half of 2010, following a series of interest rate cuts, but remain healthy overall at an annualized growth rate of about 11 percent. Sovereign and CDS spreads have increased somewhat in recent weeks, broadly in line with emerging market averages.





Sources: Lebanese authorities; Bloomberg; and staff estimates and projections.

8. **The banking system has remained sound, but credit growth has picked up recently as banks are seeking to reverse falling interest margins.** Lebanon's banks have weathered the global crisis well, thanks to relatively conservative funding and asset structures, which reflect prudent banking regulation and supervision. Supported by the strong economy, the banking system remains profitable and well-capitalized, highly liquid, and exhibits low and still falling NPL ratios. Exposure to Dubai was very limited, and is virtually non-existent with regards to Southern Europe. However, falling interest rates are putting pressure on bank profits, challenging the traditional business model that relied on intermediation of private deposits to the government and the BdL. Banks are responding by seeking new growth opportunities outside of Lebanon and expanding domestic credit to the private sector, which has accelerated to 21 percent y-o-y growth in April.



Lebanon: Banking Sector Financial Soundness Indicators, 2007–10

	Dec-07	Dec-08	Dec-09	Mar-10
Capital adequacy ratio 1/	12.5	12.1	12.4	…
Net problem loans/net total loans 2/	4.7	3.1	2.3	2.1
Provisions against problem loans/problem	56.9	61.3	64.4	63.4
Claims on the sovereign/total assets	50.8	54.8	55.9	56.0
Average return on assets (post tax)	1.0	1.1	1.1	1.0
Average return on equity (post tax)	12.1	13.8	14.4	14.5
Net liquid assets/short-term liabilities	47.9	50.1	54.2	52.1

Sources: Banque du Liban, Banking Control Commission and staff estimates.
1/ Basel II ratio.
2/ Net of provisions against problem loans.

9. **Near-term risks to the economic outlook are mainly linked to the political and regional security situation**. 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 possibility of a sudden negative confidence shock. While there has been little fallout from Greece so far, an adverse shift in global market sentiment could lead to a repricing of sovereign risk, which would hurt the debt dynamics and could put pressure on international reserves. To some extent, this risk is mitigated by Lebanon's limited exposure to external government debt markets and its loyal depositor base. However, future shocks could be different in nature and expose vulnerabilities more strongly than past crises.

10. **Against this broadly positive backdrop, economic policy still faces a number of challenges.**

- **In the near term, the key issue is to manage the buoyant economy cautiously, avoiding overheating risks, such as excessive pressures on non-tradable prices and the external current account.** This requires, in the first place, a prudent fiscal policy stance. In addition, monetary and prudential policies have to be adapted to the post-global crisis environment to temper deposit inflows and avoid potential risks that could emerge in the future if property prices continued to rise rapidly, or from the regional expansion of local banks.

- **The main medium-term challenges are to address the country's sizeable remaining macrofinancial vulnerabilities and implement growth-enhancing structural reforms**. The key issue here is to avoid complacency and instead take advantage of the positive momentum to achieve debt reduction and re-launch long-delayed structural reforms, which could jointly help entrench stability and maintain high and sustainable rates of growth.

3. MANAGING THE BUOYANT ECONOMY IN 2010

11. **The authorities' short-term policy focus is increasingly shifting from bolstering the economy in the face of a global recession toward managing its rapid expansion.** Fiscal policy seeks to reconcile plans for a substantial increase in infrastructure investments with the need to safeguard macroeconomic stability and debt reduction. The challenge for monetary policy, in turn, is to slow deposit inflows to a pace that can be absorbed without excessive credit growth or international reserves accumulation and associated sterilization costs. Finally, banking sector regulation and supervision is increasingly focusing on potential vulnerabilities emanating from high credit growth, sharply rising real estate prices, and the regionalization of domestic banks.

A. 2010 Budget—Balancing Spending Needs and Stability Goals

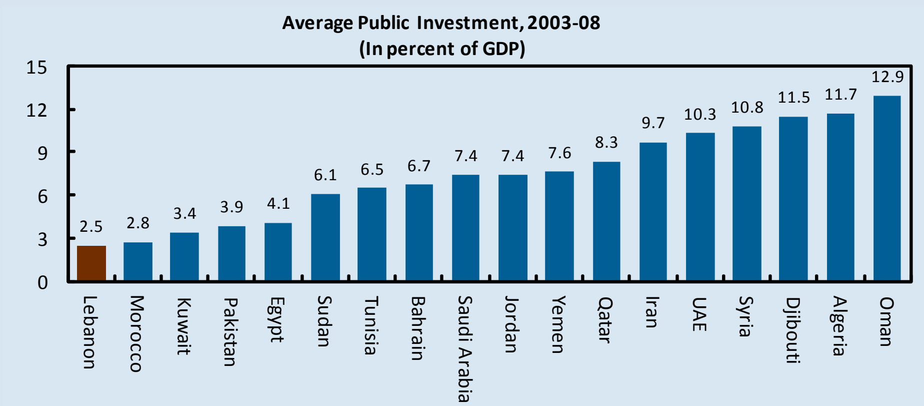
12. **The authorities' draft 2010 budget implies a substantial fiscal relaxation to accommodate higher capital expenditures.** The draft budget, which was approved by cabinet in mid-June following extended deliberations and is currently under discussion in parliament, envisages a 2.4 percent of GDP (200 percent nominal) increase in capital spending, including substantial investments in electricity generation, which has fallen significantly behind demand (Box 2). Revenue measures amount to 0.8 percent of GDP and include a 2 percentage point increase in the interest income tax, an asset revaluation tax, and higher registration fees for high-end properties. A much-discussed VAT hike was dropped for lack of political support. Full implementation of the budget would imply a fall in the primary surplus from 3 percent of GDP in 2009 to 0.5 percent of GDP this year, but would still allow a further moderate decline in the government debt-to-GDP ratio given strong economic growth.

13. **The primary surplus in 2010 may be higher than budgeted.** The authorities and staff believe that the actual primary surplus could reach about 1.5 percent of GDP because of the delays in approving the budget, normal lags in the execution of public investment, and favorable revenue trends.

14. **Staff noted that from a cyclical perspective there was little need for a fiscal impulse and encouraged the authorities to aim for a higher primary surplus**. The currency peg, which limits room for countercyclical monetary policy, places the onus for short-term demand management on fiscal policy (supported by prudential measures). Moreover, achieving a higher primary surplus would also contribute to faster debt reduction. Staff suggested a primary surplus target of at least 2 percent of GDP for 2010, which could be attained by cautiously executing current spending and saving any revenue overperformance. Planned investments to address pressing infrastructure bottlenecks could be accommodated within this fiscal envelope, although related structural reforms should proceed in parallel to ensure that these investments correct rather than reinforce existing deficiencies. For example, staff cautioned that in the electricity sector a substantial increase in investment without a simultaneous movement toward cost recovery could lead to additional losses and subsidies from the budget.

Box 2. Lebanon's Infrastructure Deficit

Public investment in Lebanon is low by international and historical standards, and there are severe infrastructure bottlenecks. Capital spending averaged only 2.5 percent of GDP during 2003–08, and reached a low of 1.5 percent of GDP in 2009. Low investment levels have contributed to generating severe infrastructure gaps, mainly in electricity, telecommunications, water, and the road network, adversely affecting the medium-term growth potential.



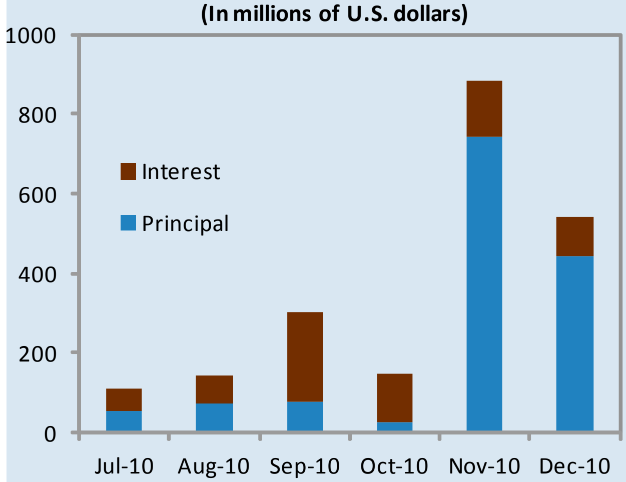
Sources: Lebanese authorities; and staff calculations and projections.

Many infrastructure sectors also suffer from deficiencies in their regulatory frameworks and poor governance and inefficiencies of public utilities. The electricity sector requires high budgetary transfers, and Electricité du Liban (EdL) is inefficient in its structure and operations. Partly due to a lack of competition, Lebanon lags behind its neighbors in telecommunications, in quality, range of services offered, and competitiveness of pricing.

15. **The financing outlook for the government remains favorable and should allow further progress toward achieving a safer debt structure.** There was agreement that—barring a major shock—the government's remaining financing needs for 2010 could be covered by the market, as banks remain very liquid despite the recent slowdown in deposit growth. Following the rollover of $1.2 billion in 10-year Eurobonds in March, the government does not face major foreign currency maturities until November–December ($1.4 billion). Staff seconded the authorities' intentions to use the opportunity to gradually lengthen the maturity profile and lower the foreign currency share of government debt. The latter could be achieved by continuing to fund in local currency some of the government's foreign currency debt service. However, such a strategy should be closely coordinated with the BdL and implemented with a view to safeguard an adequate level of international reserves. Staff also highlighted the desirability of gradually

increasing the share of non-bank funding, and welcomed the authorities' intention to mobilize concessional loans pledged at past donor conferences.

Government FX Debt Service
(In millions of U.S. dollars)



Sources: Lebanese authorities; and staff calculations and projections.

Lebanon: Gross Financing Requirement

	Jul-Dec 2010
A. Primary Balance (LL bn)	250
B. Interest (LL bn)	3172
On LL debt	2100
On FX debt	1072
C. Amortization (LL bn)	10536
On LL debt	8397
On FX debt	2139
Gross Financing Need = B+C-A	
In LL bn	13458
In US$ bn	8.9
Percent of GDP	22.8
Memorandum Item:	
GDP (LL bn)	59018

Sources: Banque du Liban; and staff estimates.

Lebanon: Foreign Assistance to Government
(In millions of U.S. dollars)

	2007 Act.	2008 Act.	2009 Act.	2010 Proj.	2011 Proj.
Total	773	678	890	775	823
Grants	348	257	139	144	43
Loans	425	421	751	631	780
Memorandum item:					
Paris III disbursements	572	382	660	659	700
Grants	147	144	102	121	32
Loans	425	237	558	538	667

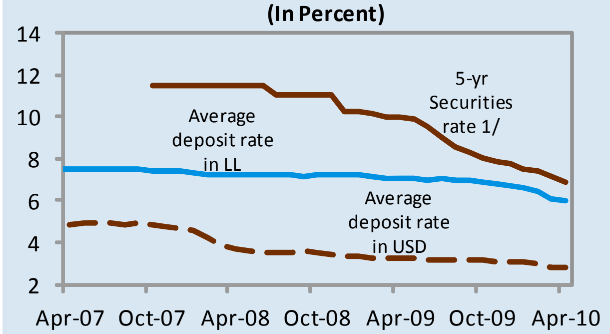
Sources*:* Lebanese authorities; and Fund staff estimates.

B. Managing Monetary Policy in the Face of Large Capital Inflows

16. **After two years of substantial accumulation, international reserves have reached adequate levels.** The authorities noted and staff agreed that Lebanon's fiscal and financial vulnerabilities and its exposure to potential political shocks provided a justification for the accumulated foreign exchange buffer. In staff's view, reserves now cover a comfortable share of broad money and short-term debt, are large enough to withstand plausible Lebanon-specific shock scenarios, and have reached optimal levels according to an applied insurance model. At the same time, self-insurance has come at a cost, as the BdL had to sterilize reserves purchases,

mainly through the issuance of high-yielding LL CDs.[2] The resulting interest cost weighs significantly on the BdL's net income position.

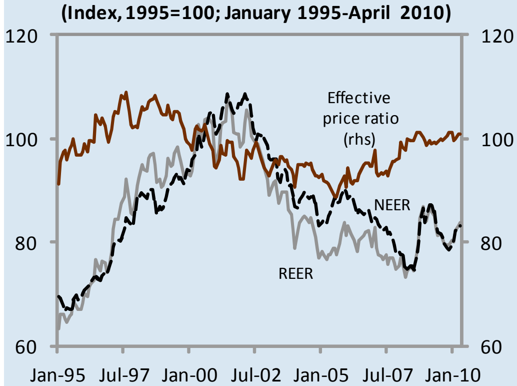
17. **With comfortable reserves in view of the staff, monetary policy has shifted focus to moderating deposit inflows.** Policy interest rates have been allowed to drop markedly (by more than 400 bps since mid-2008 on 5-year T-bills/BdL CDs, of which 70bps in April and May of 2010 alone). However, the decline in deposit rates has been more gradual and modest, reflecting imperfect monetary transmission with variable lags (Appendix 2). Deposit rates have recently started to fall more rapidly, and given the recent erosion of bank interest margins, further declines are likely in the pipeline.



Sources: Lebanese authorities; and staff estimates and projections.
1/ 5-yr BdL CD rate until June, 2009. 5-yr T-bill rate thereafter.

18. **A pause in policy interest rate reductions may be warranted to ensure a smooth adjustment process.** There was broad agreement that care should be taken not to overshoot on reducing policy rates, as risks were judged to be asymmetric. The risk of a possible drying up of inflows because of lags in the response of market interest rates to past monetary policy actions was believed to be costlier than the risk of temporarily accumulating more reserves than optimal. Cautious interest policy would also reduce the risk of having to backpedal if world interest rates and/or emerging market risk premia were to rise, for example in the context of the Southern European crisis. Given the importance of guiding market expectation in the adjustment process, staff encouraged the BdL to clearly communicate its monetary policy objectives to the public.

19. **The exchange rate peg provides a strong nominal anchor and remains the lynchpin of financial stability.[3]** Maintenance of the peg is essential in light of the government's high debt and debt service obligations in foreign currency, and the substantial currency mismatches of corporations and households, owing to widespread loan dollarization. Staff encouraged the authorities to work towards reducing these vulnerabilities. The authorities agreed with staff's assessment that, although the recent strength of the U.S. dollar has led to some real appreciation of the Lebanese pound, the real effective exchange rate remains broadly in line with fundamentals (Box 3).



Sources: National authorities; and Fund staff calculations.
Note: A higher value indicates a more appreciated exchange rate.

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[2] From August 2009 to March 2010, the Ministry of Finance also built cash balances at the BdL for pre-financing purposes, using primarily 3- and 5-year government T-bills. These balances reduced the sterilization needs of the BdL.

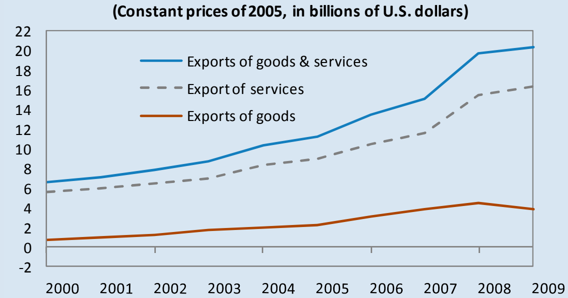
[3] Under the IMF's exchange rate arrangement classification system, Lebanon falls under the category "stabilized arrangement" since its *de facto* peg has not been formally announced.

Box 3. Real Exchange Rate Assessment

Lebanon's exchange rate appears broadly in line with its fundamentals. After several years of decline in line with a weakening U.S. dollar, the real effective exchange rate (REER) has risen somewhat since mid-2008. The recent increase in the real exchange rate reflects both a strengthening of the U.S. dollar and sustained domestic inflation.

Lebanon's strong export performance suggests that the country does not face major competitiveness problems. Both goods and services export volumes are estimated to have grown by close to 15 percent on average over the past five years (2005-09), and by 6 percent on average over the last twenty years despite a major appreciation of the U.S. dollar and hence the Lebanese pound during the 1990s. Among services exports, tourism, which accounts for one third of exports, has been particularly dynamic in recent years, as reflected—for example—in substantially higher tourist arrival numbers.

Exports of Goods and Services, 2000-2009
(Constant prices of 2005, in billions of U.S. dollars)



Sources: National authorities; and Fund staff calculations.

The application of the three methodologies proposed by the IMF's Consultative Group on Exchange Rate Issues (CGER) does not yield evidence of a marked exchange rate misalignment. The *macroeconomic balance* and the *external sustainability approaches* point to *a* somewhat overvalued exchange rate (between 3 and 9 percent), while the e*quilibrium real exchange rate approach* suggests a modest undervaluation (by up to 10 percent). The differences between the results likely reflect methodological differences and limited data availability, as some variables commonly used for equilibrium exchange rate estimations are not available for Lebanon. Taking into account the individual methodologies' strengths and weaknesses in the Lebanon context, all three methodologies should be given about equal weight in the overall assessment.

