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 was 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 relative to the end-December 2007 indicative targets and monitorable actions.

- **A safeguards assessment of the Banque du Liban (BdL) has been completed.** The report suggested areas for enhancing the BdL's financial reporting, audit, and control procedures, and the authorities have outlined steps to follow up on these recommendations.

- **The staff's findings are based on discussions held in Beirut February 21–29, 2008.** The mission comprised Messrs. Fanizza (head), Schimmelpfennig, and Sosa (all MCD); and Messrs. Finger (PDR) and Mati (FAD). Mr. Khan (MCD, Director) joined the mission February 25–26. Mr. Gardner (Senior Resident Representative) and Ms. Pineda (MCD, assistant) supported the mission in the field. The mission met with the prime minister, the governor of the central bank, the minister of finance, the minister of economy and trade, and senior government officials.

- **The authorities met all end-December 2007 indicative targets under EPCA by substantial margins.** Growth and financial conditions were resilient despite the prolonged political deadlock. The authorities succeeded in achieving a primary fiscal surplus (excluding grants), which contributed to a reduction in the debt-to-GDP ratio; and in maintaining confidence in the domestic banking system, which translated into an acceleration of deposit growth and a slight increase in international reserves.

- **Macroeconomic policies in 2008 need to focus on safeguarding these achievements.** This would provide the basis—once the current political impasse is solved—for implementing the Paris III fiscal and structural reform agenda to raise growth, improve living conditions, and reduce the debt overhang.

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I. Background and Recent Developments

1. **The political stalemate over the election of a president and the formation of a new government continues, notwithstanding international mediation efforts.** Parliament has not been convened for over a year, legislative activity has come to a standstill, and the government has refrained from major policy initiatives. The security situation remains tense.

2. **Economic performance in 2007 was significantly better than expected, despite the difficult political conditions.** Given a very strong fourth quarter, the authorities now estimate real GDP growth at 4 percent. Construction, the financial sector, and the services sector were reportedly the main drivers of growth, with expatriates visiting Lebanon adding an extra stimulus. Inflation accelerated to 6 percent year-on-year in December, mainly reflecting international price increases and the weakening of the U.S. dollar. The current account deficit widened as imports picked up following their collapse in 2006.

3. **Financial markets showed resilience.** Broad money growth has trended at over 11 percent, thanks to continued strong deposit inflows. There have been no pressures on the exchange rate, and international reserves have risen slightly, despite shortfalls in donor support. Only $565 million of the pledges made at the Paris III conference for government support were received in 2007, partly because negotiations have taken longer than envisaged (see Text Table 1).[1] Dollarization and spreads over international interest rates have widened, but nominal rates have remained broadly constant. Citing the political stalemate, Standard and Poor's downgraded Lebanon to CCC+ from B– in January 2008, while Moody's recently confirmed its B3 rating. Lebanese banks have not been affected by the fall-out from the U.S. subprime crisis, since, by regulation, they had no exposure to structured products; in addition, they do not rely much on financing from international markets. The large Lebanese banks have continued their regional expansion strategy, and close to half of new private sector credit reportedly finances foreign investments of domestic Lebanese businesses. Effective January 1, 2008, Lebanon adopted Basel II, with pillars 2 and 3 being phased in.

[1] In addition, Malaysia agreed to a debt exchange that lengthened maturities and lowered interest costs. Furthermore, $329 million support in-kind was received or was under preparation by end-2007, and private sector support totaling $944 million was signed. Other support is being channeled through UN agencies and civil society organizations.

