International Monetary Fund
Lebanon—2010 Article IV Consultation Mission
Mission Concluding Statement
June 9, 2010

Lebanon's economy has largely eluded the impact of the global crisis and performed remarkably well, reflecting a confidence boost from regained political stability and prudent macroeconomic management. Vulnerabilities have declined but nonetheless remain very high overall, in particular the public debt burden.

The key challenges in the period ahead are (i) managing the buoyant economy to prevent overheating risks, and (ii) seizing the positive momentum to implement reforms that will promote sustained medium-term growth and macrofinancial stability.

The main policy recommendations of the mission include:

- Limiting the fiscal impulse to the strongly growing economy in 2010, although investment to address infrastructure bottlenecks should go ahead jointly with structural reforms in those sectors.
- Maintaining the focus of monetary policy on moderating the pace of deposit inflows, given the comfortable level that international reserves have reached. To ensure a smooth adjustment, a cautious approach to further policy interest rate reductions seems warranted.
- Continuing to aim bank supervision and regulation at preventing excessive risk-taking, paying special attention to the banking system's changing business model.
- Adopting a medium-term fiscal strategy that provides space for higher public investment and targeted social spending, and achieves a substantial decline in the public debt-to-GDP ratio. This requires improving the quality and efficiency of public spending and taking further revenue measures.
- Implementing complementary reforms, including fixing the loss-making electricity sector, creating a sound framework for public-private partnerships, modernizing tax administration and public financial management, strengthening the Banque du Liban's income position, and improving the collection and dissemination of economic statistics.

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The International Monetary Fund (IMF) mission visited Beirut on May 27 –June 9, 2010 to hold discussions for the 2010 Article IV consultation. The mission 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 thanks the authorities and all of its interlocutors for their cooperation, frank and meaningful discussions, and warm hospitality.

I. INTRODUCTION

1. **Lebanon is reaping the benefits of improved stability.** The economy has continued to perform remarkably well, notwithstanding the challenging global environment. Strong momentum has carried over into 2010, and real GDP growth could exceed 8 percent this year. Growth has been driven by construction, tourism, retail trade, and financial services, which are benefitting from rising confidence owing to the relatively stable political and security environment. Inflationary pressures have so far remained limited. However, a closing output gap suggests that domestic price pressures could emerge in the period ahead.

2. **The authorities have maintained prudent policies, building a comfortable financial cushion and taking initial steps to address deep-seated fiscal vulnerabilities.** High growth and rising primary surpluses have led to a significant drop in the government's debt-to-GDP ratio from its peak in 2006. In addition, increased confidence and a favorable interest rate differential spurred inflows of non-resident deposits and deposit dedollarization, which allowed the Banque du Liban (BdL) to substantially increase its international reserves. Significant reductions in policy interest rates, consistent with Fund staff advice, have led to a moderation of deposit inflows in recent months, which nonetheless continue expanding at an adequate pace to cover government financing needs.

3. **Despite these successes, Lebanon's underlying vulnerabilities remain very high and key reforms are still stalled.** At 148 percent of GDP as of end-2009, the government's debt remains among the highest in the world and generates large recurring borrowing needs. The large banking system is highly exposed to the sovereign and relies to a large extent on short-term non-resident deposit inflows. Progress in strengthening economic institutions and addressing structural weaknesses has been limited. Moreover, new vulnerabilities could emerge over time. In particular, while not yet a concern, risks could emerge in the real estate sector if property prices continued to rise rapidly.

4. **Looking ahead, the key challenges are (i) managing the buoyant economy to avoid overheating risks, and (ii) seizing the momentum to implement reforms that will promote sustained medium-term growth and macrofinancial stability.** The current environment of low global interest rates and abundant liquidity will not persist indefinitely. Avoiding complacency and building consensus to address the Lebanon's structural weaknesses and vulnerabilities will therefore be key to extend the current growth spell and achieve a stable and long-lasting economic expansion.

