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

This report on Lebanon's performance under the program supported by emergency post-conflict assistance was circulated to the Executive Directors of the IMF for their information. It was prepared by a staff team of the International Monetary Fund and is based on the information available at the time it was issued on October 28, 2009. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Lebanon or the Executive Board of the IMF.

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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 Ratna Sahay and Ranil Salgado

October 27, 2009

- **Emergency Post-Conflict Assistance (EPCA). Following an initial EPCA disbursement in 2007,** the Executive Board approved a second EPCA equivalent to 12.5 percent of quota, or SDR 25.375 million, in November 2008. The EPCA-supported program for the period until June 2009 was designed to support the authorities' policies aimed at buttressing macroeconomic stability and financial discipline during the period until the parliamentary elections. This report updates Executive Directors on performance under the program relative to the end-June 2009 indicative targets and monitorable actions.
- **Staff visit.** The report's findings are based on discussions held in Beirut during September 10–18, 2009. The team comprised Messrs. Fanizza (head), Finger (both MCD), and Lopez Murphy (FAD). It was assisted by Mr. Mottu (resident representative). The mission met with the governor of the central bank, the minister of finance, and senior government officials.
- **Performance under EPCA.** The performance has remained broadly favorable, though there has been limited progress on structural reforms. The end-June quantitative target on international reserves was met by a wide margin. While the primary balance target was also met, the program ceiling on net government financing by the Banque du Liban (BdL) was missed. The BdL has adopted formal policies for the selection, appointment, and rotation of the BdL's external auditors (end-June monitorable action). However, the introduction of a Treasury Single Account (end-June monitorable action) was postponed because parliament did not pass the corresponding legislation.
- **Economic outlook.** Recent cyclical indicators point to a marked resilience of the Lebanese economy to the global recession. In light of strength in tourism, financial services, and construction, staff projects GDP growth at 7 percent this year.
- **Policy priorities.** Given Lebanon's still very high government debt-to-GDP ratio, fiscal consolidation remains a priority. In the near-term, the authorities should capitalize on buoyant fiscal revenues to achieve a primary surplus of at least a 0.9 percent of GDP this year (up from 0.6 percent in 2008). The next government should swiftly relaunch the Paris III fiscal consolidation agenda. In the near term, interest rates should be allowed to decline further, but at a gradual pace.
- **Safeguards assessment of the BdL**. An update assessment was completed on September 2, 2009. The report indicates progress in implementing some of the previous recommendations, especially those included as monitorable actions in the program, but limited progress in other areas. Further actions are required to enhance the BdL's financial reporting, transparency, governance, audit oversight, and legal framework.

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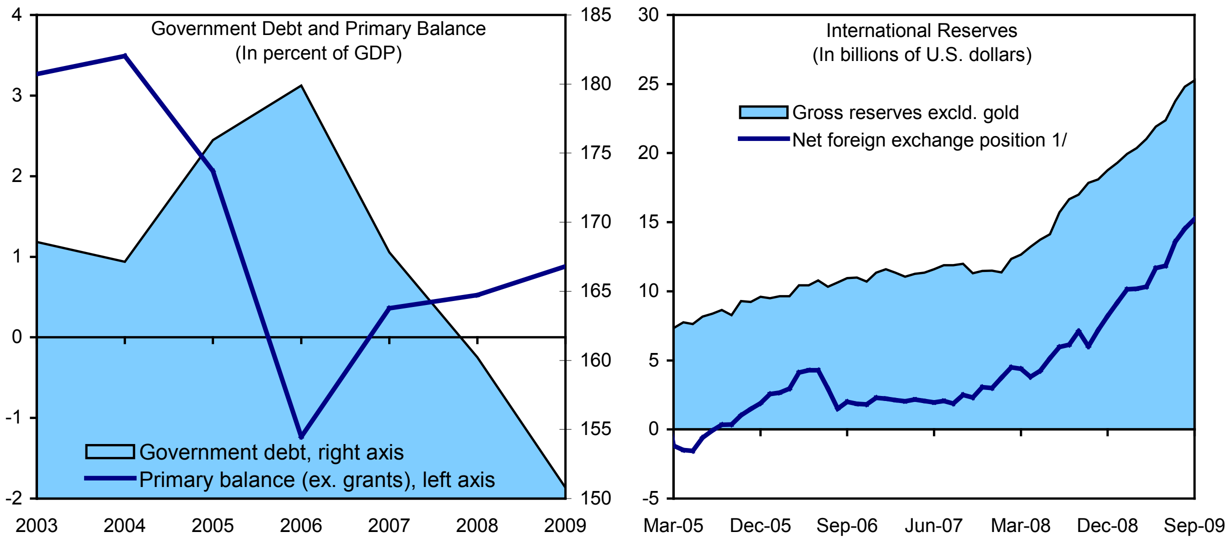
I. Introduction

