December 27, 2001
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/105

10:00 a.m., October 17, 2001

Contents

Executive Board Attendance

E. Aninat, Acting Chair

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	
	K. Kpetigo, Temporary
	P. Charleton
M.J. Callaghan	
	W. Szczuka
K. Bischofberger	G.M. Blome, Temporary
	H. Vittas
	C.A.E. Sdralevich, Temporary
	M.P. Bhatta, Temporary
V.L. Kelkar	R.A. Jayatissa
W. Kiekens	S. Çakir, Temporary
O.-P. Lehmussaari	Å. Törnqvist
R. Quarles	
P. Duquesne	G. Bauche
A. Mirakhor	M. Daïri
A.V. Mozhin	A. Lushin
	R. Villavicencio, Temporary
S. Pickford	S.P. Collins
M. Portugal	A. Rambarran, Temporary
C.D.R. Rustomjee	
A.S. Shaalan	M.B. Chatah
	Jin Qi
	A.Y.T. Wong, Temporary
	Y.G. Yakusha
K. Yagi	
A.G. Zoccali	G.R. Le Fort
	R. Maino, Temporary

A. Linde, Acting Secretary
Y.P. Chia, Assistant

Also Present

ECB: B. Kisselevsky. IBRD:C. Silva-Jauregui, Middle East and North Africa Regional Office. Asia and Pacific Department: W.S. Tseng, Deputy Director. External Relations Department: T.C. Dawson, Director; D. Hawley. Fiscal Affairs Department: E. Mottu. International Capital Markets Department: M. Fisher, E. Psalida. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; P. Dhonte, Deputy Director; S. Chami, N. Choueiri, S. Eken, M. Elhage, A. Furtado, A. Jbili, O. Kanaan, M. Lazare, A. Mazarei, K. Nashashibi, G. Terrazas, R. Valdivieso. Monetary and Exchange Affairs Department: A. Carare, C. Nickel, M. Quintyn, V. Sundararajan. Policy Development and Review Department: T. Geithner, Associated Director; S. Kashiwagi, P. Megarbane, C. Rosenberg. Secretary's Department: L. Hubloue. Technology and General Services Department: B.C. Stuart. Advisors to Executive Directors: M.A. Ahmed, E. Azoulay, S.A. Bakhache, M. Beauregard, B. Couillault, S.S. Farid, A. Fidjestøl, A.R. Ismael, M. Kabedi-Mbuyi, A. Kapteyn, J. Mafararikwa, M.F. Melhem, S. Rouai, K. Sakr, F. Vermaeten, M. Yanase. Assistants to Executive Directors: A. Alber, S. Alcaide, D. Baasanhuu, V. Bhaskar, N.J. Davidson, T. Elkjaer, N.H. Farhan, E. González-Sánchez, N. Joicey, C. Josz, T. Koranchelian, P. Lathouly, A. Maciá, P.R.D. Prasad, Y. Saito, T. Skurzewski, A. Stuart, S. Vtyurina, M. Walsh, N. Watanabe.

1. LEBANON—2001 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2001 Article IV consultation with Lebanon (EBS/01/162, 9/13/01). They also had before them a background paper on recent economic developments in Lebanon (SM/01/280, 9/14/01) and a financial system stability assessment—update (SM/01/281, 9/14/01).

The staff representative from the Middle Eastern Department (Mr. Dhonte) submitted the following statement:

> This statement reports on developments in Lebanon following the issuance of the staff report (EBS/01/162).
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> Economic activity seems to have picked up over the nine months to end-September as suggested by several of the indicators of economic activity monitored by the Banque du Liban (BdL). On this basis, a real GDP growth rate of 1–1.5 percent for the year 2001 appears achievable, still below the authorities' initial projection of 3 percent. It is too early to assess the full effect of the post-September 11 events.
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> According to preliminary data, the overall fiscal deficit for the first three quarters of 2001 (on a checks issued basis) amounted to 12.0 percent of annual GDP (compared with 14.9 percent implied in the staff report), with both revenue and cash expenditure lower than projected. When measured from the financing side (i.e., taking into account the statistical discrepancy), the deficit was 14.1 percent (compared with 16.7 percent implied in the staff report). The lower cash expenditure outcome was due primarily to lower than expected capital expenditure and treasury outlays (including transfers to the Electricité du Liban (EdL) and municipalities). The reduction in the budget transfer to EdL was possible as the company resorted to external financing and benefited from lower oil prices. Revenue was lower than projected mainly because of delays in passing the tax regularization law and the professional tax, and because of lower property taxes. In order to enhance revenue performance, in August and September, the authorities twice increased the taxes on gasoline by a cumulative 1.2 percent of GDP on a full-year basis. In view of these developments, and assuming that expenditure remains tight in the fourth quarter, the fiscal deficit (on a checks issued basis) for 2001 as a whole is now projected at 18.6 percent of GDP, compared with the staff report projection of 22.8 percent of GDP. Measured from the financing side, the deficit is projected at 20.7 percent. The primary deficit is now projected to be equal to 1.6 percent of GDP rather than 5.5 percent of GDP in the staff report.
>
> The Council of Ministers has submitted to parliament a draft budget for 2002 that is broadly in line with that envisaged during the Article IV discussions. The overall fiscal deficit would be reduced by roughly 2.5 percentage points of GDP (relative to the projected 2001 outcome) to about

16 percent of GDP, with a primary surplus of 0.5 percent of GDP. A key policy measure is the introduction of a VAT, which the authorities have conservatively budgeted to yield 3 percent of GDP in the first year, and which is to be implemented as of January 1, 2002. The draft VAT law is before parliament and the administrative preparations are at an advanced stage. Budget revenue will also benefit from the full-year effect of the increase in gasoline prices, as well as from sharp increases in administrative fees and charges. On the expenditure side, public sector wages and capital expenditure are to be contained and other non-interest expenditure (except utilities and rents) is to be cut across the board by 15 percent. Furthermore, subsidies to the tobacco monopoly and for sugar beet production are to be eliminated, and transfers to EdL contained. The details of the financing of the budget deficit are yet to be specified.

Broad money (M3) growth during January–August amounted to 5 percent, but the growth rate has decelerated and preliminary data indicate that M3 may have declined in September. At end-August, the net foreign assets (NFA) of the banking system (US$8.8 billion) were lower than projected, with the shortfall concentrated in the balance sheet of the BdL, reflecting a further increase in dollarization of deposits and limited appetite of the commercial banks for additional government paper.

In August, there was a period of domestic political uncertainty, the Lebanese pound came under severe pressure, and BdL lost substantial amounts of foreign exchange reserves. The pressure has since eased somewhat, but BdL remains the largest, and often the only, supplier of foreign exchange in the market. The BdL's gross international reserves (excluding gold) amounted to US$3.7 billion at end-September, compared with US$5.1 billion at the end of June, and US$5.9 billion at the end of 2000. Net international reserves had been severely depleted by the end of September, compared with US$1.2 billion at the end of June, and US$2.8 billion at end-2000.

The demand for government domestic currency debt has remained weak and BdL has continued to be a large purchaser of treasury bills. The holdings of LL treasury bills by commercial banks declined by 19 percent in the first nine months of 2001, and BdL's holdings went up commensurately. The demand for foreign currency debt has also softened. On September 10, the government raised US$350 million through a Eurobond issue (an augmentation of the June 2000 issue); an amount lower than previous Eurobond issues and at a slightly higher cost. Rating agencies have further downgraded Lebanon. In late September, Standard & Poor's lowered its long-term ratings for Lebanon to B from B plus over concerns of the public finances.

At end-September, the BdL imposed a 15 percent reserve requirement on the foreign currency liabilities of commercial banks. The authorities have indicated that this measure is intended to restore their capacity to act as lender of last resort in the dollarized environment. The BdL also increased the reserve requirement on LL deposits, from 13 percent to 15 percent (for time deposits) and 25 percent (for demand deposits). The BdL has also undertaken swap operations aimed at lengthening the maturity of the outstanding treasury bills.

Regarding structural issues, the law on the restructuring of the telecommunications sector is being discussed by parliament and the draft law enabling the restructuring and privatization of the electricity sector is being finalized. There remain, however, significant uncertainties as to the form and timing of these operations. Quick progress is being made in negotiating an association agreement with the European Union, which is expected to be initialed soon.

Following the approval of the anti-money laundering legislation, and the issuance of the implementing regulations, a newly formed special investigative commission has started work on several cases in cooperation with its foreign counterparts.

Staff Assessment

The above new information show that, although the authorities have made progress on the fiscal front in 2001, the recovery in growth has been weak, the debt keeps rising at a rapid pace, and the official foreign exchange reserve position has become precarious. For 2002, achievement of the targeted budget deficit will require rapid passage of the VAT now in parliament, full implementation of the VAT as of January 1, 2002, in the form adopted by the cabinet, and prompt passage of the budget proposal now before parliament. Still, the fiscal adjustment in 2002 will only help stabilize the debt ratio at the very high level of about 175 percent of GDP. While a transparent privatization program and actual sales could help, the staff is of the view that, given the extraordinarily high level of public debt together with continued very large fiscal deficits, a depletion of foreign exchange reserves, and the overvalued exchange rate, fiscal adjustment alone is unlikely to bring growth and medium-term viability. In the view of the staff, the current strategy should be urgently complemented by policies that would improve competitiveness of the economy and address the large public debt. The thrust of the staff's appraisal in the staff report remains unchanged.

Mr. Chatah submitted the following statement:[1]

Background

Following the end of the prolonged civil conflict in 1990, the focus of government policies was on the demanding task of reconstruction, economic rehabilitation, and national reconciliation. After an initial period of large currency depreciation and high inflation, the authorities moved decisively in late 1992 to establish macroeconomic stability. The economy responded strongly to the exchange rate-based stabilization policies and to the government's comprehensive reconstruction program, as growth picked up sharply and inflation was brought down gradually from over 100 percent to the low single digit levels in recent years. The substantial levels of capital inflows also reflected a high degree of external confidence in these policies and in Lebanon's economic prospects in general.

The demands of reconstruction and public sector rehabilitation, including spending associated with restoring civil peace and rebuilding security institutions, were inevitably large. Reflecting the weak state of tax administration following long years of neglect during the conflict period, government revenues, while rising substantially, failed to keep up with expenditures. This led to large deficits and a growing public debt. The weight of the fiscal imbalances—which peaked at 25 percent of GDP in 1997—and a deteriorating regional environment, coupled with a sharp cyclical downturn in the real estate sector, led to a substantial economic slowdown that started in 1997/98 and continued into 2000.

Initial attempts at fiscal consolidation only through expenditure cuts and revenue generating measures were frustrated by, and contributed to, the recessionary conditions, which worsened further in 1999 and 2000. The reconstruction and social spending needs in southern Lebanon, following its liberation in the spring of last year, posed new challenges and demands as well.

Government Economic Strategy

These developments, which brought about a general consensus that sustained success in fiscal consolidation, will require not only revenue and expenditure measures to address the imbalance in public finances directly (as well as the large stock of public debt), but also structural measures to streamline the public sector and help revive investment and growth. To this end, the authorities have designed and begun implementing an ambitious medium-term reform and adjustment strategy to decisively deal with the exceptionally difficult circumstances facing the country. The main elements of the strategy—elaborated below—are: (1) structural reforms, including

[1] See Annex I.

privatization of public utilities, as well as measures to improve the efficiency of the public sector and the general business and investment environment; and (2) fiscal consolidation through revenue-enhancing measures, including a uniform 10 percent VAT, in addition to a strict containment of recurrent budgetary expenditures.

The projections in the medium-term macroeconomic framework laid out in the staff report, which show a stabilization of the stock of debt at a high level relative to GDP, constitute a reference scenario based on the authorities' policy efforts. It is the authorities' goal to reduce the debt stock ratio over the medium term. They are indeed hopeful that such a reduction will be brought about through privatization together with international financial support to complement the authorities' own efforts. The government is in touch with Lebanon's friends in the international community on how such support can be incorporated into its medium-term strategy.

