CONFIDENTIAL

INTERNATIONAL MONETARY FUND

LEBANON

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

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

Approved by Juan Carlos Di Tata and Scott Brown

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- **The Executive Board approved Emergency Post-Conflict Assistance (EPCA) for 25 percent of quota, or SDR 50.75 million, in April 2007, and Lebanon drew the full amount shortly thereafter.** The EPCA-supported program for 2007 is based on the five-year reform program presented by the authorities at the Paris III conference in January 2007. This report updates Executive Directors on performance under the program during 2007 relative to the first- and second-quarter quantitative indicative targets and structural monitorable actions. A safeguards assessment of the Banque du Liban is underway.

- **The staff's findings are based on discussions held by two missions that visited Beirut during May 14–28 and July 19–25, 2007.** The missions comprised Messrs. Gardner (head), Schimmelpfennig, Sdralevich, and Ms. Oner (all MCD); and Messrs. Finger (PDR), Hoffmann (MCM), Le Borgne and Mati (FAD). The missions met with the minister of finance, the governor of the central bank, the minister of economy and trade, and senior officials from the prime minister's office and various agencies. Mr. Di Tata (MCD) and Ms. Choueiri (OED) participated in some of the policy discussions.

- **The 2007 program is broadly on track.** The authorities met all the end-March quantitative indicative targets, with the exception of net borrowing by the government from the central bank. All end-June quantitative targets were met with large margins. The implementation of some of the monitorable actions for end-June suffered from delays, mainly due to technical reasons. The authorities are well placed to meet the end-year targets. So far, Lebanon has been relatively insulated from the effects of the recent financial market turbulence. Donor support in 2007 is falling short of expectations, which could adversely affect financing and debt dynamics.

