INTERNATIONAL MONETARY FUND
LEBANON
2007 Article IV Consultation Mission
Mission Concluding Statement
May 28, 2007

1. **An International Monetary Fund (IMF) mission visited Beirut May 14-28, 2007 to hold discussions for the 2007 Article IV consultation.** The mission also reviewed performance under the 2007 program that was the basis for the IMF's Emergency Post-Conflict Assistance (EPCA) and prospects for the remainder of the year. The mission met with the Minister of Finance, the Governor of the Central Bank, the Ministers of Economy and Trade, Tourism, and Energy, high officials from the prime minister's office, various ministries and agencies and the public electricity company (EdL), as well as representatives of the banking sector, the industrialists association and the labor union. The mission wishes to thank the authorities for the open and constructive discussions and their warm hospitality.

I. OVERVIEW

2. As anticipated, 2007 continues to be a difficult transition year beset by continued political uncertainty and uncertain market condition. Performance under EPCA is on track, but financial and fiscal risks remain. The Paris III reform program offers a promising way out of the large debt overhang and financial vulnerabilities, and the 2008 budget as well as implementation of the structural reforms now being launched in the telecom, power and social sectors will be key in generating a clear forward momentum. Still the strategy is not without risks, and to sustain adjustment and reform over the medium-term it will be important to: generate a broad consensus behind the reform objectives; ensure that spending priorities and structural policy are supportive of high private sector growth; and reform institutions to improve the effectiveness of policy making. The success of the program also depends on the timely disbursement of pledged donor support. An improvement in the fiscal situation should also provide the opportunity to reform monetary policy instruments. A retrenchment of the central bank from quasi-fiscal activities (including direct financing of the government) is also needed to strengthen its balance sheet. The rapid expansion of Lebanese banks into the region will help diversify their large asset base and will require an adaptation of banking supervision to minimize exposure to new and unforeseen risks.

II. RECENT DEVELOPMENTS AND SHORT-TERM PROSPECTS

3. **The authorities managed skillfully the financial and fiscal pressures from the July 2006 conflict with Israel.** The Banque du Liban (BdL) intervened successfully to maintain financial stability and the deposit outflow observed during and the immediate aftermath of the conflict was fully recovered by end-2006. Likewise, the government was able to contain the conflict's impact on debt by containing discretionary spending and mobilizing generous grant support from donors.

4. **The ongoing political stalemate and recurrent outbreaks of violence are the key obstacle to economic recovery.** First quarter developments and a positive external economic environment point to a real GDP growth of at least 2 percent or higher for 2007. However, there is a large degree of uncertainty around this projected growth, with downside risks linked to the political and security situation but also a significant higher growth potential, if the country were able to capitalize on the strong regional demand. Depositors and financial markets seem to have largely factored in the political uncertainty, and the financial impact of the recent flare up of violence appears to have been contained. Still, financial risks remain high.

5. **Notwithstanding a difficult financial and economic context, the authorities met all of the end-March 2007 targets under EPCA, except for the ceiling on government borrowing from the BdL which was exceeded only by a very small margin.** Stronger than projected revenue collection helped contain the primary deficit and the accumulation of net debt in the first quarter. However, in the absence of any readjustment of domestic fuel prices, the recent increase in international oil prices has reduced excises on gasoline products to zero. If not reversed, this trend could lead to a shortfall of revenue from excises of more than ½ percent of GDP for the year as a whole. An early announcement of a floor for gasoline excises would help safeguard the authorities' fiscal objectives for 2007. In view of the exposure of public spending to unexpected demands, such as from heightened security measures, achievement of the fiscal target for 2007 calls for continued strict expenditure discipline.

6. **The authorities' financing strategy for the remainder of 2007 remains vulnerable to shocks to market confidence and delays in the disbursement of donor support.** Commercial banks were reluctant to roll over maturities in the first quarter. This was partly offset by increased subscriptions by the National Social Security Fund which is reallocating its portfolio from deposits to treasury bills, and also some additional borrowing from the BdL. However, the authorities have restated their commitment to rely on market financing, and, in recent weeks, commercial banks have returned to treasury bill auctions. The government also issued a $400 million Eurobond at end-May despite the tense security situation. To the extent that central bank financing becomes again necessary in the current uncertain environment, it should be circumscribed to short-term bridge financing.