The authorities are confident that, in addition to the immediate effects on growth and the fiscal accounts, unwavering adherence to the strategy will enhance confidence, thereby contributing to private investment and growth. Expectations of improved prospects will also contribute to lowering of interest rates, thus facilitating the task of fiscal consolidation. The strong public recognition and appreciation of the economic difficulties facing the country, and the political consensus that has emerged around the government's economic program will also contribute to investors' confidence and enhance the virtuous cycle of growth and fiscal consolidation further.

The strong national consensus underpinning the authorities' adjustment and reform strategy is reflected in the progress that has already been achieved, including in areas which had proved particularly difficult in the past. Among these, for example, were the closing down of the only state-owned and unprofitable television station, the large layoff of redundant employees in the Ministry of Information, cuts in some long-standing benefits, as well as substantial increases in gasoline prices. The government's decisiveness is also seen in the progress being made in the privatization program, including the comprehensive restructuring of the national carrier, Middle East Airlines, where more than one quarter of the employees were laid off. These steps, in addition to the passing of a series of laws and decisions regarding the privatization of public utilities are indicative of a qualitative shift in the political environment for economic policy making; an important and necessary shift, which provides a reason for optimism that the authorities will succeed in meeting the admittedly difficult challenge facing the country.

Fiscal Policy

The medium-term fiscal strategy is designed to begin with the 2002 budget. However, the authorities are already following a policy of substantial expenditure restraint in 2001, which included cutbacks in recurrent spending associated with both civil and security services. On the revenue side, a substantial improvement in tax collection and a recent large increase in gasoline prices should substantially limit the impact on revenue of the cuts in import tariffs implemented late last year. On the basis of performance in the first eight months of the year, the fiscal deficit for 2001 is projected to be lower than forecast in the budget. As indicated in the staff's statement, the fiscal outcome is now projected to be even better than what was foreseen during the Article IV discussions in August. There are also signs that the real sector has started to revive, with the particularly important construction sector experiencing a gradual rebound after a long period of stagnation. In addition, summer tourism, which is another important sector in the Lebanese economy, appears to have been quite strong this year. This should contribute to stronger performance in the fiscal area.

Beyond 2001, fiscal policy will aim at achieving primary fiscal surpluses amounting cumulatively to more than 20 percent of annual GDP over the next five years. The fiscal measures will be front loaded amounting to more than 6 percent of GDP next year alone. The 2002 budget proposal, which has already passed the cabinet and is currently under discussion in parliament, includes wide-ranging expenditure-reducing and revenue-enhancing measures. The most important measure on the revenue side is the introduction of a uniform VAT, estimated to yield around 4 percent of GDP. The authorities are confident that VAT collection will be strong, particularly given the extensive groundwork and preparation for its introduction and the fact that almost two thirds of it is expected to be collected at the port of entry, thus avoiding the typical complications associated with collection. Higher gasoline prices, as well as other fees and charges, and a generally stronger revenue performance associated with the gradual revival of economic activity should all contribute to meeting the revenue target for next year.

On the expenditure side, in addition to the cuts effected so far this year, the 2002 budget proposal includes cuts that span all ministries, as well as reductions in subsidies and transfers. At the same time, the authorities are making every effort to protect spending on the social sectors. In 2002, total expenditures, despite a slight increase in debt service, will be about 5 percent lower than budgeted this year.

The authorities are keenly aware of the critical importance of fiscal performance for their macroeconomic stabilization goals. This is reflected in the strength and front loaded nature of their fiscal adjustment. They stand ready to take additional fiscal measures in order to offset any shortfalls that could jeopardize reaching the fiscal targets.

The authorities have, for some time, been following a policy of shifting the financing of the deficit, as well as the stock of public debt generally, to lower cost and longer maturity foreign currency denominated instruments. This has also been in line with the gradual increase in dollarization of bank deposits. This policy will continue in the period ahead.

The financing outlook for the balance of 2001, as well as for 2002 and beyond is based on projections about growth in the deposit base of the banking sector, which has traditionally been the major source for financing government deficits. Capital inflows into the domestic banking sector have led to substantial rates of growth in the deposit base for many years. The medium-term reference scenario assumes a slowing down of M3 growth toward the lower end of the 5 to 10 percent trend projected by the authorities. This is broadly in line with the actual growth rate of M3 of about 7 percent over the past 12 months.

Structural Reforms

The structural reform agenda is designed with a view to improving the economy's performance over the medium term by streamlining the public sector, improving the quality of services provided, and removing impediments to investment, growth and job creation. With regard to the latter, measures include reduction of the large social security contributions by employers and the high import tariff rates, as well as streamlining administrative processes.

To reduce labor costs, employer contributions to the National Social Security Fund (NSSF) were reduced in April of last year. This was done after a careful review showed that improved compliance will keep the financial impact on the NSSF at a minimal level in light of offsetting improvement in compliance. More broadly, a social security draft law to overhaul the system and secure its long-term financial viability is currently under preparation.

As part of the government's general strategy to boost investment and growth, trade and customs policies have been reoriented to take full advantage of Lebanon's traditional role and comparative advantage as a trade center in the region. The reduction in import tariffs (which was also in line with the expected introduction of the VAT), as well as the "open skies" policy implemented late last year, reflect this reorientation. In addition, important progress is being made toward WTO membership and an Association Agreement with the European Union (EU) is expected by the end of 2001. With a view to streamlining bureaucratic procedures and facilitating foreign trade and reducing the cost of production and investment, administrative reforms are also under way, particularly in the customs department. In this regard, a new customs law that would bring Lebanon's administrative procedures in line with the WTO entered into effect in April 2001.

The privatization program is at the heart of the authorities' strategy as it will serve the multiple objectives of attracting private sector investment, improving the quality of utility services, and reducing the stock of public debt. The program, the main elements of which are the privatization of the telecommunication and power sectors, is at an advanced stage and set to proceed in a transparent and effective manner. Notwithstanding the state of the international telecom market, the authorities consider the prospects for a successful and high yielding privatization of both cellular and fixed lines to be favorable, given the sector's profit and revenue performance. The tendering of cellular licenses will take place in early 2002.

In the power sector, the preparatory process for the privatization of Electricité du Liban (EdL) is well underway. The government is working with specialized firms to undertake the auditing, legal, and financial preparations. While various modalities are being reviewed, particular consideration is being given to privatizing power generation, while maintaining transmission by EDL, though on a commercial basis. In the meantime, collection has been outsourced for areas outside the capital, Beirut. Parliamentary approval has also been granted to privatize the water utilities.

Monetary and Exchange Rate Policy

Monetary policy has been directed at maintaining price stability through an exchange rate anchor. The fixed exchange rate system has been a major contributing factor to the restoration and maintenance of macroeconomic stability since 1992. The authorities see considerable merit in maintaining the current policy for a number of reasons. They do not share the view that that the exchange rate policy has led to a loss of competitiveness. The high degree of dollarization and the cost structure in the private sector, including in the labor market, makes the impact of an exchange rate change on competitiveness extremely small.

Having said that, and as discussed above, the authorities certainly see considerable room for strengthening the economy's competitiveness. This, however, should be achieved by addressing the real causes, which—to the extent they *can* be dealt with through government policies—lie mostly in the structural and administrative areas.

Clearly, as the staff report itself recognizes, devaluation would be self-defeating if it leads to an inflation/exchange rate spiral. This is a real risk that is recognized in the staff report and one which can jeopardize the government's adjustment and reform effort as a whole.

But even if such a vicious cycle is avoided, a reduction of real government debt and the fiscal burden through currency devaluation would be tantamount to a massive unlegislated tax on one segment of the Lebanese public. Moreover, reducing the real public sector wage bill through devaluation would not be effective since, as the staff report itself recognizes, Lebanon's public sector is overstaffed and underpaid. Devaluation would not be an appropriate substitute either for serious and better targeted public sector reform (which is an important element in the government's reform strategy), or for dealing with the fiscal and debt burdens through deliberate revenue and spending measures. In a way, the government has chosen the more difficult route. But it is one that is more appropriate from an economic, social, and public policy standpoint.

The staff points out that the share of recorded merchandise exports in GDP has dramatically decreased since the late 1980s. This is indeed the case, but the implications for exchange rate policy are less than obvious. Lebanon's chaotic conditions in the late 1980s may have benefited certain export sectors given the absence of taxes and other costs associated with a normal functioning economy, not to mention the dramatic decline in real incomes as a result of spiraling inflation. Lebanon's largest export market at that time was Iraq, which it lost after 1990. The 1980s are simply not a good benchmark for assessing export performance. Moreover, while the authorities certainly see room for improvement in merchandise export performance, it is important to recognize that the strength of the Lebanese economy is in the area of services. In recent years Lebanon's comparative advantage in the services sector has again been reconfirmed through strong investment and growth in areas such as media, publishing, and information technology, in addition to the more traditional services like banking and tourism. It is in these areas that the authorities believe that the prospects for exports, growth, and job creation are particularly strong.

Banking Sector

Maintaining the soundness and credibility of the banking system is a policy priority for the Lebanese authorities. While the economic recession is inevitably having a negative impact on the sector, banks remain well capitalized, liquid, and profitable. This notwithstanding, the authorities are keeping vigilant to ensure the soundness of the banking system. In this regard, following the assessment of compliance with the Basel Core Principles, they moved swiftly to strengthen the banking regulatory and supervisory framework further and to pass legislation on combating money laundering in line with the FATF recommendations. The authorities expect early action by the FATF to de-list Lebanon given that the implementation of the new law is well under way. The authorities welcome the staff's update to the 1999 Financial System Stability Assessment, which again generally confirms the strength of the Lebanese banking system and the effectiveness of the regulatory arrangements.

Finally, the authorities continue to value the constructive discussions and policy dialogue with the Fund. The challenge facing them is unquestionably difficult, but they are fully committed to meeting it. They are confident that with full implementation of their broad strategy, and the support of the international community, they will succeed.

Mr. Lushin and Ms. Vtyurina submitted the following statement:

Learning about the developments in the Lebanese economy has left us concerned and perplexed at the same time. Concerned—because the economic situation in Lebanon is beyond difficult, perplexed—because it is hard to comprehend how a budget deficit of 25 percent of GDP and public debt of 160 percent of GDP can still be sustained. Unwittingly, the comparison with Argentine's situation at present comes to mind, where past fiscal deficits and public debt levels, and concerns about the sustainability of the peg have precipitated the current crisis. But, while respective numbers on debt and deficit for Argentine are not even close to being as high as those for Lebanon, spreads on its debt are much higher than those on Lebanese debt. This is a phenomenon that is hard to explain from the efficient capital markets point of view since the risk premium for such a country as Lebanon should be sky high given the tremendous risk to investors. However, the case of Lebanon seems to be quite unique. The sustainability of the current situation could only be explained by the fact that almost all of its debt is held by domestic investors, who up until now are willing to stay involved and receive a lesser than warranted returns. But there are indications that this may not be the case for much longer if the situation does not show significant signs of improvement. In this regard, we are curious if the staff had a chance to gather some information on the overall sentiment of such groups, as banking and business communities, and on their commitment to support the county's battered fiscal accounts.

Fiscal Imbalances

With such an exceptionally high budget deficit, and with interest and wage payments constituting more than eighty percent of expenses, there is little doubt that the situation is barely sustainable at the current pace. As these circumstances warrant the implementation of a tough austerity policy, we welcome a significant fiscal adjustment of 9½ percent of GDP envisaged in the next two years. This is to be achieved mainly through the VAT revenues and other measures, such as the elimination of EdL subsidy. In regard to the latter, it appears that this would entitle a very difficult political decision and, like it has been seen in many other countries, will take a long time to be implemented fully. For this and other reasons, we would agree with the staff that an early identification of contingency, as well as further measures is necessary to achieve primary balances of 4 percent and 6 percent of GDP in 2003 and 2006, respectively. The projected overall deficit target of 10 percent of GDP in 2006 is an ambitious (if not unrealistic) one, but certainly the one to aim for given the lack of a better alternative. Given the uncertainty of growth projections and a turbulent external environment, expenditure restraint and the implementation of structural policies will need to be flawless to achieve such a target.