Contents Page

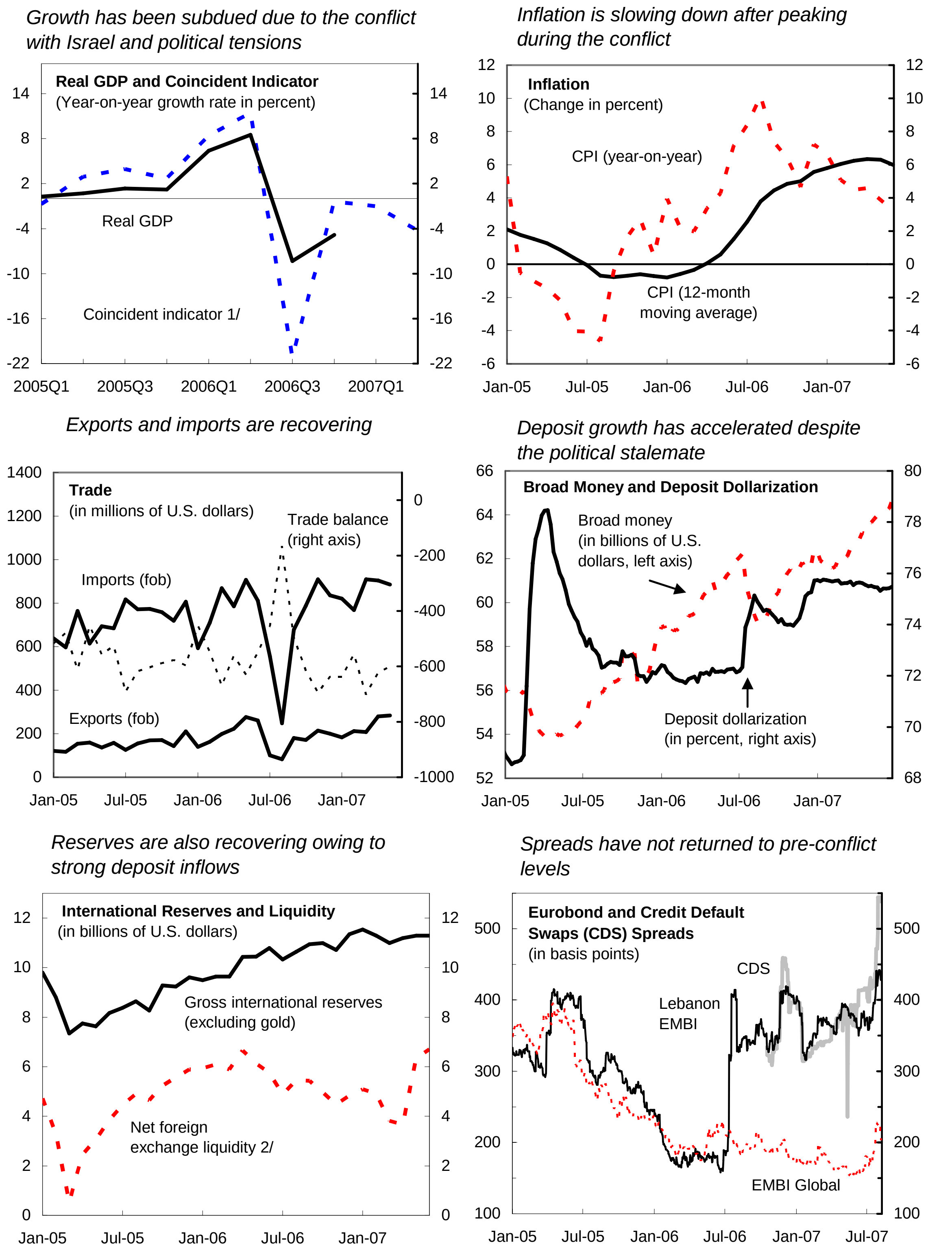
I. Background and Recent Developments

1. **There are as of yet no signs of a solution to Lebanon's political deadlock, which stems from both deep internal divisions over power sharing and geopolitical tensions.** Mediation attempts by the Arab League and France have so far failed to produce a compromise. Parliament is expected to be convened on September 25 to elect a new president, but absent a quorum (if the opposition stays out) the process will possibly stretch out until President Lahoud's term ends on November 25. Failure to elect a president could result in the formation of two parallel governments—the governing coalition could remain in power, while the outgoing president could appoint a new prime minister. While all parties have vowed to refrain from violence, the security situation remains tense.

2. **The economic situation continues to be overshadowed by the political stalemate and episodes of violence, including the assassination of an MP and the armed confrontation between the army and Islamic militants in the North.** In this environment, economic activity, including tourism, remains subdued, and real GDP is expected to rebound only slowly to achieve a moderate increase of about 2 percent in 2007, somewhat higher than envisaged in the program (Figure 1 and Table 1). Following price pressures in the summer of 2006 arising mainly from the conflict with Israel and the ensuing blockade, CPI inflation declined through mid-2007 and, on current trends, should fall to around 2 percent by year's end.

3. **The financial system remains resilient to the political uncertainty.** Owing to moderate capital inflows (and slow deposit growth), as well as limited donor disbursements, gross international reserves declined by $300 million to $11 billion in the first quarter. However, deposit growth has accelerated since then, and by end-June broad money was already 4½ percent higher than prior to the conflict with Israel, with international reserves recovering to $11.6 billion. Still, the economy is highly vulnerable to swings in confidence, and the political deadlock has increased risks, as reflected by Eurobond spreads (459 basis points as of August 29) and deposit dollarization (at around 76 percent), which remain substantially higher than prior to the 2006 conflict. The recent turbulence in international financial markets has not had a significant impact on Lebanon. While spreads have increased by around 80 basis points between mid-July and mid-August, there has been no pressure on the currency, and deposit inflows have remained robust though at a more moderate pace than in the second quarter.

Figure 1. Lebanon: Recent Developments, January 2005–July 2007



Sources: Lebanese authorities; J.P. Morgan; Bloomberg; and Fund staff calculations.

1/ Coincident indicator is a composite indicator of economic activity monitored by the central bank.