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

	Total Pledges	Of which: New Grants and Loans to Government					
		Paris III Pledges		Rev. Proj. for 2007-11 1/		2007	
		Total	Of which: Direct Budget Support	Direct and Indirect Budget Support 2/	Grant Element 3/ (Estimate, in percent)	EPCA Proj.	Received
Total	7,565	5,018	2,327	2,706	48.2	2,080	565
Multilateral	3,978	2,213	835	803	43.8	248	125
Bilateral	3,587	2,805	1,492	1,903	50.1	1,832	440

Sources*:* Lebanese authorities, and Fund staff estimates

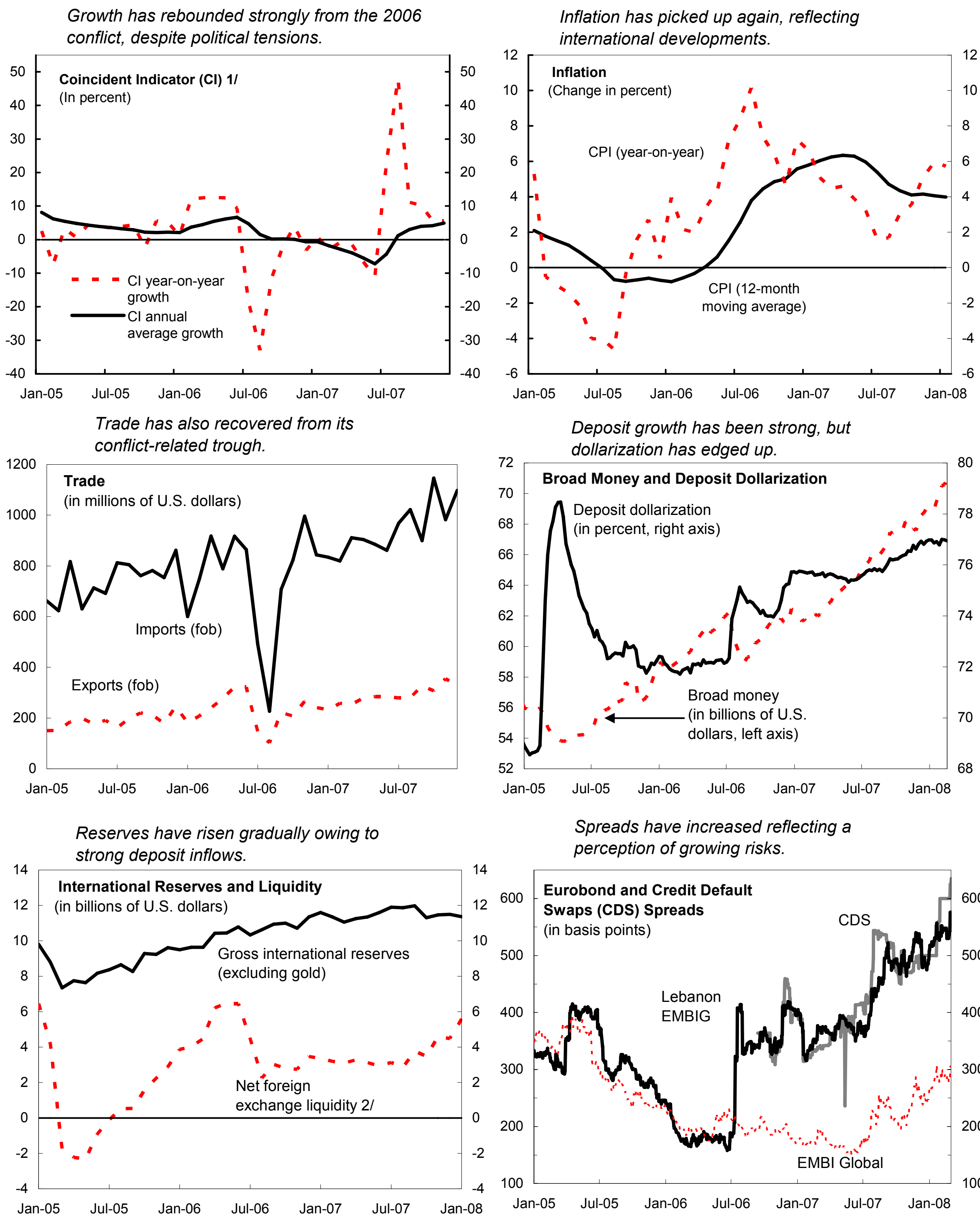
1/ The financial terms of some loans are still uncertain.
2/ Includes project loans and grants that support the existing expenditure envelope.
3/ Based on a discount rate of 8.29 percent, Lebanon's average projected rate for U.S. dollar market financing.