1. **Lebanon has started to reap the benefits of prudent macroeconomic policies.** The two key objectives of EPCA—reducing the government debt-to-GDP ratio and strengthening international reserves—were clearly met, buoying confidence and economic activity despite the difficult international environment and recent delays in forming a government. The debt-to-GDP ratio has dropped 27 percentage points since end-2006, and at $25 billion, international reserves have doubled over the past 18 months.



Sources: Lebanese authorities; and Fund staff calculations.
1/ Defined as gross international reserves (including gold) minus foreign currency obligations of the BdL to entities other than the Government of Lebanon.

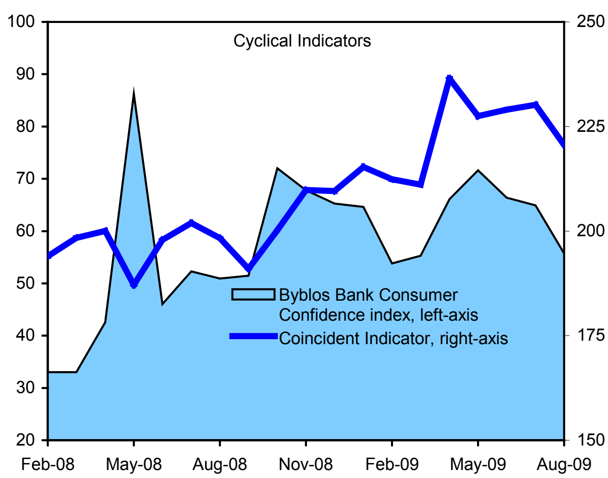
2. **Nonetheless, Lebanon continues to face serious long-standing vulnerabilities.** At over 150 percent of GDP, government debt remains high, and large financing requirements imply a substantial exposure to market conditions. The large banking sector, with assets exceeding 300 percent of GDP, is strongly exposed to the sovereign (56 percent of assets) and faces substantial maturity mismatches, with short-term deposits funding longer-term loans to the sovereign and the nonbank private sector. The government and the nonbank private sector are also faced with sizeable currency mismatches given large-scale dollar-denominated debt.

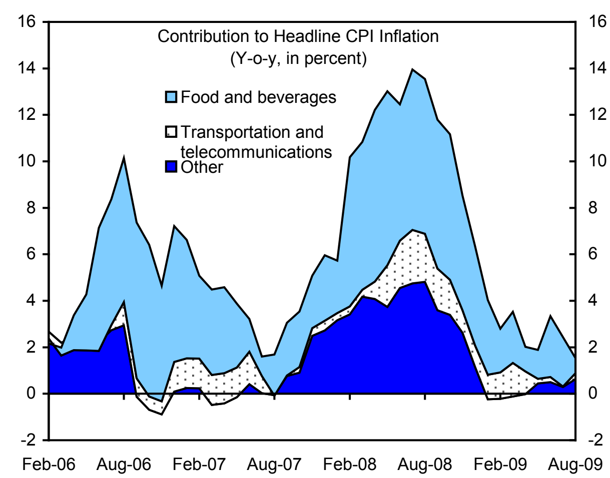
II. Recent Developments and Outlook

3. **Since the victory of a pro-Western coalition in parliamentary elections last June, the Lebanese political parties have been in a protracted process of forming a new government.** Following the resignation and subsequent re-appointment of Prime Minister-Designate Saad Hariri in September, the political parties have resumed

broad-based consultations aimed at forming a national unity government. In the interim, the outgoing cabinet has been acting as a caretaker government.

4. **The most recent cyclical indicators point to ongoing strength in economic activity.** The global financial crisis and recession has had only a limited impact on the Lebanese economy. Merchandise exports, which account for only a small share of the economy, have been negatively affected by lower external demand, but construction activity appears to hold up well, and tourism and financial services continue to expand almost unabated amidst improved security conditions. Moreover, the limited data available do not suggest a sharp drop in remittances inflows. As a result, real GDP is projected to grow at around 7 percent this year (compared to an earlier staff projection of 4 percent). Inflation has dropped and, under the peg, is likely to remain subdued in the coming months, given the benign inflation outlook in trading partners.



