

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 Lorenzo Pérez 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 is 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-September 2007 indicative targets and monitorable actions. A safeguards assessment of the Banque du Liban (BdL) is underway.
- **The staff's findings are based on discussions held in Beirut November 1–9, 2007.** The mission comprised Messrs. Gardner (head), Schimmelpfennig, Sdralevich, and Sosa (all MCD); and Messrs. Finger (PDR) and Mati (FAD). The mission met with the governor of the central bank, the minister of finance, the minister of economy and trade, and senior government officials.
- **This report focuses on developments through September and prospects for the remainder of the 2007 program supported by EPCA.** Although the government prepared a draft 2008 budget, key policy measures still need to be identified and the outlook is also dependent on the pace at which the legislative backlog can be absorbed. Staff will update the 2008 projections once the new government announces its policy agenda.
- **The 2007 program is broadly on track.** Despite a very difficult political environment, all end-September targets were met, except for the monitorable action on raising gasoline excises. Fiscal revenues were stronger than expected, and net debt was contained below the program ceiling. Owing to strong deposit inflows, the central bank accumulated international reserves at a faster pace than targeted, and government net borrowing from the BdL was limited as envisaged, despite shortfalls in expected donor support. The end-December monitorable action on inviting expressions of interest to participate in the privatization of two mobile phone networks was effectively met in November.

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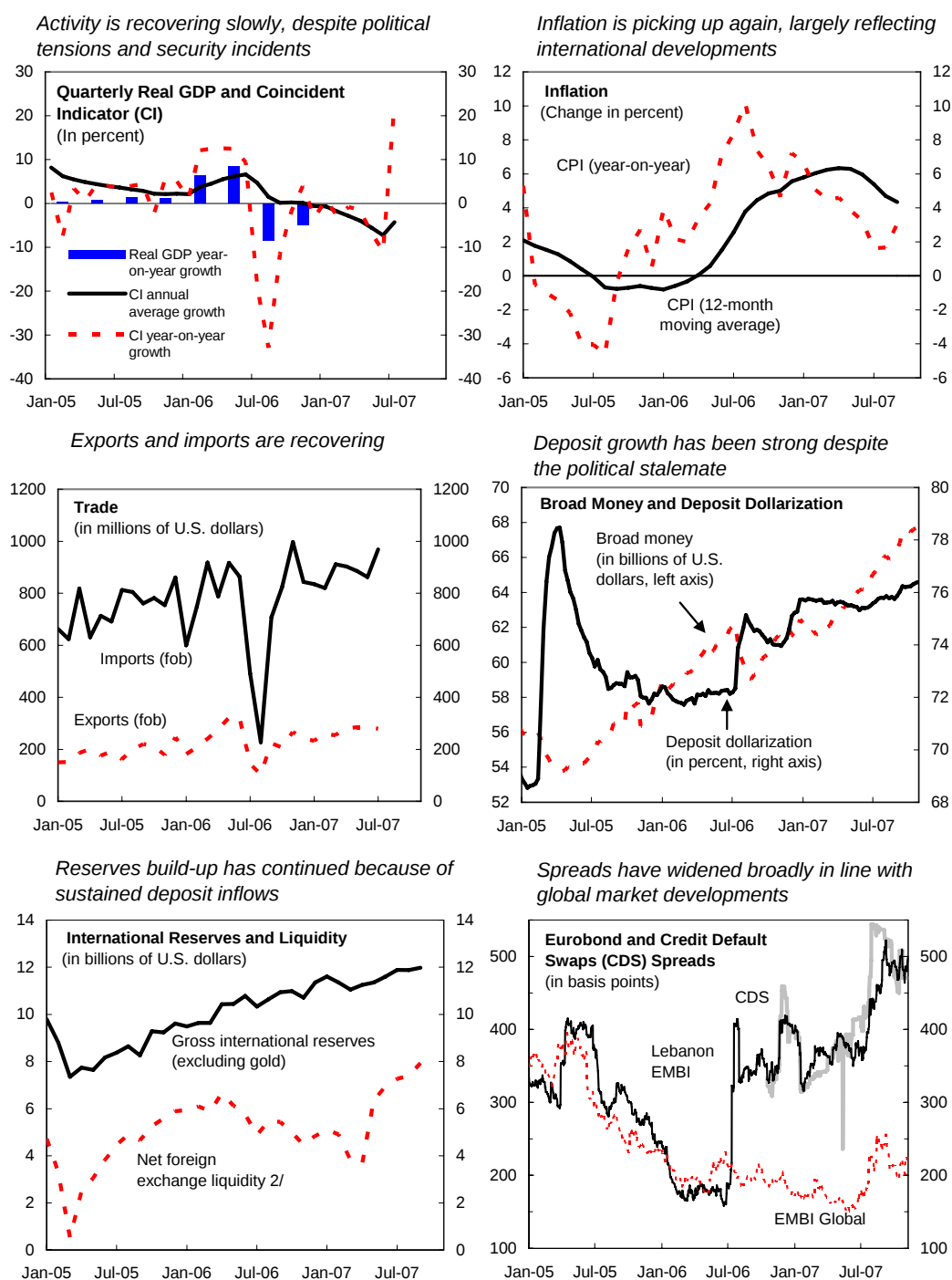
I. BACKGROUND AND RECENT DEVELOPMENTS