2/ Defined as gross international reserves minus principal and interest due over the next 12 months on all foreign currency liabilities of the central bank to entities other than the government of Lebanon. Excludes long-term foreign exchange liabilities of the central bank.

II. Performance Under EPCA

4. **All the quantitative targets for the first and second quarters of 2007 were observed, with the exception of the end-March ceiling on government borrowing from the Banque du Liban (BdL) (Table 2).** Difficult market conditions in the first months of 2007, with commercial banks reluctant to roll over maturing securities, led the government to rely more on financing from the BdL, thus exceeding the end-March target, albeit by a small margin—the outcome was LL 106 billion ($70 million) above the LL 903 billion ($602 million) flow targeted for the first quarter. All end-June targets were met by ample margins:

- The BdL was able to meet the **reserve target** with a margin of $1.5 billion due to the pick up in deposit inflows and the absence of any pressures in the foreign exchange market;
- The **primary fiscal balance** (excluding grants) through end-June is estimated at 0.6 percent of annual GDP, some 3 percentage points of GDP better than programmed, owing to a stronger than projected revenue collection on income and VAT taxes (partly due to the higher growth and to VAT carry-overs from 2006), better performance and earlier-than-expected receipt of non-tax revenue, and lower foreign-financed capital expenditures;
- The target for **net government debt** was also met despite a higher than expected interest bill in the second quarter;
- Despite additional BdL direct financing of the government in the primary market, overall **central bank credit to the government** at end-June came out significantly below the program target because of central bank sales of government paper in the secondary market. Credit to the government turned out lower than its end-March level, even after accounting for the cancellation of treasury bills held by the BdL, which was financed through a June operation involving the transfer to the government of the BdL's unrealized gold valuation gains. This operation does weaken the BdL's balance sheet.

5. **The end-June monitorable actions (structural reform measures under the program) have been mostly completed, despite some delays and except for a minor technical aspect.** [1] **At the same time, one action has become redundant (Table 3):**

- The **draft 2007 budget** was submitted to parliament on June 13. The budget is consistent with the EPCA primary deficit target and—as envisaged under the program—includes the operations of two extrabudgetary funds and does not allow for budget carryovers;

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[1] No monitorable actions were envisaged for end-March.

- The audit plan of the **electricity company** (Electricité du Liban, EdL), finalized with a small delay on July 13, envisages completing the audits of the 2002–04 accounts by the end of the year and the 2005–06 accounts by mid-2008. Moreover, for the first time in some years, EdL provided financial results for the first half of 2007, a key input into the finance ministry's fiscal projections. In August, the 2001 audit report was posted on the EdL and ministry of finance websites;
- The auditor for the **National Social Security Fund** (NSSF) was appointed on June 12, and the audit plan through 2005 was finalized on August 6. The audits of the 2001–02 accounts are expected to be completed in early 2008. Subsequent audits will cover more recent years. Because the books have not yet been closed, an auditor has not yet been appointed to audit the 2006 accounts, but the authorities considered that extending the current contract to cover 2006 would be a simple formality.
- Based on a legal opinion rendered by the ministry of justice, the authorities consider that the law for the sale of the fixed assets of the two state-owned **mobile phone operators** is no longer necessary, making the corresponding end-June monitorable action of seeking parliamentary approval redundant. On this basis, the government expects that invitations for expressions of interest for the two companies would be issued before the end of 2007.

III. Prospects for the Remainder of 2007 and Preparations for 2008

6. **Policy performance in the first half of 2007 bodes well for the achievement of the program's end-year quantitative fiscal targets.** In particular, the strong revenue collection should allow the authorities to contain the primary deficit below the program ceiling. However, not adjusting domestic gasoline prices to match the recent rise in international oil prices has eroded excise revenues to near zero since May. Looking forward, it is important to restore promptly this revenue source, which constitutes a key measure in the authorities' fiscal adjustment strategy. As a first step, the program envisages raising the gasoline excise to at least LL300 per liter by end-September 2007, which is expected to generate about ½ percent of GDP in 2007. This measure is expected to be politically difficult, but its implementation does not require parliamentary approval.

