International Monetary Fund

Lebanon and the IMF

Press Release:
IMF Executive Board Approves US$37.6 Million in Emergency Post-Conflict Assistance to Lebanon
November 19, 2008

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Lebanon: Letter of Intent and Technical Memorandum of Understanding

November 3, 2008

The following item is a Letter of Intent of the government of Lebanon, which describes the policies that Lebanon intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Lebanon, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

November 3, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The agreement reached at Doha in May 2008 paved the way for the election of a new president and the formation of a new national unity government, which was sworn in on July 11, 2008. The government's principal task is now to prepare for the legislative elections of May 2009. In parallel, the country's main political forces have resumed their national dialogue under the auspices of President Suleiman, with a view to finding a solution to the contentious political issues that have fueled internal strife and dissent.

The 2007 program supported by Emergency Post-Conflict Assistance (EPCA) was concluded successfully and was instrumental in strengthening internal financial discipline and mobilizing external financial support, although less than envisaged under Paris III. Since the 2006 conflict, Lebanon has made progress toward fiscal consolidation and has shored up its external position despite difficult circumstances. The primary fiscal balance (excluding grants) shifted into surplus in 2007, lowering the government debt-to-GDP ratio beyond what we envisaged under EPCA. Fiscal developments in the first seven months of 2008 have been favorable. In response to the heightened political uncertainty and the international financial turmoil, the policies of the Banque du Liban (BdL) ensured a steady increase in international reserves, which grew by $5.2 billion to $16.7 billion during the first eight months of 2008. The effective shielding of the domestic financial sector from exposure to international financial risks, also helped by prudent regulation, contributed to strengthening confidence in the exchange rate peg and the financial system, as reflected by the marked acceleration of deposit growth and dedollarization of deposits. As a consequence, the government was able to finance its domestic and foreign exchange currency needs largely from the market.

While macroeconomic developments have been favorable, Lebanon has not yet fully recovered from the 2006 conflict and the following stalemate. The absence of a functioning parliament and vacancies in key ministries created a substantial legislative backlog and the reconstruction and reform efforts did not progress as envisaged, also because of security issues. Finally, Lebanon will need considerable external support in 2008–09 to reinforce our balance of payments position—which has been adversely affected by the conflict and by the rise in food and energy prices—and to finance the reconstruction effort.

The government's policy statement to parliament includes an explicit commitment to the Paris III reform objectives and restates the government's intention of working closely with the IMF toward the implementation of these objectives. In this text, we hereby request continued IMF support in the form of a second drawing under the Fund's EPCA policy, in an amount equivalent to SDR 25.375 million, or 12.5 percent of quota. In support of this request, and as described in the attached tables, the government and the BdL have selected key fiscal and financial indicators and structural measures that they intend to monitor closely and report on during the period December 2008–June 2009.

Our 2008–09 program aims at addressing Lebanon's main vulnerabilities, chief among them the very high level of public indebtedness and the large external financing needs. We expect tourism and strong domestic demand to boost GDP growth to at least 6 percent in 2008 and 5 percent in 2009. The surge in consumer prices in 2008 reflects the increase of international commodity prices and the dollar weakness, and, as the impact of these factors wanes, we expect inflation to decline in 2009. Against this background, macroeconomic policies in 2008–09 will be geared toward safeguarding our achievements of 2007 and strengthening our international reserve buffer. The government will also introduce key measures from its medium-term reform agenda, including the privatization of the telecom sector and the reform of the energy sector.

In addition to fiscal consolidation efforts, the government has also taken steps to alleviate the impact of higher food prices on the poor. The government has introduced cash transfers for public school students starting this school year, and reduced customs duties on 28 selected food items in May 2008. More broadly, the government is also working with the World Bank to strengthen its social safety net. In addition, the government approved, with retroactive effect as of May 2008, an increase of public sector wages, public pensions, and the private sector monthly minimum wage, with the aim to preserve the purchasing power of the population. Public sector wages and pensions had remained stagnant since 1998, and the minimum wage had not been increased since 1996. The increase in the minimum wage was negotiated with the social partners and, while substantial, we expect that the private sector will be able to absorb it without undue pressures, partly because many private firms have already increased salaries over the past few years. With prices in Lebanon largely being determined by international developments, we also expect that the second round inflation effect from wage increases will be moderate.