Exchange Rate Arrangement

The issue of the exchange rate arrangement becomes very prominent in the economy with the problems on the competitiveness front and a huge burden of public debt. The continuous real appreciation of the Lebanese pound has hurt the economy in both areas. But while the depreciation of the currency may revive competitiveness and ease the debt burden, it does not seem to be the best option at present. While the staff argue that a controlled depreciation is possible under the current circumstances, the risks identified in the Box 4, especially the impact of interest rate increases, seem to overweigh its benefits. In addition to the staff analysis of potential implications of a depreciation, it is important to note that Lebanon is a net importer, therefore, a devaluation without major increases in capital flows will only exasperate the problem, especially, if there is no increase in export production. Also, since many wages are still in pounds, it would be difficult for the EdL to raise its charges as envisaged, thus, electricity subsidies will continue to be large. Privatization efforts can be hampered as well since the decline in purchasing power will limit the profits of to-be-privatized companies, for example, in telecommunications and electricity sectors. Investors will be offering less cash for them, therefore, limiting revenue for the planned public debt reduction. Overall, while the decline in the debt ratio could be significant and the inflationary impact could be cushioned by the massive dollarization, in the absence of a strong record of the implementation of fiscal and structural reforms to secure investor confidence, a depreciation can lead to a very grave outcome.

Monetary Policy and Financing Requirements

The high level of public debt has created a very difficult environment for the monetary policy management and put a great burden of financing on the banking system. More and more, however, pressure of financing is being diverted to the BdL since banks are gradually starting to scale back their exposure to government debt, especially in LL. In response to the latter and to the need to reduce its servicing costs, the government reverted to issuing eurobonds and selling them domestically at lower interest rates. While this also extended the maturity of the debt, in general, the decision to gradually switch to foreign debt does not seem very prudent, since it will exert constant pressure on the exchange rate and will not help effectively reduce the debt burden in a case there is a devaluation. One may argue that as long as there is an inflow of foreign exchange into the economy, this strategy could work. However, much of the foreign exchange financing is currently provided not by banks’ purchases of eurobonds, but by the BdL drawing down of banks’ foreign exchange deposits at the BdL. If the probability of a default increases (when banks will suffer not only through losses on government paper, but potentially through the loss of their deposits at BdL), banks will decide to limit their foreign exchange deposits at the BdL. In that case, the BdL will run out of foreign exchange.

In addition, a high reliance on M3 growth is reminiscent of a classic ponzi scheme where the current revenues (funds for financing) are fed by the latest inputs (deposits). All of this work until the funds dry up. This brings us to the question of what would happen if M3 growth does not resume at a projected level, especially in regards to LL deposits. The staff, as do the market analysts, are cautioning that it is possible that the flow of deposits to the banking system will fall below the financing requirement. However, the staff stop short of describing the authorities' options in this case. Given the turbulence in international financial markets, what are the possibilities of attracting external capital and at what rates? Are there indications that "friendly nations" could increase their deposits with the BdL as they have done previously? Would the BdL consider it an option to further increase the LL reserve requirements? Will domestic banks request higher interest rates on new eurobond issues, and will they be interested at all given their already high exposure? Any staff comments are appreciated.

Finally, debt reduction operations could be hampered by the overly optimistic assumptions on the privatization revenues, especially given the current state of the economy and the external environment. We would urge the authorities to be realistic in this area when designing their debt reduction strategy.

Banking Sector

As noted in the FSSA update, the economic recession has adversely affected the banking system, and most of the indicators of financial strength are declining. It is suggested that, in aggregate, the banking system remains profitable, liquid, and well capitalized. However, a high involvement of the banking system in government financing without adjusting for any credit risk, its increased vulnerability to interest and exchange rate risks, to a decline in non-interest revenue, and an on-going recessionary pressures raise a lot of concern about the banking system's resilience. And although stress tests showed that the resilience is strong in several areas due to banks' improved adherence to prudential norms, as the staff, we would point out that high exposure to government debt by far presents the most prominent risk to the system. During the 1999 FSSA and in the recent update (para. 27, page 18), the staff made important recommendations on how to improve the capacity for market resilience. However, we did not find much reference to these proposals in the authorities' structural reform agenda. We would be interested in some comments from the staff in this area. We do wish, though, to commend the authorities for a swift reaction to the recommendations of the 1999 FSSA regarding improving compliance with the Basel Core Principles and reinforcing the regulatory and supervisory framework.

Competitiveness, Growth and Trade Issues

Improvements in the these areas are at the top of the structural reform agenda because of their great significance for growth of the Lebanese economy. While being considered a fairly open economy, its competitiveness and trade growth have been hampered, among other things, by high production costs and a high level of customs duties. The decision by the authorities to expeditiously address these issues through the implementation of a set of important reforms (para. 30 of the main paper and in Mr. Chatah's statement) is a very welcome one. As to the reduction of customs duties and tariffs, we share the staff's concerns about its appropriateness at the time of such fiscal imbalances. However, we can also understand the authorities' desire to get the customs reform going, which along with other reforms, will help lower the cost of doing business in Lebanon and improve competitiveness.

We wish the authorities success in their reform efforts.

Mr. Toyama and Ms. Saito submitted the following statement:

Because of the downfall in growth accompanied by the deceleration in money growth, the fiscal situation seems to have deteriorated to the point where the central bank needs to monetize the deficit, thereby sacrificing the level of foreign reserves. The medium-term debt dynamics look even more serious. The expansionary policy that Lebanon has pointed to was formed on a rather fragile framework, in which each of the following factors—GDP, money growth, sustainability of public debt, and credibility of the banking sector—were all "stretched out" and mutually supporting each other. Therefore, if there is a weakening in one factor, the delicate balance of the macroeconomy will crumble. The difficulty that the Lebanese economy is facing today exposes such weakness. Simply put, the strength of that economy arose from the fact that the banks capable of attracting funds were able to finance the otherwise unsustainable public debt. The health of the banking sector, however, now relies heavily and primarily on the sustainability of the public debt, as the percentage of government bonds increases in the banks' assets. The fragility of this interdependence has increased to the point where banks need to seriously consider the "risk" of the government bonds, and has led to their moving away from Lebanese pound-denominated government bonds since 2000. The authorities can no longer depend on the banking sector as their cornucopia, and are pressed to control their own debt, and show that it is sustainable.

The authorities' basic strategy is to enhance confidence through fiscal tightening and structural reforms that will lead to growth recovery and enable them to obtain funds to finance the public debt. Such a strategy is rational, assuming that the present exchange regime is sustained. Even so, pro-cyclical fiscal tightening could push down growth even further. Also, measures to strengthen competitiveness could not be expected to reap benefits in the short term. In addition, given the heightened risks that the slowdown in the global economy could become even more prolonged, more movement for a "flight to quality" in the capital markets, the rising uncertain situation in the Middle East following the recent tragic events in the United States, are all factors which only bode unfavorably for the situation in Lebanon. The authorities' strategy will succeed only if confidence recovers and in the absence of a major shock that would influence growth and the movement in capital, all of which must happen before its foreign reserves are depleted. On the other hand, as Box 4 of the staff report points out, the alternative to change over to a floating system is important because of the following points; even though an increase in interest rates to alleviate overshooting of the exchange rate may weaken economic activity and carries the risk of hurting the health of the banking sector, as well as the risk of hyperinflation, it does seem to be the last resort to decrease the debt burden and to improve competitiveness. Such a transition to a floating regime will become difficult if there is further dollarization and the amount of eurobonds within the public debt increases. If the authorities wish to sustain the present regime however, although this may sound contradictory, it will be necessary for them to firm up their debt sustainability while it is still feasible to move on to a floating system. If this cannot be achieved, the only path left for the authorities to take in the event that the debt dynamics do not improve, is to default.

The reference scenario assumes that that there will be a sizable improvement in the fiscal position, from a primary deficit of 5.5 percent in 2001 to a surplus of 4 percent by 2003, through measures such as the introduction of the VAT in January 2002. However, the percentage of debt to GDP is predicted to remain at the heightened level of 173 to 176 percent during 2002 to 2006, because of an increase in interest payments. In other words, this means that the primary balance needs to improve by 9.5 percent of GDP in order not to aggravate this percentage. Two things are noteworthy to point out. First, the debt to GDP ratio will increase according to the delay in fiscal consolidation, and the more delayed it becomes, the greater the consolidation needed to keep the ratio from increasing. Therefore, we agree with staff that a serious effort to tighten the fiscal stance is necessary as soon as possible. Second, if growth and interest rates do not follow the assumed path, it will become necessary to undergo even stricter fiscal tightening. Considering the implementation of the tightened fiscal policy, it will be necessary for the authorities to keep in mind contingency measures, and in addition, have several scenarios that could be implemented in steps. The authorities seem to feel complacent that privatization receipts would alleviate such tight financing requirements. However, given that the telecom sector is in distress globally, and that the rating for Lebanon has been revised downward due to the heightened country risk, it would be wise to be cautious about the probability that sales would go through as expected by the authorities. In any case, the staff's call for importance in transparency in application procedures and a practical regulatory framework is indeed to the point.

The reasons for the deterioration in competitiveness of the Lebanese economy is explained in Box 3 of the Recent Economic Developments paper. It is important to address each of these factors, and we commend the authorities' initiative to do so. That said, these structural measures are significantly important in the medium term, but will not show in the form of increased growth in the short term. Moreover, some items could even have detrimental effects in the short term, such as in the area of revenue. Therefore, concerning the timing of implementation, it will be important to thoroughly examine the pros and cons of completing the implementation.

With these remarks, we wish the authorities the best in their future endeavors.

Mr. Mirakhor submitted the following statement:

The excellent staff report and Mr. Chatah's lucid and comprehensive statement provide an insightful analysis of the daunting economic challenges facing the Lebanese economy. Since the last consultation discussion some two years ago, the economic situation appears to have become more difficult. Economic growth has slowed amid sharp erosion in competitiveness, macroeconomic imbalances have widened dramatically, and public debt has soared to unprecedented levels. While the external environment and political factors have added to Lebanon's difficulties, macroeconomic policies have been too expansionary with aggregate demand significantly outpacing the economy's supply potential. The need for prompt and forceful adjustment measures aimed at stabilizing economic conditions has now become compelling.

Against this background, the recent policy actions of the new government constitute a good start. We support the emphasis that the authorities are giving to reigniting growth, strengthening the external position, and reversing the trend of the public debt ratio. We also welcome the implementation of the measures taken to deregulate and liberalize the economy through tariff cuts, an open sky policy and trade facilitation, and are impressed by the scope of the authorities' privatization program. These measures promise to facilitate investment and bolster productivity and competitiveness over the medium term.

Nevertheless, we agree with staff that there remains a risk, especially in the short term, that these measures will prove insufficient to the extremely challenging task of durably turning the economy around and that excess demand will continue to place pressures on reserves. Although the quality and strength of fiscal adjustment is impressive, it is regrettable that its implementation will be delayed until 2002–03 and will need "an extraordinary degree of political determination" over a long period of time. With much of the initial deficit reduction expected to come from the implementation of the VAT, it will be critically important to ensure that there are no delays in the passage of the VAT law. However, based on experience in other countries, a delay cannot be ruled out and we wonder whether the authorities have a contingency plan if a delay should, in fact, occur. We support the staff's call for a durable strengthening of revenue administration especially as it relates to income, property and other taxes.

The staff note that, even assuming full implementation of the authorities' ambitious fiscal plans, the debt ratio will stabilize at a fairly high level and small changes in assumptions could lead to a more precarious outcome. The authorities feel that a more manageable debt situation can be achieved by substantial net privatization proceeds. While we certainly hope that this will indeed be the case, there is considerable uncertainty regarding the timing and the volume of these receipts. The World Bank's analysis of the privatization program suggests that the yield from the privatization of the telecommunications sector will depend on the transparency of the process and the establishment of an effective regulatory framework. The staff also notes the generally adverse conditions in the global telecom market. The expected yield from privatization in other sectors could be significantly lowered once large restructuring costs are factored in. In the case of EdL, the yield will depend on the timely elimination of the subsidy and a change in management. These considerations and uncertainties suggest that the authorities should stand ready to take supplemental fiscal measures and we join the staff in encouraging them to consider carefully all available means.

On exchange rate policy, the authorities have reaffirmed their commitment to the exchange rate peg. While the reluctance to contemplate an exchange rate adjustment is understandable, maintaining the current regime requires strong supportive policies. There is a risk also that relying only on structural reforms to reverse the erosion of competitiveness could prove to be unavailing. There is, therefore, merit in the view that exchange rate adjustment could serve a useful adjunct to appropriately tight fiscal and monetary policies, and impart a powerful stimulus to growth.