1. **The parliamentary majority and the opposition were not able to reach a compromise on a successor to President Lahoud, whose term came to an end on November 23.** Constitutionally, the prime minister takes on the presidential responsibilities during this vacuum. Prime Minister Siniora has indicated that, until a new president is elected, his government would be acting in a caretaking role and refrain from taking new political initiatives. The ruling coalition and the opposition are engaged in discussions over the election of a new president who would then appoint a new prime minister and cabinet.

2. **Notwithstanding political tensions and repeated security incidents, the economic recovery from the 2006 post-conflict trough has maintained momentum.** Developments through July suggest that real GDP could grow by 2–3 percent in 2007 (Figure 1 and Table 1). Exports and imports have been buoyant in the first seven months of 2007, and it is expected that the trade and the current account deficits will widen relative to 2006. With rising international commodity prices and the depreciation of the U.S. dollar against the euro, CPI inflation has risen in the third quarter of 2007, and is projected to reach 5 percent in December 2007 (year-on-year). Inflows of external donor support of the government have continued to fall short of expectations, partly because negotiations have taken longer than envisaged; Paris III disbursements of budgetary grants and loans for 2007 are now projected at \$0.8 billion compared with \$2.0 billion assumed under EPCA (Text Table 1). Most of this inflow is expected to come in at the end of the year.

3. **Financial markets have weathered the political impasse and global financial market turbulence quite well.** Partly in response to the global repricing of risks, spreads increased over the summer. However, the Eurobond market saw very limited trading, suggesting that investors are generally maintaining their positions pending a resolution of the political situation. Deposit inflows have continued at a sustained pace, with broad money growing at an annual rate of 11 percent. However, deposit dollarization has edged up slowly to over 76 percent. There has been little market reaction to the failure to elect a president by the November 23 deadline, as concerns that the outgoing president would name a second and parallel governments did not materialize.

Figure 1. Lebanon: Recent Developments, January 2005–November 2007



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.

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

	Total Pledges	New Grants and Loans to Government					
		Paris III Pledges		Rev. Proj. for 2007–10 1/		2007	
		Total	Of Which: Budget Support	Budget Support 2/	Grant Element 3/ (Estimate, in percent)	Proj.	Received Jan–Sept
Total	7,565	5,018	2,327	2,716	47.5	793	200
Multilateral	3,978	2,213	835	667	43.1	174	100
Bilateral	3,587	2,805	1,492	2,048	48.9	619	100

Sources: Lebanese authorities, and Fund staff estimates.

1/ The financial terms of some loans are still uncertain.

2/ Outright budget support plus project loans and grants that support the existing expenditure envelope.

3/ Based on a discount rate of 7.45 percent, Lebanon's average projected rate for U.S. dollar market financing.

II. PERFORMANCE UNDER EPCA AT END-SEPTEMBER

4. **The primary balance and net debt targets for end-September 2007 were met with significant margins** (Table 2). The primary balance (cash basis, excluding grants as defined in the program) posted a small surplus of 0.3 percent of GDP, compared with a projected deficit of 2.8 percent of GDP. This substantial overperformance results from better than projected revenue collection (Value-Added Tax and telecom revenues in particular show a stronger trend than expected) and delays in the execution of capital expenditure as well as lower than expected transfers to the power utility, reflecting in part electricity rationing through power cuts. As a result, net debt was contained to below the target despite somewhat higher than projected interest payments. At the same time, it should be noted that the budgetary cost of higher fuel prices will be felt only in 2008 as much of the fuel supplies for Electricité du Liban are financed through letters of credit.

5. **The program targets on international reserves and government net borrowing from the BdL were also met comfortably.** Given the continued deposit inflows, and in the absence of foreign exchange market pressures, the BdL was able to increase its gross international reserves (excluding gold) by \$400 million during the third quarter to \$12 billion by end-September 2007, somewhat higher than expected, and despite significant shortfalls in donor support relative to program expectations.¹ Despite the ample liquidity in the system,

¹ In the program definition, reserves (including gold and Lebanese Eurobonds) increased to \$17.8 billion. For program purposes, however, the floor on international reserves is adjusted for changes in the Eurobond portfolio (See the Technical Memorandum of Understanding attached to the EPCA Letter of Intent, EBS/07/33).

commercial banks were reluctant to roll over government paper at t-bill offer rates which have remained unchanged since early 2005, and the government had to rely on financing from the BdL again during the third quarter, though still below the end-September ceiling.