7. **Donor disbursements have been lower than expected.** So far in 2007, actual disbursements of pledges committed at the Paris III (Text Table 1) and Stockholm conferences have been disappointing, as the finalization of many agreements is taking significantly longer than expected, owing mostly to technical and administrative reasons. During the first six month of 2007, the shortfall was moderate because disbursements had been programmed to take place mainly in the second half of the year. Unless an acceleration takes place during the remainder of the 2007 in line with Paris III pledges, disbursements are likely to fall short of the projection under EPCA. As it is difficult to foresee where there would be scope for further fiscal adjustment to offset such a shortfall, the government would be forced to borrow the difference at market interest rates.

Text Table 1. Lebanon: Paris III Aid
(In millions of U.S. dollars, unless otherwise specified)

	Total Pledges	New Grants and Loans to Government					
		Paris III Pledges		Rev. Proj. for 2007-10 1/		2007	
		Total	Of which: Direct Budget Support	Direct and Indirect Budget Support 2/	Grant Element 3/ (Estimate, in percent)	Proj.	Received Jan-Jun
Total	7,565	5,018	2,327	3,083	51.5	1,888	100
Multilateral	3,978	2,213	835	738	37.7	306	0
Bilateral	3,587	2,805	1,492	2,346	55.9	1,583	100

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

1/ The financial terms of some loans are still uncertain.

2/ Includes project loans and grants that support the existing expenditure envelope.

3/ Based on a discount rate of 7.45 percent, Lebanon's average projected rate for U.S. dollar market financing.

8. **The end-year quantitative indicative targets for gross international reserves and central bank credit to government should be achievable.** A reallocation of the assets of the NSSF from bank deposits to treasury bills covered much of the government's domestic financing need in the first half of the year. As this one-off portfolio reallocation comes to an end, the availability of liquidity in the banking sector should enable the government to rely to a greater extent on market financing, thus limiting recourse to central bank credit to below the program's ceiling. However, greater interest rate flexibility may be needed to tap the financial markets, particularly if donor disbursements do not materialize as projected in the second half of the year. Looking beyond 2007, the current global repricing of risk could increase Lebanon's financing costs, though spreads, so far, have been primarily driven by domestic politics and may well decline if the political crisis is resolved.

9. **The budget law and other fiscal legislation for 2008 are under preparation, but the presidential election and its aftermath are likely to delay their approval to end-2007, at the earliest.** The 2008 budget process is at its initial stages, and so far only limited information is available. The authorities' indicated that the draft Global Income Tax law is near completion and should be ready for submission to parliament by end-year, as planned under Paris III. Parliamentary adoption and completion of the necessary administrative measures before end-2007 would allow the law to be introduced in 2008. Work is also proceeding on a new tax code that harmonizes tax procedures and on a new risk-based tax audit strategy. Meanwhile, there is scope to advance on administrative reforms that do not require parliamentary action. In this regard, ongoing work by the new cash management unit to establish a cash flow plan is encouraging, and further progress is expected in implementing a public financial management reform plan that was developed with assistance from the Fund's Fiscal Affairs Department. Improvements in these areas are key to prepare the ground for more effective budgeting, monitoring, and control in 2008.[2]

[2] A forthcoming FAD technical assistance mission will focus on the distributional impact of reducing subsidies.

