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SM/87/150
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

August 26, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Lebanon - Staff Report for the 1987 Article IV Consultation

The following corrections have been made in SM/87/150 (7/1/87):

Page 4, para. 2, line 15: for "LL 7.8" read "LL 106.4"

Page 7, second full para., line 12: for "the total" read "the goal"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

Table 1. Lebanon: Selected Economic Indicators, 1982-87

	1982	1983	1984	1985	1986	Fund Staff Estimates 1/ 1987
			(Percentage changes)			
Inflation						
Consumer price index	14	7	15	54	95	...
Fiscal operations						
Receipts	... 2/	63	-43	43	46	86 3/
Expenditures and net extrabudgetary spending	... 2/	34	8	75	39	126 3/
			(Ratios as a percent)			
Public sector deficit as a percentage of budgetary expenditures and net extra-budgetary spending	71	65	82	85	84	87 3/
Domestic bank financing as a percentage of						
(i) Lebanese pound component of money and quasi-money at beginning of period	24	21	21	31	32	62 3/
(ii) change in Lebanese pound component of money and quasi-money during period	54	76	129	66	110	...
			(Percentage changes)			
Monetary developments						
Money and quasi-money (M2)	20	27	24	56	172	...
Lebanese pound component of M2	45	27	16	47	[illegible]	...
Real Lebanese pound balances	32	23	-7	-8	-48	...
U.S. dollar value of residents' foreign currency deposits with Lebanese banks	-6	-13	-9	-12	20	...
Net claims on public sector	91	52	47	49	36	...
Credit to private sector	21	30	27	25	136	...
Lebanese pound component of credit to private sector	23	25	26	15	52	...
External sector						
Exchange rate (percent change in average for last quarter of year) (appreciation +)						
Nominal effective exchange rate	27	-15	-27	-60	-23	...
Real effective exchange rate	31	-11	-14	-39	-39	...
			(In billions of U.S. dollars)			
Balance of payments						
Exports	0.9	0.7	0.6	0.6	[illegible]	...
Imports	-3.5	-3.7	-3.0	-2.2	-1.9	...
Other items, net	3.0	2.4	1.2	2.0	0.6	...
Overall balance	1.2	-0.6	-1.2	0.4	-0.6	...
Central bank reserves						
Gross official reserves (end of period) 4/	2.6	1.9	[illegible]	1.1	[illegible]	...

Sources: Ministry of Finance, Bank of Lebanon, and Fund staff estimates.

1/ Projections are without new measures, i.e., assuming that the recent proposals to link retail petroleum product prices to pound costs is not implemented in 1987.
2/ Complete data for 1981 are not available.
3/ Projections made prior to the 45-62 percent increase in petroleum products prices on June 20, 1987; only a modest further depreciation of the Lebanese pound is assumed.
4/ Excludes gold holdings which have been constant over the period at 9.[illegible] million fine troy ounces.

The acceleration in the growth of domestic liquidity (the sum of money and quasi-money including foreign currency deposits) has reflected the high growth rates of the Lebanese pound component and, especially in 1986, the acceleration in the rate of increase (in pound terms) of the foreign currency component (Chart 3 and Table 1) mostly due to the depreciation of the pound. The high growth of the domestic currency component resulted from both the large amount of bank financing of the fiscal deficit and the steady growth of credit to the private sector. The latter was mainly due to the generally liquid position of commercial banks, the relatively low level of pound interest rates (Chart 4), and, in 1986, the lack of full compliance with regulations on the part of commercial banks. Declining confidence has led the private sector to shift its liquidity toward foreign currencies (foreign currency deposits rose from 37 percent of domestic liquidity at the end of 1981 to 68 percent at the end of 1986). Nevertheless, domestic transactions continue to be almost always effected in pounds, although for many commodities (especially internationally tradable goods) prices are notionally set in U.S. dollars. Despite the slower growth of the pound component of domestic liquidity in 1986, the private sector's real pound balances (which declined at an annual rate of 8 percent in 1984-85) dropped by 48 percent in 1986.

The exchange rate for the pound has come under pressure since 1982 from the expansion of the Lebanese pound component of liquidity during a period of falling production and low pound interest rates; the decrease in foreign exchange receipts from workers' remittances; and waning confidence. On the other hand, some pressure has been relieved by the reduction in imports in response to lower real incomes and, in 1986, lower international oil prices. In 1983-84, despite strong exchange market support from the Bank of Lebanon, the pound depreciated by 23 percent in real effective terms (Chart 5). Since November 1984, the Bank has resumed pursuit of its traditional policy of infrequent and limited intervention, with the exception of February-March 1986 when exchange market intervention was timed to coincide with concerted efforts to reach a political settlement. From November 1984 to the end of 1986, the pound depreciated by over 60 percent in real effective terms. Since then the pound has depreciated from LL 106.4 per SDR to about LL 160 per SDR at the end of May 1987. The Bank's foreign exchange reserves stood at US$0.6 billion at the end of April 1987 1/ (equal to four months of imports in 1986), about US$0.1 billion lower than when extensive support for the pound ceased at the end of 1984.