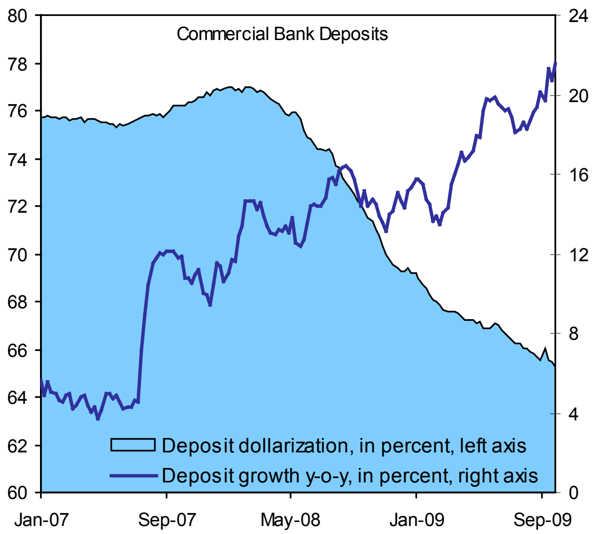


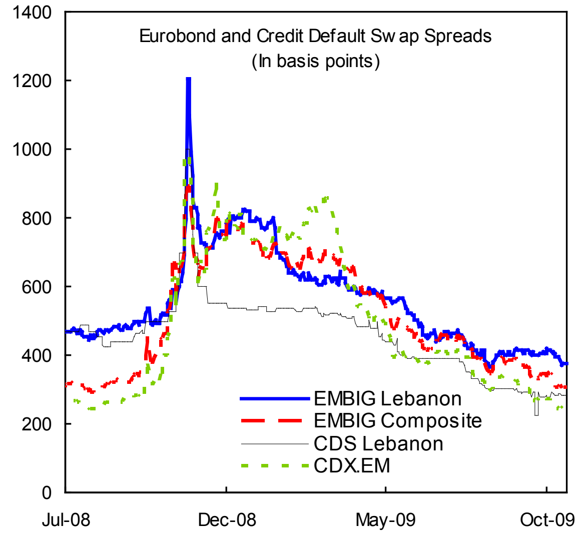
Sources: Lebanese authorities; Byblos Bank Group; and Fund staff calculations.

5. **Sustained growth and fiscal discipline in line with EPCA targets have allowed for a further reduction in the government debt-to-GDP ratio.** Strong tax revenues in light of the reintroduction of gasoline excises, improved tax collection, and sustained economic growth have helped to widen the primary surplus despite increased expenditure pressures in the run-up to the elections (including increases in the wage bill and transfers for housing reconstruction). The favorable macroeconomic situation, paired with continued fiscal discipline, has led the debt-to-GDP ratio to drop from 160 percent at end-2008 to 153 percent at end-June 2009, although it remains among the highest in the world.

6. **Financial indicators point to ongoing strength in the banking sector.** Commercial bank deposits are growing at more than 20 percent year-on-year and deposit dollarization has dropped, helped by ongoing confidence and attractive domestic interest rates. In part thanks to prudent banking sector supervision, banks have virtually not been affected by the global financial crisis and have remained profitable and well-capitalized. They were also not

materially affected by the recent unraveling of a large financial fraud case in the Lebanese nonbank sector. Eurobond and Credit Default Swap spreads have moderated, and now move around the emerging markets average.





Sources: Lebanese authorities; Bloomberg; and Fund staff calculations.

Lebanon: Banking Sector Financial Soundness Indicators, 2006–09

	Dec-06	Dec-07	Dec-08	Jul-09
Capital adequacy ratio 1/	25.0	12.5	12.1	...
Net problem loans/net total loans	6.8	4.7	3.1	2.7
Provisions against problem loans/problem loans	54.4	56.9	61.0	61.8
Claims on the sovereign/total assets	54.9	50.8	54.8	56.4
Average return on assets (post tax)	0.9	1.0	1.1	1.0
Average return on equity (post tax)	10.1	12.1	14.0	13.9
Net liquid assets/short-term liabilities	51.0	47.9	50.1	51.4

Sources: Banque du Liban, Banking Control Commission and staff estimates.

1/ From 2007: based on Basel II risk weights.