We intend to achieve a further reduction in the government debt-to-GDP ratio. In 2008, the government aims at maintaining a primary surplus of the central government (excluding grants), despite mounting EdL transfers and the budgetary cost of the new social measures. In 2009, the government plans to continue fiscal consolidation through the following measures: (i) increase in the withholding tax on interest income from 5 to 7 percent; (ii) application of rental charges related to seashore real estate; (iii) elimination of the VAT law provision which allows for a refund on some exempted activities; (iv) increase of capital gains tax on revaluation of assets by companies from 1.5 to 2 percent; (v) rationalization of subsidies; and (vi) reduction of transfers to EdL, mainly by adopting a new tariff structure. In addition, the government will consider reforming the determination of regulated profit margins for fuel importers, which would allow to increase the gasoline excise without affecting retail prices.

On current trends, continued strong deposit inflows in the rest of 2008 and in 2009 should allow the government to meet its financing needs from the market and avoid relying on BdL borrowing to the extent possible. While the government expects to continue meeting its financing needs in local currency at current interest rates, it stands ready to adjust rates on Treasury bills in line with market conditions. We expect that parliament will soon raise the ceiling on contracting foreign currency debt, enabling the government to meet all of its remaining foreign currency financing needs ($6 billion during 2009) in the market. In the second half of 2009, the government will use the proceeds from the expected sale of the telecom companies to reduce, as envisaged under the law, foreign exchange and domestic currency debt held by the private sector and the BdL, which will help increase international reserves.

The exchange rate peg to the U.S. dollar has been key to maintaining financial stability and remains appropriate. In this context, our objective is to further strengthen our gross international reserves position. So far, Lebanon has remained relatively insulated from the ongoing global financial crisis, as banks are severely restricted from entering positions in derivative products. Nevertheless, we have closely followed developments in international financial markets and their possible impact on Lebanon, including via the Gulf countries, to which Lebanon has been increasingly linked. To limit risks, the Banking Control Commission is stepping up controls on allocation and quality of banks' assets with foreign banks. We will also stand ready to adjust interest rates if needed.

Reforms to strengthen fiscal management are ongoing. On the revenue side, the government will finalize the remaining steps for the introduction of the global income tax by (i) adopting the revision of the tax procedure code; (ii) submitting the GIT law to parliament by end-March 2009; and (iii) eventually merging taxpayer services, auditing and collection for VAT and income tax administration. At present, the government is also reviewing procedures related to domestic VAT refund claims, which have recently increased by more than expected. Similarly, the government is improving the administration of the built-property tax and stamp duties, which we envisage to continue yielding additional revenue gains. On the public financial management side, the government expects parliament to approve the 2009 budget, by end-year, and the Treasury Single Account, which we want to make operational by end-June 2009. In addition, parliament has just approved the law establishing the public debt directorate.

EdL's losses remain a large drain on budget resources. Transfers in 2008 are estimated at $1.5 billion or 5.2 percent of GDP. The government will contain losses by revising electricity tariffs with a yield of about $240 million. Further savings will be obtained in 2009 as production is switched from oil to less expensive natural gas at the Beddawi power plant starting in January 2009, lowering fuel costs by $100 million. In parallel, the government plans to enhance the service quality in the power sector (e.g., through the installation of remote meters).

To strengthen Lebanon's growth potential, the government intends to resume the privatization of the telecom mobile companies, which was interrupted by the May conflict. It also intends to gather broad parliamentary support for the modalities of the telecom sale and issue the request for applications in March 2009 with the objective to complete the sale by June 2009.

The government intends to restore actuarial balance of the National Social Security Funds (NSSF) to limit demands on the budget. Losses in the medical and family allowance branches constitute a large and open-ended drain on public finances. Initial steps to address these problems have been taken through auditing and the full computerization of the database of users. The government is discussing plans to reform access to medical care with the World Bank, and is considering the need to revise contribution rates and the income ceiling for calculating insurance premia. With the help of the World Bank, it is also carrying out an actuarial study of the NSSF liabilities.