Lebanon: Real Exchange Rate Overvaluation Estimates Using CGER Approaches 1/

	NEAP 1 - IFS 2/		NEAP 2 - BIS 3/	
1. Macrobalance approach 4/				
Current account norm (in percent of GDP)	-6.8		-6.2	
	Underlying	Steady state	Underlying	Steady state
Current account (in percent of GDP)	-8.0	-9.9	-8.0	-9.9
Overvaluation (in percent)	2.8	7.4	4.3	8.8
2. External sustainability approach				
Overvaluation (in percent)	4.0		9.1	
3. Equilibrium real exchange rate approach overvaluation 5/		Min	Max	
Overvaluation (in percent)		-10.4	-0.2	

1/ Using CGER parameters and a current account elasticity of 0.4.
1/ Net external asset position (NEAP) estimate based on International Financial Statistics data.
3/ Net external asset position (NEAP) estimate based on Bank for International Settlements data.
4/ For each parametrization, compares the norms with a) underlying 2009 current account stripped of temporary factors and b) steady state (2015) current account.
5/ Range of estimates obtained using different model specifications.

C. Tailoring Supervision to an Evolving Banking Sector

20. **The authorities are focusing bank regulation and supervision on preventing excessive risk taking.** For example, they limited the loan-to-value ratio for most real estate loans to 60 percent. Staff agreed that the BdL and the Banking Control Commission (BCC) should remain vigilant to the potential risks of weakening credit standards, increasing leverage in specific sectors, and deteriorating asset quality. Staff noted that, despite conservative prudential regulation on leverage and limited bank exposure to the real estate sector, care should be taken that the recent surge in housing prices and accelerating credit growth do not feed off each other to produce a real estate bubble. Moreover, prudential regulation may need to support monetary and fiscal policies in dealing with the booming economy. In particular, if credit growth accelerates further, the authorities should consider increasing effective reserve requirements,

including by phasing out existing exemptions that were created to stimulate lending in domestic currency. Looking forward, the BdL and BCC could also consider the merits of introducing countercyclical prudential regulation.

21. **The regional expansion of Lebanese banks justifies the BCC's heightened focus on effective cross-border supervision**. Current supervisory activities are broadly in line with good practices and could be further enhanced through continued efforts to deepen de facto cooperation and information sharing with host country supervisors, and greater focus on conducting stress testing and scenario analyses (Box 4).

22. **Further progress is needed in the areas of anti-money laundering and combating the financing of terrorism (AML/CFT).** The authorities are committed to conform their AML/CFT framework to the Financial Action Task Force's 40+9 Recommendations. The recent Middle East and North Africa Financial Action Task Force Mutual Evaluation Report recognized significant progress accomplished by the authorities in several areas, including the performance of the Financial Intelligence Unit, while noting that the framework needs further strengthening in other areas, in particular the criminalization of money laundering and the financing of terrorism, and the reinforcement of the AML/CFT supervisory system.

Box 4. The Regionalization of Lebanese Banks

Lebanese banks have substantially increased cross-border activities in recent years by opening affiliates abroad and increasing non-resident lending from their headquarters in Lebanon. There are currently more than 50 affiliates (branches, subsidiaries and representative offices) of Lebanese banks operating in about 20 countries. Total assets of foreign affiliates amount roughly to $25 billion, or 19 percent of the domestic banking sector. Loans to non-residents booked by parent banks have tripled since 2006, reaching 16 percent of private sector credit.

The foreign expansion has been motivated by the limited growth potential of the domestic credit market and untapped opportunities in countries with growing banking sectors. Lebanese banks have traditionally been active in Europe, but more recently they have primarily targeted countries in North Africa and the Middle East with business models that adapt to host country conditions. For example, in Syria, Egypt, and Jordan banks engage in universal banking, while Cyprus is used as a gateway for offshore services. In Europe, banks concentrate on trade finance and private banking, while in Africa, they cater largely to the Lebanese diaspora.

Lebanese Banks Abroad 1/

	Total assets (in US$ billions)	Number of affiliates
Syria	7.0	9
France	4.2	4
Egypt	3.7	3
Cyprus	2.2	10
Jordan	1.9	3
Switzerland	1.2	2
Belgium	0.9	1
Turkey	0.8	1
Sudan	0.6	2
United Kingdom	0.4	1

Sources: Fund staff estimates based on preliminary data from authorities.

1/ Top 10 countries by the total assets of affiliates.

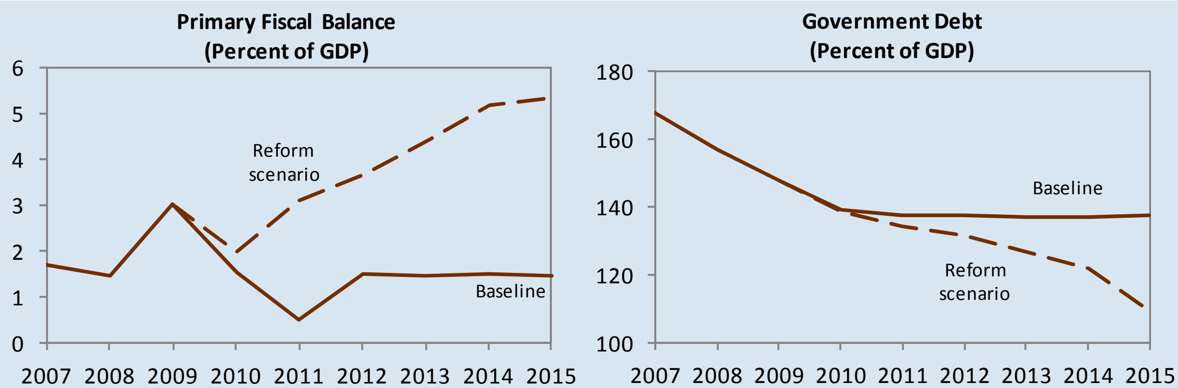
The growing regionalization of banks calls for effective regulation and cross-border supervision, which the Banque du Liban and the BCC are undertaking. The authorities have implemented a number of measures to strengthen the oversight of Lebanese affiliates abroad. Any equity investment by a Lebanese bank abroad requires prior approval from the BCC. Foreign affiliates are required to submit monthly financial statements and audit reports to their parent banks and the BCC, and parent banks must set up a special committee to oversee their foreign affiliates. To limit the foreign exposure, total net financing from a parent bank to its affiliates cannot exceed 25 percent of equity, while non-resident lending is subject to a ceiling that depends on the sovereign rating of borrower's country. The BCC has also signed memoranda of understanding with most host country supervisors, which establish procedures for information exchange and off- and on-site inspections.

4. A MEDIUM-TERM ROADMAP FOR CONTINUED STABILITY AND SUSTAINED GROWTH

23. **The authorities and staff agreed that lowering the government debt-to-GDP ratio remains the top medium-term priority to reduce Lebanon's macro-financial vulnerabilities.** Under the staff's baseline no-policy change scenario, the debt-to-GDP ratio would remain above 135 percent throughout the medium term and could become explosive if the economy suffers a negative shock and policies are not strengthened (Box 5). Large gross financing requirements also carry substantial rollover risks, and the high interest burden (45 percent of revenues) crowds out productive public spending, limiting the economy's growth potential. Against this backdrop, the authorities reiterated their commitment to pursue an ambitious reduction of the public debt over the medium term.

24. **The baseline scenario would imply a further temporary relaxation of the fiscal primary balance in 2011**. Given the delays in the approval of the 2010 budget and spending lags, the increase in public investment set in motion in the 2010 draft budget would be executed to a significant extent in 2011. With unchanged policies, this would lead to a further decline in the primary surplus next year to about 0.5 percent of GDP, before returning to around 1.5 percent of GDP in 2012-15. With this, the debt-GDP ratio would stabilize at around 137 percent of GDP over the medium-term.

25. **Staff also presented a reform scenario that envisages sizeable fiscal consolidation and the implementation of long-delayed structural reforms.** The scenario centers on increasing the government's primary surplus to 5 percent of GDP by 2015, while creating fiscal space to maintain a permanently higher level of public investment and social spending to broaden the social safety net (Tables 7 and 8; and Box 5). The additional adjustment would boost confidence, help reduce interest rates, and raise the medium-term growth potential. Under these assumptions, the government debt-to-GDP ratio could decline by 25–30 percentage points by 2015.



Sources: Lebanese authorities; and staff estimates and projections.

26. **Fiscal space would need to be created through a combination of expenditure rationalization and tax measures.**

- On the spending side, staff argued for a rationalization of current expenditures, stressing in particular that there is room for shifting the high and poorly targeted budget transfers to EdL (4.2 percent of GDP in 2009) to more productive uses. This requires reforms to EdL's administration to achieve efficiency gains and a decisive move in the tariff structure toward cost recovery. The authorities agreed on the importance of reforming the electricity sector, noting that a strategy to this effect has been developed with support from the World Bank and was recently approved by cabinet. They also noted that budget subsidies to EdL had been 1 percent of GDP lower during the first quarter of 2010 than in the first quarter of 2009, reflecting lower fuel costs but also some improvements in the collection of electricity bills.

- On the revenue side, staff presented a menu of options to generate additional revenues of about 3 percent of GDP over five years. The final revenue package should take equity and efficiency considerations into account and focus on increasing uniformity, broadening tax bases, and possibly raising some tax rates that are moderate by international standards (Appendix 3). Potential measures encompass reforming the income tax, including to cover capital gains for individuals; broadening the VAT base by eliminating exemptions; raising excises on alcohols; and protecting the real value of excise taxes through indexation. In addition, both the VAT and the corporate income tax rates are comparatively low and offer potential for a gradual increase. The authorities intend to submit later this year a new income tax law to parliament that goes in the recommended direction. They will also consider further tax reforms for the 2011 budget, although this would require consensus-building.

27. **Telecom privatization could enhance the economy's growth potential while helping to reduce the public debt.** The authorities ruled out privatizations in the very short term, but considered that the sale of the two public mobile phone providers could be envisaged at a later stage. The telecom sector is inefficient in infrastructure investment and pricing, and privatization could be one route towards unlocking the sector's large growth potential.

Box 5. Government Debt Sustainability Analysis

Debt level and structure. Lebanon's sovereign gross debt amounted to LL 77 trillion (US$51 billion) as of end-2009. This was equal to 148 percent of GDP, 139 percent of GNDI, and 53 percent of commercial bank assets. Domestic currency debt accounted for 58 percent of total government debt and carried an average maturity of 1.6 years. Foreign currency debt made up for the remaining 42 percent of the government debt and had a higher average maturity of 4.6 years. The government debt is mainly held by commercial banks (58 percent), the BdL (15 percent), and other government institutions (8 percent).

Baseline scenario. Under the baseline ("no policy-change") scenario, we assume that the medium-term primary balance (including grants) of the government is kept constant at 1.5 percent of GDP. Real growth would slow to a potential growth rate of around 4 percent, and Lebanese interest rates would increase over time in line with projected world interest rates. Under this scenario, the debt-to-GDP ratio would remain roughly unchanged from its 2010 level of nearly 140 percent of GDP, as the debt-reducing effects of the primary surpluses and economic growth would be offset by high interest payments resulting from the large debt stock (Table 11 and Figure 1, panel 1).

Shocks. The risks to this outlook would be substantial. Higher interest rates, lower economic growth, and fiscal shocks could reverse the downward trend for the debt-to-GDP ratio observed during 2006–10:

- A permanent increase in the real interest rate of 230 basis points (one-half standard deviation from its past distribution) relative to the baseline would lead to an increase in the debt-to-GDP ratio to 158 percent by 2015 (Figure 1, panel 2).
- A permanent decrease in real GDP growth of 1.7 percentage point (one-half standard deviation from its past distribution) relative to the baseline would raise the debt to 161 percent of GDP (Figure 1, panel 3).
- A combination of the former two shocks would lead to an increase in the debt to 183 percent of GDP (Figure 1, panel 4).
- A permanent decrease in primary balance of 1.6 percent of GDP (one-half standard deviation from its past distribution) relative to the 2000–09 average would lift the debt to 150 percent of GDP (Figure 1, panel 5).

Reform scenario. Fiscal consolidation, higher investment in social and physical infrastructure, and structural reforms to strengthen economic institutions would lower interest rates and raise medium-term growth. Telecom privatization could also contribute to lowering the debt. Under such a scenario, debt could decline to below 110 percent by 2015 (Figure 1, panel 6).

28. **The authorities are planning to develop public-private partnerships (PPPs) as an alternative avenue to involve the private sector in addressing the country's infrastructure gaps.** Staff agreed that PPPs can offer better value for money than the public provision of infrastructure services, but noted that they may also generate important fiscal liabilities. A number of preconditions should therefore be met before embarking on a PPP program, such as a legal framework that ensures adequate risk transfer to the private sector, prescribes a clear process for the evaluation and approval of PPPs, and establishes a "gatekeeper role" for the Ministry of Finance to assess and manage fiscal risks. Other elements of a sound PPP framework involve competitive bidding procedures, incentive-based regulation, capacity-building at the government level, and proper accounting and reporting of fiscal implications (Box 6). The authorities are currently in the process of strengthening an earlier draft framework law for PPPs, which could be re-submitted to parliament during the summer.

Box 6. Public Private Partnerships in Lebanon

Public-Private Partnerships (PPPs) are mechanisms for the provision and operation of infrastructure assets and services, and represent an alternative to traditional public procurement or privatization. The main advantage of PPPs is the potential for higher quality services at lower costs. The main risks with PPPs are related to unforeseen fiscal contingencies.

The international experience with PPPs has been mixed and several preconditions should be in place to maximize the chances of success. While there is evidence that PPPs have contributed to efficiency gains, particularly in the United Kingdom where they have been used since the 1990s, there is also evidence to the contrary. The country experiences suggest that five preconditions should be in place for PPPs to be successful and contain fiscal risks. First, a sound institutional framework covering all major aspects of the PPP process and conducive to private participation. Second, a government and a public administration with sufficient technical expertise to handle a PPP program, including the capacity to evaluate and select among projects. Third, the allocation of PPP contracts based on competitive bidding, and reliance on incentive-based regulation. Fourth, an adequate risk transfer to the private sector. And fifth, proper accounting and reporting of the fiscal implications of PPPs. To reduce fiscal risks, the Ministry of Finance should be given a strong role in the process and set up a specialized PPP unit to screen and evaluate potential projects. This unit should have the authority to approve or reject feasibility studies, tender documents, preferred bidders, and PPP contracts.

PPPs could be a valuable alternative to traditional public procurement of infrastructure in Lebanon, but should only be pursued if they provide efficiency gains and limit fiscal risks and contingent liabilities. The latter is particularly important in Lebanon, given the country's high debt-to-GDP ratio. To ensure positive outcomes, the authorities will need to refine the existing PPPs draft law to include comprehensive legal provisions, investment project evaluation and selection, accounting and reporting procedures, and a strong role for the Ministry of Finance before potential projects are considered.

29. **Fiscal institutions should be strengthened to support the medium-term strategy.** Staff argued that there is scope to modernize tax administration to further improve compliance and avoid the perception that taxpayers are affected unevenly by any new tax measures. Synergies in tax collection could be realized from integrating the VAT and income tax administrations, strengthening the large taxpayers unit, and introducing electronic filing of tax returns. In addition, amnesties on fines and penalty interest for tax arrears should be discontinued. The introduction of the planned more uniform income tax law would constitute a simplification of existing procedures, easing the administrative burden on tax payers and the tax administration. On the public financial management side, staff welcomed the provision in the draft 2010 budget to cast future budgets in a multi-year framework, and encouraged the authorities to reenergize efforts to broaden the coverage of the budget, introduce a Treasury Single Account, and strengthen the treasury's capacity. The authorities are gradually enhancing the debt management capacity at the Ministry of Finance, including by preparing a decree to operationalize the debt management unit, which is welcome.

30. **The BdL's balance sheet should be strengthened.** The management of past crises and large sterilization operations in the last two years have substantially weakened the BdL's net income position. Lower interest rates and a much slower pace of reserve accumulation are helping to ease the drain of the sterilization operations on the BdL's finances. In addition, the

BdL should prepare a strategy for strengthening its income position. In this context, staff argued that phasing out the exemptions from reserve requirements would be beneficial. Privatization of the non-financial assets, including the planned partial sale of the national air carrier MEA and the ongoing divestment of the real estate portfolio, would also help improve the BdL's financial balance.

31. **Further efforts are required to improve the statistical system, including its coverage, quality, and timeliness.** Staff called on the authorities to address important remaining statistical gaps, in particular improving national accounts and balance of payments statistics, as well as expanding the coverage of fiscal statistics to encompass the various extrabudgetary entities. In addition, the development of regular and timely wage, employment, and real estate statistics would allow for enhanced economic monitoring and policy development (see the Informational Annex).

5. STAFF APPRAISAL

32. **Lebanon's economy has performed remarkably well, bucking international trends in the face of the global crisis.** Growth has been fueled by regained political stability and continued capital inflows, while inflation has remained under control so far.

33. **The authorities are to be commended for pursuing prudent macroeconomic policies, though structural reforms have remained largely stalled**. The government took advantage of the favorable environment to increase the primary surplus in 2009, which contributed to a further reduction in the debt-to-GDP ratio, while the BdL used the opportunity provided by abundant capital inflows to bolster its international reserves. However, little progress has been made toward strengthening economic institutions and addressing other structural weaknesses.

34. **Short-term risks have declined, but Lebanon's underlying vulnerabilities remain high and new ones could emerge.** The public debt-to-GDP ratio is still among the highest in the world and government financing and financial sector stability are reliant on continued inflows of short-term non-resident deposits. In this environment confidence depends crucially on continued political stability and the absence of regional tensions.Additional vulnerabilities could emerge, for example from rapidly rising real estate prices, potential fiscal contingencies from planned PPPs, or the ongoing internationalization of local banks, unless these processes are carefully managed.