Table 1. Lebanon: Selected Economic Indicators, 2003–08

	2003 Act.	2004 Act.	2005 Act.	2006 Prel. Act.	2007 EBS/07/33	2007 Rev. Proj.	2008 EBS/07/33
Output and prices	(Annual percentage change)						
Real GDP (market price)	4.1	7.4	1.0	0.0	1.0	2.0	3.5
Consumer prices (end-of- period)	2.2	2.0	0.5	7.2	2.0	2.0	3.0
Consumer prices (period average)	1.3	1.7	-0.7	5.6	3.5	3.5	2.5
Investment and saving	(In percent of GDP)						
Gross capital formation	19.3	22.0	17.0	11.4	16.6	16.8	19.9
Government	3.1	3.3	2.2	2.5	5.0	4.9	3.0
Nongovernment	16.2	18.8	14.8	8.9	11.7	11.9	16.9
Gross national savings	6.1	6.5	3.4	5.2	5.6	5.7	9.9
Government	-10.2	-5.4	-6.3	-8.6	-7.4	-8.2	-7.7
Nongovernment	16.3	11.9	9.6	13.8	13.1	14.0	17.5
Public finances	(In percent of GDP)						
Revenue (including grants)	22.1	23.1	22.8	24.8	26.7	26.5	25.6
Expenditure	35.4	31.8	31.2	35.9	39.1	39.6	36.2
Budget balance (including grants)	-13.3	-8.6	-8.4	-11.1	-12.4	-13.1	-10.6
Primary balance (including grants)	3.3	3.5	2.1	1.7	0.0	0.1	1.1
Total government debt	169	167	179	178	176	174	147
Monetary sector	(Annual percentage change, unless otherwise indicated)						
Credit to the private sector	0.3	5.2	1.9	6.0	5.0	7.7	27.5
Base money	12.3	10.3	4.7	8.2	4.4	5.2	8.4
Broad money 1/	15.5	12.3	3.5	6.4	3.5	5.0	7.0
Velocity of broad money (level)	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Interest rates (period average, in percent)							
Three-month treasury bill rate	6.7	5.2	5.2	5.2	...	...	...
Two-year treasury bill rate	8.0	7.9	8.5	8.7	8.2	8.7	7.6
External sector	(In percent of GDP, unless otherwise indicated)						
Exports of goods (in US$, percentage change)	43.2	18.3	11.1	22.5	12.9	14.8	14.6
Imports of goods (in US$, percentage change)	10.4	30.3	-1.2	1.8	17.5	17.3	4.3
Merchandise trade balance	-24.2	-30.1	-28.4	-25.3	-29.2	-28.4	-27.5
Current account excluding official transfers	-13.9	-16.0	-14.2	-7.4	-15.3	-13.4	-10.6
Current account including official transfers	-13.2	-15.5	-13.6	-6.2	-11.0	-11.1	-10.0
Foreign direct investment	8.7	10.9	12.2	12.0	7.6	9.2	23.4
Total external debt	175	187	190	198	183	192	175
Gross reserves (in millions of U.S. dollars)	10,271	9,575	9,611	11,353	10,440	11,583	13,139
In months of next year imports of goods and services	8.1	7.7	7.2	7.6	6.7	7.2	7.7
In percent of short-term external debt 2/	35.6	27.1	28.4	31.7	32.5	31.5	40.1
In percent of banking system foreign currency deposits	40.3	31.9	29.0	30.1	26.7	29.3	31.2
In percent of total banking system deposits	24.8	21.0	20.1	21.9	19.3	21.3	22.4
Memorandum items:							
Nominal GDP (in billions of U.S. dollars)	19.8	21.5	21.5	22.7	23.6	24.0	25.0
Net imports of petroleum products (in millions of U.S. dollars)	-1,057	-1,833	-2,082	-2,172	-2,072	-2,094	-2,286
Local currency per U.S. dollar (period average)	1,508	1,508	1,508	1,508	...	...	...
Real effective exchange rate change)							
(annual average, percent change)	-10.7	-6.8	-4.1	2.2	...	...	...
Stock market index	457	637	1,309	1,184	...	...	...

Sources: Lebanese authorities; and Fund staff estimates.