The BdL is taking steps to strengthen its operating procedures. In particular, the BdL is working toward full adoption of the International Financial Reporting Standards, and will adopt an implementation roadmap by end-2008. In addition, the BdL will establish a formal investment committee, draft formal guidelines for foreign reserve management, and adopt formal policies for the selection, appointment, and rotation of its external auditors. It will also sharpen its focus on core activities by starting the privatization of shares in the BdL's non-financial assets, notably Middle Eastern Airlines and the investment company Intra.

In the context of the program, we remain committed to an open trade and exchange system, and are taking steps to become a full member of the World Trade Organization. We will avoid imposing restrictions on payments and transfers for international transactions, introducing or intensifying trade restrictions for balance of payments purposes, or resorting to multiple currency practices.

A satisfactory implementation of our 2008 program under EPCA, a further strengthening of capacity, including through technical assistance from the Fund, and an improvement in economic and social conditions should allow the government to move to a more ambitious part of its reform program in the second half of 2009. At that stage, we intend to explore the possibility of further Fund support for our program through a Stand-By Arrangement.

The Government of Lebanon and the BdL will provide the IMF with any available information it may request on the implementation of the program, consistent with the understandings reflected in the attached Technical Memorandum of Understanding, and will consult with Fund staff regarding any revision to the policies described above.

Sincerely yours,

/s/
Mohamad Chatah
Minister of Finance

/s/
Riad T. Salamé
Governor
Banque du Liban

Attachments to LOI

I. Quantitative Indicative Targets, December 2008–June 2009
II. Monitorable Actions, December 2008–June 2009
III. Technical Memorandum of Understanding

Attachment I. 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			
	Dec	Mar	Jun	Sept	Dec
	Prog	Prog	Prog	Proj	Proj
I. Gross reserves of the Banque du Liban (stocks) 2/	24,718	24,867	25,436	27,818	29,049
II. Primary balance of the government, before grants (cumulative flows)	79	-346	314	157	283
III. Government net borrowing from the Banque du Liban (stocks)	5,905	5,700	5,700	4,469	4,388
IV. Accumulation of government gross arrears (cumulative flows, continuous)	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
Memorandum items:					
Outstanding letters of credit contracted by Electricité du Liban (stock, millions of U.S. dollars)	1,046	766	733	777	777
Disbursements of official grants and loans to government (cumulative flows)	1,304	222	365	822	1,431
Banque du Liban's holdings of Republic of Lebanon Eurobonds (stock)	1,187	1,187	1,187	1,187	1,187
Disbursements of grants to the government (cumulative flows)	522	39	113	186	237
Of which: disbursements of project grants (cumulative flows)	242	39	56	73	90
Transfers of gold valuation gains from Banque du Liban to government (cumulative flows)	0	0	0	0	0
Projection of revenue from companies slated for privatization (cumulative flows)	...	415	830	909	988

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.
3/ Defined by currency (not by residency), as official foreign currency assets, including gold and SDR, less foreign currency liabilities.
Liabilities include the exceptional deposits by foreign governments at the BdL, but exclude liabilities to the government of Lebanon and other official creditors.

Attachment II. Lebanon: Monitorable Actions, December 2008–June 2009

Measure	Target Date	Implementation
Fiscal		
Submit to parliament the Global Income Tax draft law	End-March 2009	
Establish a Treasury Single Account	End-June 2009	
Banque du Liban		
Establish an investment committee and draft formal guidelines for foreign reserve management.	End-December 2008	
Adopt formal policies for the selection, appointment, and rotation of the BdL's external auditors.	End-June 2009	
Power sector		
Revise electricity tariff structure consistent with program objectives.	End-December 2008	
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	

ATTACHMENT III. LEBANON: TECHNICAL MEMORANDUM OF UNDERSTANDING

I. INTRODUCTION

1. This memorandum sets out the commitments of the Lebanese authorities for the period to June 30, 2009 relating to the Emergency Post-Conflict Assistance (EPCA) requested in the Letter of Intent. Section II defines the indicative quantitative targets and relative adjustors reported in Attachment I, and Section III establishes the content and frequency of the data to be provided to IMF staff for monitoring the program.

II. QUANTITATIVE INDICATIVE TARGETS

A. Definitions and Concepts

2. **Test dates.** Quantitative indicative targets are set quarterly starting December 31, 2008 through June 30, 2009, and are to be met at the end of each quarter unless otherwise specified.