35. **Thus, while significant progress has been made, the Lebanese authorities continue to face a number of policy challenges.** In the near-term, a key issue is to manage the buoyant economy cautiously to prevent overheating. In addition, policies should be proactive to prevent the build-up of new vulnerabilities. Over the medium term, the main challenges are to decisively reduce the high government debt and address emerging structural bottlenecks. While Lebanon's economy has been remarkably resilient to shocks in the past, it will be important to avoid complacency and act on these fronts, as future crises could be very different in nature and expose vulnerabilities more strongly than in the past.

36. **The fiscal expansion in 2010 should be limited in light of the fast-growing economy.** Staff believes that a higher-than-budgeted primary surplus of at least 2 percent of GDP this year is both appropriate and achievable, and would leave enough room for a substantial increase in capital expenditures. Higher public investment is important to address growing infrastructure gaps, but must be accompanied in parallel by reforms to improve the efficiency and cost recovery of public utilities, particularly the electricity sector.

37. **Monetary policy has rightly focused on moderating deposit inflows as international reserves have reached adequate levels, but a pause in policy interest rate reductions may now be warranted.** The authorities have reduced policy interest rates substantially and the pace of deposit growth has slowed to a level that can be more readily absorbed by the economy. Given the imperfect monetary transmission mechanism with uncertain lags in Lebanon, staff suggests a cautious approach to further policy rate reductions. With interest rate policy now effectively being conducted jointly by the BdL and Ministry of Finance, policy plans need to be well-coordinated.

38. **The exchange rate peg has been important for financial stability.** The peg has acted as an important nominal anchor for the economy. In addition, the government's high foreign-currency debt and balance-sheet mismatches of corporations and households suggest that the peg remains the adequate exchange rate regime. While maintaining the peg, efforts should continue to reducing these important vulnerabilities over time.

39. **Bank regulation and supervision should continue to focus on preventing excessive risk taking.** The banks' conservative funding and—the large exposure to the sovereign aside—asset structures, backed by effective banking supervision and regulation, have limited exposures to global liquidity conditions and the real estate market. However, high liquidity and declining interest rates are leading banks to increase private sector credit and expand their businesses in the region. Bank supervision and regulation should hence remain vigilant, with heightened focus on the banks' regionalization.

40. **The medium-term fiscal strategy should target a substantial reduction in the public debt-to-GDP ratio, while allowing space for permanently higher investment and social spending.** These goals can be achieved by rationalizing current expenditures, in particular reducing budget transfers to the electricity sector, and putting in place a socially balanced tax package.

41. **The medium-term fiscal strategy should be supported by a number of institutional reforms.** These include strengthening the tax administration and reenergizing the implementation of public financial management reforms. In particular, a strong framework needs to be put in place to minimize the risk of contingent liabilities stemming from PPPs. In addition, reforming the telecom sector, through privatization or otherwise, would help unlock the sector's large growth potential.

42. **The BdL's balance sheet is in need for strengthening.** The sterilized accumulation of international reserves, while appropriate, has weakened the net income position of the BdL. While lower interest rates and a slower pace of reserve accumulation are already helping to ease the drain of the sterilization operations on the BdL's finances, the authorities should devise a medium-term plan to bolster the BdL's balance sheet.

43. **Clear, timely and proactive communication of policy intentions will be important to anchor expectations and confidence, and build ownership for necessary reforms.** Communication of the government's debt reduction objective will be particularly relevant. The intended movement toward multi-year fiscal frameworks is a welcome step in this regard. Similarly, the BdL should clearly present its policy objectives, including its views on the adequacy of international reserves, to help guide market expectations especially at time of policy shifts.

44. **The statistical system needs to be further improved.** Despite recent efforts, data insufficiencies, including in the areas of the national accounts, employment and wage statistics, coverage of the fiscal accounts, and balance of payments statistics, still hamper economic analysis and policy development. A high-level commitment from the government is needed to push the statistical reform agenda forward.

45. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Lebanon: Selected Economic Indicators, 2008-15
(Population: 3.9 million; 2009)
(Per capita GDP: US$8,467; 2009)
(Quota: SDR 203 million)
(Poverty rate: 28 percent; 2004-05)
(Unemployment: 8.1 percent; 2007)

		Prel.	Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015
Output and prices	(Annual percentage change)							
Real GDP (market prices)	9.3	9.0	8.0	5.0	4.0	4.0	4.0	4.0
GDP deflator	9.3	5.8	5.0	3.5	2.2	2.2	2.2	2.2
Consumer prices (end-of- period) 1/	6.4	3.4	4.7	2.8	2.2	2.2	2.2	2.2
Consumer prices (period average) 1/	10.8	1.2	5.0	3.5	2.2	2.2	2.2	2.2
Investment and saving	(In percent of GDP)							
Gross capital formation	30.0	30.2	31.0	31.0	29.8	29.2	28.6	28.5
Government	1.6	1.5	2.6	3.5	2.5	2.7	2.6	2.5
Nongovernment	28.4	28.7	28.5	27.4	27.4	26.5	26.0	26.0
Gross national savings	20.7	20.7	20.0	19.8	19.4	19.2	18.7	18.6
Government	-8.0	-6.7	-6.1	-6.1	-5.7	-5.2	-5.6	-6.0
Nongovernment	28.7	27.4	26.0	25.9	25.1	24.4	24.4	24.6
Central government finances (cash basis)	(In percent of GDP)							
Revenue (including grants)	23.8	24.6	24.1	24.1	24.2	24.5	24.5	24.5
of which: grants	0.9	0.4	0.4	0.2	0.3	0.3	0.2	0.2
Expenditure	33.4	32.7	32.8	33.7	32.3	32.3	32.7	33.0
Budget balance (including grants)	-9.6	-8.1	-8.7	-9.6	-8.1	-7.8	-8.2	-8.5
Primary balance (including grants)	1.4	3.0	1.5	0.5	1.5	1.5	1.5	1.5
Primary balance (excluding grants)	0.6	2.6	1.2	0.3	1.2	1.1	1.3	1.3
Total government debt	157	148	139	137	137	137	137	138
Monetary sector	(Annual percentage change, unless otherwise indicated)							
Credit to the private sector	18.5	15.1	18.0	9.7	9.0	9.0	9.0	9.0
Broad money 2/	15.5	23.2	12.0	12.0	12.0	12.0	12.0	12.0
Velocity of broad money (level)	0.37	0.35	0.35	0.34	0.33	0.31	0.29	0.28
Interest rates (period average, in percent)								
Three-month treasury bill yield	5.2	5.0	...	...	...	...	...	...
Two-year treasury bill yield	8.6	7.6	5.8	6.3	6.9	7.4	7.7	7.8
External sector	(In percent of GDP, unless otherwise indicated)							
Exports of goods (in US$, percentage change)	29.1	-10.2	12.0	8.0	8.0	8.0	8.0	8.0
Imports of goods (in US$, percentage change)	36.3	-2.3	12.0	7.2	8.0	8.5	8.5	8.5
Balance of goods and services	-17.9	-16.2	-15.9	-15.9	-16.0	-16.4	-17.1	-17.8
Current account (excluding official transfers)	-9.7	-9.7	-11.3	-11.2	-10.5	-10.0	-9.9	-9.9
Current account (including official transfers)	-9.3	-9.5	-11.1	-11.2	-10.4	-9.9	-9.9	-9.9
Foreign direct investment	8.8	10.7	10.0	9.7	9.4	9.2	8.9	8.7
Total external debt 3/	172	171	160	162	169	178	188	198
Gross reserves (excluding gold), in billions of U.S. dollars	18.8	27.4	29.6	31.8	35.1	40.8	47.2	53.0
In months of next year imports of goods and services	7.9	10.3	10.3	10.3	10.6	11.4	12.3	13.8
In percent of short-term external debt 4/	45.7	55.2	55.4	53.2	52.4	53.2	55.7	54.7
In percent of banking system foreign currency deposits	34.7	44.4	44.4	43.4	43.4	45.7	48.0	48.9
In percent of total banking system deposits	24.1	28.6	27.5	26.5	26.0	27.0	27.8	27.9
Memorandum items:								
Nominal GDP (in billions of U.S. dollars)	29.9	34.5	39.1	42.5	45.2	48.1	51.1	54.3
Foreign-exchange-denominated bank deposits (percent change)	4.0	14.1	7.7	10.3	10.3	10.3	10.2	10.2
Commercial bank total assets	315	334	330	341	359	379	400	422
Real effective exchange rate (annual average, percent change)	-3.0	7.1	...	...	...	...	...	...
Stock market index	1182	1566	...	...	...	...	...	...
EMBI Global - Lebanon (spread; basis points)	794	293	...	...	...	...	...	...

Sources: Lebanese authorities; and Fund staff estimates.

1/ Through 2008: based on the CPI index by Consultation and Research Institute; from 2009: based on the CPI index by Central Administration of Statistics.

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

3/ Includes non-resident deposits.

4/ Short-term debt on a remaining maturity basis, including short-term non-resident deposits.

Table 2. Lebanon: Central Government Overall Deficit and Financing, 2008–15

	2008	2009	2010		2011	2012	2013	2014	2015
	Year	Year	Q1	Year	Year	Year	Year	Year	Year
	Act.	Act.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In billions of Lebanese pounds, unless otherwise indicated)								
Revenue and grants	10,741	12,802	3,082	14,224	15,454	16,496	17,718	18,857	20,028
Revenue	10,354	12,591	3,082	14,006	15,302	16,300	17,496	18,717	19,889
Tax revenue	7,183	8,968	2,360	10,280	11,177	11,935	12,875	13,829	14,717
Taxes on income and profits	1,564	1,839	430	2,314	2,587	2,834	3,267	3,643	3,919
Taxes on property	786	809	275	977	1,140	1,212	1,288	1,369	1,454
Taxes on domestic goods and services	2,895	3,260	867	3,730	3,980	4,247	4,498	4,806	5,134
Taxes on international trade 1/	1,588	2,664	663	2,831	3,004	3,146	3,295	3,451	3,615
Other taxes	350	396	125	429	466	496	527	560	595
Nontax revenue	2,613	3,065	553	2,924	3,268	3,474	3,693	3,925	4,169
Other treasury revenue	558	558	170	802	857	891	927	964	1,003
Grants	387	210	0	218	152	196	223	139	139
Total expenditures	15,101	17,092	3,945	19,335	21,595	22,052	23,414	25,191	26,979
Current primary expenditure	9,393	10,536	2,355	11,784	12,879	13,789	14,725	15,707	16,772
Wages, salaries and pensions	3,969	4,936	1,233	5,234	5,687	6,047	6,428	6,831	7,257
Transfers to EDL 2/	2,315	2,165	483	2,302	2,576	2,835	3,080	3,333	3,626
Other current 3/ 4/ 5/	3,109	3,435	639	4,248	4,616	4,907	5,217	5,544	5,890
Interest payments	4,979	5,799	1,401	6,023	6,485	6,582	6,747	7,490	8,162
Domestic currency debt	2,847	3,663	918	3,851	4,126	4,156	4,275	4,817	5,303
Foreign currency debt	2,132	2,136	483	2,172	2,359	2,426	2,472	2,672	2,859
Capital expenditure	729	757	189	1,528	2,231	1,681	1,942	1,994	2,045
Domestically financed	425	478	123	1,078	1,326	900	1,265	1,517	1,565
Foreign financed	304	279	66	450	905	780	678	477	480
Overall balance (checks issued)	-4,360	-4,290	-863	-5,111	-6,141	-5,556	-5,696	-6,334	-6,951
Primary balance (checks issued)	619	1,509	538	912	344	1,026	1,051	1,155	1,212
Statistical discrepancy/float	33	62	103	2	6	7	8	1	1
Overall balance (cash basis)	-4,327	-4,228	-760	-5,109	-6,135	-5,549	-5,688	-6,333	-6,949
Primary balance (cash basis)	652	1,571	641	914	351	1,033	1,059	1,156	1,213
Net financing	4,327	4,228	760	5,109	6,135	5,549	5,688	6,333	6,949
Banking system	3,232	4,856	1,267	5,098	4,546	4,502	4,373	5,071	5,799
Government institutions	266	1,016	-112	346	564	620	329	444	874
Other creditors	1,014	-1,615	-470	-334	1,024	427	986	818	277
Net change in arrears	0	0	0	0	0	0	0	0	0
Exceptional financing	0	0	0	0	0	0	0	0	0
Change in accrued interest 6/	-267	-28	3	0	0	0	0	0	0
Valuation adjustment	82	0	72	0	0	0	0	0	0
Memorandum items:									
Primary balance on a checks issued basis (excluding grants)	232	1,298	538	694	192	830	828	1,016	1,072
Total government debt	70,888	77,019	77,588	82,013	88,147	93,696	99,385	105,718	112,667
Of which: foreign denominated debt	31,881	32,046	31,935	32,458	34,277	35,080	38,250	41,186	41,451

Sources: Lebanese authorities; and Fund staff estimates and calculations.
1/ Includes domestic excises, which are collected at customs and are classified as taxes on international trade.
2/ Excludes principal and interest payments paid on behalf of EdL.
3/ Includes transfers to the National social security fund (NSSF), bread subsidy, Displaced Fund, and Council of the South.
4/ Includes transfers to hospitals, High Relief Committee, and the interest subsidy.
5/ Includes transfers to municipalities.
6/ Public debt figures include accrued interest.

Table 3. Lebanon: Central Government Overall Deficit and Financing, 2008-15

	2008 Year Act.	2009 Year Act.	2010 Year Proj.	2011 Year Proj.	2012 Year Proj.	2013 Year Proj.	2014 Year Proj.	2015 Year Proj.
	(In percent of GDP, unless otherwise indicated)							
Revenue and grants	23.8	24.6	24.1	24.1	24.2	24.5	24.5	24.5
Revenue	22.9	24.2	23.7	23.9	23.9	24.1	24.3	24.3
Tax revenue	15.9	17.2	17.4	17.4	17.5	17.8	18.0	18.0
Taxes on income and profits	3.5	3.5	3.9	4.0	4.2	4.5	4.7	4.8
Taxes on property	1.7	1.6	1.7	1.8	1.8	1.8	1.8	1.8
Taxes on domestic goods and services	6.4	6.3	6.3	6.2	6.2	6.2	6.2	6.3
Taxes on international trade 1/	3.5	5.1	4.8	4.7	4.6	4.5	4.5	4.4
Other taxes	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Nontax revenue	5.8	5.9	5.0	5.1	5.1	5.1	5.1	5.1
Other treasury revenue	1.2	1.1	1.4	1.3	1.3	1.3	1.3	1.2
Grants	0.9	0.4	0.4	0.2	0.3	0.3	0.2	0.2
Total expenditures	33.5	32.8	32.8	33.7	32.3	32.3	32.7	33.0
Current primary expenditure	20.8	20.2	20.0	20.1	20.2	20.3	20.4	20.5
Wages, salaries and pensions	8.8	9.5	8.9	8.9	8.9	8.9	8.9	8.9
Transfers to EDL 2/	5.1	4.2	3.9	4.0	4.2	4.2	4.3	4.4
Other current 3/ 4/ 5/	6.9	6.6	7.2	7.2	7.2	7.2	7.2	7.2
Interest payments	11.0	11.1	10.2	10.1	9.7	9.3	9.7	10.0
Domestic currency debt	6.3	7.0	6.5	6.4	6.1	5.9	6.3	6.5
Foreign currency debt	4.7	4.1	3.7	3.7	3.6	3.4	3.5	3.5
Capital expenditure	1.6	1.5	2.6	3.5	2.5	2.7	2.6	2.5
Domestically financed	0.9	0.9	1.8	2.1	1.3	1.7	2.0	1.9
Foreign financed	0.7	0.5	0.8	1.4	1.1	0.9	0.6	0.6
Overall balance (checks issued)	-9.7	-8.2	-8.7	-9.6	-8.1	-7.8	-8.2	-8.5
Primary balance (checks issued)	1.4	2.9	1.5	0.5	1.5	1.5	1.5	1.5
Statistical discrepancy/float	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis)	-9.6	-8.1	-8.7	-9.6	-8.1	-7.8	-8.2	-8.5
Primary balance (cash basis)	1.4	3.0	1.5	0.5	1.5	1.5	1.5	1.5
Net financing	9.6	8.1	8.7	9.6	8.1	7.8	8.2	8.5
Banking system	7.2	9.3	8.6	7.1	6.6	6.0	6.6	7.1
Government institutions	0.6	2.0	0.6	0.9	0.9	0.5	0.6	1.1
Other creditors	2.2	-3.1	-0.6	1.6	0.6	1.4	1.1	0.3
Net change in arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in accrued interest 6/	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Valuation adjustment	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Primary balance on a checks issued basis (excluding grants)	0.5	2.5	1.2	0.3	1.2	1.1	1.3	1.3
Nominal GDP (Annual and in billions of LL)	45,124	52,051	59,018	64,128	68,180	72,482	77,021	81,825
Total government debt (in percent of GDP)	157	148	139	137	137	137	137	138
Of which: foreign denominated debt (in percent of gross debt)	45	42	40	39	37	39	39	37

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

1/ Includes domestic excises, which are collected at customs and are classified as taxes on international trade.

2/ Excludes principal and interest payments paid on behalf of EdL.