III. Implementation of the Paris III Program

7. **The 2007 program is the first step in the long process of adjustment and reform outlined in the authorities' Paris III document, the main aims of which are to restore the foundations for solid growth and reduce the risks of a financial crisis stemming from the large debt overhang.** The strategy envisions the implementation of fiscal measures equivalent to around 10 percent of GDP over five years. In combination with privatization and external donor support, this large scale adjustment would bring down government debt to under 130 percent by 2012. Restored confidence and structural reforms would in parallel

contribute to improve the GDP growth outlook. To enhance the chances of success, it will be important that reforms be properly sequenced so that policies can reinforce each other.

8. **While the strategy remains the most promising way forward, it is not without risks.** These include political implementation risks, shocks to the macroeconomic environment, uncertainty about the yield of reforms, and risks stemming from contingent fiscal liabilities. Contingent liabilities may arise from actuarial imbalances in the public and private pension systems, the open-ended nature of transfers to the health and family allowance funds, and unforeseen costs from power sector reform

9. **Timely and flexible disbursement of Paris III pledges is another important element of the strategy.** Welcome progress has been made in locking in the terms and conditions for the release of funds from some key donors. Negotiations are still under way with others and the mission fully supports the authorities' request that donors convert their pledges from project to budget support, or at least align their project disbursements to the government's own spending priorities.

Setting fiscal and structural policy priorities for 2008

10. **The Paris III program envisions a strong acceleration of fiscal adjustment in 2008.** Encouragingly, the draft 2007 budget law already precommits the increase in the value-added tax and the tax on interest income. Preparations for introducing a global income tax as of 2008 are advancing, but require legislative approval before the end of 2007. Ongoing efforts to strengthen tax administration and non-tax revenue collection should further boost revenues. The program also envisions further adjustment in gasoline excises. On the expenditure side, containment of current spending will continue to be necessary, but, as recognized by the authorities, implementation of energy and social sector reforms with the assistance of the World Bank will be key to achieving durable adjustment. The success of power sector reforms will require a careful sequencing of infrastructural and governance initiatives to avoid compounding the existing problems. The audits of EdL and NSSF and the ongoing computerization of NSSF are important steps in this process.

Mobilizing domestic support for adjustment and reform by protecting the most vulnerable

11. **Public and political support will need to be mobilized to sustain reform and adjustment over the medium term**. The financial support of the international community (through phased disbursement of financial assistance) provides incentives for successive governments to continue on the reform path. However, unless the reforms also enhance social and economic conditions for the population at large, it may prove difficult to maintain the reform momentum. Sustaining high economic growth (through the policies discussed below) is key in this regard, but the most vulnerable also need to be protected by effective social safety nets. The social pillar of the Paris III strategy addresses this important concern, and the authorities are encouraged to implement swiftly their plans of reallocating social spending toward better targeted redistribution schemes.

Aligning public spending and policy priorities to growth objectives.

12. **On the fiscal front, the structure of current spending needs to move toward more productive expenditure choices.** Outright transfers account for a large share of current spending, and even the wage bill contains a large redistribution component in as much as it is not allocated on the basis of public sector needs. The planned phasing out of some extra budgetary funds is an important step in this direction and should not be delayed beyond the planned horizon. Structural reforms in the power sector are also expected to reduce considerably non-productive public spending, and to improve the reliability of energy supply. Once these reforms are launched, attention should be turned to civil service reform to address ingrained governance and efficiency problems., including through revisiting staffing and remuneration.

13. **Privatization remains a core element of the overall strategy and should be seen first and foremost as an instrument to raise growth.** Telecom privatization will have a direct impact on debt and thereby can be expected to improve confidence. Beyond that, it offers the opportunity to liberalize the sector and introduce greater competition under the supervision of the newly established telecom regulatory authority. Under the current duopoly in mobile telecommunication, Lebanon has lost ground to other countries in the region in terms of telecommunication costs and service. The Paris III growth objective require that this sector become again a dynamic contributor to the economy.

14. **The authorities have begun to address problems in the business environment by reducing red tape, streamlining business licensing procedures and targeting improvements in public services to enterprises.** Reducing the costs of doing business is important, but these actions should be complemented by measures to reduce rent-seeking behavior in the public and private sector. In many sectors, oligopolistic market structures still inhibit competition and need to be dismantled, and the competition law needs to be backed by proper enforcement mechanisms.

Developing stronger institutional mechanisms to improve the control over budgetary outcomes and the quality of spending.