3. **Government.** For the purposes of the program, "government" includes the central government, the Council for Development and Reconstruction (CDR), and the grant-financed operations of the Higher Relief Commission (HRC). It excludes all other agencies not specifically listed, including, but not limited to, the following: Electricité du Liban (EDL), municipalities, the Régie, and NSSF. The government balance is defined on a modified cash basis to include foreign-financed expenditure of the CDR, all operations of the HRC, any treasury advance, and arrears (as defined below). Unless otherwise specified, fiscal data are compiled according to the Government Finance Statistics (GFS) manual 1986.

4. **Project grants** are defined as those grants to the government (as defined above) linked to specific project financing, and do not include grants received for general budgetary support. **Budgetary grants** are grants received for general budgetary support, including grants in support of specific budget lines and grants to be applied to debt reduction. These concepts include—but are not limited to—conflict-related and Paris III grants.

5. **Arrears.** Domestic arrears are defined as government expenditures that have not been paid within 90 days of a payment order being issued. External arrears are defined as overdue payments (principal or interest) on external debt contracted or guaranteed by the government or the Banque du Liban (BdL).

6. **Valuation changes**. All data are expressed in Lebanese pounds (LL), unless otherwise indicated. To exclude foreign exchange valuation effects: (i) gold will be valued at the December 31, 2007 price of US$ 828.4 per fine troy ounce; (ii) the U.S. dollar value of foreign assets and liabilities will be converted into LL at the exchange rate of US$1 = LL 1507.5; and (iii) all foreign assets and liabilities denominated in currencies other

than the U.S. dollar will be converted into U.S. dollars and/or LL at their respective exchange rates prevailing as of December 31, 2007, as published in the IFS.

B. Indicative Targets

7. **Target 1**. For the purpose of the program, the **Gross Reserves (GR) of the BdL** (floor, U.S. dollars) are defined as BdL's callable foreign exchange deposits abroad, foreign exchange holdings (including SDR), gold, Eurobonds issued by the Republic of Lebanon (henceforth "Eurobonds"), and holdings of investment grade liquid foreign currency-denominated securities. Encumbered assets will be excluded from GR. The floor for GR will be adjusted (i) downward (upward) for the full amount of any shortfall (excess) in disbursements of official grants and loans to the government relative to those projected in the program; and (ii) downward (upward) for the full amount of sale (purchase) by the BdL of Eurobonds relative to the baseline projection of BdL holdings.

8. **Target 2**. **The primary balance of the government, before grants** (floor) is defined as the **overall fiscal balance on a modified cash basis** plus interest payments minus grants received. Securitization proceeds will not be counted as above-the-line revenue. For the purpose of the program, any transfer from the BdL not related to realized profits (including from gold revaluation) will be considered to be capital (below the line) transfers and therefore excluded from the primary balance.

9. **Monitoring of the primary balance before grants**, for the purpose of the program, will be carried out from the financing side. The **overall balance on a modified cash basis** is calculated as the negative of the sum of the following: (i) the change in net BdL claims on the central government; (ii) the change in net claims on the central government by the rest of the banking system; (iii) the change in net claims on the central government by public sector institutions; (iv) the change in net claims on the central government by other creditors; (v) the net change in government arrears; (vi) proceeds from exceptional financing (items such as privatization revenues, gold or foreign exchange revaluation proceeds, and securitization proceeds); minus (vii) the net change in the CDR and HRC accounts at the BdL. Budgetary and project grants to the government (as defined above) will also be measured through BdL. All changes will be calculated as the difference between end-period stocks, net of any valuation changes resulting from currency movements and changes in accrued interest reflected in the gross debt stock that are reported separately by instrument. For the purpose of the program, interest payments will be measured on a cash basis.

10. **The floor on the primary balance before grants will be adjusted** (i) downward (upward) for higher (lower) than projected project grant disbursements and (ii) downward for the net amount of the revenues lost due to privatization pro-rated on the basis of the revenue projections specified in Attachment I.

11. **Target 3**. **Net government borrowing from the BdL** (ceiling) is defined as the difference between the BdL claims on the government, in domestic and foreign currency, including all holdings of government securities; and the deposits in domestic and foreign currency of the government at the BdL. For the purpose of the program, any transfers from the BdL other than realized profits (e.g., from securitization of future profits) will be treated as net government borrowing from the BdL. The ceiling for net government borrowing from the BdL will be adjusted: (i) downward for the full amount of any excess in transfers from the BdL's gold revaluation relative to those projected under the program; and (ii) downward (upward) for higher (lower) than projected budgetary grant disbursements.