Lebanon's banking system is strong and the continuing growth of M3 is a testimony to the authorities' successful efforts to maintain its soundness and credibility. Nevertheless, as the staff cautions, the high level of M3 also constitutes a "standing vulnerability" that harbors risks as long as macroeconomic imbalances remain unaddressed. We are pleased to note from the Financial System Stability Assessment Update (SM/01/281) that the law on Fighting Money Laundering Offences has been passed by the Parliament, and that the FATF, in its recent meetings, has taken recognition of Lebanon's efforts in this area. It is hoped that vigorous and sustained implementation of this law will pave the way for an early consideration of de-listing by the FATF.

Mr. Kelkar submitted the following statement:

We thank the staff for a set of well-prepared documents that bring out, in a lucid manner, various facets of economic growth in Lebanon. We also thank Mr. Chatah for his helpful statement. We appreciate the Lebanese authorities for taking up the demanding task of reconstruction, economic rehabilitation and rebuilding security institutions since the early 1990s. The mismatch between the government revenue and expenditure, and consequent increase in public debt due to weak tax administration during the conflict period point to the need for durable peace and security in the region. We are concerned at the continued slow growth, extremely high fiscal deficit and increasing debt stock. The objectives of the present government to raise growth rate, lower inflation and maintain exchange rate stability and reverse the trend of public debt ratio are indeed commendable. We hope the authorities' strategy to revive the economy based on fiscal consolidation and structural reform including privatization yield results early. We are happy to note that economic activity has modestly picked up during the first part of 2001 and the real GDP growth is projected to move upward starting from the current year. However, in regard to vulnerability of the economy in the short term, we agree with the staff on the need for immediate tightening of fiscal policy stance.

The fiscal outcome through June 2001 showed an improvement. The introduction of a business tax and the implementation of tax regularization scheme would hopefully reverse the declining trends in tax revenue. Any delay in passing VAT law could only worsen the fiscal situation and is likely to throw up difficult challenges to the authorities on the fiscal front. We encourage the authorities to pursue introduction of VAT as suggested by the staff in order to create good base for addressing fiscal deficit issues in 2002.

We are concerned that the Lebanese foreign currency rating, as well as its domestic currency rating has been downgraded recently. We agree with the staff that for continued confidence in the banking system, the authorities have to bring public debt under control through fiscal consolidation. We are happy to note that that the authorities have issued additional eurobonds at nominal interest rates and intend to make inroads into the international capital markets aiming to contain the debt burden. However, we are concerned about the declining international reserves. On the privatization front, the proposal of the authorities to focus on this area and reduce cost of doing business is timely. We encourage the authorities to create an appropriate legal framework and enabling environment expeditiously for large-scale privatization of the targeted sectors, especially in telecom and power sectors. The privatization proceeds are also expected to ease debt burden as a supplementary measure to fiscal adjustment.

The banking systems is well capitalized and highly liquid. Profitability is also good. We are happy that the Financial System Stability Assessment (FSSA) established that the previously identified issues as having been effectively addressed and effective steps have been taken to the reform the provisions of bank secrecy and concerns of money laundering.

We hope that the rehabilitation of the Central Administration of Statistics would generate reliable and timely availability of national accounts data. We support the staff views on providing additional technical assistance in this area.

We wish the authorities all the success in their policy endeavors.

Mr. Chatah made the following additional statement:

The staff visited Beirut early last week and updated some of the information, contained in the staff report. The statement issued by the staff shows that the macroeconomic situation in Lebanon remains difficult, and has been for some time. It was difficult when the mission visited in June/July, and when this government came into office a year ago. The government realized from the outset that the nature of the macroeconomic situation required a comprehensive effort, both fiscal and structural, to be implemented with credibility and decisiveness. It spent the first few months of its term securing the support needed to advance the economic adjustment effort decisively, not only in terms of meeting the numerical targets, but also in terms of the quality of the adjustment, both fiscal and structural. The staff's statement shows the kind of actions that the government has been engaged in recently.

The staff and the authorities initially projected a fiscal adjustment of 8.5 percent for 2001/2002, of which approximately 6 percent was to come in 2002. However, it was realized that the situation required faster action which was discussed with the staff in June/July, and of course within Lebanon where there has been a great urgency on everybody's part to move fast. As a result of the recent measures taken, the weight of the fiscal adjustment has shifted to 2001, which is currently projected to yield an adjustment of 6 percent of GDP. Although a large fiscal adjustment of 20 percent of GDP is still planned for the medium term, as indicated in the reference scenario, important fiscal action has already been taken this year, and included difficult measures in some areas. For example, gasoline prices were raised substantially by about

30 percent—the equivalent of 50 cents a gallon—at a time of major slowdown. This illustrates the kind of difficult measures taken by the government, in addition to wide-ranging expenditure cuts, as mentioned in the staff's statement. This point responds to the concern expressed by a number of Directors, such as Mr. Toyama, Mr. Mirakhor, and Mr. Kelkar, who rightfully stressed that there should be front-loading in the authorities' fiscal adjustment.

Mr. Lushin mentioned the importance of demonstrating resolve. That has been on the authorities' mind from the outset. They realized that, for the fiscal adjustment to work, given the nature of the difficulties facing Lebanon, it was not enough to implement the measures, but also essential to convince all concerned within and outside Lebanon that fiscal effort was qualitatively strong, decisive, comprehensive, and having a good chance of success. Economic decision making can be difficult in a country like Lebanon, but there is a qualitative shift in the policy-making landscape.

With respect to the growth of M3 which gives indication of the domestic financing pool, the most recent figures show that, on a monthly basis in the last four weeks, M3 has been growing at 11½ percent. However, the annual M3 growth rate assumed in the authorities' adjustment scenario was between 5 and 10 percent. M3 has been growing, September to September, at 7½ percent. This confirms two things: first, that the authorities are working with realistic assumptions, and second, that the last few weeks have shown a resurgence in confidence. The most recent indications, both anecdotal and quantitative, show an increase in confidence. The latest figures also show that gross reserves increased by about $100 million in the last two weeks. Therefore, there is an indication that the authorities are moving in the right direction in implementing their fiscal adjustment strategy.

The reference scenario in the staff report is not a full adjustment scenario. There are no targets involved. The idea was to present a benchmark, a reference that shows what happens to the debt ratio if there are no additional debt reduction measures. The government realizes that the objective is to bring these ratios down, notwithstanding the caveat that, given Lebanon's economic structure, the GDP is not the best indicator of the sustainability of financing deficits.

Mr. Collins asked if the references to the fiscal adjustment made by Mr. Chatah referred to 2002, and whether the budget for 2002 would be passed by parliament without major modifications.

Mr. Chatah replied that the original projections showed 2002 as the first year of the multi-year fiscal adjustment program. However, a great effort had been made to reduce spending in all areas, where possible, within the current fiscal year. Thus, the adjustment for 2001 had turned out to be larger than had been expected in June/July. On the 2002 budget, which the parliament was currently considering, it was not expected to undergo any major changes. There was a broad recognition from all quarters that there was no room for altering the 2002 budget. The environment for policy-making was qualitatively different, brought about by a clear realization of the serious repercussions if measures were not carried out quickly to stabilize the economy.

Mr. Al-Turki made the following statement:

> The Lebanese economy remains burdened by the lingering aftermath of the post-civil war reconstruction and development in a neighborhood long subject to unsettled conditions. Against that background, the distance that the authorities have covered in the past decade in the recovery of the country's output and institutions is indeed impressive. While growth slipped in the past few years, its recent resumption and expected continuation are welcome. The challenge is to ensure that the expected improvements would be realized fully. This would require an early return to a more growth-conducive macroeconomic environment, as well as faster progress in structural reforms. To that end, I am encouraged by the assurance in Mr. Chatah's statement that there has been a helpful "qualitative shift in the political environment for economic policy-making."
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> That said, I agree with the staff that the policy challenge ahead is "formidable" in view of the accumulation of past economic problems, as well as the exceptionally difficult external environment. Here, the authorities have laid out an ambitious strategy that, as Mr. Chatah stresses, is difficult, but appropriate to the country's economic and social particulars. I will add the following remarks in that context.
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> First, I strongly endorse the consensus on the high priority for a rapid fiscal consolidation. Indications that reduction of the fiscal deficit this year will exceed the budget forecast are welcome. Indeed, the authorities are to be commended for their efforts, which are expected to reduce the primary deficit to 1.6 percent compared with 5.5 percent in the staff report. The additional consolidation in the 2002 draft budget is a further testament to the authorities' resolve. Here, prospects are promising on the revenue front in view of the groundwork already done to implement the VAT, as scheduled. Timely passage of the pending legislation is critical in that regard. On the spending front, the tension between fiscal strength and growth stimulation may indeed rise. Here, sustained focus to contain current spending, as well as subsidies and transfers is crucial. Improved expenditure management and faster reform of the civil service are also priorities. While front-loading of action and application of privatization proceeds would indeed be helpful, additional fiscal correction may need to be identified for a more manageable exposure to debt.
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> Second, I share the authorities' view that the monetary policy anchored on the exchange rate peg has helped to stabilize expectations and contain inflation. The link between the exchange rate and competitiveness

appears weak in the case of Lebanon in view of the economy's particulars, including the high degree of dollarization. The analysis in Box 4 rightly highlights the dangers, including the risk of hyperinflation, from recourse to manipulation of exchange rates for competitive advantage. In this regard, a comprehensive policy package that focuses first on fiscal condition and further structural reforms is appropriate. Here, I agree with the views expressed in the statement of Mr. Lushin and Ms Vtyurina on the exchange rate issue.

Third, the banking system's continued vitality remains an outstanding bright spot in the economy. Indeed, the Lebanese banks' resilience as a magnet for deposits is an asset that should be nurtured and guarded. The authorities' diligence in that regard is evident from the last FSSA update, which reports that previously identified issues have been duly addressed. From the record so far, I feel confident that the authorities' will remain vigilant and take further actions, if needed, in this area

Finally, turning to other structural reforms, I thank Mr. Chatah for the extensive update on the expected impact of recent and prospective structural reforms. These are welcome reforms, and when fully implemented, should greatly enhance the economy's prospects. In this regard, it would be useful for the staff to elaborate its views on the authorities' broad reform strategy.

With these remarks, I wish the authorities success.

Mr. Çakir made the following statement:

Lebanon presently finds itself at a difficult juncture. Its debt problem has no easy solution. The sustainability (or non-sustainability) of its debt situation occupies most of the staff report, and my comments will focus on the same issue.

We are glad the authorities have recognized the urgency of fiscal consolidation. Many, including myself, have been surprised at how the authorities have managed to continue rolling over their debt. A major factor has apparently been the ability of Lebanese bankers to attract deposits from within and outside Lebanon, and the continued trust of the depositors. The weak demand for government securities and the pressure on the Lebanese pound are signals that this trust may not last much longer. Chart 3 of the staff report shows the ratio of debt to broad liquidity reaching 70 percent. This leaves almost no liquidity to be used for any purpose, but purchasing government paper. It is not surprising that growth has come to a halt.

What solutions can be found? We do not think that floating the exchange rate, which will introduce an inflationary scenario, will help solve Lebanon's debt problem. Almost one-third of the debt stock is denominated in foreign exchange, and Lebanon's domestic currency denominated government papers carry a short maturity. Once the exchange rate is floated, a bank run is very likely, and the authorities would have to introduce capital account restrictions. A default, or a float, would reduce the capital base of the financial system, and the government would have to face a banking problem and the consequent fiscal costs. In Lebanon, it is a zero sum game for the government. Any move that would reduce their debt burden, would hit the banking system, and ultimately would lead to a further government debt increase.

The staff report's medium-term scenario raises several questions. I myself have calculated many sustainability scenarios. Based on my rough calculations, the figures in the staff's scenarios do not appear to imply a stable debt-to-GDP ratio. Using the staff's assumptions, this ratio seems likely to exceed 220 percent by 2006. Apparently, the staff and the authorities assume substantial inflows that are not identified in the staff report. Could the staff comment on this issue?