15. **Planned reforms in public financial management will help enhance the effectiveness of policies.** The planned establishment of debt management institutions within the ministry of finance should contribute to lowering the government's debt service burden. Timely implementation of the action plans to improve cash management functions (including the Treasury Single Account) and the budgetary process will be equally important to achieve the objectives discussed above, notably to direct scarce public resources to priority sectors, and reduce inefficiencies in public financial management. By linking current policies to medium-term objectives, a medium-term budget framework is essential to keep the process on track and contain the risks of backtracking. The decision to introduce the notion of medium-term budget planning and to provide a top down budget envelope for the 2008

budget preparation process is very encouraging in this regard. Building on these reforms, a fiscal rule or a fiscal responsibility law could eventually help provide self-correcting mechanisms in the budget process to safeguard overall fiscal objectives against unforeseen deviations.

IV. MONETARY AND EXCHANGE RATE POLICY

16. **Successful fiscal adjustment will provide an opportunity to reform the monetary policy framework.** In the current fiscal situation and unpredictable financial environment, monetary stability objectives have been well served by deploying a range of special intervention instruments. More stable and predictable market conditions should enable the central bank to refocus on guiding interest rates through short-term transparent instruments,. Interest rate and exchange rate stability cannot be pursued simultaneously, and the current premium placed on the stability of the T-bill rate as the main indicative interest rate overly constrains monetary policy management. By using its own short-term instruments, the central bank will gain flexibility in responding to balance of payments and dollarization objectives. Such an environment would also create the conditions for the government securities market to develop, thereby attracting a wider range of investors and helping the government diversify its financing base. In the short term, the interlinkages between the government's cash and debt management and the BdL's liquidity and reserve management call for close cooperation between the two institutions to increase the efficiency of financial policies. The establishment of a working group at the technical level to exchange relevant information on a high frequency basis would be a very welcome step in this regard.

17. **The BdL also needs to make progress on strengthening its balance sheet to preserve the effectiveness of monetary policy over the medium term.** In large part, the BdL balance sheet has been weakened by measures taken to replenish reserves and maintain financial stability during the recent crises episodes. However, the cost of sterilizing government financing in the past and the indirect costs associated with quasi fiscal activities in support of specific objectives and sectors have also contributed. Going forward, it would be important to scale back quasi-fiscal activities, such as selective reductions in reserve requirement and the recent scheme to provide below-market loans for banks with an exposure to businesses who have been affected by the conflict. To the extent that these activities merit public support, they should be funded explicitly by the budget. Over the medium-term, an improvement in the economy's financial situation and de-dollarization will help strengthen the BdL's balance sheet. Privatization of the assets held by the central bank will also help its financial balance, while contributing to the government's growth agenda.

18. **The exchange rate peg has served the authorities well in maintaining financial stability, and the exchange rate does not appear to be misaligned.** The exchange rate peg has served as a nominal anchor, fixing expectations including during times of financial pressures. International reserves held by the BdL combined with the banking system's liquidity cushion appear sufficient to meet temporary pressures on the exchange rate, should

they occur. Lebanon's strong export performance is an indication that the exchange rate is not misaligned, with the depreciation of the U.S. dollar against major currencies broadly offsetting the impact of the spike in inflation in the aftermath of the 2007 conflict. However, the expectation of private-sector led growth in the Paris III medium-term program requires steady improvements in competitiveness. In the absence of adjustments in the exchange rate, the onus will be on realizing productivity gains through improvements in the business environment supported by the structural reforms discussed above.

V. Banking Sector

19. **Commercial banks are diversifying their asset structure through regional expansion and focusing more on private sector lending, in particular retail lending.** The diversification strategy is welcome both from a risk management point of view, and given the projected decline in government financing needs. Moreover, the banking system appears ready to meet the Basel II capital adequacy standards, which the authorities plan to introduce on January 1, 2008. The changing business model of the domestic banking system will require a parallel adaptation of banking supervision to ensure that new activities, including activities abroad, do not create new and undue risks. While most banks seem well placed to adjust to these changing circumstances, some consolidation of the sector seems likely over the medium term. It is important that the mechanisms put in place to facilitate consolidation minimize moral hazard and increase banks' management accountability and shareholder responsibility. The reform of the deposit insurance fund that is being contemplated would provide an opportunity to develop a more comprehensive bank resolution a mechanism.