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

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

Table 2. Lebanon: Quantitative Indicative Targets Under the Program Supported by Emergency Post-Conflict Assistance, March–December 2007
(Billions of Lebanese pounds unless otherwise indicated; end-of-period) 1/

	2006	2007							
	December	March			June			September	December
	Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.	Prog.
I. Gross reserves of the Banque du Liban (stocks) 2/	18,084	17,505	17,263	17,645	17,166	16,045	17,539	16,863	17,475
II. Net debt of the government (stocks) 3/	59,361	61,121	61,121	60,497	59,766	59,838	58,327	60,507	61,504
III. Primary balance of the government, before grants (cumulative flows)	...	-575	-575	-324	-848	-942	223	-1,005	-1,317
IV. Accumulation of government gross arrears (cumulative flows, continuous)	...	0	...	0	0	...	0	0	0
V. Accumulation of external arrears by the government and the Banque du Liban (cumulative flows, continuous)	...	0	...	0	0	...	0	0	0
VI. Government net borrowing from the Banque du Liban (stocks) 4/	9,791	10,696	10,694	10,797	9,237	9,309	7,687	8,696	7,630
Memorandum items:									
Letters of credit contracted by Electricité du Liban (stock)	690	...	...	690	...	...	740	...	...
Disbursements of official grants and loans to the public sector (cumulative flows)	...	0	...	2	620	...	251	2,197	4,006
Banque du Liban's holdings of Eurobonds (stock)	2,147	...	...	1,963	...	...	1,014	...	...
Disbursements of grants to the government (cumulative flows)	...	0	...	2	318	...	246	983	1,316
Of which: disbursements of project grants (cumulative flows)	...	0	...	0	0	...	93	43	91
Receipts from privatization/securitization operations (cumulative flows)	...	0	...	0	0	...	0	0	0
Transfers of gold valuation gains from Banque du Liban to government (cumulative flows)	...	0	...	0	2,380	...	2,380	2,380	2,380
Projection of revenue from companies slated for privatization (cumulative flows)	...	331	...	...	521	...	...	1,036	1,566

Source: Lebanese authorities.

1/ At program exchange rates.
2/ In millions of U.S. dollars. Defined as Banque du Liban's foreign exchange deposits abroad, foreign exchange holdings (including SDRs), gold and holdings of liquid foreign currency-denominated securities, less encumbered foreign assets.
3/ Includes the accounts of the Center for Reconstruction and Development and the Higher Relief Council maintained at the Banque du Liban.
4/ Includes a decline in net borrowing of LL2380 billion on account of the gold revaluation transfer which took place in the second quarter of 2007.

Table 3. Lebanon: Monitorable Actions for the Period March–December 2007

Measure	Target Date	Implementation Status
Fiscal		
Submit to parliament a draft 2007 budget law consistent with the targeted primary balance of the central government, and including detailed HRC operations and CDR foreign-financed expenditures. The budget law should not allow budget carryovers for expenditures for which no third-part liability already exists, and treasury advances of more than one month after the fiscal year.	End-June 2007	Draft budget consistent with program commitments submitted to parliament on June 13, 2007 (decree # 403).
Appoint auditor for NSSF accounts. Auditor to prepare an audit plan of NSSF for 2001–06.	End-June 2007	Auditor appointed on June 12, 2007. Contract will be extended to cover 2006 once accounts are closed. Audit plan finalized on August 6.
Issue a Cabinet of Ministers decision setting a specific floor on gasoline excise of LL 300 per liter of gasoline.	End-September 2007	. . .
Power sector		
Appoint auditor for EdL accounts. Auditor to prepare an audit plan of EdL for 2002–06. Publish 2001 audit report.	End-June 2007	Auditors for 2002–04 appointed on June 1, 2005, and auditors for 2005–06 appointed on April 13, 2007. Audit plan for 2002–06 finalized on July 13. 2001 audit report posted on website on August 27.
Privatization		
Submit to parliament the draft law to authorize the sale of the mobile sector's assets and relevant operating licenses by the government.	End-June 2007	Based on a legal opinion from the ministry of justice, the law is not necessary to proceed with the privatization.
Issue an invitation for expression of interest (EOI) in participating in the process of acquiring the licenses and assets of the two mobile telephone companies (MIC1 and MIC2).	End-December 2007	. . .