Last updated on June 6, 2009

LEBANON—PROGRAM NOTE

Current IMF-Supported Program: US$37.6 million in Emergency Post-Conflict Assistance (EPCA), approved by the IMF's Executive Board on November 19, 2008.

Background

On paper, the Lebanese economy looks highly vulnerable, but it nevertheless retains a surprising ability to weather storms. Lebanon's government debt-to-GDP ratio (160 percent) remains among the highest in the world, its large banking system (assets of more than three times GDP) is excessively exposed to the government and dependent on inflows of nonresident deposits, and the country lies at the crossroads of regional political tensions.

With large government and private sector currency mismatches, the maintenance of the Lebanese Pound's peg to the U.S. dollar remains essential for continued financial stability. Despite all this, the Lebanese economy has proven remarkably robust to economic shocks. But this resilience cannot be taken for granted. Following the Israeli invasion in 2006, the international community therefore agreed to support an ambitious Lebanese program of reconstruction and macroeconomic stabilization.

Role of the IMF

In the aftermath of the 2006 invasion, the authorities, backed by the international community, developed a comprehensive economic reform program (the Paris III agenda).The reform agenda aims at:

- fiscal adjustment, related structural measures and privatization to tackle the large public debt overhang and reinvigorate the economy; and
- social sector reforms to alleviate poverty, reduce regional income disparities, and improve education and health indicators.

The Fund supported this agenda through a quarterly monitoring framework and a first drawing of EPCA in 2007. Domestic political conflict interrupted progress in implementing the Paris III agenda. To help maintain economic and financial stability, the Fund supported the authorities through a second EPCA drawing in 2008.

Progress to Date

The program has been very successful**.** Since 2006, the debt-to-GDP ratio has declined by nearly 20 percentage points. Real GDP growth exceeded 8 percent in 2008, helped by prudent policies and an improvement of the political and security situation after the May 2008 Doha agreement. The Lebanese financial system has so far weathered the global financial crisis unscathed. Deposit inflows, key for the financing of the large budget deficits, have continued at a rapid pace. Deposit dollarization has been declining steadily. There have been no pressures on the peg, and the central bank has continued to accumulate international reserves at a swift pace.

Challenges Ahead

In the short term, the global recession and tight international capital markets weigh on the economic and financial outlook. Economic growth is likely to slow to 4 percent this year, and deposit growth could decline to 10 percent from over 15 percent in 2008. The main downside risks to this outlook stem from the possible confluence of domestic political uncertainty, regional instability, and further weakening of global and regional economic conditions, which could again test the country's fiscal and financial vulnerabilities.

Following the June 2009 parliamentary elections and formation of a new government, continued implementation of the Paris III agenda will be essential to reduce Lebanon's still high vulnerabilities. A key objective of this agenda is the further reduction of government debt, mainly through an increase in the VAT, fixing the loss-making public electricity company, and privatizing the two mobile phone operators. Monetary policy will need to continue to aim at safeguarding the peg and further building international reserves.