II. Performance Under EPCA at End-December

4. **The primary balance and net debt targets for end-December 2007 were met with significant margins.** The authorities achieved a primary surplus excluding grants of ½ percent of GDP, compared to a target of –3.7 percent. This substantial overperformance reflected: (a) strong overall revenues, in particular, significant gains from the value-added tax (VAT), income taxes, and telecom revenues that more than offset the loss from gasoline excises that over the year were reduced to zero; and (b) expenditure savings, deriving mainly from a lower pace of foreign-financed spending, and lower than expected transfers to municipalities and the power utility (EdL). Government net debt declined from 173 to 165 percent of GDP in 2007, in part because the primary surplus rose above its debt-stabilizing level. However, most of the decline resulted from the transfer of unrealized gold valuation gains from the BdL to the government (about 6 percentage points of GDP), which weakened the central bank's balance sheet. The full budgetary impact of higher fuel prices will be felt only in 2008 since EdL's fuel supplies are financed through letters of credit, the stock of which has increased gradually during 2007.

5. **The program targets on international reserves and government net borrowing from the BdL were also met comfortably.** With strong deposit inflows, and in the absence of foreign exchange market pressures, gross international reserves of the BdL rose to $11.5 billion, despite the shortfall in donor financing. During the fourth quarter of 2007, commercial banks returned to the market for government paper—this was facilitated by a swap of BdL certificates of deposit held by commercial banks for five-year treasury bills. As a result, the government was able to reduce its reliance on net financing from the BdL significantly below program expectations.

Figure 1. Lebanon: Recent Developments, January 2005–February 2008



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.

6. **Some progress has been made on the structural reform agenda.** Preparations for the privatization of the two mobile phone operators are near completion. In November, the government issued a request for applications to participate in the auction of the existing mobile phone licenses, assets, and contracts (end-December monitorable action). Given the ongoing political stalemate, the auction has been postponed until May, but, in the absence of a new government, further delays are possible. In the energy sector, consultants have been appointed to assist in reforming EdL in collaboration with the World Bank. In addition, modernization of the revenue administration is advancing through: (a) the adoption of a new audit strategy; (b) the preparation of regulations to implement the tax procedures code; (c) the opening of satellite offices; and (d) the launching of e-services by mid-2008. On the expenditure side, the authorities are strengthening cash flow planning and laying the groundwork for multiyear budgeting.

III. Outlook for 2008

7. **The political stalemate and concerns about the security situation weigh on the economic outlook for 2008.** Real GDP growth is projected in the 2–3 percent range (well below potential), which implies that activity remains near the level achieved during the fourth quarter of 2007. Inflation is likely to stay above 5 percent, given international developments. With lackluster growth and continued fiscal tightness, the external current account deficit relative to GDP should improve moderately. Deposit inflows are likely to remain strong, barring any unexpected worsening in the political and security conditions.

8. **The government has limited scope for fiscal policy actions in the absence of an active parliament.** As such, the tax increases envisaged in the Paris III reform agenda for 2008 have been put on hold. Still, revenue should at least grow broadly in line with nominal GDP, taking into account one-off effects in 2007. Notwithstanding pressures for increases in subsidies and the minimum wage, the government plans to maintain strict expenditure control, and expects to realize savings from a hiring freeze and a reassessment of priorities in capital spending and transfers. Moreover, the increase in transfers to EdL should be limited by the planned partial switch in electricity production from gas-oil to natural gas. As a result, the authorities should be able to keep the primary balance excluding grants relative to GDP close to its 2007 level, or even achieve a further improvement. This would keep the public debt-to-GDP ratio on a gradual downward trend and help limit vulnerabilities until political conditions permit a resumption of the Paris III fiscal reform agenda. Pressing forward with the privatization of the telecommunication sector would not only reduce the public debt-to-GDP ratio, but also raise productivity and growth.