3/ Includes transfers to the National social security fund (NSSF), bread subsidy, Displaced Fund, and Council of the South.

4/ Includes transfers to hospitals, High Relief Committee, and the interest subsidy.

5/ Includes transfers to municipalities.

6/ Public debt figures include accrued interest.

Table 4. Lebanon: Government Debt, 2008-15 1/

	2008 Year Act.	2009 Year Act.	2010 Q1 Prel.	2010 Year Proj.	2011 Year Proj.	2012 Year Proj.	2013 Year Proj.	2014 Year Proj.	2015 Year Proj.
	(In millions of U.S. dollars)								
Net debt 2/	43,585	46,366	46,822	49,758	53,843	57,524	61,297	65,499	70,108
Gross debt by holder	47,024	51,091	51,468	54,404	58,489	62,170	65,944	70,145	74,755
Banking system	33,093	37,558	38,321	40,863	43,878	46,865	49,765	53,129	56,976
Treasury bills	21,652	24,693	25,053	27,260	29,654	32,286	33,682	35,566	39,273
Other domestic loans	305	263	264	264	264	264	264	264	264
Eurobonds	11,136	12,603	13,004	13,338	13,960	14,315	15,819	17,299	17,439
Nonbanks	13,930	13,533	13,147	13,542	14,611	15,306	16,178	17,016	17,779
Treasury bills	3,918	4,878	4,967	5,348	5,817	6,333	6,607	6,977	7,704
Government institutions 3/	3,358	4,032	3,958	4,261	4,635	5,047	5,265	5,560	6,139
Other	560	846	1,009	1,086	1,182	1,287	1,342	1,417	1,565
Eurobonds	6,653	5,402	5,058	5,188	5,430	5,568	6,153	6,728	6,783
Concessional loans	3,081	2,957	2,826	2,988	3,346	3,386	3,400	3,310	3,292
Foreign currency Tbonds	278	297	297	19	19	19	19	0	0
Government deposits	3,439	4,724	4,646	4,646	4,646	4,646	4,646	4,646	4,646
	(in percent of GDP)								
Net debt 2/	146	134	120	127	127	127	127	128	129
Gross debt by holder	157	148	131	139	137	137	137	137	138
Banking system	111	109	98	104	103	104	104	104	105
Treasury bills	72	72	64	70	70	71	70	70	72
Other domestic loans	1	1	1	1	1	1	1	1	0
Eurobonds	37	36	33	34	33	32	33	34	32
Nonbanks	47	39	34	35	34	34	34	33	33
Treasury bills	13	14	13	14	14	14	14	14	14
Government Institutions 3/	11	12	10	11	11	11	11	11	11
Other	2	2	3	3	3	3	3	3	3
Eurobonds	22	16	13	13	13	12	13	13	12
Concessional loans	10	9	7	8	8	7	7	6	6
Foreign currency Tbonds	1	1	1	0	0	0	0	0	0
Government deposits	11	14	12	12	11	10	10	9	9
Memorandum items:									
Nominal GDP	45,124	52,051	59,018	59,018	64,128	68,180	72,482	77,021	81,825
Foreign currency debt (in percent of gross debt)	45	42	41	40	39	37	39	39	37

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

1/ Includes all debt contracted by the treasury on behalf of the central government and public agencies other than the Banque du Liban; accrued interest; and Banque du Liban lending to Electricite du Liban. Excludes possible government arrears to the private sector.

2/ Defined as gross debt less government deposits.

3/ Denominated in domestic currency; mainly to the National Social Security Fund, and the National Deposit Insurance Fund.

Table 5. Lebanon: Monetary Survey, 2008-12

	2008	2009	2010	2011	2012
	Act.	Act.	Proj.	Proj.	Proj.
	(In billions of Lebanese pounds)				
Net foreign assets	59,271	81,428	86,953	95,989	107,472
Banque du Liban	36,927	52,665	57,346	61,034	66,383
Commercial banks	22,344	28,763	29,607	34,955	41,088
Net domestic assets	61,590	67,418	79,754	90,723	101,646
Net claims on public sector	41,397	46,655	51,707	56,253	60,755
of which: Net claims on government	42,751	48,233	53,341	57,887	62,389
Banque du Liban	4,437	4,422	3,765	3,044	2,250
Commercial banks	38,314	43,812	49,575	54,843	60,139
Claims on private sector	32,056	36,903	43,550	47,763	52,054
Other items (net)	-11,863	-16,140	-15,503	-13,293	-11,163
Broad money (M5) 1/	120,862	148,845	166,707	186,712	209,117
In Lebanese pounds	38,692	55,062	65,640	75,257	86,251
Currency in circulation	2,175	2,383	2,669	2,989	3,348
Deposits in Lebanese pounds	36,517	52,679	62,971	72,268	82,903
Deposits in foreign currency	82,170	93,784	101,066	111,455	122,866
	(Year-on-year percent change)				
Net foreign assets	17.0	37.4	6.8	10.4	12.0
Net domestic assets	14.0	9.5	18.3	13.8	12.0
Net claims on public sector	7.1	12.7	10.8	8.8	8.0
Claims on private sector	18.5	15.1	18.0	9.7	9.0
Broad money (M5) 1/	15.5	23.2	12.0	12.0	12.0
In Lebanese pounds	51.5	42.3	19.2	14.7	14.6
Deposits in foreign currency	3.9	14.1	7.8	10.3	10.2
Memorandum items:					
	(In billions of Lebanese pounds, except where otherwise indicated)				
Banque du Liban:					
Net foreign exchange position 2/	12,382	27,209	30,138	31,915	35,166
Foreign assets	40,809	56,843	61,210	64,615	69,531
Foreign currency liabilities	28,427	29,634	31,073	32,700	34,365
Net foreign exchange position, in millions of U.S. dollars 2/	8,214	18,049	19,992	21,171	23,327
Claims on public sector (net)	4,415	4,433	3,711	2,990	2,196
Claims on commercial banks	-6,689	-18,352	-20,597	-22,083	-24,642
Reserve money	9,430	10,766	12,648	14,428	16,456
GIR (including gold), in millions of U.S. dollars 3/	26,801	37,467	40,394	42,682	45,973
GIR (excluding gold), in millions of U.S. dollars 4/	18,769	27,405	29,559	31,848	35,138
in percent of banking system foreign currency deposits	34.7	44.4	44.4	43.4	43.4
in percent of total banking system deposits	24.1	28.6	27.5	26.5	26.0
Foreign currency deposits in percent of total private sector deposits	69.6	64.5	62.0	61.0	60.0

Sources: Banque du Liban; and Fund staff estimates and projections.

1/ Broad money (M5) is defined as M3 (currency + resident deposits) + non-resident deposits.
2/ Defined by currency (not by residency), as official foreign currency assets, including gold and SDR, less foreign currency liabilities. Liabilities include the exceptional deposits by GCC governments, but exclude liabilities to the government of Lebanon and other official creditors.
3/ Defined as all official foreign currency assets, less encumbered foreign assets.
4/ Defined as all official foreign currency assets, less encumbered foreign assets and gold.

Table 6. Lebanon: Balance of Payments, 2008–15

	2008 Est.	2009 Prel.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
	(In millions of U.S. dollars, unless otherwise indicated)							
Current account (excl. official transfers)	-2,902	-3,350	-4,435	-4,779	-4,729	-4,790	-5,083	-5,394
Goods (net)	-11,010	-11,179	-12,520	-13,379	-14,450	-15,709	-17,077	-18,565
Exports, f.o.b.	5,251	4,716	5,282	5,705	6,161	6,654	7,186	7,761
Imports, f.o.b.	-16,261	-15,895	-17,802	-19,084	-20,611	-22,362	-24,263	-26,326
Services (net)	5,666	5,569	6,293	6,614	7,226	7,808	8,338	8,915
Income (net)	-810	-768	-1,758	-2,038	-1,918	-1,575	-1,482	-1,376
Of which: interest on government debt	-563	-429	-572	-603	-616	-620	-679	-700
Current transfers (net) 1/	3,252	3,027	3,549	4,025	4,413	4,686	5,138	5,632
Capital and financial account	7,298	8,257	6,169	6,822	7,930	10,380	11,242	10,891
Capital transfers (net)	124	66	50	19	21	22	23	25
Direct investment (net) 2/	2,620	3,678	3,916	4,139	4,268	4,414	4,571	4,706
Portfolio investment, loans, other capital	4,554	4,513	2,203	2,664	3,642	5,944	6,648	6,160
Government (net) 3/	-404	-951	-326	171	-34	199	96	-140
BdL 4/	37	196	-208	-188	-288	-269	-250	-250
Of which: IMF repurchases	0	0	-19	-38	-38	-19	0	0
Banks (net) 5/	4,820	1,742	1,429	-1,320	-1,574	-626	-749	-2,247
Foreign assets of banks 6/	1,836	-4,257	-560	-3,548	-4,068	-3,420	-3,879	-5,752
Non-resident deposits 5/	2,985	6,000	1,989	2,227	2,495	2,794	3,129	3,505
Non-bank private sector (net)	101	3,526	1,309	4,000	5,537	6,641	7,551	8,798
Errors and omissions	2,298	2,940	0	0	0	0	0	0
Overall balance	6,694	7,846	1,734	2,043	3,201	5,591	6,159	5,497
Financing	-6,694	-7,846	-1,734	-2,043	-3,201	-5,591	-6,159	-5,497
Official reserves (- increase)	-7,273	-8,636	-2,154	-2,289	-3,291	-5,694	-6,412	-5,751
Exceptional financing	578	790	420	246	90	103	253	254
Budgetary grants	133	73	95	22	23	24	26	28
Budgetary loans 7/	406	716	325	224	67	79	227	227
IMF purchases	40	0	0	0	0	0	0	0
Memorandum items:								
Current account (incl. official transfers)	-2,769	-3,277	-4,340	-4,757	-4,706	-4,765	-5,057	-5,366
Current account balance (in percent of GDP)								
Including official transfers	-9.3	-9.5	-11.1	-11.2	-10.4	-9.9	-9.9	-9.9
Excluding official transfers	-9.7	-9.7	-11.3	-11.2	-10.5	-10.0	-9.9	-9.9
Gross official reserves (excl. gold, year-end) 8/	18,769	27,405	29,559	31,848	35,138	40,832	47,244	52,996
External debt (year-end; in percent of GDP) 9/	172	171	160	162	169	178	188	198
Government external debt (in percent of GDP)	29.2	24.6	21.7	20.9	19.7	19.1	18.4	17.2
GDP	29,933	34,528	39,149	42,539	45,227	48,081	51,092	54,279

Sources: Lebanese authorities; BIS; and IMF staff estimates and projections.
1/ Excluding official budgetary transfers.
2/ From 2009: includes new data source for real estate investment.
3/ Excluding budgetary loan disbursements.
4/ Change in the foreign liabilities of the BdL, excluding IMF purchases.
5/ Differs from banks' reported data, to include estimated deposit flows by Lebanese nationals living abroad but classified as residents.
6/ Net of non-deposit foreign liabilities.
7/ Including disbursements of non-war/non-Paris III related project loans.
8/ Excludes Eurobonds and encumbered reserves.
9/ Includes all banking deposits held by non-residents, including estimated deposits of Lebanese nationals living abroad but classified as residents.

Table 7. Lebanon: Selected Economic Indicators, 2008-15, Reform Scenario

		Prel.	Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015
Output			(Annual percentage change)					
Real GDP (market prices)								
Baseline scenario	9.3	9.0	8.0	5.0	4.0	4.0	4.0	4.0
Reform scenario	...	...	8.0	5.0	5.0	5.0	5.0	5.0
GDP deflator								
Baseline scenario	9.3	5.8	5.0	3.5	2.2	2.2	2.2	2.2
Reform scenario	...	...	5.0	3.5	2.2	2.2	2.2	2.2
Central government finances (cash basis)			(In percent of GDP)					
Revenue (including grants)								
Baseline scenario	23.8	24.6	24.1	24.1	24.2	24.5	24.5	24.5
Reform scenario	...	...	24.1	26.0	26.6	26.9	26.8	26.4
Expenditure								
Baseline scenario	33.4	32.7	32.8	33.7	32.3	32.3	32.7	33.0
Reform scenario	...	...	32.3	32.8	31.7	30.2	28.9	27.6
Budget balance (including grants)								
Baseline scenario	-9.6	-8.1	-8.7	-9.6	-8.1	-7.8	-8.2	-8.5
Reform scenario	...	...	-8.2	-6.8	-5.1	-3.3	-2.1	-1.2
Primary balance (including grants)								
Baseline scenario	1.4	3.0	1.5	0.5	1.5	1.5	1.5	1.5
Reform scenario	...	...	2.0	3.1	3.6	4.3	5.0	5.1
Total government debt								
Baseline scenario	157	148	139	137	137	137	137	138
Reform scenario	...	...	139	134	130	125	118	106
Monetary sector			(Annual percentage change, unless otherwise indicated)					
Credit to the private sector								
Baseline scenario	18.5	15.1	18.0	9.7	9.0	9.0	9.0	9.0
Reform scenario	...	...	18.0	11.0	10.7	10.7	10.8	14.6
Broad money 1/								
Baseline scenario	15.5	23.2	12.0	12.0	12.0	12.0	12.0	12.0
Reform scenario	...	...	12.0	10.0	6.5	6.5	6.5	6.5
Two-year treasury bill yield								
Baseline scenario	8.6	7.6	5.8	6.3	6.9	7.4	7.7	7.8
Reform scenario	...	...	5.8	5.7	5.7	5.7	5.5	5.6
External sector			(In percent of GDP, unless otherwise indicated)					
Current account (including official transfers)								
Baseline scenario	-9.3	-9.5	-11.1	-11.2	-10.4	-9.9	-9.9	-9.9
Reform scenario	...	...	-11.1	-10.7	-10.4	-9.4	-8.8	-7.9
Foreign direct investment								
Baseline scenario	8.8	10.7	10.0	9.7	9.4	9.2	8.9	8.7
Reform scenario	...	...	10.0	9.7	9.3	8.9	8.6	11.2
Total external debt 2/								
Baseline scenario	172	171	160	162	169	178	188	198
Reform scenario	...	...	161	158	151	145	140	133
Gross reserves (excluding gold), in billions of U.S. dollars								
Baseline scenario	18.8	27.4	29.6	31.8	35.1	40.8	47.2	53.0
Reform scenario	...	...	29.7	31.8	32.5	34.9	37.9	40.3
Gross reserves (excluding gold), in percent of total banking system deposits								
Baseline scenario	24.1	28.6	27.5	26.5	26.0	27.0	27.8	27.9
Reform scenario	...	...	27.7	26.9	25.8	26.0	26.5	26.4

Sources: Lebanese authorities; and Fund staff estimates.

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

2/ Includes non-resident deposits.

Table 8. Lebanon: Central Government Overall Deficit and Financing: 2008–15, Reform Scenario

	2008 Year Act.	2009 Year Act.	2010 Year Proj.	2011 Year Proj.	2012 Year Proj.	2013 Year Proj.	2014 Year Proj.	2015 Year Proj.
	(In percent of GDP, unless otherwise indicated)							
Revenue and grants	23.8	24.6	24.1	26.0	26.6	26.9	26.8	26.4
Revenue	22.9	24.2	23.7	25.8	26.3	26.5	26.6	26.2
Tax revenue	15.9	17.2	17.4	19.3	19.9	20.2	20.3	21.2
Taxes on income and profits	3.5	3.5	3.9	4.4	4.9	5.3	5.3	5.3
Taxes on property	1.7	1.6	1.7	1.7	1.7	1.7	1.7	1.7
Taxes on domestic goods and services	6.4	6.3	6.3	7.5	7.5	7.5	7.5	8.5
Taxes on international trade 1/	3.5	5.1	4.8	5.0	5.0	5.0	5.0	5.0
Other taxes	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Nontax revenue	5.8	5.9	5.0	5.1	5.1	5.1	5.1	3.8
Other treasury revenue	1.2	1.1	1.4	1.3	1.3	1.3	1.3	1.2
Grants	0.9	0.4	0.4	0.2	0.3	0.3	0.2	0.2
Total expenditures	33.5	32.8	32.3	32.8	31.7	30.2	28.9	27.6
Current primary expenditure	20.8	20.2	20.0	19.4	19.1	18.3	17.8	17.2
Wages, salaries and pensions	8.8	9.5	8.9	8.9	8.9	8.9	8.9	8.9
Transfers to EDL 2/	5.1	4.2	3.9	2.8	2.0	1.2	0.8	0.2
Other current 3/ 4/ 5/	6.9	6.6	7.2	7.7	8.2	8.2	8.2	8.2
Interest payments	11.0	11.1	10.2	9.9	8.7	7.6	7.1	6.4
Domestic currency debt	6.3	7.0	6.5	6.2	5.3	4.5	4.2	3.8
Foreign currency debt	4.7	4.1	3.7	3.7	3.5	3.1	2.9	2.6
Capital expenditure	1.6	1.5	2.1	3.5	3.8	4.3	3.9	4.0
Domestically financed	0.9	0.9	1.4	2.1	2.7	3.3	3.3	3.4
Foreign financed	0.7	0.5	0.8	1.4	1.1	0.9	0.6	0.6
Overall balance (checks issued)	-9.7	-8.2	-8.2	-6.8	-5.1	-3.3	-2.1	-1.2
Primary balance (checks issued)	1.4	2.9	2.0	3.1	3.6	4.3	5.0	5.1
Statistical discrepancy/float	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis)	-9.6	-8.1	-8.2	-6.8	-5.1	-3.3	-2.1	-1.2
Primary balance (cash basis)	1.4	3.0	2.0	3.1	3.6	4.3	5.0	5.1
Net financing	9.6	8.1	8.2	6.8	5.1	3.3	2.1	1.2
Banking system	7.2	9.3	8.3	4.7	4.1	2.5	1.7	-3.1
Government institutions	0.6	2.0	0.5	0.5	0.5	0.1	0.0	0.3
Other creditors	2.2	-3.1	-0.6	1.5	0.5	0.7	0.4	-1.9
Net change in arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing 6/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.9
Change in accrued interest 7/	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Valuation adjustment	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Primary balance on a checks issued basis (excluding grants)	0.5	2.5	1.6	2.9	3.3	4.0	4.9	5.0
Nominal GDP (Annual and in billions of LL)	45,124	52,051	59,018	64,139	68,847	73,895	79,278	85,046
Total government debt (in percent of GDP)	157	148	139	134	130	125	118	106
Of which: foreign denominated debt (in percent of gross debt)	45	42	40	40	39	40	41	36

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

1/ Includes domestic excises, which are collected at customs and are classified as taxes on international trade.