Once Lebanon's financing needs are identified, the authorities must go to work on satisfying them. Substantial fiscal efforts and vigorous privatization efforts are essential for closing the gap. The authorities' efforts are on the right track. Although their fiscal targets are ambitious, such an effort is needed to prevent Lebanon's debt from continuing to increase. Nonetheless, given the current level of the debt stock, the financing gap is unlikely to be closed without bilateral or multilateral resources. And given the banking system's high capital adequacy ratios, it is our feeling that the banks could help by accepting a "haircut" on their present claims on the government.

With these comments, I wish the authorities success in their endeavors.

Mr. Callaghan made the following statement:

I agree with the views in the statements by Mr. Toyama and Ms. Saito, and Mr. Lushin and Ms. Vtyurina. It is difficult to fully comprehend the magnitude of the economic difficulties facing Lebanon, and the policies that are required to address the severe fiscal imbalances and restore growth. As Mr. Lushin and Ms. Vtyurina put it, when it comes to the Lebanese economy, we are concerned and perplexed. In many respects, the fact that the economy has been able to avoid a financing crisis to date is contrary to what we would have expected and predicted, and that alone suggests that we should be careful in making judgments and predictions about Lebanon.

The staff paper is comprehensive, as is Mr. Chatah’s statement and the remarks he made earlier. I will just make a few observations on the perilous debt situation, which certainly dominates any assessment of the Lebanese economy.

The staff statement and the comments that Mr. Chatah have made about the progress on the fiscal front in 2001, which is more than had previously been expected, are very welcome. Perhaps the staff or Mr. Chatah could elaborate on the circumstances behind this fiscal progress, in particular the fact whether much of the improvement has been achieved through lower capital expenditure? I noticed that there were essentially delays in capital expenditure in 2002. I wonder if there is any shifting of capital expenditure or delays, which may have to be accounted for in the future.

However, notwithstanding the improvement that we have seen in 2001 against a particularly high base, as the staff has noted, the debt keeps rising at a rapid pace. The fiscal dynamics are explosive and the magnitude of the task of addressing this is particularly difficult.

I find it difficult to see how the massive fiscal adjustment fits in with the prime minister's election mandate of pursuing a pro-growth strategy. One of the reasons why there was not originally to be a fiscal tightening in 2001 was because it would have been harmful for growth. In looking ahead, I find it difficult to see how the authorities can reconcile the substantial fiscal adjustment with avoiding actions that may be harmful to growth in the short term. We have seen a number of other countries having to sacrifice growth in the short term in order to achieve fiscal stability, and, ultimately, pave the way for a resumption of growth. I find it hard to see how Lebanon can avoid such a situation. Put it another way, I find it hard to see how realistic the reference scenario in Table 1 of the staff report is. Mr. Chatah says this is just a benchmark to show what would happen if there were not additional reductions to the debt, but I think that even that is not realistic.

The basic issue is, with ongoing ambitious fiscal adjustments—the reference scenario has growth recovering a little in 2001, around 1 percent, but picking up to 2.5 percent in 2002, and then 4 percent in 2003—what is going to provide this boost to growth? The answer has to be structural reform measures designed to arrest the substantial decline in the competitiveness of the economy in recent years.

Competitiveness has been impeded by the substantial appreciation of the real effective exchange rate, resulting in real wages growing twice as fast as productivity, high utility prices and high real interest rates. The challenge is whether there will be sufficient progress on the structural reform front to give a large boost to growth, which will ameliorate some of the short-term pain of the fiscal consolidation. The government now has to undertake the deeper institutional reforms, such as overhauling the taxation system, implementing a broad consumption tax, and introducing a fully transparent and business-friendly foreign investment law. On this point, I understand that several foreign enterprises have recently withdrawn from projects, such as port management, telecommunications, and postal delivery services.

In addition, inefficient and costly public enterprises need to be reformed or closed, and administered processes have to be streamlined to make it easier to do business in Lebanon—this would include boosting the authority of the judicial legal bodies. Privatization will help, but this reform path includes some tough measures to reduce the budget, which will require firm political resolve. Again, it is not dissimilar to the situation facing some other countries. The staff paper highlights the uncertainties when it says that the staff underscored the extent to which the reference scenario was sensitive to confidence factors and assumptions regarding the responses of economic growth to structural reforms. The adjustment task is so large that it is hard to see the reference scenario being particularly realistic. If growth does not pick up, additional measures will be required on top of a fiscal adjustment that will already require an extraordinary degree of political determination. But, again, this is not dissimilar to the task facing some other countries.

The ability to meet the financing requirement of such a large debt overhang through the intermediation of the banking system has been remarkable. It has also been remarkable that Lebanon has successfully extended its financing strategy beyond traditional markets. But these sources of financing seem to be waning. The central bank is increasingly financing the deficit and the foreign exchange reserves position has become precarious. However, the success of the commercial banking system to finance the deficit has not been a benefit to the economy in the long run, for it has allowed the buildup of a massive fiscal imbalance, and the larger the imbalance, the higher the potential cost of arresting the situation.

Financing through the banking system is only possible while confidence is maintained, and confidence will not be maintained unless the debt dynamics are brought under control. The staff paper suggests that a depreciation in the exchange rate supported by appropriate policies could provide a boost to growth. Given the growing dollarization of the economy, exchange rate adjustment would be traumatic and carry substantial short-term costs. As such, the authorities have rejected the thought of any movement in the exchange rate. Box 4 is candid about the risks of a controlled depreciation.

On the question of the exchange rate adjustment, the situation in Lebanon seems similar to the problems facing some other countries, including program countries where the Fund has endorsed the view that the cost of an exchange rate adjustment would be excessive. However, it is possible that Lebanon will reach the situation that it does not have a choice on letting the exchange rate move. Foreign reserves have fallen from about $7 billion in early 2000 to around $3.8 billion in September. And, as Mr. Toyama and Ms. Saito have also noted, if the authorities do not firm up their debt sustainability, then perhaps the only path left is default.

The situation in the Lebanon is extremely difficult, and it poses a number of challenges in terms of the Fund exercising its surveillance responsibilities. The policy adjustment path and the options available are difficult and traumatic, but perhaps the alternative may be even bleaker. We wish the authorities well in meeting these challenges.

Mr. Duquesne made the following statement:

Let me first thank the staff for their well written report, which provides us with a precise picture of the economic and financial situation of Lebanon. The timing for this Article IV consultation is opportune. In a particularly difficult external environment, the economic performance of the country has deteriorated significantly over the past two years, and I am indeed glad that we are able to discuss today the situation of Lebanon, almost two years after our last Board meeting.

I do not need to recall in detail the picture described by the staff. However, it must be acknowledged that the economic and financial situation of Lebanon, faced with a deepening recession, recurring high budget deficits and a massive public debt, has indeed deteriorated to an alarming point.

First, the volume of the debt, now at an exceptional level by international standards when compared to GDP, is keeping interest rates at an unsustainable level, while crowding out investment. From that viewpoint, the staff's serious concerns over the government's ability to control spiraling debt stock are understandable.

Second, local banks, which have so far been able to finance most of the domestic and foreign public debt, seem now to display less appetite for the public debt, forcing the Central Bank to acquire a significant share of the bonds on offer to cover the shortfall.

Third, and equally worrying, the unfavorable economic climate, as well as regional and domestic political tensions, have provoked a heavy demand for dollars, increasing pressure on the pound. The Central Bank has intervened to keep the pound stable, as evidenced in Chart 4. In their recent statement, the staff indicates that net international reserves have been severely depleted by the end of September, an outcome that is indeed extremely worrisome, even if we have noticed the recent gross figures just given by Mr. Chatah.

Faced with an exceptionally difficult context, that can but only be aggravated by the post-September 11 context, the authorities have embarked on an ambitious and courageous twofold program, encompassing structural reforms and fiscal consolidation. The question is now whether such a strategy will prove instrumental in achieving their macroeconomic stabilization goals.

Concerning the medium-term fiscal strategy, I must say that I am truly impressed by the scope of the planned adjustment and by its front-loaded character, aiming at achieving primary fiscal surpluses amounting, cumulatively, to some 20 percent of GDP in 5 years, and 6 percent of GDP for 2002 alone, as recalled by Mr. Chatah. At the same time, it must be acknowledged that the room for maneuver in terms of curbing expenditure, in a difficult social environment, may be limited and hamper the authorities' ability to stick to their objectives. Further, on the revenue side, it remains to be seen whether the introduction of the VAT will produce its full effects rapidly. Indeed, the introduction of the VAT seems to have been thoroughly prepared, which is welcome news, but in light of current difficulties in tax collection, the authorities should indeed be encouraged to implement it swiftly, since it is at the very heart of their fiscal strategy.

In the same vein, a significant part of the fiscal adjustment relies on the privatization proceeds, now more than ever subject to great uncertainties, especially considering the distressed state of the telecom sector worldwide. While the introduction of the VAT depends on the political determination of the authorities, the privatization prospects are largely out of their hands. That certainly reinforces the case for an immediate tightening of the fiscal policy stance as suggested by the staff, so as to provide more room for maneuver, should weaker investors' confidence jeopardize the authorities' plans for privatization.

That leads me to the second pillar of the authorities' strategy, which is the structural reforms agenda, aiming at reinvigorating the economy and, more fundamentally, at improving the overall competitiveness, hampered by high production costs and a high level of custom duties. Like Mr. Lushin, I believe that the measures indicated in paragraph 30 of the staff report and emphasized in Mr. Chatah's statement, are very welcome decisions. However, let me also stress the need for the authorities to address the remaining vulnerabilities of the banking sector, in a context where their capacity to resist high exposure to government debt may be tested in the period ahead. Incidentally, let me thank the staff for their update on the situation of Lebanon regarding the fight against money laundering. I am glad that steps have been taken by the authorities especially concerning the provisions of bank secrecy and I hope that Lebanon could be, as soon as possible, in a position to fully adhere to the FATF 40 recommendations.

To conclude, considering the high quality of the staff report before us today and the stimulating discussions we are having today at this Board, it seems to me that the authorities can but only benefit greatly from sustained policy dialogue with the Fund. I would like to encourage them to intensify their constructive discussions, beyond those taking place in the context of Article IV consultations. Having said that, of course, we wish the authorities full success in their reform efforts.

Mr. Sdralevich made the following statement:

The economic situation in Lebanon is very worrying. As well explained by the complete set of staff papers, and stressed by other speakers, many economic and financial indicators are rapidly worsening. Most worrying is the deterioration of the debt ratio, reaching increasingly high levels, against the background of a weak fiscal position and slow economic growth.

It is clear that urgent action is required. The improvement in the political situation offers a rare opportunity to address the gravity of the economic conditions. We, therefore, welcome the medium-term economic program of the authorities based on structural reform and fiscal tightening, as detailed in Mr. Chatah's useful statement, stressing the commitment of the new government. Indeed, both structural reform and fiscal tightening are necessary to rein in the debt dynamics and prepare the ground for sustained growth through improved competitiveness.

However, the prospects of success of the economic program should be qualified. First, while the envisaged tightening is very ambitious, some of the structural measures proposed or already implemented, such as social security reform and the decrease in customs tariffs, could bring about a weakening of fiscal revenues. Second, while structural reform is beneficial to growth and indirectly to public finances, it tends work out in the medium-long term, and in the short-medium term, the government should avoid placing excessive reliance on it. Third, some of the sources of revenues could be over-optimistic, particularly in the field of privatization.

These cautionary remarks must be placed in the wider framework of worsening external conditions. Indeed, the staff's sensitivity analysis shows that the debt ratio would stabilize only under a flawless execution of the program, and that any deviation in policy, or impact of any unforeseen exogenous shocks would bring the ratio back to an explosive path. From these considerations follow two implications.

First, a prudent approach should favor a stronger fiscal adjustment, and we tend to share the staff's opinion that the fiscal consolidation should have begun already in 2001, and their recommendation to define contingency measures. Here, the words of Mr. Chatah this morning are reassuring with regard to the timing of fiscal consolidation. At any rate, the authorities will have to pursue vigorously the planned adjustments. The recent development outlined in the staff's statement are encouraging in this regard.