9. **The government faces substantial gross financing needs in 2008, including over $4½ billion in foreign currency.** Expected donor support of $800 million is crucial to cover some of these needs.[2] In addition, the government can use its foreign exchange revenues of around $1 billion a year. For the remainder, the government should be able to rely largely on market financing, with commercial banks expected to roll over the 2008 Eurobond maturities of $2½ billion; indeed, in March, the authorities successfully rolled over a maturity of $875 million. If the authorities' financing strategy succeeds and donor support is in line with projections, gross international reserves should increase by more than $1 billion during 2008, reflecting expected deposits from Gulf countries at the BdL.

10. **This outlook, however, is subject to significant risks.** So far, the region has been somewhat isolated from the slowdown in major industrial countries, but Lebanon remains vulnerable to possible changes in regional liquidity and demand, e.g., if oil prices were to drop sharply. A worsening of the Lebanese political and security situation could rattle confidence and trigger a slowdown or even a reversal of deposit inflows, which would complicate the government's financing strategy and put pressure on reserves. Another risk is that increased inflation could eventually result in rising subsidies and wages, worsening the fiscal outlook. On the upside, an early resolution of the political stalemate is likely to improve investor confidence and the country's growth prospects.

11. **The authorities are likely to request continued Fund support for their economic reform program in 2008 under a follow-up EPCA.** With the macroeconomic program supported by EPCA having expired at end-2007, the authorities have expressed interest in continued quarterly monitoring of Lebanon's economic policies and performance by the Fund.

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[2] This includes delayed disbursements from 2007 of about $350 million. Pledges conditional on privatization of the two mobile phone licenses are not included in the projections for 2008.

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

	2003	2004	2005	2006	2007		2008
	Act.	Act.	Act.	Prel. Act.	EBS/07/33	Est.	Proj.
Output and prices	(Annual percentage change)						
Real GDP (market price)	4.1	7.5	1.1	0.0	1.0	4.0	3.0
GDP deflator	1.6	0.9	-0.6	5.6	...	4.1	5.5
Consumer prices (end-of- period)	2.2	2.0	0.5	7.2	2.0	6.0	5.0
Consumer prices (period average)	1.3	1.7	-0.7	5.6	3.5	4.1	5.5
Investment and saving	(In percent of GDP)						
Gross capital formation	19.3	22.0	21.1	13.6	16.6	14.3	13.6
Government	3.1	3.3	2.2	2.5	5.0	2.4	2.1
Nongovernment	16.2	18.8	19.0	11.1	11.7	11.9	11.5
Gross national savings	6.1	6.5	7.5	7.6	5.6	3.6	3.8
Government	-10.2	-5.4	-6.2	-8.6	-7.4	-8.6	-8.2
Nongovernment	16.3	11.9	13.8	16.2	13.1	12.2	12.0
Public finances	(In percent of GDP)						
Revenue (including grants)	22.1	23.1	22.8	24.7	26.7	24.8	24.0
Expenditure	35.4	31.8	31.2	35.8	39.1	35.8	34.3
Budget balance (including grants)	-13.3	-8.6	-8.4	-11.1	-12.4	-11.0	-10.3
Primary balance (including grants)	3.3	3.5	2.1	1.7	0.0	1.8	2.0
Primary balance (excluding grants)	3.3	3.5	2.1	-1.2	-3.7	0.4	0.6
Total government debt	169	167	178	177	176	171	167
Monetary sector	(Annual percentage change, unless otherwise indicated)						
Credit to the private sector 1/	0.3	5.2	1.9	6.0	5.0	3.2	10.0
Base money	12.3	10.3	4.7	8.2	4.4	12.6	10.5
Broad money 2/	15.5	12.3	3.5	6.4	3.5	11.2	9.0
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 yield	6.7	5.2	5.2	5.2	...	5.2	...
Two-year treasury bill yield	8.0	7.9	8.5	8.7	8.2	8.7	8.7
External sector	(In percent of GDP, unless otherwise indicated)						
Exports of goods (in US$, percentage change)	43.2	18.3	11.1	22.5	12.9	27.8	20.0
Imports of goods (in US$, percentage change)	10.4	30.3	-1.2	1.8	17.5	26.7	13.7
Merchandise trade balance	-24.2	-30.1	-28.4	-25.3	-29.2	-29.5	-30.0
Current account excluding official transfers	-13.9	-16.0	-14.2	-7.2	-15.3	-11.8	-11.2
Current account including official transfers	-13.2	-15.5	-13.6	-6.0	-11.0	-10.7	-9.8
Foreign direct investment	8.7	10.9	12.2	12.0	7.6	10.8	10.1
Total external debt	175	187	190	197	183	198	196
Gross reserves (in millions of U.S. dollars)	10,271	9,575	9,611	11,353	10,440	11,494	12,572
In months of next year imports of goods and services	8.1	7.7	7.2	7.2	6.7	6.6	6.6
In percent of short-term external debt 3/	35.6	27.1	28.4	32.2	32.5	30.6	31.8
In percent of banking system foreign currency deposits	40.3	31.9	29.0	30.1	26.7	26.5	26.2
In percent of total banking system deposits	24.8	21.0	20.1	21.9	19.3	19.7	19.5
Memorandum items:							
Nominal GDP (in billions of U.S. dollars)	19.8	21.5	21.6	22.8	23.6	24.6	26.8
Net imports of petroleum products (in millions of U.S. dollars)	-1,057	-1,833	-2,082	-2,172	-2,072	-2,500	-3,382
Local currency per U.S. dollar (period average)	1,508	1,508	1,508	1,508	...	1,508	...
Real effective exchange rate (annual average, percent change)	-10.7	-6.9	-4.1	2.1	...	-4.0	...
Stock market index	457	637	1,309	1,184	...	1,454	...