2/ Excludes principal and interest payments paid on behalf of EdL.

3/ Includes transfers to the National social security fund (NSSF), bread subsidy, Displaced Fund, and Council of the South.

4/ Includes transfers to hospitals, High Relief Committee, and the interest subsidy.

5/ Includes transfers to municipalities.

6/ Privatization of the Telecom takes places in 2015.

7/ Public debt figures include accrued interest.

Table 9. Lebanon: Banking Sector Financial Soundness Indicators, 2006–10

	2006	2007	2008	2009	2010 Mar
	(In percent, unless otherwise indicated)				
Assets (in millions of U.S. dollars)	74,271	82,255	94,255	115,250	119,913
Capital					
Capital adequacy ratio 1/	25.0	12.5	12.1	12.4	n.a.
Capital to asset ratio	9.1	8.9	8.5	7.0	6.8
Asset quality					
Net problem loans/net total loans	6.8	4.7	3.1	2.3	2.1
Net problem loans/bank capital	14.3	11.5	8.4	6.9	6.9
Provisions against problem loans/problem loans	54.4	56.9	61.3	64.4	63.4
Total provisions/problem loans	72.4	76.8	86.4	98.4	101.0
Asset concentration					
Share of claims on government	27.9	26.1	27.0	25.2	24.6
Of which: T-bills	13.4	12.6	15.9	15.1	14.6
Of which: Eurobonds	14.4	13.5	11.0	10.1	9.9
Share of claims on BdL	27.0	24.7	27.8	30.7	31.4
Of which: Certificates of Deposit	11.7	9.0	12.1	16.3	16.9
Share of claims on private sector	20.6	21.6	22.3	21.0	21.5
Share of claims on nonresidents	18.8	20.9	16.3	16.6	15.6
Of which: foreign banks	16.5	17.7	12.1	13.0	11.5
Net foreign currency assets as percent of capital	15.5	18.4	18.9	15.0	17.7
Earnings					
Average return on assets (post tax)	0.9	1.0	1.1	1.1	1.0
Average return on equity (post tax)	10.1	12.1	13.8	14.4	14.5
Net interest margin	2.0	2.0	2.1	1.9	1.8
Liquidity					
Net liquid assets/total assets	42.9	40.3	42.3	69.9	67.5
Net liquid assets/short-term liabilities	51.0	47.9	50.1	54.2	52.1
Private sector deposits/assets	69.1	70.1	70.3	68.7	68.4
Nonresident deposits/assets	12.6	11.7	12.2	14.4	13.4
Other indicators 2/					
Change in assets (12 month, in percent)	7.2	12.7	14.3	22.5	22.4
Change in private sector credit (12 month, in percent)	-5.6	15.9	18.6	15.2	20.2
Change in deposits (12 month, in percent)	6.5	10.8	15.6	23.1	21.9
FC deposits/total deposits	72.5	75.9	77.0	69.2	62.9
FC loans/total loans	83.0	83.4	83.2	80.6	79.6
FC loans/GDP	57.3	59.8	59.1	57.1	52.9
Memorandum items:					
LL deposit rate (average)	7.5	7.5	7.3	7.0	6.1
LL loan rate (average)	10.3	10.3	10.0	9.6	8.7
FC deposit rate (average)	4.4	4.8	3.7	3.2	2.9
FC loan rate (average)	8.5	8.3	7.5	7.3	7.2
Government's 3-year T-bill rate (marginal)	9.5	9.5	9.4	8.6	6.7
Government's Eurobond rate (marginal) 3/	7.5	8.9	9.0	7.2	5.3
Spread over 5-year U.S. note 3/	2.8	4.5	6.2	5.0	2.9
GDP (in millions of U.S. dollars) 4/	22.4	25.1	29.9	34.5	39.1

Sources: Banque du Liban, Banking Control Commission and staff estimates.

1/ From 2007: based on Basel II risk weights.
2/ FC and LL stand for "foreign currency" and "Lebanese pound," respectively.
3/ 2010 March data is the average of 2010 Q1.
4/ March 2010 reflects staff projection for 2010.

Table 10. Lebanon: Indicators of Financial and External Vulnerability, 2006-10

	2006 Act.	2007 Act.	2008 Act.	2009 Act.	2010 Proj.
	(In millions of U.S. dollars, unless otherwise indicated				
Monetary and financial indicators					
Broad money, M5	62,606	69,423	80,174	98,737	110,585
Annual percentage change	6.4	10.9	15.5	23.2	12.0
Private sector credit (annual percentage change)	-5.7	15.8	18.5	15.1	18.0
Public finance indicators					
Overall fiscal balance	-2,523	-2,808	-2,892	-2,846	-3,391
In percent of GDP	-11.2	-11.2	-9.7	-8.2	-8.7
In percent of government revenue	-44.8	-46.6	-40.6	-33.5	-35.9
Interest payments on debt	2,906	3,139	3,303	3,847	3,996
In percent of GDP	13.0	12.5	11.0	11.1	10.2
In percent of government revenue	51.6	52.1	46.3	45.3	42.3
Nominal GDP	22,438	25,057	29,933	34,528	39,149
Government revenue	5,631	6,026	7,127	8,495	9,439
Banking-sector indicators					
Problem loans (in percent of total loans) 1/	6.8	4.7	3.1	2.3	2.1
Provisions against problem loans (in percent of problem loans) 2/	54.4	56.9	61.3	64.4	63.4
Capital adequacy ratio 3/	25.0	12.5	12.1	12.4	…
Credit to the private sector (in percent of GDP)	69.1	71.6	71.0	70.9	73.8
Debt indicators					
Gross public debt	40,365	42,033	47,024	51,091	54,404
In percent of government revenue	716.8	697.5	659.8	601.4	576.4
In percent of GDP	179.9	167.7	157.1	148.0	139.0
Of which: foreign currency	20,330	21,221	21,148	21,258	21,532
In percent of GDP	90.6	84.7	70.7	61.6	55.0
Gross public debt held by the market	27,871	29,206	33,993	36,229	43,244
In percent of GDP	124.2	116.6	113.6	104.9	110.5
External debt 4/	44,617	48,603	51,624	59,112	62,752
In percent of GDP	198.8	194.0	172.5	171.2	160.3
External public debt (central government and BDL)	10,222	11,350	11,306	11,267	11,057
In percent of GDP	45.6	45.3	37.8	32.6	28.2
Short-term external public debt 5/	1,455	1,456	744	1,773	1,693
Short-term foreign currency public debt 5/	2,039	2,812	1,113	2,576	2,574
Short-term external debt 4/ 5/	35,850	38,709	41,062	49,618	53,388
Short-term foreign currency debt 5/ 6/	54,268	63,019	63,478	74,116	80,754
Total foreign currency deposits	46,319	52,099	54,175	61,824	66,603
International reserves					
Gross official reserves 7/	11,353	11,496	18,769	27,405	29,559
In percent of short-term external debt	32	30	46	55	55
Gross official reserves and commercial banks' foreign assets	27,768	32,206	37,896	51,085	54,984
In percent of short-term external debt	77	83	92	103	103
In percent of short-term foreign currency debt	51	51	60	69	68
External current account indicators					
Merchandise exports, f.o.b.	3,207	4,067	5,251	4,716	5,282
Annual percentage change	40.8	26.8	29.1	-10.2	12.0
Merchandise imports, f.o.b.	9,345	11,926	16,261	15,895	17,802
Annual percentage change	11.3	27.6	36.3	-2.3	12.0
External current account balance	-1,182	-1,698	-2,769	-3,277	-4,340
In percent of GDP	-5.3	-6.8	-9.3	-9.5	-11.1
In percent of exports of goods and services	-8.6	-10.6	-12.2	-14.3	-16.8

Sources: Lebanese authorities; Bank for International Settlements; and Fund staff estimates and projections.

1/ Net of provisions and unearned interest)
2/ March 2010 data is used for 2010.
3/ From 2007: based on Basel II risk weights.
4/ Includes estimates for public debt and banking deposits held by non-residents, and non-resident claims on the nonfinancial
5/ On a remaining maturity basis (scheduled amortization over the next year).
6/ Short-term foreign currency debt of the public sector and the banking sector plus external debt of the nonbank sector.
7/ Excludes gold and encumbered assets.

Table 11. Lebanon: Public Sector Debt Sustainability Framework, 2006–15

(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-Stabilizing Primary Balance 7/
Baseline: Public sector debt 1/	179.9	167.7	157.1	148.0	139.0	137.5	137.5	137.2	137.3	137.7	2.1
Of which: foreign-currency denominated	89.4	83.5	69.7	60.7	55.0	53.4	51.4	52.8	53.5	50.7	
Change in public sector debt	3.9	-12.1	-10.6	-9.1	-9.0	-1.5	0.0	-0.3	0.1	0.4	
Identified debt-creating flows	6.7	-13.9	-17.7	-12.7	-8.8	-1.5	0.0	-0.3	0.1	0.4	
Primary deficit	-1.7	-1.3	-1.4	-2.9	-1.5	-0.5	-1.5	-1.5	-1.5	-1.5	
Revenue and grants	25.1	24.0	23.8	24.6	24.1	24.1	24.2	24.5	24.5	24.5	
Primary (noninterest) expenditure	23.4	22.7	22.4	21.7	22.6	23.6	22.7	23.0	23.0	23.0	
Automatic debt dynamics 2/	8.4	-6.3	-16.3	-9.8	-7.3	-1.0	1.5	1.1	1.6	1.9	
Contribution from interest rate/growth differential 3/	8.4	-6.3	-16.3	-9.8	-7.3	-1.0	1.5	1.1	1.6	1.9	
Of which: contribution from real interest rate	9.4	5.8	-3.2	2.5	3.2	5.4	6.7	6.3	6.8	7.1	
Of which: contribution from real GDP growth	-1.0	-12.1	-13.1	-12.3	-10.4	-6.4	-5.2	-5.2	-5.2	-5.2	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	-6.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (Paris II and III assistance)	0.0	-6.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 5/	-2.8	1.7	7.0	3.5	-0.2	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	717.1	697.7	660.0	601.6	576.6	570.4	567.9	560.9	560.8	562.7	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	0.6	7.5	9.3	9.0	8.0	5.0	4.0	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 6/	7.6	7.8	7.9	8.2	7.8	7.9	7.5	7.2	7.5	7.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.5	3.9	-1.4	2.4	2.8	4.4	5.2	5.0	5.4	5.6	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	…	…	…	…	…	…	
Inflation rate (GDP deflator, in percent)	2.0	3.9	9.3	5.8	5.0	3.5	2.2	2.2	2.2	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	15.2	4.5	7.9	5.4	12.3	9.8	0.0	5.4	3.9	4.1	
Primary deficit	-1.7	-1.3	-1.4	-2.9	-1.5	-0.5	-1.5	-1.5	-1.5	-1.5	
Memorandum items:											
Public sector debt based on historical GDP growth data 8/	179.9	167.7	157.1	148.0	143.4	142.3	142.0	141.3	140.9	140.6	
Public sector debt based on historical data 9/	179.9	167.7	157.1	148.0	149.3	152.2	154.0	155.8	157.4	158.9	

Sources: Lebanese authorities; and Fund staff projections.

1/ Central government gross debt.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

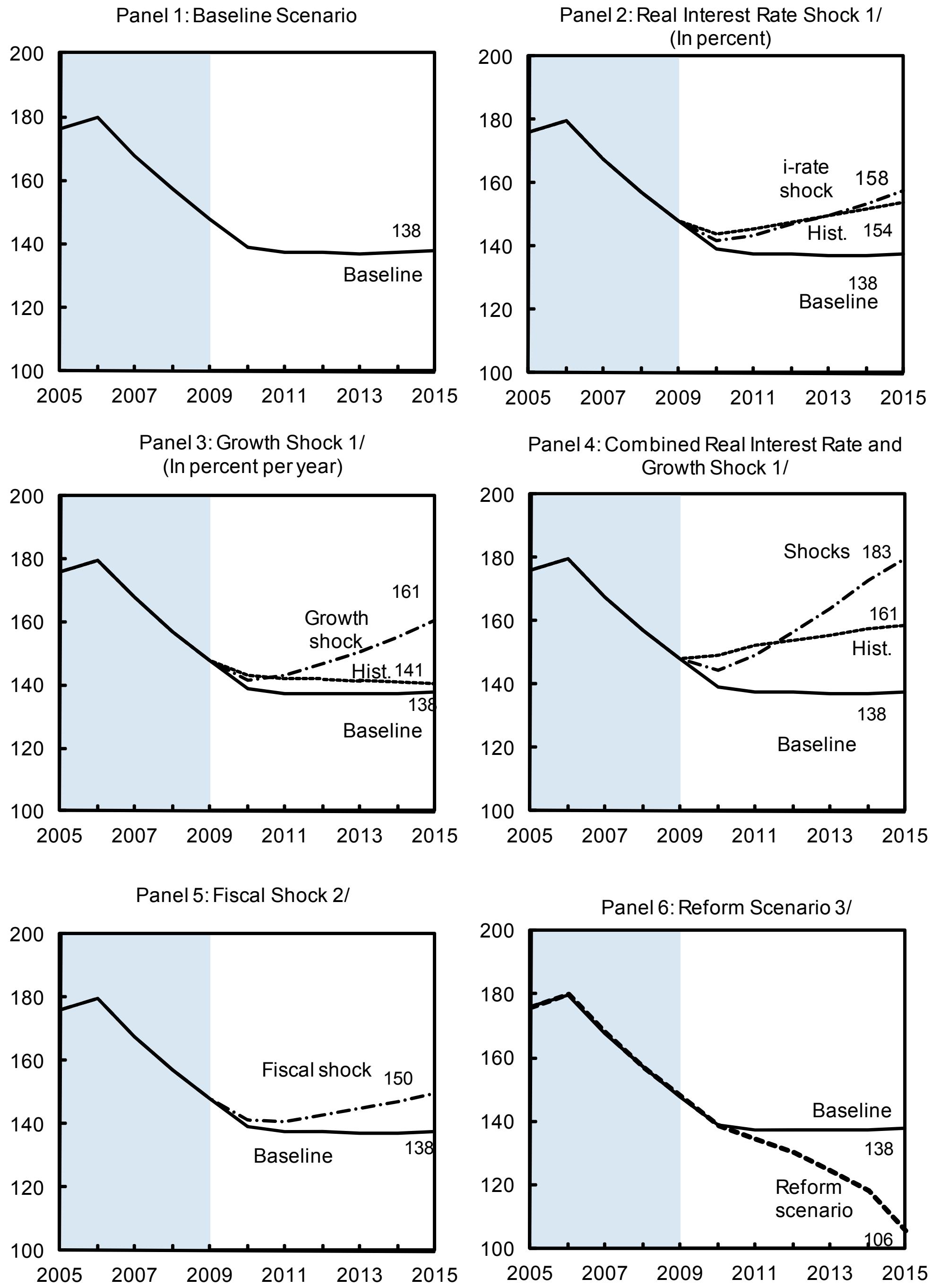
6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

8/ This path assumes that, from 2010 onwards, real GDP growth is set at its 10-year average level while the primary fiscal balance and real interest rates are the same as in the baseline scenario.

9/ This path assumes that, from 2010 onwards, real interest rate and real GDP growth are set at their 10-year average level while the primary fiscal balance is the same as in the baseline scenario.

Figure 1. Lebanon: Public Debt Sustainability, 2005–15
(Public debt in percent of GDP)



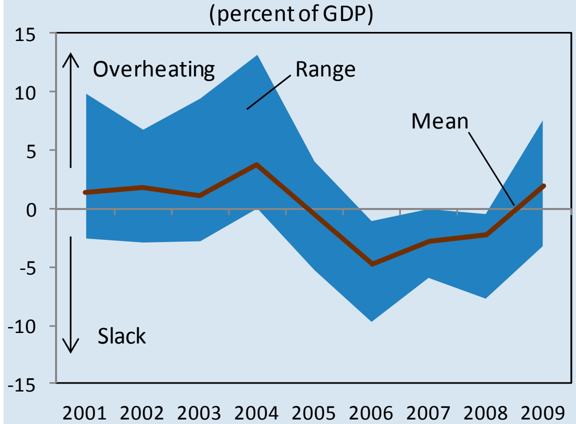
Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Growth and interest rate shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline scenario and shock scenario; historical refers to 10-year averages.
2/ The primary balance is one -half standard deviation lower than the 2000-09 average.
3/ Higher primary balance, higher growth, lower interest rates, telecom privatization (as described in the main text).