Second, the emergence of a financing gap is a possibility, and while Lebanon will certainly have the support of the international community, in case of need, the Fund would be the most appropriate and natural source of financing in the context of a program. At the moment, it is impossible to define the lines of such a program, but different options are available, including both the authorities' program and the exchange-rate based approach illustrated by the staff. The staff's own assessment of this latter option stresses that it is very delicate and that it would require a firm implementation of tight policies. The pros and cons of this approach have been debated by many Directors, including Mr. Mirakhor, and Mr. Lushin and Ms. Vtyurina, and most vividly, Mr. Çakir. Choosing any one option is a very difficult process and will require full cooperation between the staff and the authorities.

Lastly, let me welcome the actions undertaken by the authorities in response to the concerns raise by the FATF and the FSF. We encourage them to further strengthen money laundering-related supervision, especially in the banking system.

With these remarks, we wish the authorities success in their challenging endeavors.

Mr. Blome made the following statement:

We thank the staff for their excellent report and Mr. Chatah for his comprehensive statement. Like other speakers, we are concerned about the marked deterioration of the economic situation in Lebanon, as demonstrated by the soaring public debt, the loss in competitiveness, the fall in international reserves, and the downgrading of Lebanon's credit ratings. The authorities are aware of the need for a fundamental change in the policy stance, and their economic program for 2002 and beyond contains important steps in the right direction.

The staff has, however, pointed out that the authorities' fiscal strategy, even if fully implemented, and assuming that economic growth resumes and privatization receipts materialize, would only just stabilize the public debt ratio at the very high level of around 175 percent of GDP. Even this very moderate goal might not be achieved as some assumptions of the authorities might prove too optimistic. For example, privatization receipts in the telecommunications sector might well fall behind expectations, given the adverse conditions in the global telecom market at present.

Concerning the envisaged structural reforms, we share the staff's view that they may not be sufficient to restore competitiveness. Some of these reforms could even further complicate fiscal adjustment. For example, it is doubtful whether the 40 percent reduction in the contribution to the National Social Security Fund can be financed by improved compliance and other not-yet-even-specified measures. Moreover, we have to take into account the repercussions of the events of September 11. It is likely that these repercussions will put an additional strain on Lebanon, too.

Against this background, we feel that the authorities should consider additional adjustment measures. Such measures should include a more flexible exchange rate. The staff has noted that a controlled devaluation, if supported by appropriate fiscal and monetary policies, could help improve competitiveness, spur growth, and reduce the real burden of debt. The success of such a strategy would hinge critically on the strength of supporting fiscal and monetary policies aimed at avoiding an inflation-devaluation spiral. In the framework of such a strategy, fiscal policy should strive for a rapid reduction of the public expenditure-to-GDP ratio to levels around 35 percent, similar to the levels already achieved in 1998 and 1999. Another element of such a strategy should be a monetary policy that avoids monetization of the fiscal deficit.

After these comments on the general economic policy stance, we would like to address a couple of specific issues.

First, on the banking system, we welcome that banks remain well capitalized and highly liquid. We also note that resilience to credit risks had generally improved and that direct exposure to foreign exchange risks remain contained. There is, however, some concern about increasing interest rate risks due to the large and growing duration mismatch between bank assets and liabilities. This mismatch has been aggravated by the public debt management strategy to convert short-term treasury bills with longer term foreign currency bond issues. The growing interest rate risks underline the need for a fundamental fiscal adjustment, which would also allow a more prudent public debt management strategy.

Second, on statistical issues, we are aware of the problems of building up a new statistical infrastructure after the collapse of administrative capacity during the war. Nevertheless, we agree with the staff that the efforts for a further improvement of economic statistics should be intensified, and that the authorities should seek Fund technical assistance to this end.

Third, we have read in the consultation report that the authorities aim at moral support from international financial institutions for successful government debt issues in the international capital market. Perhaps the staff could explain what sort of support is envisaged here.

We wish the authorities success in their adjustment efforts.

Mr. Quarles made the following statement:

We thank staff for their detailed and in-depth analysis. We would like to point out that this Consultation, while focusing upon Lebanon’s economy, is also relevant to the broader issue of the IMF’s surveillance function. Over the past several years, the Fund has devoted a great deal of attention to this area, recognizing the key role of surveillance in crisis avoidance. As part of this effort, the Fund, working closely with the Bank and other relevant institutions, has given increased attention to analysis of potential sources of vulnerability—financial, macroeconomic and others—and has endeavored to sharpen its message in a way that strikes an appropriate balance between the need to flag signs of trouble as early and as clearly as possible, while not precipitating a crisis. While on certain points it strikes us that staff's assessment of the gravity of the situation facing Lebanon could have been a bit sharper, the overall message emerging from staff's assessment is clear enough. Lebanon's economy displays many signs of growing vulnerability to a financial crisis and it is not at all clear that the steps outlined by the authorities to avoid a crisis and set the economy on a sustainable path are adequate. In such circumstances, it is essential for the Board to reinforce and where necessary sharpen staff's message.

While we support the broad economic objectives of the GOL, we share staff's concern and note the report's very guarded assessment of the feasibility of the GOL's economic reform plan and its ability to implement the necessary steps to stabilize the economy. Furthermore, we do not see how an economy can be deemed "stabilized" in the medium-term at a debt ratio of 175 percent of GDP, overall fiscal deficits in excess of 15 percent of GDP, and current account deficits in the 15 percent of GDP range. While we are encouraged by the GOL's continued consultation with the Fund, we urge the authorities to heed the policy prescriptions produced by these consultations. Building upon this, we ask that staff consider what additional policies are necessary for the GOL to put the economy on a path towards realistic, long-term sustainability. Taking the necessary policy steps, while difficult in the short run, would likely accelerate Lebanon's economic reform, strengthen Lebanon's economy, and reassure both domestic and international markets more than any "moral support" given by the international financial Institutions

The greatest challenge for authorities is to take control of the chronic fiscal deficits that further add to Lebanon's debt burden and threaten both short- and long-term sustainable growth. We share staff's welcome of the GOL's ambitious fiscal adjustment plan but similarly share staff's concern that a more up-front adjustment effort and immediate fiscal tightening have not been implemented.

Improving Lebanon's debt dynamics, both the stock and flow, is of paramount importance to the country's economic reform efforts and long-term sustainability. As part of this effort, the GOL must strive to reign in its fiscal deficits. We were therefore troubled to note staff's projected doubling of financing requirement in the second half of 2001 which could worsen the debt load while undermining whatever progress is made on structural and other reforms. Over reliance upon privatization receipts in even the best economy is a tenuous strategy, and in the current economic environment could be particularly precarious. Worsening debt dynamics threaten to erode confidence in the banking system while spreads on recent Eurobond issues have widened, in part due to lower credit ratings related to continued debt accumulation.. Debt levels clearly are approaching levels that may be unsustainable, and more difficult steps will be necessary to bring the debt situation under control.

The trend in rising dollarization is worrisome, albeit a not unexpected reaction to the GOL's increasing debt burden. The lack of pound deposits and the corresponding increased pace of deficit monetization and reserve loss are directly related to Lebanon's fixed exchange rate regime. With credit ratings worsening and spreads widening, authorities should not count upon the Eurobond market as a source of continued financing. Furthermore, the GOL's increasing dependence upon foreign exchange debt sets the stage for a potential external currency crisis which could have long-term effects on Lebanon's ability to interact with international financial markets.

We welcomed staff's commentary on Lebanon's exchange rate regime, and support the policy prescription of a gradual move towards a more flexible mechanism. The continued loss of reserves suggests the peg may not be sustainable. A more flexible system would help protect remaining foreign exchange reserves and guard against the possibility of a larger, forced exchange rate movement at a later date.

We are pleased that staff included Table 2 in the FSSA update with indicators of banking system financial strength. We encourage staff in the future to standardize this table so that cross-country comparisons may be drawn. The government's borrowing requirements are putting serious pressure on the banking sector. Staff noted that the extension of government debt maturities is resulting in an asset liability mismatch. We are concerned that with the current assumptions of M3 growth, the banking system may not be able to meet the financing requirements of the government and wonder about other financing options.

We welcome the progress made on combating money laundering, including passage of the April 2001 Anti-Money Laundering law and the formation of a Higher Commission to address bank secrecy. We also welcome the GOL's public commitment to combating terrorist financing and implementing related UN Security Council resolutions. These steps are important to ensure a transparent financial system that is able to operate in the global environment.

We welcome the progress made in increasing fiscal transparency. The regular publication of this data is useful in planning going forward. We urge the authorities to make productive use of IMF technical assistance in the area of enhancing additional data quality.

> We want to remark briefly on the medium-term strategy assessment in this Article IV consultation, which would seem to run counter to this institution's efforts to focus more strongly on forward-looking assessments and early warning systems. Specifically, we question the usefulness of basing the exercise scenario on a reference scenario that represents the authorities' approach. This would appear to provide us with a self-fulfilling assessment that provides no alternative scenarios for medium-term developments and necessary policy responses should current adverse conditions persist both in Lebanon and the global economy.

The staff representative from the Middle Eastern Department (Mr. Dhonte) stated that, in the medium-term perspective, Lebanon had to address three basics issues: first, to regain control over the budget deficit in a flow sense; second, to restart economic growth; and third, to deal with a debt ratio that is, by all accounts, excessive. It was important to note that these three problems were interdependent. Critically, the key to stabilizing the debt ratio was the relationship between the growth rate of the economy and the real interest rate and the primary balance, the staff representative explained. The projection in the reference scenario had stabilized the debt ratio because there was, in part, a fiscal effort that would reduce the deficit, and also because there were structural and other policies that would lead to a resumption of growth. This was a critical element in Lebanon's overall economic picture, which also addressed Mr. Çakir's question on the technical aspects of the medium-term scenario.

The authorities had been unevenly clear in the definition of their policies to address the three basic issues outlined earlier, the staff representative continued. Regarding the control of the flow aspect of the fiscal deficit, the authorities had fairly specific policies, which they were beginning to implement. Mr. Mirakhor had asked whether there was a fall-back position if there were a delay in passing and implementing the VAT law. The authorities had decided not to develop a contingency plan because they wanted the VAT law to be passed and implemented. As far as the staff could assess, the planned VAT law was proceeding on schedule.

On the issue of economic growth, the authorities had some specific plans, the staff representative remarked. Mr. Al-Turki had asked for an elaboration on the structural policies. The authorities had one general vision, which was to restore the role of the private sector in what had become an economy in which the state played a large role. There had been good progress on negotiating an association agreement with the European Union, liberalizing trade policies, and implementing the privatization program, which would not only produce revenues for the treasury, but also improve the efficiency of the economy. The authorities did have some proposals on restarting economic growth, but the economy was not yet responding to them. Although the staff considered that the policies were commendable, the markets did not think they were sufficient.

On the third issue of how to address the debt ratio, the authorities' definition of their policies was wanting, the staff representative said. The authorities had failed to develop a specific policy to reduce the debt ratio.

All together, the authorities currently had some elements of a strong set of policies, but lacked a full and comprehensive policy framework that would allow the various objectives to be pursued simultaneously and interdependently, the staff representative commented. The thrust of the findings of the most recent staff mission, which had been described in the earlier staff statement, was that, although there had been some acceleration in the fiscal efforts, confidence in the solvency of government was still lacking. While there was confidence in the banking system, where there had been a steadily rising level of M3, the staff had clear indications, both in the data and in discussions with the decision makers, that there was a great reluctance on the part of the banking system to increase further their exposure to government debt instruments. With the government deficit running as high as it was, it was urgent for the authorities to develop a fully comprehensive, and therefore fully convincing, policy package soon.

The consideration of an exchange rate adjustment should not be fully ruled out, the staff representative said. Mr. Chatah had eloquently emphasized its difficulties, and the staff had also given them fair recognition in Box 4 of the staff report. However, experience had shown that, provided there were appropriate supporting policies, the adjustment of an over-valued currency was helpful to restart growth. In the case of Lebanon, being a largely dollarized economy with two-thirds of its public debt denominated in Lebanese pounds, there was also sufficient scope to achieve an upfront and totally credible reduction in the debt ratio and a further improvement in the primary balance of the budget through an exchange rate adjustment. Markets had been expecting an adjustment in some ways because they had been demanding an interest premium for Lebanese pound denominated government instruments of about 4 to 5 percent per annum for a number of years, which amounted to being a risk premium. However, to be successful, such an exchange rate adjustment would need the full complement of all other policies.