Sources: Lebanese authorities; and Fund staff estimates.

1/ For 2007, the low headline growth reflects a change in reporting of non-performing loans. Underlying private sector credit growth has trended above 10 percent in 2007.

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

3/ 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.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.
I. Gross reserves of the Banque du Liban (stocks) 2/	18,084	17,505	17,263	17,648	17,166	16,172	17,544	16,863	14,971	17,847	17,475	14,731	17,293
II. Net debt of the government (stocks) 3/	59,212	61,122	61,122	60,604	59,766	59,932	58,699	60,508	61,295	59,954	61,505	62,541	60,873
III. Primary balance of the government, before grants (cumulative flows)	...	-575	-575	-223	-848	-942	228	-1,005	-1,099	105	-1,317	-1,401	181
IV. Accumulation of government gross arrears (cumulative flows, continuous)	...	0	...	0	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	0	...	0
VI. Government net borrowing from the Banque du Liban (stocks) 4/	9,678	10,696	10,694	10,801	9,237	9,402	7,678	8,696	9,483	8,960	7,630	8,666	7,523
Memorandum items:													
Letters of credit contracted by Electricité du Liban (stock)	690	...	...	690	...	...	740	...	...	873	...	...	966
Disbursements of official grants and loans to the public sector (cumulative flows)	...	0	...	2	620	...	258	2,197	...	483	4,006	...	1,005
Banque du Liban's holdings of Eurobonds (stock)	2,147	...	...	1,963	...	...	1,010	...	....	1,009	...	...	1,013
Disbursements of grants to the government (cumulative flows)	...	0	...	2	318	...	246	983	...	290	1,316	...	363
Of which: disbursements of project grants (cumulative flows)	...	0	...	0	0	...	93	43	...	137	91		174
Receipts from privatization/securitization operations (cumulative flows)	...	0	...	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	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 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	Not implemented.
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 accounts appointed on March 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 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	A Request for Application was issued on November 2, 2007. Applications with pre-auction bids had been requested for February 1, 2008, but the auction has been delayed.