12. **Target 4. New gross domestic arrears of the government** (continuous ceiling) are defined as the change in gross domestic arrears arising after September 30, 2008. "Gross" arrears indicates that the taxes and contributions owed to the government are not netted out of the arrears.

13. **Target 5. New external arrears of the government and the BdL** (continuous ceiling) are defined as the change in external arrears after September 30, 2008.

III. Reporting Requirements

14. To permit the monitoring of developments under the program, and as part of and in addition to the regularly reported data, the government will provide to the office of the Resident Representative of the IMF in Beirut the information specified below:

- Gross Reserves and components (monthly).
- BdL's net foreign exchange position, defined, on the basis of currency, as official foreign currency assets, including gold and SDRs, less foreign exchange liabilities. These are defined to include the exceptional deposits by foreign government at the BdL and IMF purchases, but exclude liabilities to the government of Lebanon and other official creditors.
- Weekly BdL gross foreign exchange market purchases and sales.
- Monetary aggregates, including currency in circulation, M3 and non-resident deposits (weekly).
- BdL balance sheet, including a break down of all assets and liabilities by instrument, by currency and remaining time to maturity (monthly).
- Data on outstanding BdL instruments by type (coupon or discount), currency, amounts, remaining maturity, and yield (monthly). Data on auctions or sale of

CDs by the BdL, including amount, maturity, yield, and any premium paid (monthly).

- BdL income statement on an accrual basis (quarterly).

- Commercial banks' balance sheet (monthly).

- On a checks-issued basis, summary budget operations, revenues, expenditures (including net advances), net domestic financing, balances in the government accounts with the BdL and commercial banks (including privatization accounts), the receipt and use of privatization proceeds (monthly), monthly cash data on foreign-financed capital expenditures, and relief and reconstruction expenditures.

- Government debt and financing: Government debt statistics as per the usual reporting format provided by the BdL, including BdL lending to EdL. Government interest expenditure on a cash basis by debt instrument and currency. Grants received by government (including CDR and HRC), of which project-related grants. Privatization proceeds. Valuation changes to the outstanding stock of debt due to currency fluctuations. Changes in the outstanding stock of accrued interest that is reflected in the debt stock. The new stock of domestic and external arrears. Any put or call options, collateral guarantees, warrants or similar derivative arrangements entered into by the government or the BdL. On-lending operations of the government. Securitization of future payment flows to the government or resulting in future payment flows to or from the government. Amortization payments by debt instrument.

- Outstanding debt contracted by EdL and guaranteed by the government, including letters of credit entered into, with breakdown of principal and interest (monthly).

- The annual accounts of the NSSF, including the disaggregated accounts of each of the three NSSF funds and any contractual arrears (as defined above) from the central government on NSSF contributions.

- Foreign assistance received (separating grants from loans and budget support from project financing), and full terms of the newly-contracted but not disbursed loans (monthly).

- Balance of payments (current, capital, and financial accounts) (monthly);

- List of short-, medium-, and long-term public or publicly guaranteed external loans contracted during each quarter; identifying, for each loan: the creditor, the borrower, the amount and currency, the maturity and grace period, and interest rate arrangements (quarterly);

- Revision of electricity tariff structure and resulting savings for EdL.

15. Weekly data and data on the central bank CD auctions should be sent to the Resident Representative's office in Beirut with a lag of no more than one week. Monthly and quarterly data should be sent within a period of no more than four weeks, except for balance of payments data, which should be sent within a period of no more than eleven weeks. Any revisions to previously reported data should be communicated to the Resident Representative's office in the context of the regular updates.

16. The authorities will prepare and send to the Resident Representative's office reports, with appropriate documentation, indicating progress achieved, explaining any deviations relative to the initial targets, and specifying expected revised completion dates of the monitorable actions specified in Section III.

17. Details on major economic and social measures taken by the government that are expected to have an impact on program sequencing (such as new legislation on decrees) will be sent in a timely manner to the Resident Representative's office.