II. MANAGING THE ECONOMY IN 2010

Balancing public investment needs and the risk of emerging macroeconomic pressures

5. **From a cyclical perspective there is little need for a fiscal impulse in 2010**. The draft budget targets substantial increases in public investment to address urgent infrastructure bottlenecks, especially electricity generation. These increases are only partially compensated by revenue measures, leading to a potential relaxation of the primary surplus to 0.5 percent of GDP from 3 percent of GDP in 2009. In light of the buoyant economy, which is operating at or close to capacity, and the public debt burden, fiscal policy should aim at a higher primary surplus.

6. **The mission supports the planned increase in public investment, coupled with the implementation of sectoral reforms.** Public investment is low by international standards and widening infrastructure gaps could lower Lebanon's medium-term growth potential. To ensure that additional public investment is effective and does not reinforce existing deficiencies, it must be accompanied by structural reforms. In the loss-making electricity sector, this will require adjusting tariffs towards medium-term cost recovery and addressing technical and non-technical losses.

7. **The growing economy provides room for simultaneously increasing public investment, achieving a higher-than-budgeted primary surplus, and substantially reducing the public debt-to-GDP ratio in 2010.** Delays in the approval of the budget, normal lags in budget execution, and the primary surplus achieved in the first quarter (0.9 percent of annual GDP) suggest that even in a passive scenario the actual primary surplus could reach about 1.5 percent of GDP this year. Beyond that, the mission suggests cautious execution of current spending and saving of revenue overperformance from higher growth, with a view to achieving a primary surplus of no less than 2 percent of GDP. The government debt-to-GDP ratio could decline further to 139 percent of GDP by the end of 2010.

8. **Under current conditions, the government should be able to cover its financing needs for the remainder of 2010 from the market.** Domestic banks, which are the main source for government financing, remain liquid. The government should continue to take advantage of favorable interest rate conditions to maintain a pre-financing buffer in Lebanese pounds.

9. **The favorable financing environment should allow further progress toward a safer public debt structure.** The Ministry of Finance is strengthening its debt management capacity and seeking to reduce financing costs by mobilizing the disbursement of remaining Paris III pledges. Looking forward, the government could continue, in coordination with the BdL, funding in local currency some of its foreign currency debt service, while safeguarding an adequate level of international reserves. The government could also gradually lengthen the maturity profile of its debt, taking due consideration of cost trade-offs. These steps would help reduce public sector refinancing risks and currency mismatches, while supporting dedollarization.

Managing monetary policy in the face of large capital inflows

10. **The recent focus of monetary policy has rightly been on moderating the pace of deposit inflows by lowering policy rates, although a pause may now be warranted.** Reserves accumulation in the past two years has been adequate and prudent in view of the volatile global financial environment, although it has imposed sterilization costs on the BdL. A range of indicators show that international reserves have now reached a comfortable level and this has provided room for interest rate reductions, which the authorities have used. The recent slowdown of deposit growth, imperfect monetary transmission, and uncertain transmission lags warrant some caution going forward. The authorities should thus consider a pause to allow earlier policy rate cuts to pass through to deposit rates, before proceeding with further reductions.

11. **The exchange rate peg remains a key pillar for financial stability.** Maintaining it is essential in light of the government's high debt and debt service obligations in foreign currency and currency mismatches of the corporate and household sectors from widespread dollarization. Although

the renewed strength of the U.S. dollar has recently led to some real appreciation of the Lebanese pound, the real effective exchange rate remains broadly in line with fundamentals.

Regulating a growing banking sector

12. **The Lebanese banking system is adjusting to a changing business environment.** Banks have weathered the global crisis well, thanks to prudent banking regulation and supervision and banks' conservative funding and asset structures. They remain profitable and well-capitalized, with adequate provisioning and declining NPL ratios. However, falling net interest margins are putting pressure on bank profits. Banks are responding by seeking growth opportunities outside of Lebanon, and domestically by expanding private sector credit, which has accelerated in recent months.

13. **Continued focus of bank regulation and supervision on preventing excessive risk taking is warranted.** The BdL and the Banking Control Commission (BCC) should remain vigilant to the potential risks of weakening credit standards, increasing leverage, and deteriorating asset quality. While prudential standards for housing and real estate lending are conservative and bank exposure to these sectors is limited, care should be taken that the recent price surge 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 implications of large deposit inflows. In particular, if credit growth accelerates further, the authorities should consider capping and gradually phasing out incentive schemes that provide exemptions to reserve requirements. The ongoing regional expansion of Lebanese banks justifies a heightened focus by the BCC on effective cross-border supervision.