1/ Excluding gold holdings of 9.2 million fine ounces; gold holdings have been constant at this level since the beginning of the 1970s.

exchange rate used for customs duty valuations as they felt that this might make importers firm supporters of the continued operation of the illegal ports.

The mission noted that the fee charged for registering real estate and land transactions was the only major revenue source that had recently exceeded the budgeted level (except profit transfers from the Bank of Lebanon). As people would continue to register such transactions to have proof of ownership and as individuals purchasing real estate and land were also more likely to be able to afford additional taxes, the mission suggested that the registration fee could be raised. The Lebanese representatives agreed, adding that, to encourage buyers to report accurately the values of their transactions (as well as to raise revenue), a capital gains tax could be levied on real estate and land transactions which would have to be paid before transactions could be registered.

With regard to the financing of the fiscal deficit, the mission welcomed the decision of the Treasury not to draw on the Bank of Lebanon's exchange revaluation account, which recorded the counterpart of the higher pound value of the Bank's foreign assets resulting from the depreciation of the pound. Heavy drawings on this account, the balance of which was about equivalent to the fiscal deficit projected by the Fund staff for 1987, would seriously misrepresent government revenue in the official presentation and thus disguise the urgent need for measures to improve public finances. Moreover, because the economic effect of drawing on the exchange revaluation account was the same as borrowing from the Bank of Lebanon, resorting to this account would be inconsistent with the goal of minimizing financing from the Bank so as to slow the growth of reserve money. In this regard, the Bank was reselling treasury bills at a further discount from its own holdings to the nonbank private sector, which held about 9 percent of the Government's domestic debt outstanding at the end of 1986.

2. Monetary and credit policies

The mission observed that the effectiveness of monetary policy was now severely limited by the need for large amounts of bank financing for the public sector and waning confidence which was reflected in the large share of domestic liquidity held in foreign currency. Nevertheless, monetary policy had an auxiliary role which it had played quite well in 1986. Tighter commercial bank reserve and treasury bill portfolio requirements introduced at the beginning of 1986 (which were subsequently modified as a result of commercial bank pressure) raised the average ratios of reserves and treasury bills to Lebanese pound deposits, helping to slow the growth of credit to the private sector in the face of strong demand for pound credit due to the relatively low interest rates charged and the need for rising amounts of pound credit to finance imports. The Lebanese representatives reported that the Bank of Lebanon had raised reserve and treasury bill requirements again at the end of 1986 with the acquiescence of commercial banks. However, since the new requirements were proving very stringent, the Bank was granting exemptions on a bank-by-bank basis, allowing a bank's pound credit to the private sector to grow at the same rate as its lending interest rate. Thus a de facto ceiling had been placed on private sector credit in pounds. The mission encouraged the Bank to persevere with its current policy as well as to explore the practicability of an explicit ceiling on private sector credit since it appeared that some of the credit growth in 1986 had been financed from the banks' large and growing "other liabilities" which were not subject to reserve and treasury bill requirements.

The Lebanese representatives explained that, by selling treasury bills from its own portfolio at a larger discount than on original sales, the Bank of Lebanon had increased interest rates somewhat. However, raising interest rates for treasury bills and hence Lebanese pound deposits to fully competitive levels entailed considerable risk. First, the Government's debt outstanding had reached such a magnitude that a substantial rise in interest rates could actually increase reserve money growth. Moreover, anticipating that the increase in interest rates would further weaken the fiscal position, the private sector would likely form expectations of more rapid inflation and depreciation so that the higher interest rates would not be successful in encouraging the holding of pound assets. Thus the Bank of Lebanon would continue to adjust interest rates so as to encourage banks and the private sector to hold treasury bills and pound deposits, while taking account of the Government's interest expense.

The Lebanese representatives noted that discussions were under way with commercial banks over introducing new capital adequacy criteria that would vary according to the risk of the assets, along the lines of the recent agreement between the Bank of England and U.S. federal regulatory institutions. Since the Lebanese pound had begun depreciating rapidly, Lebanese banks had found it difficult to keep their capital, which was fixed in pounds, proportional to their balance sheet totals due to the growth in pound terms of the foreign currency components in their assets and liabilities. However, as foreign assets with correspondent banks had low risk, the depreciation had not weakened bank solvency. In 1986, the Bank of Lebanon had allowed banks to denominate in foreign currency retained earnings that originated from profits in foreign currency. The Lebanese representatives felt that the condition of the banking system had improved substantially in 1986 from, inter alia: (i) banks continuing to refrain from distributing profits; (ii) greater foreign currency earnings from holding net foreign currency assets; and (iii) improved finances of bank borrowers due to the revival in economic activity.

3. External sector policies

The Lebanese representatives believed that psychological considerations and speculation were the main factors determining the exchange rate for the pound, which had depreciated more than was