7. **Balance of payments developments remain broadly favorable.** The current account deficit will likely decline marginally this year, helped by the drop in oil import prices and strong tourism inflows, which together more than compensate for projected declines in exports and remittances in light of the global recession. Despite stagnating foreign direct investment, strong non-resident deposit flows should allow the BdL to continue accumulating international reserves at a comfortable pace, even in the absence of government market financing from abroad. Donor support has temporarily picked up in the second quarter of 2009, but this is unlikely to be sustained unless a new government can be formed soon (text table).

Lebanon: Foreign Assistance to the Government
(In millions of U.S. dollars, unless otherwise specified)

	2007	2008	2009 Jan–Mar	2009 Apr–Jun	2009 Jul–Sep Prel.	2009 Sep–Dec Proj.	2009 Year Proj.
Total	773	678	75	219	80	603	978
Grants	348	257	21	71	18	33	143
Loans	425	421	54	149	62	570	834
Memorandum items:							
Paris III disbursements	572	382	19	120	22	474	634
Grants	147	144	11	53	6	23	93
Loans	425	237	8	67	16	452	542

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

III. END-JUNE PERFORMANCE UNDER EPCA

8. **Performance under the EPCA-supported program has remained broadly favorable, despite a few slippages.**

- **International reserves exceeded the end-June indicative target by a wide margin.** Strong deposit inflows and ongoing dedollarization enabled the BdL to accumulate international reserves at a rapid pace, easily surpassing the program target.

- **The primary surplus target was also met.** Strong growth and the reintroduction of gasoline excises boosted tax revenues. Higher tax revenues compensated for lower telecom receipts and higher transfers to the *Higher Relief Council* and *Electricité du Liban*, resulting in a primary surplus above the program floor.

- **Despite these favorable outcomes, government net borrowing from the BdL was substantially higher than the program ceiling, although the BdL's monetary interventions more than offset the impact on reserve money.** The net borrowing target was missed by 44 percent (LL 2.6 trillion) reflecting a drawdown of government deposits at the BdL and further T-bill purchases by the BdL. This overrun was in part a result of the commercial banks' preference to purchase high-yielding 5-year Certificates of Deposit (CDs), offered on tap by the BdL primarily for sterilization purposes, rather than lower-yielding 3-year T-bills. Conducting monetary operations through CDs helped attract inflows, build reserves, and support confidence during the global crisis, but crowded out demand for lower-yielding T-bills and increasingly weighed on the BdL's finances. In July, the BdL modified its conduct of monetary operations by discontinuing all issuance of CDs, thereby reviving the banks' demand for T-bills. Combined with a sizeable reduction in the BdL's holdings of Lebanese government Eurobonds, this led to a sizeable decline in government net borrowing from the BdL (by around LL 1.6 trillion).

- **There has been limited progress on the program's structural reform measures.** The BdL adopted formal policies for the selection, appointment, and rotation of the BdL's external auditors (end-June monitorable action). However, the introduction of a Treasury Single Account (end-June monitorable action) was postponed because parliament did not pass the corresponding legislation. There was also little progress on the revision of energy tariffs and the Global Income Tax law (end-December 2008 and end-March 2009 monitorable actions, respectively) because of the difficult political environment in the run-up to the election. Moreover, privatization of the mobile telephone companies (end-March monitorable action on the issuance of a request for applications), which had been postponed due to market conditions, would require a renewed political decision by the incoming government.

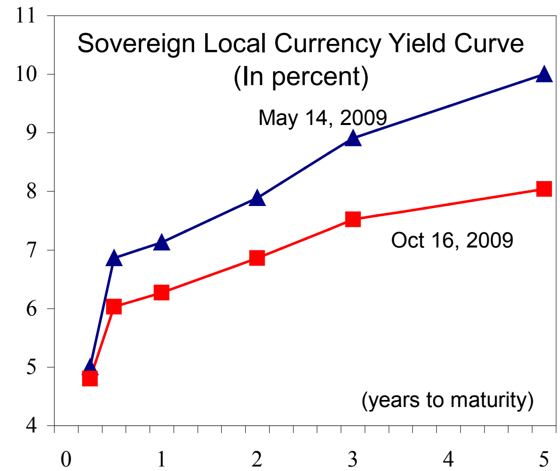
IV. Economic and Financial Policies

9. **Strong economic growth offers an opportunity to move decisively towards fiscal consolidation.** Despite the recent successes in reducing the government debt-to-GDP ratio, the still very high debt remains a key vulnerability that needs to be addressed through higher primary surpluses. In the near term, buoyant fiscal revenues provide a window of opportunity that should be used, together with strict expenditure discipline, to reduce the large fiscal deficit. On unchanged policies, a primary surplus (excluding grants) of 0.9 percent of GDP this year appears achievable (up from 0.6 percent in 2008), implying an overall fiscal deficit of 10.6 percent of GDP. With this, and given expected strong GDP growth, the debt-to-GDP ratio could decline to 151 percent by the end of the year.