APPENDIX 1. THE OUTPUT GAP[1]

Lebanon's strong economic growth in recent years has raised questions about potential output growth and the output gap. Following a series of profound shocks in the early and mid-2000s, Lebanon has experienced three years of rapid economic growth since 2007, raising the question whether the recent economic strength constitutes a mere catching up that should be expected to subside, or whether potential growth may have risen, possibly allowing for high growth to continue into the medium term with limited risk of overheating.

Common methods to estimate potential output and the output gap yield varying results but broadly indicate that a large output gap that existed in 2006 virtually closed by 2009. We employ univariate filtering in the form of the Hodrick-Prescott filter, using two standard calibrations for the smoothing factor λ. In addition, we pursue a growth accounting approach, with income tax payer data and, alternatively, employment-linked public health insurance contributions as proxies for employment in the absence of national labor statistics. Using these methods, five out of six estimates suggest that the output gap turned positive in 2009, indicating that slack has been eliminated from the economy. The range of estimates for the output gap (between -3.2 and +7.6 percent of GDP in 2009) is too large, however, to draw conclusions about its precise magnitude.

Output Gap: Range of Estimates
(percent of GDP)



Estimates for potential output growth also vary too widely to draw firm conclusions. Estimates for 2009 potential output growth range from -0.8 percent to 7.1 percent, with half of the estimates pointing to an increase from past potential output growth, and the other half suggesting a decline. Estimates are sensitive to the type of specification and to underlying assumptions, not least due to the use of proxies for employment in the absence of employment statistics. This underscores the desirability of developing national labor statistics.

Output Gap and Potential Output

Model	Filter	Output Gap	Potential Output Growth	
		2009	2009	2002-06 average
		(percent of GDP)	(percent)	(percent)
HP Filter	HP 1/	3.2	4.8	4.2
	RU 2/	1.1	7.1	4.1
Growth Accounting				
Tax Payer	HP 1/	-3.2	4.4	4.3
	RU 2/	1.6	2.9	4.4
Health Insurance	HP 1/	7.6	-0.8	7.7
	RU 2/	4.4	2.3	6.6

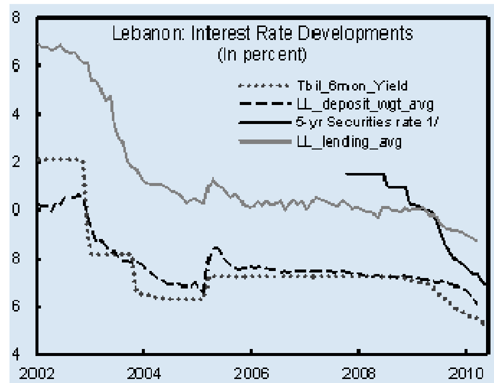
1/ Filter specification based on Hodrick/Prescott (1997).
2/ Filter specification based on Ravn/Uhlig (2002).

In light of these estimation results, cautious macroeconomic policies are warranted going forward. The strongly growing economy and the evidence of a narrowing or closed output gap suggest that additional fiscal or monetary stimulus to the economy could add to overheating risks.

[1] By Harald Finger (MCD).

APPENDIX 2. INTEREST RATE TRANSMISSION[1]

The weak response of deposit interest rates to changes in policy rates raises questions about the effectiveness of interest rate transmission in Lebanon. Policy interest rates remained flat from 2005 until mid-2008. Subsequently, the sharp fall in world interest rates opened a substantial premium in favor of LL rates. This resulted in large deposit inflows and allowed rapid reserve accumulation. To moderate deposit inflows, policy interest rates (that is, rates on BdL CDs and government T-Bills) were allowed to fall, but only gradually. Although the BdL initiated the policy interest rate decline in mid-2008 and brought rates on key instruments down by over 350 bps by end-2009, deposit rates did not register a meaningful fall until early 2009 and declined by far less (a mere 50 bps) during the 18-month period. Starting 2010, the decline in market interest rates accelerated, with deposit rates dropping by 65 bps through end-March. Moreover, deposit rates could come under further downward pressure going forward, given that policy rates have declined by another 70 bps since then.



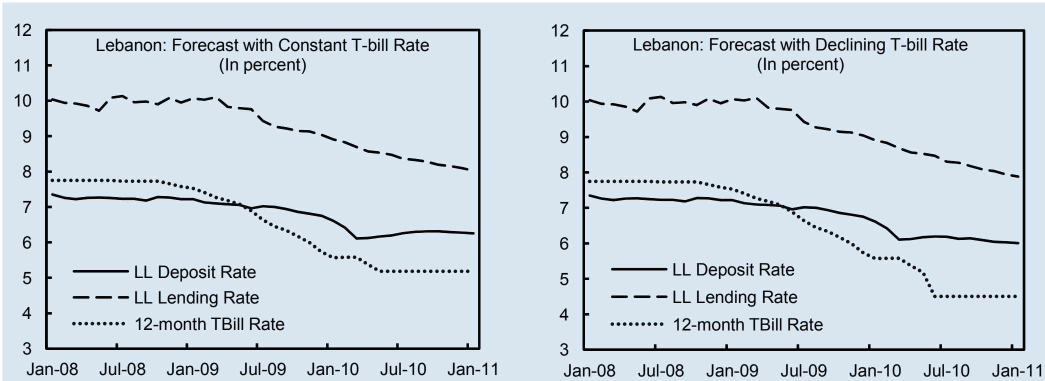
Source: National authorities; and Fund staff calculations.

1/ 5-yr BdL CD rate until June, 2009. 5-yr T-bill rate thereafter.

Econometric analysis shows that interest rate transmission in Lebanon is moderate, and the full impact of changes in policy rates is only observed with lags of up to 6 months. A monthly VAR model of the 12-month T-Bill interest rate, the LL deposit rate, and the LL lending rate finds a significant impact from T-bill rates to deposit rates, with a moderate transmission of 0.28 and 0.53 percent points after three and six months for a one percentage point change in the T-Bill rate. Variance decomposition reveals that the T-Bill rate accounts for 30-47 percent of the variation of the deposit rate. The findings imply that the transmission mechanism in Lebanon works, but imperfectly.

Out-of-sample forecasting suggests that deposit rates may have caught up with earlier policy interest rate reductions. In a first scenario, the T-bill rate is assumed to remain constant at its May 2010 level (5.18 percent). Because of a faster-than-predicted drop in deposit rates in March, the model forecasts only a small correction going forward. However, this conclusion is not foregone, because the recent drop in deposit rates could be due to factors not captured by the parsimonious structure of the model. A second scenario assumes that the T-bill rate drops to 4.5 percent in June and remains constant thereafter. In this scenario, the deposit rate would decline very gradually from 6.11 percent in March 2010 to 6.01 percent in January 2011.

[1] By Heiko Hesse and Azim Sadikov (both MCD).

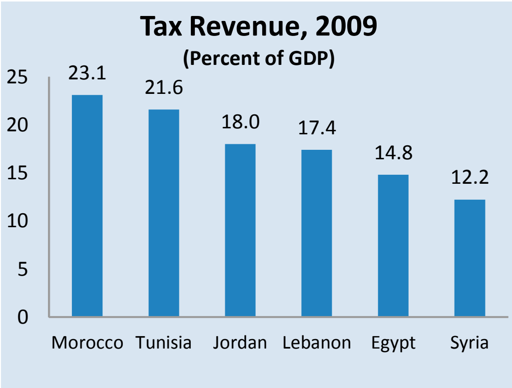


Overall, the findings suggest that the BdL should take a cautious approach to further policy interest rate reductions. The lagged response of deposit interest rates and the substantial drop in policy rates since March suggest that a pause may be warranted to observe market developments for some time. The large decline in deposit rates in March could reflect a number of factors not captured by the model. If so, a further decline in deposit rates could be already in the pipeline and its impact on deposit inflows should be established.

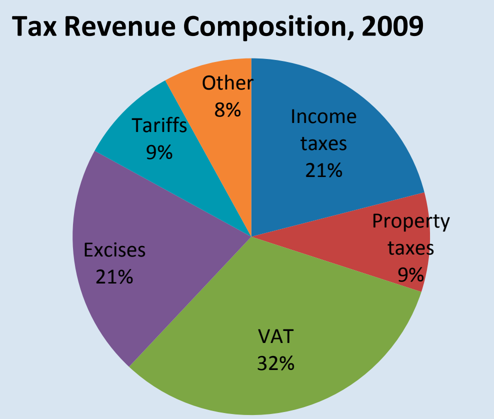
APPENDIX 3: TAX POLICY OPTIONS[1]

Lebanon's tax ratio is about average in relation to regional comparator countries, while its per capita income and fiscal financing needs are higher. At 17.4 percent of GDP in 2009, the tax ratio was lower than in Morocco, Tunisia, and Jordan, but higher than in Syria and Egypt. However, Lebanon has a higher income per capita and higher fiscal financing needs than the comparator countries, which suggests that its tax ratio is not particularly high once these additional considerations are taken into account.

Compared to other countries in the region, the tax revenue mix in Lebanon is more tilted toward "indirect" taxes. Income taxes accounted for 21 percent and property taxes for 9 percent of total tax revenues in 2009 ("direct" taxes therefore accounted for 30 percent of total tax revenues). Jordan is the only country in the region with a lower share of direct taxes than Lebanon.

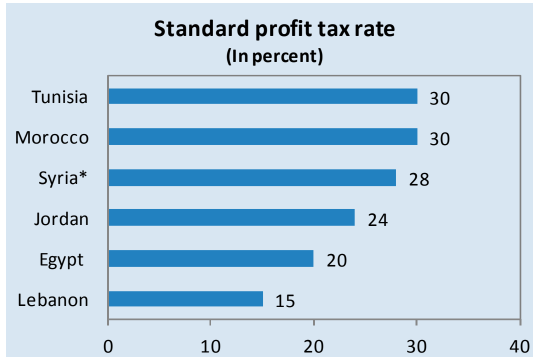


Sources: Lebanese Ministry of Finance; and IMF staff.



Direct Taxes

Lebanon currently has a schedular personal income tax system by which different types of income are taxed at different rates. *Employment income* is taxed at progressive marginal rates ranging from 2 to 20 percent, *business income/profit* is taxed from 4 to 21 percent, and *rental income* is taxed from 4 to 14 percent. A flat rate of 15 percent applies to *corporations profits*. *Interest income* is taxed at 5 percent and dividend income is taxed at 10 percent. *Capital gains* by corporations are taxed at 10 percent while capital gains for individuals are not taxed. This differential treatment generates distortions (e.g., a person with business income in the 21 percent



Source: IMF staff.
* top rate

[1] By Pablo Lopez Murphy (FAD), drawing on FAD Technical Assistance provided during May 2010.

bracket has an incentive to turn into a corporation to pay less taxes). In addition, it creates horizontal inequities because individuals with equal total income might be taxed differently if their sources of income are different.

Income tax reform in Lebanon should seek a more uniform taxation of different types of income. Ideally all the sources of income of an individual should be aggregated and a progressive tax rate schedule be applied to total income. However, in practice, virtually no country in the world applies a truly "global income tax" because taxing the more mobile sources of income is more difficult than taxing the less mobile sources of income. In the case of Lebanon, employment, business, and rental income could be combined and subject to a single progressive rate schedule. Capital gains, dividends, and interest could be subject to a lower flat rate. Moreover, Lebanon's profit tax rate is low when compared with other countries in and outside of the region, and thus offers potential for a moderate increase.

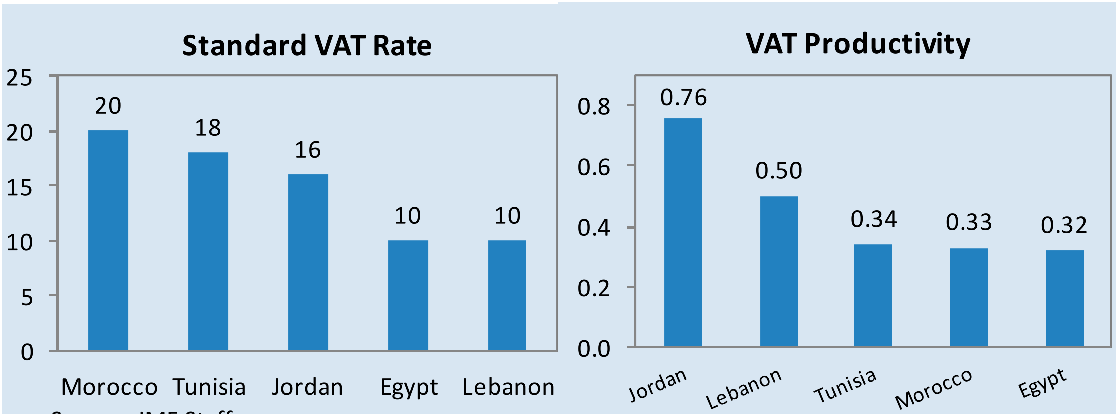
There is room to improve the special income tax regime for small businesses. The current criteria to qualify for a special regime are too broad and should be revised. For example, currently there are activities (e.g., insurance) and professions (e.g., doctors, engineers) for which taxable income is calculated as a mark-up to turnover. The criterion to qualify for a simplified regime should be the ability to produce books of account, which is more closely related to the *scale* of the business than its *nature*. Thus, only businesses up to a specified turnover (e.g., the VAT registration threshold) should be allowed to tax under a small taxpayer regime that establishes a presumed amount of profit as a specified percentage of turnover (different percentages could be set for different activities to reflect differences in business structures).

Existing property taxes have some attractive features but also drawbacks. Taxes on immobile factors, of which land is the archetype, are generally more difficult to escape. However, the existing registration fee has the disadvantage that it discourages buying/selling transactions in the real estate market and encourages evasion through non-registration. The most appealing avenue to reform property taxes in Lebanon is to improve the ability of authorities to enforce the current taxes. To improve the enforcement of the current system, the registration fee and the (proposed) tax on capital gains could be integrated. Integration could be accomplished (and revenue preserved) by allowing sellers of property a (non-refundable) credit against capital gains tax equal to the registration fee.

Indirect Taxes

The VAT is a key pillar of the Lebanese tax system as it accounts for more than 30 percent of total tax revenues. Around 70 percent of VAT revenues are collected at the border and the remaining 30 percent in the interior of the country. The standard VAT rate is relatively low compared to relevant comparator countries in the region, but revenue productivity is relatively high.[2]

[2] Revenue performance is usually compared by relying on VAT productivity which is usually measured as VAT revenue (in percent of GDP) divided by the main VAT rate.



Source: IMF Staff.

Exemptions undermine the effectiveness and implementation of the VAT. The most peculiar feature of the VAT in Lebanon is that many exempted activities (e.g., health, education, agriculture, transportation) have the right to claim a refund for the VAT paid on inputs. While many countries exempt these sectors from charging VAT on its output, it is much less common to exempt them from paying VAT on its inputs. Reducing exemptions, including the ability of exempt activities to claim refunds, would help broaden the VAT base and increase revenues.

With a broader VAT base and lower compliance gaps, an increase in the VAT rate would generate more revenues and less distortions. Lebanon's VAT rate is comparatively low, and thus a candidate to be increased to generate additional revenues. However, such an increase would be more efficient and revenue productive if coupled with the reduction of exemptions and measures to strengthen compliance.

Significant tax revenue gains could be achieved from increasing tax rates on alcohol and from indexing specific excises tax rates. Lebanon levies excises taxes on alcohol, tobacco, cars, gasoline and mobile telecommunications. With the exception of mobile telecommunications, this is in line with international practices in developing countries. Excises on tobacco, cars, and gasoline are collected only on imports, while excises on alcohol apply to both imports and domestic production. The revenue yield of alcohol excises is insignificant mainly because tax rates are specific and were set in 1991 and never revised upwards. The erosion by inflation is a vulnerability of specific tax rates and requires periodic (i.e., once a year) indexation to protect the real revenue yield of specific excises taxes.

In sum, Lebanon's tax pressure is moderate and an additional revenue effort appears warranted to generate resources for critical infrastructure investments and debt reduction. The strategy to mobilize additional revenues should weigh the implications of any tax measures on equity, the incentive structure of the economy, and tax administration. Substantial revenue gains could be achieved in the short-run through broadening the base of the VAT and the income tax, increasing a number of tax rates that are relatively low by international standards, and implementing a number of other reforms that will increase the coherence of the tax system and reduce the burden on tax administration.

INTERNATIONAL MONETARY FUND

LEBANON

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by Middle East and Central Asia Department

July 14, 2010

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Annex I. Lebanon: Fund Relations

(As of May 31, 2010)

I. **Membership Status:** Joined 04/14/47; Article VIII (07/01/93).

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	203.00	100.00
Fund holdings of currency	260.29	128.22
Reserve position in Fund	18.83	9.28

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	193.29	100.00
Holdings	209.37	108.32

IV. **Use of Fund Resources**

Lebanon's outstanding credit to the IMF comes from two drawings under Emergency Post-Conflict Assistance (EPCA) in April 2007 and November 2008. The last EPCA assessment report was issued in November 2009.

