

IMF Executive Board Concludes 2010 Article IV Consultation with Lebanon

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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 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.

Lebanon: Selected Economic Indicators, 2007–09

	2007	2008	Prel. 2009
Output and prices	(Annual percentage change)		
(Annual percentage change) Real 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	1507.5	1507.5	1507.5

average)			
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.

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/hp/sec/misc/qualifiers.htm>.