Regarding Mr. Callaghan's question on the impact of the fiscal adjustment on growth, fiscal contraction could be expansionary if it were part of a comprehensive strategy, the staff representative reiterated. A fiscal contraction that was not balanced by suitable adjustment in competitiveness may be deflationary. But in the context of a comprehensive package with sufficient credibility, a fiscal contraction, starting from a totally unsustainable position, would be helpful to restore confidence and growth.

On Ms. Vtyurina's and Mr. Blome's question on Lebanon's access to international capital markets, Lebanon had presently made little use of international capital markets and had focused on the client base of the banking system for its financing needs, the staff representative responded. The authorities had been considering the possibility of enhancing some bond issues with guarantees or collateral. The securing of such collateral or support could be one of the objectives of foreign assistance or official creditor assistance. The design of such various instruments had been evolving, and a more specific debt strategy was needed in this regard. The possibility of further deepening the access to the domestic resource base by increasing interest rates was ruled out for various reasons, including the excessive cost of such an approach to the budget. By restoring confidence, it was possible to gain further access at a given or lower interest rate. The authorities were sensitive to the average cost of capital. By shifting from domestic currency borrowing to dollar borrowing domestically and dollar borrowing externally, they expected to achieve a significant reduction in the average cost of their resources.

Regarding Ms. Vtyurina's question on whether the FSSA recommendations on improving the banks' market resilience were being implemented, the recommendations had been taken into careful consideration by the authorities, the staff representative replied. There had yet been no action on some of the recommendations because circumstances had not been favorable. The recent increase, and greater uniformity, of reserve requirements indirectly took into account some of those recommendations.

The Deputy Director of the Monetary and Exchange Affairs Department (Mr. Sundararajan), on Ms. Vtyurina's question on the FSSA recommendations on improving the banks' market resilience, added that some technical measures, mainly relating to the rediscounting procedures and the refining of the reserve level requirements for domestic and foreign currency deposits had been implemented, as outlined in Appendix I of the staff report. However, the full range of measures that the staff had recommended to strengthen the public debt management and developing government securities markets could not be easily implemented unless it was done as part of a comprehensive package. For example, for some of the measures to be implemented, flexibility in interest rates would be needed, but which was currently constrained because of the high levels of debt. Therefore, in this context, the FSSA recommendations of changes in public debt management, secondary market arrangements, trading arrangements, settlement arrangements, and reserve average would have to be implemented as part of a comprehensive strategy, which included fiscal adjustment and measures to improve confidence. A strategy paper on public debt management had been prepared by the Ministry of Finance and had been submitted to the Council of Ministers for approval. The staff looked forward to studying the strategy paper and hoped it would address many of the concerns that had been raised by Directors.

Mr. Collins asked about the possibility of World Bank guarantees for Lebanon's foreign exchange borrowing, and on Lebanon's desire to shift its debt stock toward dollar-denominated and lower costing debt instruments.

The staff representative from the Middle Eastern Department (Mr. Dhonte) responded that there had been a meeting in Paris in February/March between the Lebanese authorities, the European Union, the World Bank, and the French authorities, in which a number of ideas had been explored, including the possibility of providing guarantees on Lebanon's foreign exchange borrowings. This was one of the channels through which the authorities had hoped to be able to access the international capital markets, so as to relieve pressure on the domestic market and, therefore, to reduce the cost of financing. The possibility of World Bank guarantees had been explored, and had not been found to be quite feasible. However, the discussion of such an option would continue.

The staff representative from the World Bank (Mr. Silva-Jauregui), on Mr. Collins's question on World Bank guarantees for Lebanon's foreign exchange borrowing, added that, without a track record of reforms, the guarantees that the World Bank could give on Lebanon's external borrowing from the international capital markets would have no significant value. Thus, while the issue had not been completely closed, the World Bank had signaled that a track record of reforms would be required before considering the use of these guarantees.

The staff representative from the Middle Eastern Department (Mr. Dhonte), on Mr. Collins's question on Lebanon shifting its debt to dollar-denominated instruments, replied that this was because Lebanese depositors were switching from pound deposits to dollar deposits. The Lebanese pound denominated government debt instruments were 100 percent the counterpart of the pound deposits. As the pound deposits shrunk, so would the bank holdings of Lebanese pound denominated debt instruments. The switch from pound to dollar deposits could be, to some extent, countered by projecting greater confidence in the government's policies, and not by increasing the interest rate differential, which would become self-defeating.

Mr. Chatah said that the authorities did not consider the exchange rate peg to be sacred. They only considered the exchange rate policy from the view point of its impact on competitiveness. The authorities believed that Lebanon was not competitive in some sectors because of its high labor cost, the nature of the imported labor, and market-determined wages, and not because of high Lebanese pound denominated wages due to an overvalued exchange rate. In addition, there were risks involved in an exchange rate adjustment, as recognized by the staff. If there were no supportive policies, neither a fixed exchange rate nor a floating exchange rate would help restart economic growth. The authorities viewed that an exchange rate adjustment was not an appropriate way of reducing the fiscal deficit and debt. It would not address the public sector reform needs, and would depress wages in the low-paid sector—the government sector, which was over-staffed and underpaid—and it would be a severely unfair, regressive and unlegislated tax. It was because of these considerations regarding the impact on competitiveness that the authorities viewed an exchange rate adjustment as being inappropriate, and not because the exchange rate peg could not be altered at any cost.

Mr. Kpetigo made the following statement:

> We would like to thank the staff for the comprehensive set of papers on Lebanon. We also thank Mr. Chatah for his informative statement, and his oral statement this morning that gives us an update on the recent economic developments in the country. Over the past three years, Lebanon has experienced a very difficult fiscal and increasing debt situation. Indeed, public debt increased, interest costs have soared, and the fiscal deficit has widened. The substantial appreciation of the currency hampered the competitiveness of the economy. However, the banking system management remains strong and liquid.
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> Against this background, shortly after the war, the authorities undertook to establish macroeconomic stability. To this end, they committed themselves to protect the integrity of the banking system and preserve the full convertibility of the currency, while focusing on the three major challenges of

reviving economic growth, curbing the fiscal deficit, and reducing debt burden. We note from Mr. Chatah's statement that the focus of government policies was on the demanding task of reconstruction, economic rehabilitation, and national reconciliation. Furthermore, the government has relied on structural reforms to restore competitiveness of the economy. The comprehensive set of policy measures undertaken by the new government to address the difficulties facing the economy, notably the structural reform measures, are welcome. However, we are moving to serious economic weaknesses. Like Mr. Mirakhor and Mr. Kelkar, we support the staff recommendations urging the authorities to undertake strong and ambitious fiscal adjustment without delay.

We are heartened to hear from Mr. Chatah that the authorities are moving to that area. We encourage the authorities in their effort to start cutting unnecessary expenditures, and preparing for the introduction of the value-added tax to pave the way for more vigorous action in 2002, aiming at reducing the deficit.

The authorities acknowledge the risks they are facing, and are enduring to preserve confidence in the banking system. They are of the view that the Fund could help them achieve the objectives, and we think they deserve our assistance.

Concerning the medium-term strategy, the authorities should implement forcefully the measures agreed upon with the staff on the fiscal adjustment aiming at regaining control of the debt dynamics. For additional resources needed to secure the stabilization of the debt ratio, significant efforts are necessary to achieve this goal. To this end, the authorities count on privatization proceeds to make significant progress in debt ratio improvement. However, like the staff, we think that these assumptions seem too optimistic.

It is noteworthy that the authorities structural reform agenda is set to cover a comprehensive area, including social security system, the modernization of the Port of Beirut, and the relaxation of restrictions on real estate investment by foreigners. The key elements of the reform program indicates the determination of the authorities to bring the Lebanese economy back on track after several years of civil war.

However, on exchange rate policy, we share the views expressed by Mr. Mirakhor that there may be some risk if the authorities choose to rely on structural reform to reverse the erosion of competitiveness.

Regarding the privatization program, breakthrough was made with the government's approval of a telecommunications law, and it is expected that it will shortly be passed by the parliament. This law, if effective, will open the way for a sharp realization of privatization receipts, which could contribute somewhat to the easing of the debt burden.

Finally, we encourage the authorities' efforts to contribute to the rehabilitation of the statistics and fill the gap of the data deficiency.

Mr. Rambarran made the following statement:

The economic legacy of the Lebanese civil war (1975-1989) has been very large fiscal deficits and exceptionally high public debt. The prolonged conflict worsened the fiscal position as the government experienced a near collapse of its already narrow tax base without a corresponding reduction of its expenditures. On the contrary, the reconstruction needs of the country led to an expansion of expenditures. The tax-to-GDP ratio and the expenditure-to-GDP ratio changed from about 15 percent each in 1975 to 6 percent and 39 percent, respectively, in 1990. By 1991, per capita national income had fallen to less than half of its 1981 level, and there was massive destruction of the physical capital stock, heavy labor migration of skilled and professional persons, as well as capital flight. The result of this situation was a reliance on the banking system for debt financing of rising deficits at high real interest rates, which have come to dominate the Lebanese economy in the post war period.

Over the past few years, the staff and the Board have rightly warned the authorities about the consequences and risks of expansionary fiscal policy and have urged them to adopt a strategy of fiscal consolidation. Now that the government is already adopting an ambitious program of fiscal consolidation, which, if implemented, would stabilize the debt-to-GDP ratio, the message that the Board should be sending is to encourage the authorities towards full implementation.

As Mr. Chatah has indicated in his statement, the government is taking this concern very seriously and, as part of its medium-term economic strategy, has already made progress in implementing a strong front-loaded fiscal adjustment effort—equivalent to 6 percent of GDP this year—to reduce the deficit and stabilize debt. The centerpiece of additional effort is the implementation of a VAT, supported by structural reforms, notably privatization of telecom and power sectors, to improve the general business climate. We welcome and support this strategy.

Obviously, it is the duty of the staff to alert the Board of possible risks and uncertainties surrounding the situation and the economic strategy of any country as part of the Fund's surveillance mandate, as indicated by Mr. Quarles, and we agree that the challenges facing the Lebanese authorities are indeed daunting. We would not like, however, that the doubts raised by staff about the sustainability of the government's strategy, and the quite negative and critical tone of the staff report are taken as a disapproval of the strategy. Quite the contrary, we should instead be encouraging full implementation of the measures announced and, if it is the case, suggesting complementary or alternative measures that stand a good chance of generating greater confidence and credibility.

The staff examines the possibility of a controlled depreciation of the Lebanese pound in order to reduce the real burden of the debt stock, which reached in excess of 150 percent of GDP at the end of 2000. But, as they recognize, and as Mr. Chatah in his statement, and Mr. Lushin and Ms. Vtyurina in their statement indicate, floating the exchange rate could be self-defeating in the Lebanese context, especially since Lebanon's comparative advantage lies in services, non-tradables, and the country no longer has access to its main export market, Iraq. The economy is highly dollarized, only the public sector deals with the Lebanese pound. Moreover, as more than 45 percent of its public debt is denominated in foreign currency, it is not apparent what salutary effects a depreciation would achieve in the short-term, beyond threatening an inflation/exchange rate spiral.

As said earlier, in our view, the real issue is one of implementation, and to be sure there are risks to program implementation. We are reassured, however, by the reaffirmation in Mr. Chatah's statement and his recent remarks that the authorities are fully aware of the difficult economic situation and are implementing their stabilization program in line with strong commitment and ownership. With the firm implementation of their strategy and the support of the international community, they have a chance of succeeding in their endeavors.

Mr. Wong made the following statement:

We are grateful to the staff for an excellent set of papers. We thank Mr. Chatah for his very comprehensive and useful statement. The economy of Lebanon has been heavily burdened by the demands of reconstruction and public sector rehabilitation, and has continued to experience difficulties over the last two years, despite the efforts of the authorities. We agree with the staff appraisal and share many concerns of other Directors. The macroeconomic risks and vulnerabilities are most pressing to deal with. With the budget deficit at 25 percent of GDP and public debt at 160 percent of GDP, the economy is fragile. I believe that there is a great deal of consensus in this Board with regard to the challenges facing Lebanon, with the single most important and urgent task being fiscal consolidation. It is encouraging to know that the authorities are well aware of it, as reflected in the recent policy initiatives as outlined by Mr. Chatah. We believe that the authorities are on the right track and the initiatives represent important first steps in bringing the economy back to a sustainable growth path. We welcome the FSSA update that banks have remained well capitalized and profitable. Nonetheless, we agree with the staff and other Directors that we must think ahead and the authorities should stand ready to take supplemental fiscal measures when necessary. In the following, I would like to limit my comments only to external vulnerability issues.