Outstanding Purchases:	**SDR Million**	**Percent of Quota**
EPCA	76.13	37.50

V. **Latest Financial Arrangements:** None

VI. **Projected Obligations to Fund:**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal	12.69	25.38	25.38	12.69	0.00
Charges/Interest	0.45	0.66	0.31	0.11	0.00
Total	**13.14**	**26.03**	**25.69**	**12.79**	**0.00**

VII. **Implementation of HIPC Initiative:** Not Applicable

VIII. **Implementation of Multilateral Debt Relief Initiative (MDRI):** Not applicable

IX. **Safeguards Assessment**:

Pursuant to Fund policy, the Banque du Liban (BdL) was subject to a full safeguards assessment in conjunction with the first Emergency Post-Conflict Assistance (EPCA). The 2008 safeguards assessment report proposed several specific measures for enhancing the BdL's financial reporting, audit, and control procedures, and recommended an update of the central bank law. An update safeguards assessment was completed in August 2009 in the context of the second EPCA. The update noted progress achieved in enhancing procedures for reserve management and external audit, but recommended further actions to strengthen financial reporting transparency, oversight, central bank legislation, and internal audit.

Nonfinancial Relations

X. **Exchange Arrangement**
Lebanon has accepted the obligations of Article VIII, Sections 2, 3, and 4 in 1993 and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. The exchange arrangement, which maintains a *de-facto* peg to the U.S. $, is classified as stabilized. Since October 1999, the BdL has intervened to keep the pound around a mid-point parity of LL 1,507.5 per $1, with a bid-ask spread of LL+/-6.5.

XI. **Article IV Consultation**
The 2009 Article IV Consultation was concluded by the Executive Board on April 15, 2009. At the time, Directors noted the remarkable resilience of the Lebanese economy in the face of the global financial crisis. In addition, they underscored the need for fiscal and structural reforms to address Lebanon's longstanding vulnerabilities, and for continued vigilance in bank regulation and supervision to safeguard macrofinancial stability.

XII. **Financial Sector Assessment Program**
Lebanon participated in the Financial Sector Assessment Program in 1999, and the related report was presented to the Executive Board at the time of the Article IV consultation (FO/DIS/99/113). A Financial System Stability Assessment update was conducted in 2001, and the related report presented to the Executive Board at the time of the Article IV consultation (SM/01/281).

XIII. **Resident Representative Office**
Mr. Eric Mottu took his position as Resident Representative in Lebanon in September 2009.

XIV. **Technical Assistance**
Fiscal area—FAD has provided advice on introducing the VAT, reforming customs tariffs and income taxes, strengthening tax and customs administration, improving public expenditure management, and consolidating fiscal accounts. A fiscal ROSC was published in May 2005. During 2005–07, technical assistance focused on (i) consolidating fiscal accounts; (ii) improving public liquidity management; (iii) identifying fiscal reform priorities; (iv) reforming subsidies and restoring gasoline excises; and (v) improving the budget preparation process. In 2008–09, FAD and the Middle East Technical Assistance Center (METAC) provided targeted follow-up support to ongoing initiatives in both tax administration and public

financial management (e.g., tax audit program, treasury single account, and cash management). There were two FAD technical assistance missions in 2010 on (i) tax administration reforms; and (ii) tax policy options. Considerable TA needs remain in budget preparation, fiscal management, public accounting and reporting, tax and customs administration, including on compliance and enforcement programs, and taxpayer segmentation. The authorities would also benefit from technical assistance in establishing a risk management framework for PPPs.

Financial area—Over the past few years, the Monetary and Capital Markets Department has provided technical assistance in the areas of the payments and settlements systems and vulnerability indicators. The related missions undertook an assessment of compliance with Core Principles for Systemically Important Payments Systems, advised on developing systems to improve the efficiency and liquidity management of public sector payments and receipts, and assisted in the elaboration of a framework for collecting and analyzing macro-prudential indicators to develop capacity to monitor systemic financial sector vulnerabilities. However, progress in implementing these recommendations has been limited. In 2010, METAC provided training on consolidated supervision, stress-testing techniques, and assessing banks' business and strategic plans. Going forward, technical assistance should focus on (i) strengthening supervision and regulation of banks' cross-border activities; and (ii) introducing an early warning system.

Statistical area—The Statistics Department has provided technical assistance in national accounts, price and balance of payments statistics. During 2007, several missions on the consumer price index (CPI) were undertaken through the METAC. As a result, in March 2008 a new monthly country-wide CPI was launched. Technical assistance in building capacity for national accounts statistics and economic surveys was provided through the resident advisor in real sector statistics. In March 2008, METAC provided technical assistance on balance of payments and international investment position statistics, and more recently, it provided recommendations on improving work processes in the Statistics and Economic Research Department of the BdL. In February 2010, a technical assistance mission assessed the work processes at the BdL, focusing on legal and institutional arrangements; human and technical resources; and coverage, periodicity, and timeliness of statistics produced by the BdL. Nevertheless, statistical gaps—including in quality, coverage, and timelines—remain substantial, particularly in the areas of national accounts, wages, employment, real estate, and the balance of payments statistics (see Annex III). A stronger commitment to fill these gaps is needed for further technical assistance to be effective.

Annex II. Lebanon: World Bank-IMF Collaboration

46. **The Lebanon teams of the Fund and the World Bank met on June 4, 2010, to identify macrocritical structural reforms and to coordinate work of the two teams for the period July 2010-June 2011.**[8] The teams agreed that Lebanon's main macroeconomic challenges are to reduce the very high government debt-to-GDP ratio and to maintain stability of the financial sector. To meet these challenges, Lebanon needs to achieve and maintain fiscal consolidation and strong growth over a number of years, and maintain close vigilance in financial sector supervision.

47. **Based on this shared assessment, the teams identified seven structural reform areas as macrocritical,** in view of their central role in achieving fiscal consolidation and sustained growth:

- **Electricity sector reform:** Reduce budgetary transfers to the electricity provider by (i) reducing the cost of production, including through reducing reliance on expensive fuel oil, (ii) increasing revenue collection, (iii) enhancing electricity supply by making necessary investments and, (iv) gradually adjusting tariff towards cost recovery levels, possibly in conjunction with transfers to poor households. These measures should be accompanied by a comprehensive reform of the regulatory and institutional framework. Electricity sector reform is macrocritical because the presently very large budgetary transfers to the sector undermine fiscal sustainability and insufficient electricity supply weighs on growth.

- **Telecommunications sector reform:** Reduce costs and enhance the quality and scope of telecom services by making necessary investments and implementing the regulatory framework needed for increased private sector involvement. Telecommunications sector reform is macrocritical because (i) the sector generates large revenues for the government; (ii) sector reforms can lift the country's growth potential; and (iii) proceeds from licensing and/or privatization could be used to repay part of the government's large debt.

- **Public financial management reform:** Lebanon's public financial management is compartmentalized and not very effective. Key elements of a reform are: (i) establishing a macrofiscal unit in the Ministry of Finance; completing the coverage of the Treasury Single Account; strengthening expenditure programming, budget preparation, aid and debt management, and coordination with the Central Bank

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[8] The IMF team was led by Mr. Bauer (mission chief) and the World Bank team by Mr. Ba (Country Manager) and Hedi Larbi (Country Director).

(feasible in the short to medium term); and (iv) strengthening accounting, payment, and auditing functions, including by introducing a **Government Financial Management Information System** (feasible in the longer term). These reforms are macrocritical because they will help create fiscal space needed for fiscal consolidation and for higher public investment and targeted social spending. The authorities' plans to enter into public-private partnerships (PPPs) could help address infrastructure bottlenecks, but a sound institutional framework must be put in place to control fiscal risks and maximize benefits.

- **Social services and safety net reform:** Delivery of social services in Lebanon and the social safety net are weak. The following reforms would help: (i) health: rationalizing and expanding health insurance coverage; (ii) education: improving the quality of public education including strengthening higher education and vocational training; (iii) pension systems: strengthening financial sustainability and administration of the National Social Security Fund, and creating a new pension system for private sector workers; and (iv) social safety nets: improving the targeting to the most needy. These reforms are macrocritical because better health and education services, stronger pensions systems, and a more effective social safety are needed to enhance the productivity of the workforce and strengthen growth prospects, reduce inequalities and generate political support for the needed fiscal consolidation.

- **Investment climate reform:** Lebanon's corporate sector is held back by the extraordinarily high costs of doing business. High costs arise mainly from weaknesses in governance, finance, power supply, regulatory systems, and weak contract enforcement. Wide-ranging reforms are needed to address these issues. They are macrocritical because a more conducive investment climate is needed to maintain strong growth.

- **Financial sector stability assessment:** Given the large financial sector and the high prevalence of dollarization, financial sector stability is key for macroeconomic stability. Conducting a Financial System Stability Assessment (FSSA) is macrocritical and desirable, because it would help the authorities identify potential threats to financial sector stability and provide suggestions for addressing them.

- **Reform of the statistical system:** Lebanon's statistical system suffers from fragmentation and has limited ability to provide timely and reliable data. Strengthening the statistical authorities is macrocritical because timely and reliable data are needed to monitor economic and social developments and to enable evidence-based decision making.

48. **The teams agreed the following division of labor:**

- **Electricity sector reform:** The Bank will continue to elaborate reform options and discuss them with the authorities. In this context, the Bank will draw on the recently completed "Electricity Strategic Plan" prepared by the Ministry of Energy to focus its support on priority measures to be taken soon by the government. The new Country Partnership Strategy of the Bank includes technical and financial support to the electricity sector to assist the government in implementing its strategic plan.

- **Telecommunications sector reform:** The Bank will support the Government's objective to structure the telecommunications sector in a way that introduces competition, improves capacity and quality of services, and reduces cost to consumers. The Bank Group will continue providing advice to finalize the development of the telecommunication sector strategy. An Institutional Development Fund Grant will be mobilized to finance capacity building to the Telecommunications Regulatory Authority. In addition, IFC Advisory and Investment products could be leveraged to the extent the private sector becomes part of the government's strategy for telecom reform. The Fund will lead work on taxation and broader implications of the sector reform on the budget.

- **Public financial management reform:** The Bank is providing technical assistance (TA) on budget preparation and execution, debt management, and aid coordination through the Emergency Fiscal Management project (EFMIS). The project also includes macro-fiscal projection and capacity building activities covering all four fields of TA. The Fund is providing TA (via METAC), in close coordination with the EFMIS program above, on (i) completing the coverage of the Treasury Single Account and on cash management; and (ii) enhancing consistency of budget classification and chart of accounts with the GFSM 2001 and improving fiscal coverage. The Fund will also review a recent TA request regarding payments decentralization. The Fund and the Bank will work jointly to assist with establishing a sound framework for PPPs, if requested by the authorities. The Fund will assist in building capacity for assessing and containing fiscal risks, while the Bank will lead in setting up a mechanism for competitive bidding procedures and incentive-based regulation.

- **Social services and safety net reform:** The Bank will continue its analytical work in the area of social safety nets and provide a prioritized list of policy recommendations, and is preparing the poverty-targeting project. The Bank has already launched a cash transfer pilot.

- **Investment climate reform:** The Bank has completed the update of its survey-based investment climate assessment in March 2010. This update includes a list of policy recommendations. A national workshop sponsored by the Prime Minister will be held before end-2010 to share the results of the survey and agree on an action plan that the government will implement to address the main binding constraints to private sector development.

- **Financial sector stability assessment:** The Bank and the Fund are encouraging the authorities to consider an FSSA update. The update would provide a prioritized list of recommendations for addressing any threats to financial sector stability.

- **Reform of the statistical system:** The Bank will continue to provide TA on the preparation of social statistics, including in the areas of health and education, with a focus on poverty analysis. The Bank will assist the authorities in implementing a statistical master plan (SMP) and reforming the legal framework for the statistical activity in Lebanon. The Fund TA will continue to focus on national accounts, monetary, price and balance of payments statistics.

49. **The teams have the following requests for information from their counterparts:**

- The Fund team requests to be kept informed of progress in the Bank's work in the above macrocritical structural reform areas. Timing: when milestones are reached (and at least semi-annually).

- The Bank team requests to be kept informed of the Fund's assessments of macroeconomic policies and prospects, as well as of Fund's TA in the above reform areas. Timing: in the context of Article IV Consultation and other missions (and at least semi-annually).

- The table below lists the teams' separate and joint work programs during July 2010–June 2011.

Lebanon: Bank and Fund Planned Activities in Macrocritical Structural Reform Areas, July 2010–June 2011

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	Country Assistance Strategy.	Preparatory work is ongoing.	Board Discussion expected in August 2010
	Assistance to the Electricity Sector	Possible investment lending in support of the strategic plan of the government.	Board discussion in April 2011
	Technical assistance on public financial management (budget preparation, debt and aid management).	Implementation of the TA project started in May 2009. Progress will be monitored through the Bank's semi-annual supervision reports and the authorities' quarterly progress reports.	Implementation through September 2011
	Analytical work, technical assistance, and possibly lending operations in the area of social services and social safety net (including education, health, and pensions systems).	Ongoing.	Implementation throughout FY2010–11
	Sector work on social safety net, gender, health, energy, water and environment	Work will be ongoing throughout FY10. Over the coming period, areas of focus are: pensions; labor market reform; technical assistance for LNG and energy efficiency; and continued engagement in education, health, water and environment sectors.	Implementation throughout FY2011–12
	Survey-Based Investment Climate Assessment (ICA) Update.	Completed.	Draft report to government in the second half of 2010
	Program for Business Environment Reforms	Initiation mission in September 2010	Implementation throughout FY2011–12
	Foreign Inflows and Broad Based Growth—Impact of Policy Choices	Initiation mission in July 2010	Implementation throughout FY2011
	Statistics TA (social statistics, poverty analysis).	Ongoing.	Implementation throughout FY2010–11
	Assistance in implementing the statistical master plan	Initiation mission in September 2010	Implementation throughout FY2011–12

2. Fund Work Program	Article IV Consultation	May-June 2010	July 2010
	TA missions on: - Tax Administration - Tax Policy Options - Public financial management - Statistics (national accounts, BOP, PPI) - Banking Supervision	April 2010 April–May 2010 Ongoing Ongoing Ongoing	June 2010 June 2010
3. Joint Work Program	FSAP Update (tentative)	TBD	TBD

ANNEX III. LEBANON—STATISTICAL ISSUES

As of July 2, 2010

I. Assessment of Data Adequacy for Surveillance

General: Data provision has serious shortcomings that significantly hamper surveillance. In particular, there are serious weaknesses in the compilation of data on the national accounts, employment, general government and the rest of the nonfinancial public sector, and balance of payments. There is no national data on wages and real estate activity and prices. In addition, data on poverty and income distribution is patchy, impairing social policy formulation. Raising the statistical capacity in Lebanon to internationally accepted levels will require a firm commitment from the government, including high-level support and the allocation of sufficient resources to the Central Administration of Statistics (CAS).

National Accounts: The national accounts data are weak. Only annual data are available, currently until 2008. National accounts statistics are still being produced by a team in the Prime Minister's office with some bilateral support, using mostly administrative data sources and compilation methods that do not conform to best practices. The transfer of national accounts statistics compilation to the CAS and the launch of comprehensive economic surveys have been repeatedly delayed, but are now scheduled to take place in 2011. Maintaining this timetable will be an important step toward improving the quality of the national accounts statistics. STA is currently assisting the CAS in building capacity to produce national accounts estimates based on a sound methodology and a comprehensive data collection program. Work is underway to incorporate the 2004 economic survey data into the national accounts estimates.

Price statistics: Since May 2008, the CAS compiles and disseminates a monthly Consumer Price Index (CPI) following internationally accepted methodology. The CPI is disseminated within three weeks after the end of the reference month. Geographical coverage is expanded to include all areas in Lebanon (a previous CAS index was based on prices collected from Beirut and its suburbs). Staff has adopted the new CAS index as the primary CPI for Lebanon since 2009. There is a need to develop regular and timely statistics on producer prices, wages, and real estate prices. A METAC mission is scheduled for July 2010 to assist the CAS in compiling a producer price index.

Government finance statistics: The coverage of government finance statistics is not comprehensive. The dissemination of central government finance statistics has improved markedly in recent years. However, published monthly data on the central government budgetary accounts does not cover widespread extra-budgetary activities conducted by public entities, omit certain transfers, financing data, foreign-financed capital expenditure, and arrears. Certain (treasury) spending is only

identified ex-post, and its economic classification with a lag. However, these items are provided to the staff in the context of surveillance activities. Government finance statistics are on a cash basis, with a modified cash-basis for budgetary expenditure data, corresponding to the issue of payment orders.	
Monetary and financial statistics: Monetary statistics are adequate. At the same time, sectoralization of institutional units and classification of financial instruments in the data reported to STA fall short of what is needed for compilation of Standardized Report Forms (SRFs). The reporting of monetary data to STA is irregular and occurs with a three- to four-month lag, though the MCD country team receives it on a timely basis. Reflecting in part restrictions imposed by domestic legislation, the Banque du Liban (BDL) does not publish externally audited financial statements and its reporting practices are not yet fully compliant with the IFRS. The lack of a reliable classification of deposits by residency complicates the balance of payments analysis.	
Balance of payments: Balance of payments statistics are weak. The data reflect deficiencies in the current account (unrecorded exports, uncertainty with respect to the estimates of private sector services and workers' remittances, irregularities in the income account), the capital account (grants), and the financial account (foreign direct investment, equity investment in the nonbank private sector, and corporate borrowing abroad).. The BdL is in the process of implementing new FDI survey forms and amending reporting requirements for banks and non-banks to include more comprehensive and detailed breakdown of BOP components. Lack of effective interagency cooperation and staff constraints at both the BdL and CAS are among the main factors impeding progress.	
II. Data Standards and Quality	
Participant in the General Data Dissemination System since January 2003. Metadata and the plans for improving the real and fiscal statistics need to be updated.	No data ROSC is available.