10. **With continued fiscal discipline, the government will likely be able to obtain the necessary financing from the market during the remainder of 2009.** In light of continued strong commercial bank deposit inflows and the gradual unclogging of international capital markets, financing conditions are broadly favorable. Sufficient market financing will likely be available for the government during the remainder of 2009. Following the formation of a new government, swift authorization by parliament of additional foreign currency bond issuance would be welcome, and the government should continue to closely coordinate its foreign exchange financing policy with the BdL.

11. **Decisive action by the incoming government will be necessary to reach the substantial primary surpluses required to reduce the still high public debt, since the recent high GDP growth rates may prove difficult to sustain.** The incoming government should strive to quickly relaunch the fiscal consolidation agenda set out under Paris III, including a reduction in the need for budgetary transfers to *Electricité du Liban* and an increase in the VAT rate. In addition, the authorities should work towards broader reform of the energy sector and move ahead with the privatization of the two mobile phone providers as market conditions improve.

12. **Interest rates should gradually decline further in line with market conditions.** Prior to the welcome discontinuation of CD issuance (mainly 5-year maturities), the BdL had reduced 5-year CD interest rates to 9 percent, a decline of 100 basis points over a 2½ month period. With an 8 percent yield, the newly issued 5-year T-bills trade even lower. Despite lower rates, deposit inflows have continued strongly, perhaps in part because of lags. Further declines should therefore be implemented at a gradual pace, to allow adequate time for a fuller evaluation of the effects of earlier reductions. To absorb excess liquidity, the BdL should rely on its large T-bill portfolio. This should help prevent an overly quick decline in yields and allow the BdL to reverse the second quarter increase in net lending to government. Although these steps will likely help to reduce the cost of sterilization, a medium-term strategy to strengthen the BdL's balance sheet would be important.



Source: Lebanese authorities.

13. **The increased confidence in the Lebanese pound has also helped to reduce dollarization.** The share of U.S. dollar deposits in total bank deposits has declined to 66 percent in August 2009, down more than 10 percentage points since early 2008. However, dollarization of bank credit to the private sector has declined only marginally and still stands at 82 percent. Lower interest rates in Lebanese pound would increase the attractiveness of local currency loans and over time also reduce the need for subsidized local currency lending as a means to encourage loan dedollarization.

14. **The authorities have expressed interest in continued close collaboration with the Fund following the expiration of EPCA.** The staff and the authorities remain in close contact to monitor macroeconomic developments, but discussions on a possible future arrangement with the Fund will have to wait for a new cabinet to be in place.