6. **The government did not introduce a floor (of \$0.20 per liter) on gasoline excises by end-September as previously envisaged (Table 3).** The increase in international oil prices since May 2007 has been absorbed largely by lowering gasoline excises, which are thus yielding minimal revenue at current oil prices. As such, the planned introduction of a floor on gasoline excises would have required an increase in the retail price of around 30 percent. The authorities did not consider this to be feasible in the current very difficult political circumstances and were also concerned about the possible inflationary impact. However, they did raise retail prices by 2½ to 3 percent in November to prevent the excises from becoming negative. In 2007, the overperformance on other revenue sources is expected to more than offset the resulting shortfall from excises (around ½ percent of GDP in the last quarter). However, raising gasoline excises remains an important pillar of the Paris III fiscal adjustment objectives.

7. **Progress has also been made on structural reforms.** The global income tax law was approved by Cabinet in November. The law significantly improves the tax system, though it leaves important details to be specified by ministerial decrees. Introduction of the global income tax will likely be delayed to 2009—one year later than planned under Paris III—given the technical work still needed on the related administrative measures. On the expenditure side, the new cash management unit is in the process of designing a cash flow plan, while work on multiyear budgeting in pilot ministries is continuing. With respect to the power sector reforms, the authorities expect to switch some production from fuel oil to gas by mid-2008 which should lower production costs significantly. However, the installation of remote meters to improve billing, and thus its budgetary cost, are likely to be delayed into 2008.

III. OUTLOOK FOR THE REMAINDER OF 2007 AND 2008

8. **Given the strong performance through September, fiscal targets for 2007 appear achievable with an ample margin.** The authorities expect revenue overperformance through the first three quarters of the year to compensate for the shortfall in excises. In addition, spending is likely to be lower than projected under the program, as the authorities now expect lower transfer payments and low execution of foreign financed capital expenditures. In all, the authorities expect significant overperformance on the primary fiscal balance (excluding grants). This should more than offset the somewhat higher interest spending relative to that projected under EPCA, so that government net debt would also come out below the program ceiling, adjusted for the significant shortfall in budget grants.

9. **The target on international reserves is also achievable.** Provided the political situation remains manageable, financial inflows are expected to continue at a sustained pace through the remainder of the year, which should allow the BdL to maintain international reserves at their current level or realize a modest further build-up.

10. **The challenge in the fourth quarter is to reduce government net borrowing from the BdL as envisaged under the program.** In this regard, the exchange of LL 1 trillion (\$667 million) in certificates of deposits for treasury bills effected in October was an important step to reduce the government's reliance on BdL financing in as much as it facilitated the government's ability to tap the market, by raising implicit yields well above the t-bill offer rate. The authorities commitment to the end-year financing target will require deliberate efforts to mobilize additional market financing.

11. **The privatization process of the two mobile phone networks has been initiated ahead of schedule.** On November 2, the government issued a request for applications to participate in the auction for two thirds of the two existing mobile phone licenses, assets, and contracts, thus effectively meeting the end-December monitorable action under EPCA. The auction is scheduled for the first quarter of 2008, and the transfer of ownership is expected to be completed during 2008. The remaining one third will be sold on the stock exchange through an initial public offering.

12. **The authorities restated their commitment to the 2008 objectives outlined in the Article IV staff report, and the mission did not discuss an updated 2008 projection with the authorities.** At this stage, policy plans are still too uncertain in regard to key revenue and expenditure issues to provide the basis for a solid projection. Although the outgoing government has adopted a draft 2008 budget, the issue of how to compensate for the loss of fuel excise revenue is still open, and the draft budget does not provide enough guidance on the timing and cost of energy sector reform, or the policies underlying assumed reductions in transfers. Details on fiscal policy plans for 2008 will need to be discussed with the next government.