Lebanon: Table of Common Indicators Required for Surveillance
As of June 15, 2010

	Date of Latest Observation	Date Received	Frequency of Data[8]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange Rates	06/14/10	06/15/10	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/2010	05/2010	M	M	M
Reserve/Base Money	04/2010	05/2010	M	M	M
Broad Money	04/2010	06/2010	M	M	M
Central Bank Balance Sheet	04/2010	05/2010	M	M	M
Consolidated Balance Sheet of the Banking System	04/2010	06/2010	M	M	M
Interest Rates[2]	6/2010	06/2010	W/M	W/M	W/M
Interest Rates[3]	04/2010	06/2010	M	M	M
Consumer Price Index	04/2010	05/2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[5]	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[4]– Central Government	03/2010	05/2010	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	03/2010	04/2010	M	M	M
External Current Account Balance	Q4/2009	05/2010	Q	Q	Q
Exports and Imports of Goods and Services	Q4/2009	05/2010	Q	Q	Q
GDP/GNP	2008	4/2010	A	A	A
Gross External Debt[7]	12/2009	03/2010	M	M	M
International Investment Position	N/A	N/A	N/A	N/A	N/A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined policy interest rates (including discount rates, rates on treasury bills, notes and bonds).
[3] Market interest rates (including average deposit and lending rates in Lebanese pounds and U.S. dollar).
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] Staff estimate based on public external debt, non-resident deposits, and claims of the BIS banks on nonfinancial private sector.
[8] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); or Not Available (NA).

Statement by the Staff Representative on Lebanon
Executive Board Meeting
July 30, 2010

1. **This statement reports on most recent developments and their impact on the economic outlook.** It complements information contained in the staff report for the 2010 Article IV Consultation (SM/10/199), issued on July 15, 2010, and does not change the thrust of the staff appraisal.

2. **Information has become available regarding some modifications that were introduced to the draft 2010 budget prior to its approval in cabinet and submission to Parliament**. The proposed asset revaluation tax was dropped and some minor expenditure increases were added. With this, full implementation of the 2010 budget would imply a primary balance close to zero (instead of a 0.5 percent of GDP surplus, as noted in the staff report). These developments notwithstanding, staff continues to advise the authorities to target a primary balance of at least 2 percent of GDP, which could be achieved by cautiously implementing the budget and saving any revenue overperformance.

3. **The primary balance of the government in the first four months of 2010 reached a surplus of about 1 percent of GDP, more than three times the level achieved in the same period of 2009**. The surplus reflects substantial tax revenue increases (+16 percent year-on-year) and lower transfers to Electricité du Liban. Available data indicates that fiscal performance remained strong in May, suggesting that the primary balance floor of 2 percent of GDP recommended by staff for the full year is within reach.

4. **Other recent economic data releases have been broadly consistent with the 2010 projections presented in the staff report.**

- **Inflation.** CPI inflation dropped to 3.5 percent year-on-year in June (May: 4.9 percent), helped by lower energy prices.

- **Monetary developments.** Following a period of substantial moderation, deposit growth picked up in the first half of July, increasing by $1.3 billion (1.3 percent). With sizeable deposit inflows, international reserves (excluding gold) reached around $29.7 billion in mid-July, an increase of nearly $400 million since end-June. Staff remains of the view that the authorities should maintain a pause in the interest reduction cycle to allow pass-through of earlier policy interest cuts. However, if strong deposit growth persists in the coming weeks, there could be room for a further gradual reduction in policy rates.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
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DEPARTMENT

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October 8, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with Lebanon

On July 30, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Lebanon.[1]

Background

Lebanon's economy performed remarkably well during the global financial crisis. The economy benefited from a confidence rebound following the political reconciliation agreement reached in Doha in 2008 and the successful formation of a national unity government in 2009. Backed by buoyant activity in construction, tourism, commerce, and financial services, real Gross Domestic Product (GDP) grew by 9 percent last year. With momentum carrying into 2010, growth is now expected to reach at least 8 percent this year. Inflation has risen since late 2009, driven partly by fuel prices. Price pressures in the non-tradable sector have so far remained relatively contained, but could rise if the economy accelerates further.

The banking sector has been resilient in the face of the global crisis, thanks to relatively conservative funding and asset structures, and prudent banking regulations and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

supervision. Banks remain profitable, well-capitalized, and highly liquid, with adequate provisions and declining non performing loans (NPL) ratios. Commercial bank deposits surged by 23 percent in 2009 and deposit dollarization dropped below 64 percent, driven by high domestic interest rates and the decline in political and security risks. Following a series of interest rates cuts, deposit inflows have moderated in recent months, but are still growing at a healthy annualized rate of about 11 percent. There has been little fallout from the developments in Dubai and Southern Europe, with Lebanon's sovereign spreads moving broadly in line with the emerging market average.

Macroeconomic policies have been strong, but structural reforms have remained stalled. Abundant capital inflows allowed the Banque du Liban to raise international reserves to record levels (over $29 billion). Buoyant revenues, boosted by growth and the reintroduction of gasoline excises, and spending discipline raised the fiscal primary surplus to 3 percent of GDP in 2009. As a result, the government debt-to-GDP ratio declined by 9 percentage points to 148 percent of GDP in 2009. However, little headway has been made on critical structural reforms, including addressing the loss-making electricity sector, raising the value added tax (VAT) rate, eliminating extra-budgetary funds, and overhauling the budget process.

Despite the economy's impressive resilience to the crisis, Lebanon continues to suffer from high underlying vulnerabilities. Domestic stability rests on the fragile political system split along confessional lines, and the country lies at the crossroads of regional tensions. The government's debt remains among the highest in the world, and almost half of it is denominated in foreign currency. The large banking system depends on short-term deposit inflows from nonresidents to roll over its large exposure to the sovereign. With high loan dollarization, banks carry significant exposure to unhedged borrowers.

Executive Board Assessment

Executive Directors welcomed Lebanon's strong economic and financial performance during the global recession and commended the authorities for prudent macroeconomic management and financial sector oversight. While noting progress in reducing short-term risks, Directors cautioned that the underlying vulnerabilities remain large. Directors advised to manage the buoyant economy cautiously to avoid overheating and to prevent the build-up of new vulnerabilities. They emphasized the need to address the high government debt and to implement growth-enhancing structural reforms.

Directors supported the authorities' intention to increase capital spending to address growing infrastructure gaps, but cautioned against a substantial fiscal relaxation given the booming economy. They encouraged the authorities to execute current spending prudently and to save revenue over-performance with the objective of achieving a larger primary surplus in 2010.

Directors agreed that a further reduction in the government debt-to-GDP ratio remains the top medium-term policy priority. Lowering the debt burden, while maintaining permanently higher investment and social spending will require a combination of expenditure rationalization and socially balanced tax measures. Directors encouraged the authorities to reduce budgetary transfers to the electricity sector and consider tax measures, including income tax reform and broadening of the VAT.

Directors recognized the challenges the authorities have faced in managing large capital inflows, and agreed that Lebanon's vulnerabilities and exposure to shocks require a strong international reserves position. They welcomed the buildup of reserves that took place over the past two years. Directors recommended that the authorities carefully assess the pace of reserve accumulation, paying due regard to the need to continue to ensure confidence, while considering the costs of sterilization. In this context, Directors supported the recent policy interest rate reductions that moderated the pace of deposit inflows. Looking forward, Directors concurred that a pause in interest rate reduction would be advised given the imperfect policy transmission mechanism and uncertain lags in Lebanon.

Directors welcomed that Lebanon's banks have weathered the global crisis well. They called for continued vigilance, with a focus on preventing excessive risk-taking as high liquidity and declining interest rates are leading banks to increase private sector credit and expand their activity.

To underpin the medium-term fiscal strategy and growth, Directors encouraged the authorities to take the opportunity of the positive economic environment to implement structural reforms, including modernizing tax administration and public financial management, and reforming the electricity, water, and telecommunications sectors. Directors also underscored the importance of strengthening the Banque du Liban's balance sheet.

Directors noted remaining weaknesses in the availability, quality, and timeliness of economic data, and urged the authorities to take bold steps to improve Lebanon's statistical system.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Lebanon is also available.

Lebanon: Selected Economic Indicators, 2007–09

	2007	2008	Prel. 2009
Output and prices	(Annual percentage change)		
(Annual percentage changeReal GDP (market prices)	7.5	9.3	9.0
GDP deflator	3.9	9.3	5.8
Consumer prices (period average) [1]	4.1	10.8	1.2
Central government finances (cash basis)	(In percent of GDP)		
Revenue (including grants)	24.0	23.8	24.6
Expenditure	34.9	33.4	32.7
Budget balance (including grants)	-10.8	-9.6	-8.1
Primary balance (including grants)	1.7	1.4	3.0
Total government debt	168	157	148
Monetary sector	(Annual percentage change, unless otherwise)		
Credit to the private sector	15.8	18.5	15.1
Broad money [2]	10.9	15.5	23.2
Interest rates (period average, in percent)			
Three-month treasury bill yield	5.2	5.2	5.0
Two-year treasury bill yield	8.7	8.6	7.6
External sector	(In percent of GDP, unless otherwise indicated)		
Exports of goods (in US$, percentage change)	26.8	29.1	-10.2
Imports of goods (in US$, percentage change)	27.6	36.3	-2.3
Current account (excluding official transfers)	-7.6	-9.7	-9.7
Foreign direct investment	7.5	8.8	10.7
Total external debt [3]	194	172	171
Gross reserves (excluding gold), in billions of U.S. dollars	11.5	18.8	27.4
In percent of short-term external debt [4]	29.7	45.7	55.2
In percent of total banking system deposits	17.1	24.1	28.6
Memorandum items:			
Nominal GDP (in billions of U.S. dollars)	25.1	29.9	34.5
Commercial bank total assets	328	315	334
Local currency per U.S. dollar (period average)	1507.5	1507.5	1507.5
Real effective exchange rate (annual average, percent change)	-1.0	-3.0	7.1
Stock market index	1454	1182	1566
EMBI Global - Lebanon (spread; basis points)	493	794	293

Sources: Lebanese authorities; and IMF staff estimates and projections.
[1] Through 2008: based on the CPI index by Consultation and Research Institute; from 2009: based on the CPI index by Central Administration of Statistics.
[2] Defined as currency in circulation plus resident and non-resident deposits.
[3] Includes non-resident deposits.
[4] Short-term debt on a remaining maturity basis, including short-term non-resident deposits.

Statement by Mr. Shaalan on Lebanon
Executive Board Meeting
July 30, 2010

1. On behalf of the Lebanese authorities, I would like to thank staff for the valuable and constructive discussions during the mission, including the useful exchange of views on key issues topical to Lebanon at this time. The authorities also wish to express their appreciation for the continued provision of timely and effective technical assistance.

Recent Developments and Outlook

2. Regained domestic political stability and improved regional conditions, as well as prudent macroeconomic policies and continued capital inflows, all contributed to the remarkable performance of the Lebanese economy during the global financial crisis. Real GDP growth averaged about 9 percent since 2008, one of the highest in the region, driven by construction, tourism, trade, and financial services. Inflation remained under control, although it has risen above the 2009 average, partly on account of fuel prices. Moreover, the authorities made further progress toward fiscal consolidation, as evidenced by the steady decline in the overall fiscal deficit. As a result, gross public debt-to-GDP is projected to reach 139 percent at end–2010 after peaking at 180 percent at end–2006. Deposit inflows continued to increase at a rapid pace―despite some moderation in recent months―deposit dollarization declined, and the Banque du Liban (BdL) accumulated significant international reserves. Moody's upgrade of Lebanon's sovereign ratings in April 2010 reflects these favorable developments.

3. The authorities' policy objective in the near term is to prevent the economy from overheating. They are well aware that vulnerabilities remain, notwithstanding the economy's strong performance. These vulnerabilities pertain to the fragile domestic and regional political environment, the high public debt-to-GDP ratio, and large gross public financing requirements which carry important rollover risks. To minimize the possible impact of the aforementioned risks and pave the way for stable and sustained growth, the authorities are committed to take advantage of the current favorable environment to address infrastructure bottlenecks and decisively reduce public debt over the medium term.

Fiscal Policy and Reforms

4. The draft budget for 2010, currently being discussed in parliament, aims at balancing essential spending needs with stability goals. It envisages a significant increase in capital spending—which will remain low in comparison with other countries in the region—to address pressing infrastructure bottlenecks, notably in electricity generation which has lagged far behind demand. Part of the increase in spending will be offset by revenue measures, including a 2 percentage point increase in the tax on interest income and higher registration fees for high-end properties. Taking account of the delayed implementation of the budget and given the higher than forecast revenue performance this year, the decline in the primary surplus is likely to be limited to about 1 ½ percentage points of GDP in 2010. The authorities view the relaxation of the budget as temporary, and they remain fully committed to fiscal consolidation and debt reduction in the medium term.

5. Further progress has been made in the area of budgetary reforms, notably with regard to public financial management with the provision in the 2010 draft budget law to cast future budgets in a multi-year framework. Moreover, further to the introduction of transparent reporting through the issuance of the Quarterly Debt and Debt Markets' report since Q2 2007, the Ministry of Finance is enhancing its debt management capacity by preparing a decree to activate the debt management unit.

6. Banks remain very liquid despite the slowdown in deposit growth in recent months. Accordingly, the government expects to meet its 2010 financing needs from the market. It intends, in close coordination with the BdL, to gradually lengthen the maturity profile and lower the foreign currency share of government debt, which has declined over the past few years (Tables 4 and 10). In doing so, due consideration will be given to preserving an adequate level of international reserves.

Monetary and Exchange Rate Policies

7. The monetary policy framework has helped to bolster confidence in the Lebanese financial system. The exchange rate peg continues to serve the economy well by providing a firm anchor for financial stability. At the same time, the level of international reserves preserves confidence in a country with underlying vulnerabilities, an open capital account, and a fixed exchange rate. In line with the intention that was expressed during the previous Article IV Consultation discussion, the authorities have markedly reduced policy interest rates (by more than 400 basis points since mid-2008 on 5-year Treasury-bills/BdL Certificates of Deposit) as market conditions became more predictable. This reduction resulted in a significant slowdown in deposit growth. Given the imperfect monetary transmission mechanism with uncertain lags in Lebanon, the authorities fully concur with staff that a pause in policy interest rate reductions is warranted.

8. The authorities appreciate staff's analysis regarding the merits and costs of further reserve accumulation. Nonetheless, the message on the relatively low "insurance" value of additional coverage and high associated sterilization costs ought to be interpreted with caution. While reserve holdings entail an opportunity cost, the model-based approaches outlined in Appendix 2 do not fully account for the positive confidence effects related to holding reserves. These were made clear during several crisis episodes during 1993-2009. Moreover, Lebanon's ratio of reserves-to-broad money—at about 28 percent in 2009—was below the emerging market median of 33 percent.[1] Finally, the reserve coverage of short-term external debt, currently at 56 percent, remains well-below the 100 percent Greenspan-Guidotti threshold, and the 153 percent median for emerging countries.[2] With potentially volatile non-resident deposits accounting for three quarters of short-term external debt, the country could be subject to rapid shifts in risk appetite during times of turbulence.

Banking Sector

9. Effective banking regulation and supervision, coupled with conservative bank funding and asset structures, have shielded the domestic financial sector from the global turmoil. At the same time, conservative prudential regulations on leverage and limited bank exposure to real estate, have protected banks from potential effervescence in the real estate market. In this regard, staff found little speculation in the real estate market, and developers generally use low leverage in their projects.

10. High liquidity and declining interest rates have led banks to increase private sector credit and expand their businesses in the region over the past few years. Bank regulation and supervision have particularly focused on preventing excessive risk taking in this regard. The BdL and the Banking Control Commission have indeed reinforced cross-border supervision and measures aimed at strengthening the oversight of Lebanese affiliates abroad, as detailed in Box 4 of the staff report.

Structural Reforms

11. The authorities are fully aware of the importance of structural reforms to create the conditions for sustainable growth. They have identified priority focus areas in which immediate reform and investments will help address the pressing needs of the population. These areas include electricity, water, telecoms, urban transport, local development, environment, public education, and social protection. The authorities believe that early successes with these actions will create favorable social and political space for building

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[1] SM/10/166, June 30, 2010.

[2] EBS/10/146, July 16, 2010.

consensus on deeper and more difficult reforms in these sectors that are essential for sustainable growth.

12. Electricity sector reform ranks high on the authorities' agenda in view of the large budgetary transfers to the sector. The authorities have developed with World Bank support an electricity sector policy note, which was endorsed by the Cabinet in June 2010. The note includes an action plan to improve the performance of the sector and to lay the foundation for financial sustainability. The World Bank's new Country Partnership Strategy will provide technical and financial support to help the government implement its electricity sector strategy, and the authorities plan to mobilize concessional donor support for it.