Table 1. Lebanon: Selected Economic Indicators, 2006–09

	2006	2007	Est. 2008	Proj. 2009
Output and prices	(Annual percentage change)			
Real GDP (market prices)	0.6	7.5	8.5	7.0
GDP deflator	2.1	3.8	8.0	4.0
Consumer prices (end-of- period)	7.2	6.0	6.4	2.9
Consumer prices (period average)	5.6	4.1	10.8	2.5
Investment and saving	(In percent of GDP)			
Gross capital formation	22.7	27.4	28.5	27.7
Government	2.5	2.4	1.6	2.3
Nongovernment	20.2	25.0	26.9	25.4
Gross national savings	17.4	20.6	17.0	16.5
Government	-7.8	-8.4	-8.1	-8.2
Nongovernment	25.3	29.1	25.1	24.6
Central government finances (cash basis)	(In percent of GDP)			
Revenue (including grants)	25.1	24.4	24.4	26.2
of which: grants	2.9	1.4	0.9	0.4
Expenditure	35.5	35.3	34.2	36.7
Budget balance (including grants)	-10.4	-10.8	-9.8	-10.5
Primary balance (including grants)	2.6	1.7	1.5	1.3
Primary balance (excluding grants)	-0.4	0.3	0.6	0.9
Total government debt	180	168	160	151
Monetary sector	(Annual percentage change, unless otherwise indicated)			
Credit to the private sector	-5.7	15.8	18.5	10.4
Reserve money	-1.9	9.6	19.1	11.5
Broad money 1/	6.4	10.9	15.5	15.0
Velocity of broad money (level)	0.40	0.36	0.37	0.35
Interest rates (period average, in percent)				
Three-month treasury bill yield	5.2	5.2	5.2	...
Two-year treasury bill yield	8.7	8.7	8.6	8.0
External sector	(In percent of GDP, unless otherwise indicated)			
Exports of goods (in US$, percentage change)	40.8	26.8	25.3	-8.0
Imports of goods (in US$, percentage change)	11.3	27.6	36.7	-0.5
Balance of goods and services	-13.5	-18.2	-18.7	-16.0
Current account (excluding official transfers)	-6.5	-7.6	-12.0	-11.5
Current account (including official transfers)	-5.3	-6.8	-11.6	-11.3
Foreign direct investment	11.9	7.5	8.9	8.0
Total external debt	199	194	187	187
Gross reserves (in billions of U.S. dollars)	11.4	11.5	18.8	25.2
In months of next year imports of goods and services	6.6	4.9	7.7	9.7
In percent of short-term external debt 2/	31.7	29.7	41.4	48.6
In percent of banking system foreign currency deposits	30.1	26.5	42.8	55.0
In percent of total banking system deposits	21.9	19.7	28.2	33.2
Memorandum items:				
Nominal GDP (in billions of U.S. dollars)	22.4	25.0	29.3	32.7
Net imports of petroleum products (in millions of U.S. dollars)	2,247	2,554	3,875	2,629
Local currency per U.S. dollar (period average)	1,508	1,508	1,508	...
Real effective exchange rate (annual average, percent change)	2.2	-4.6	1.3	...
Stock market index	1,184	1,454	1,182	...

Sources: Lebanese authorities; and Fund staff estimates.

1/ Defined as currency 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, December 2008–June 2009
(In billions of Lebanese pounds unless otherwise indicated; end-of-period) 1/

	2008			2009					
				March			June		
	Prog.	Adj. Prog.	Est.	Prog.	Adj. Prog.	Est.	Prog.	Adj. Prog.	Est.
I. Gross reserves of the Banque du Liban, floor (stocks) 2/	24,718	24,510	26,793	24,867	24,981	28,871	25,436	25,482	30,617
II. Primary balance of the government, before grants, floor (cumulative flows)	79	134	265	-346	-337	-271	314	308	318
III. Government net borrowing from the Banque du Liban, ceiling (stocks)	5,905	5,984	4,428	5,700	5,777	6,331	5,700	5,759	8,315
IV. Accumulation of government gross arrears, ceiling (cumulative flows, continuous)	0	0	0	0	0	0	0	0	0
V. Accumulation of external arrears by the government and the Banque du Liban, ceiling (cumulative flows, continuous)	0	0	0	0	0	0	0	0	0
Memorandum items:									
Outstanding letters of credit contracted by Electricité du Liban (stock, millions of U.S. dollars)	1,046		997	766		502	733		521
Disbursements of official grants and loans to government (cumulative flows)	1,304		1,022	222		114	365		445
Banque du Liban's holdings of Republic of Lebanon Eurobonds (stock)	1,187		1,155	1,187		1,749	1,187		1,459
Disbursements of grants to the government (cumulative flows)	522		387	39		32	113		139
Of which: disbursements of project grants (cumulative flows)	242		187	39		30	56		62
Transfers of gold valuation gains from Banque du Liban to government (cumulative flows)	0		0	0		0	0		0
Projection of revenue from companies slated for privatization (cumulative flows)	...		…	415		331	830		610

Source: Lebanese authorities.

1/ At program (end-December 2007) 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.

Table 3. Lebanon: Monitorable Actions, December 2008–June 2009

Measure	Target Date	Implementation
Fiscal		
Submit to parliament the Global Income Tax draft law.	End-March 2009	Not met.
Establish a Treasury Single Account.	End-June 2009	Not met.
Banque du Liban		
Establish an investment committee and draft formal guidelines for foreign reserve management.	End-December 2008	Done on January 28, 2009.
Adopt formal policies for the selection, appointment, and rotation of the BdL's external auditors.	End-June 2009	Done on January 28, 2009.
Power sector		
Revise electricity tariff structure consistent with program objectives.	End-December 2008	Not met.
Privatization		
Issue a Request for Application in participating in the process of acquiring the licenses and assets of the two mobile telephone companies (MIC1 and MIC2).	End-March 2009	Not met. Privatization has been postponed due to unfavorable international capital markets.