III. POLICIES TO SUSTAIN HIGH GROWTH AND TACKLE VULNERABILITIES

14. **The medium-term fiscal strategy should center on creating space for public investment and targeted social spending, while also achieving a substantial reduction in the public debt-to-GDP ratio.** A further decline in the public debt burden is necessary to reduce Lebanon's underlying vulnerabilities. This will require achieving higher primary surpluses in 2011 and beyond, as growth will likely moderate over the medium term and world interest rates may increase. A medium-term plan that includes sizeable fiscal consolidation coupled with higher capital and social investment could enhance credibility, boost market confidence, help reduce interest rates, and raise the medium-term growth potential.

15. **Additional fiscal space could be created through a combination of measures to increase the efficiency of public spending and mobilize additional revenues.**

- On the spending side, there is room to reduce high and untargeted subsidies to Electricity du Liban (EdL). In addition to investments in electricity generation, transmission, and distribution, this requires raising tariffs to cost recovery levels and improving the efficiency of EdL.

- The mobilization of additional revenues should take equity and efficiency considerations into account, and focus on broadening tax bases and possibly increasing some tax rates that are moderate by international standards. Possible measures include moving from the current schedular system to a more uniform income tax, which covers capital gains for individuals and other forms of income that are currently taxed very lightly or not at all; broadening the VAT base by reducing exemptions; raising excises on alcohols; and protecting the real value of excise taxes through indexation. In terms of tax rates, both the VAT and the corporate income tax rates are comparatively low and may offer potential for a gradual and moderate increase.

16. **Public-private partnerships (PPPs) could provide a useful vehicle to address infrastructure bottlenecks, but a sound institutional framework must be put in place to control fiscal risks.** PPPs can offer better value for money in the provision of public infrastructure. However, international experience has shown that PPPs can also generate important fiscal liabilities. A number of preconditions should therefore be met before embarking on such a program, including approval of a legal framework that ensures adequate risk transfer to the private sector and prescribes a clear process for the evaluation and approval of PPPs. This process should include a “gatekeeper role” for the Ministry of Finance to assess and manage fiscal risks. Other elements of a sound PPP framework include competitive bidding procedures and incentive-based regulation, capacity-building at the government level, and proper accounting and reporting of fiscal implications.

17. **There is a need to strengthen fiscal institutions to support the medium-term strategy.** The tax administration can be strengthened to improve compliance and avoid the perception that taxpayers are unevenly affected by new tax measures. Recommended measures include integrating the VAT and income tax administrations, strengthening the large taxpayers unit, and ending amnesties on fines and penalty interest. A transition over time to electronic tax filing would also be advisable. On the public financial management side, efforts to broaden the coverage of the budget and ensure its unity, introduce a treasury single account, and strengthen the treasury’s capacity should be reenergized.

18. **The BdL’s balance sheet should be strengthened.** The management of past crises and the large sterilization operations of the last two years have weakened the BdL’s income position. Lower interest rates and a slower pace of reserve accumulation are helping to ease the drain of sterilization operations on the BdL’s finances. Phasing out exemptions from reserve requirements would also be beneficial. Privatization of the BdL’s non-financial assets, including the planned partial sale of Middle East Airlines and the ongoing divestment of the real estate portfolio, will also help improve its financial balance.

19. **Further improvements in economic statistics and proactive communication of policy intentions will be important to anchor expectations and support confidence.** A clear articulation of the government’s debt reduction objective will be particularly important, along with continuous communication on monetary policy objectives and instruments. The requirement of multi-year fiscal frameworks in the 2010 draft budget law is welcome, as it can provide an anchor for annual fiscal budgets in the coming years. Further efforts are required to improve the statistical system, including its coverage, quality and timeliness. Progress has been made in a number of areas, particularly the dissemination of fiscal data for the central government. However, the national accounts, balance of payments, and the coverage of the public sector in the fiscal statistics need to be improved. The development of regular and timely wage, employment, and real estate statistics would allow for enhanced economic monitoring.