Table 1. Lebanon: Selected Economic Indicators, 2003–07

	2003	2004	2005	2006	2007	
	Act.	Act.	Act.	Prel. Act.	EBS/07/33	Proj.
Output and prices						
	(Annual percentage change)					
Real GDP (market price)	4.1	7.5	1.1	0.0	1.0	2.0
GDP deflator	1.6	0.9	-0.6	5.6	...	3.0
Consumer prices (end-of- period)	2.2	2.0	0.5	7.2	2.0	5.0
Consumer prices (period average)	1.3	1.7	-0.7	5.6	3.5	4.0
Investment and saving						
	(In percent of GDP)					
Gross capital formation	19.3	22.0	16.9	11.6	16.6	16.7
Government	3.1	3.3	2.2	2.5	5.0	2.8
Nongovernment	16.2	18.8	14.8	9.1	11.7	13.9
Gross national savings	6.1	6.5	3.4	5.6	5.6	6.3
Government	-10.2	-5.4	-6.2	-8.6	-7.4	-9.3
Nongovernment	16.3	11.9	9.6	14.2	13.1	15.6
Public finances						
	(In percent of GDP)					
Revenue (including grants)	22.1	23.1	22.8	24.7	26.7	25.1
Expenditure (including unidentified measures in 2008)	35.4	31.8	31.2	35.8	39.1	37.1
Budget balance (including grants)	-13.3	-8.6	-8.4	-11.1	-12.4	-12.0
Primary balance (including grants)	3.3	3.5	2.1	1.7	0.0	0.8
Primary balance (excluding grants)	3.3	3.5	2.1	-1.2	-3.7	-0.9
Total government debt	169	167	178	177	176	173
Monetary sector						
	(Annual percentage change, unless otherwise indicated)					
Credit to the private sector	0.3	5.2	1.9	6.0	5.0	2.2
Base money	12.3	10.3	4.7	8.2	4.4	12.6
Broad money 1/	15.5	12.3	3.5	6.4	3.5	11.0
Velocity of broad money (level)	0.4	0.4	0.4	0.4	0.4	0.4
Interest rates (period average, in percent)						
Three-month treasury bill rate	6.7	5.2	5.2	5.2	...	...
Two-year treasury bill rate	8.0	7.9	8.5	8.7	8.2	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	19.2
Imports of goods (in US\$, percentage change)	10.4	30.3	-1.2	1.8	17.5	19.0
Merchandise trade balance	-24.2	-30.1	-28.4	-25.3	-29.2	-28.6
Current account excluding official transfers	-13.9	-16.0	-14.2	-7.2	-15.3	-11.5
Current account including official transfers	-13.2	-15.5	-13.6	-6.0	-11.0	-10.4
Foreign direct investment	8.7	10.9	12.2	12.0	7.6	8.7
Total external debt	175	187	190	197	183	209
Gross reserves (in millions of U.S. dollars)	10,271	9,575	9,611	11,353	10,440	12,089
In months of next year imports of goods and services	8.1	7.7	7.2	7.5	6.7	7.3
In percent of short-term external debt 2/	35.6	27.1	28.4	32.2	32.5	30.6
In percent of banking system foreign currency deposits	40.3	31.9	29.0	30.1	26.7	28.4
In percent of total banking system deposits	24.8	21.0	20.1	21.9	19.3	20.7
Memorandum items:						
Nominal GDP (in billions of U.S. dollars)	19.8	21.5	21.6	22.8	23.6	23.9
Net imports of petroleum products (in millions of U.S. dollars)	-1,057	-1,833	-2,082	-2,172	-2,072	-2,361
Local currency per U.S. dollar (period average)	1,508	1,508	1,508	1,508	...	...
Real effective exchange rate (annual average, percent change)	-10.7	-6.8	-4.1	2.2	...	...
Stock market index	457	637	1,309	1,184	...	...

Sources: Lebanese authorities; and Fund staff estimates.

1/ Defined as cash 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, March–December 2007
(In billions of Lebanese pounds unless otherwise indicated; end-of-period) 1/

	2006	2007									
	December	March			June			September			December
	Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.	Adj. Prog.	Prel. Act.	Prog.
I. Gross reserves of the Banque du Liban (stocks) 2/	18,084	17,505	17,263	17,648	17,166	16,167	17,536	16,863	14,946	17,847	17,475
II. Net debt of the government (stocks) 3/	59,212	61,122	61,122	60,606	59,766	59,932	58,702	60,508	61,295	59,955	61,505
III. Primary balance of the government, before grants (cumulative flows)	...	-575	-575	-225	-848	-942	225	-1,005	-1,099	104	-1,317
IV. Accumulation of government gross arrears (cumulative flows, continuous)	...	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
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	8,953	7,630
<i>Memorandum items:</i>											
Letters of credit contracted by Electricité du Liban (stock)	690	...	...	690	...	...	740	...	...	873	...
Disbursements of official grants and loans to the public sector (cumulative flows)	...	0	...	2	620	...	251	2,197	...	445	4,006
Banque du Liban's holdings of Eurobonds (stock)	2,147	...	...	1,963	...	...	1,010	...	...	1,009	...
Disbursements of grants to the government (cumulative flows)	...	0	...	2	318	...	246	983	...	290	1,316
Of which: disbursements of project grants (cumulative flows)	...	0	...	0	0	...	93	43	...	137	91
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
Projection of revenue from companies slated for privatization (cumulative flows)	...	331	...	...	521	...	...	1,036	...	...	1,566

Source: Lebanese authorities.

1/ At program exchange rates. Figures reflect data revisions as of November 6, 2007.

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 the Period 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 are requested for February 1, 2008.