First, I wanted to comment on the exchange rate regime. We have already had much discussions and Mr. Chatah has also responded eloquently just now. In sum, we believe that the exchange rate regime has so far served the economy well and it is not the time to introduce changes. Our view is based on three considerations. First, there are risks associated with a change as discussed by the staff in Box 4 of the staff report. Second, exports account for only 4 percent of GDP. Third, many economic activities in Lebanon have already been dollarized. Therefore, we do not think that a change in the regime can help the external position very much. Nonetheless, we trust that the authorities will examine this issue at some stage in the context of improving the long-term competitiveness of the country. But, at this stage, it seems wiser to maintain status quo.

However, we hasten to add that, with the current account deficit standing at 20 percent of GDP, the external position is vulnerable. The deficit must be reduced. Over the short to medium term, as the export sector is so small, it seems that the only possible way to do so is to lower imports, which is consistent with the current efforts of fiscal consolidation. But even if these measures are effective, it is still difficult to imagine that the deficit can be reduced to a comfortable level in the foreseeable future. This, therefore, makes the task of securing enough capital inflows to finance the current account deficit very important. Without enough capital inflows, foreign exchange reserves, though currently at reasonably comfortable levels, can be depleted rapidly.

Table 19 of the Recent Economic Developments paper shows that foreign direct investment accounts for at least one-third of the capital inflows. According to the staff, the foreign direct investment mainly goes into real estate, despite the sharp downturn in the sector. Can the staff explain the phenomenon? What is the reading of the staff for its outlook? Do they see any vulnerability in this sector? These are important questions, as this sector can have serious implications for foreign direct investment. The same table reveals that there is another important source of capital inflow, namely errors and omissions, which financed half of the current account deficit in 1999 and close to two-thirds in 2000. Can the staff elaborate on this?

Finally, we would like to say that we appreciate the difficult situation facing the authorities. We commend them for their serious commitment to carrying out tough and bold measures and reforms, as elaborated both by the staff and Mr. Chatah. The economic challenges are daunting and the Lebanese authorities will require a lot of technical assistance. We trust that the staff will continue to work closely with the authorities and extend their assistance.

With the above remarks, we wish the authorities well in meeting with the challenges ahead.

Mr. Maino made the following statement:

At the outset, we would like to commend the staff for a concise and candid report on the Article IV consultation with Lebanon, and to Mr. Chatah for his informative statement. In the midst of a deteriorating regional environment and a cyclical downturn in the real estate sector, the very large, widening and persistent macroeconomic imbalances remain an obstacle for growth and development in Lebanon.

We would also like to associate ourselves with Mr. Al-Turki in commending the Lebanese authorities for the commitment shown by advancing an upfront adjustment effort of structural reforms and fiscal consolidation, while preserving the full convertibility of its currency and reinforcing its banking system. I should also acknowledge the continuous consultation process with the Fund that Mr. Quarles has also underlined earlier. Recent policy actions, and the qualitative change in policy underscored by Mr. Chatah today, are commendable steps to facilitate investment, bolster productivity and competitiveness and to, thereby, raise the rate of real GDP growth.

The limited progress on structural reforms, coupled with the delicate social balance and the weak government institutions following the war, impairs revenue mobilization. In this regard, it is important to increase the tax base, implement clear tax rules and procedures, and penalize tax evasion. In particular, as Mr. Kelkar has also emphasized, the introduction of a business tax and the decisions already made on implementing a VAT represents a good base to address the fiscal conundrum. However, these undertakings are not sufficient, in our opinion, to stabilize the debt ratio and to regain control of the debt dynamics.

The authorities' intentions to allocate privatization proceeds to reduce the public debt and to improve its maturity structure are welcomed. Nevertheless, we associate ourselves with the staff to underscore the need for a more complete and comprehensive fiscal adjustment effort as a necessary condition to reignite growth and to ease the pressure on reserves. We would like to ask the staff about the status of the discussions on the preparations for a longer-term plan on tax reform. As Mr. Mirakhor has also stressed, there is still considerable uncertainty concerning the volume and timing of the privatization receipts.

The Lebanese authorities are right in maintaining the exchange rate peg in this highly dollarized economy, since any change or alteration would surely induce higher interest rates and an exacerbation of fiscal and debt problems. Moreover, the high level of government expenditure has clearly worsened competitiveness. Hence, the long lasting solution is to advance an unambiguous commitment to reduce the fiscal imbalance and to enforce clear structural reforms.

Concurring with the staff on the limited progress achieved on structural reforms, we remain concerned about the delay in the privatization program, given the impact of the loss-making public enterprises that erode the competitiveness of the overall economy. We believe that sustainable economic growth in Lebanon will be, in part, the direct consequence of improving budgetary procedures, containing public wages, and further strengthening the banking and financial sectors. We would like to ask the staff about the updating review process on public expenditure management initiated with the technical assistance of the World Bank, and the options for further progress on other relevant structural conditions cited by Mr. Chatah.

Finally, we welcome the FSSA update concluding that the banking system remains profitable, liquid and well capitalized under a limited exposure to foreign exchange risk. As Mr. Toyama and Ms. Saito state, the strength of the economy derives from the fact that the banks were capable of attracting funds to finance the otherwise unsustainable public debt. Nevertheless, the percentage of government bonds in bank assets is high. We remain concerned by the deterioration of financial indicators, such as the capital-adequacy ratios, return on asset and equities, and non-performing loans. In this regard, given the high bank exposure to government paper and the pace of M3 growth, it is evident that the government is approaching a limit or threshold on debt accumulation. The increasing dollarization of bank liabilities and the unstable demand for money complicate the resolution of the debt problem. Nonetheless, interest rate risk increased due to the growing maturity mismatch between bank assets and liabilities that is inextricably connected to fundamental macroeconomic imbalance. We would like to ask the staff whether the introduction of floating interest rate debt instruments is the appropriate option in an environment of increasing interest rate risk.

We wish the authorities success in their policy endeavors.

Mr. Charleton made the following statement:

I agree with most of the points made by Ms. Saito and Ms. Vtyurina in their statements and, indeed, with almost all of the staff's analysis.

The situation in Lebanon is both frightening and perplexing. The level of debt is extreme and one wonders how any government let its country get to this situation and why markets remained so willing to finance it—at interest rates which are not particularly high in the circumstances.

Reconstruction and recovery from civil war are the proximate causes of the deficit, but nothing justifies deficits in excess of 20 percent of GDP. Moreover, these deficits have not boosted economic growth.

In the past couple of years, there has been negligible growth and the excessive level of public expenditure is reflected simply in current external deficit. The inevitable fiscal contraction may indeed have an adverse impact on growth, but hopefully much of the impact will again be seen in the external account.

In some respects, it seems as though the deficit was driven by the availability of financing—not by any analytical concept such as the need for expenditure to create a real growth rate in excess of the real interest rate. It was always very dangerous to judge the debt in relation to money supply (much of which is generated from abroad), rather than in relation to GDP. It is only GDP which provides the resources to service debt and it requires exports to service foreign currency debt. I think there is still an element in Lebanese thinking that the situation will be OK if money supply growth holds up. This should be rejected—as Ms. Vtyurina notes, it is a classic ponzi scheme.

Similarly, juggling with the maturity structure or currency composition of the debt will not solve the fundamental problem of its excessive level and the absence of economic growth.

The authorities and the staff are agreed that the only remedy is to slash the fiscal deficit and start generating large primary surpluses, and this has to be done before the whole thing collapses. A well thought-out VAT is clearly a critical step forward, but I concur with the staff that this is only a start—there will have to be additional revenue effort and much more effective collection. With debt service preempting so much revenue, expenditure reductions will not be easy, but are there any proposals to reduce the over-staffed public service? Given the fiscal situation, I would find it hard to judge that the public service is underpaid and suspect that it will not suffer the most in the forthcoming adjustment.

The other key element to reduce the debt level is privatization. This is clearly necessary, but I share the staff's and others' view that the Lebanese may be too optimistic on this. They claim that the reference scenario is on the conservative side, but, worldwide, the value of telecom assets is only a fraction of what people thought it was a couple of years ago, and there is a great deal of reluctance by banks to finance telecom acquisitions. Moreover, Lebanon is facing up to its problems just at a time when the world economy and the entire regional political situation may well conspire to thwart their best efforts.

I also have a nagging worry that we expect privatization to do too much. Changing the ownership of an asset, in itself, solves nothing and, as I have previously noted, the FDI associated with privatization, is itself, a form of external borrowing. The true gains from privatization derive over time from efficiency gains and competitiveness. It is not simply resources.

The really fascinating question in Lebanon is what to do about the exchange rate. I must admit that if I was a Lebanese policy maker, I would probably fight hard to retain the present peg. There are many reasons outlined by the staff in Box 4 and in Mr. Chatah's statement why it could be dangerous to devalue. Not least of these is the fact that the strong exchange rate and the minimal level of inflation are about the only elements of stability in the whole system, and I would worry about the potential impact on the banking system of a sharp depreciation.

In the end, however, I think the exchange rate has to come down—even if it is risky. Past fiscal policy is simply incompatible with the present exchange rate: the domestic cost structure is clearly uncompetitive and the level of exports in such a small economy is abysmally low. There has to be something in the Lebanese policy to kick start growth and I think it will have to be the exchange rate.

I must admit, however, that the nightmare scenario would be one where the degree of fiscal adjustment fell short of its ambitious targets and the exchange rate was let depreciate. Thus, I do not think the exchange rate can be adjusted until there is demonstrable progress on the fiscal front and it is clear that the fiscal effort can be sustained.

While it is difficult to be optimistic, Lebanon has always demonstrated remarkable resilience and the financial markets have not lost confidence in them despite the patent unsustainability of the debt situation. Hopefully, vigorous implementation of their adjustment program will reinforce that shaky confidence and they will manage to pull back from the brink of disaster. I wish them every success in their endeavor.

Mr. Collins made the following statement:

I am grateful to the staff for a very clear paper, and for their comprehensive answers, and to Mr. Chatah for his comprehensive statement and comments. The staff describe an economy on the brink of a major financial crisis, which will, if it occurs, cause major dislocation in the real economy and hardship for many people. I agree with this bleak assessment. Debt service is now on such a scale that even the extremely aggressive adjustment, seen in the 2002 budget proposal, may not guarantee a soft landing: it would appear that, at best, a particularly favorable combination of circumstances will be required if economic catastrophe is to be avoided.

Despite the bleak outlook, there are positive features of the situation.

There is a new political seriousness about tackling the huge budget deficit, which is at the root of the problem. In the past, substantial progress on the budget had been blocked by a mixture of misplaced optimism about economic performance and resistance to change from powerful political interests. The recent budget demonstrates that the authorities have begun to face up to the challenge. The sharp rise in petrol prices has already demonstrated a willingness to grasp nettles previously seen as untouchable.

Against the more positive political background, it is understandable that the staff should focus with the authorities on the possibility that an aggressive budgetary adjustment will permit a soft landing. However, in our judgment, the risks of a collapse in confidence remain large. With public debt approaching 175 percent of GDP, debt service commitments will remain enormous even if there is an aggressive fiscal adjustment which wrenches the primary balance back into surplus. The authorities' hope of engineering a soft landing, which will permit a steady reduction of debt to more sustainable levels would appear to require a peculiarly favorable combination of circumstances unlikely even before the events of September 11.

These circumstances include four important assumptions:

First, the Lebanese diaspora having the confidence to continue actually to increase their already large flows into the economy; and second, domestic savers retaining enough confidence in the local currency for dollarization to slow, M3 to grow, and banks, in consequence, to be able to finance additional local currency borrowing by the government.

Confidence on both these fronts may hold up—it is, after all, diaspora money in particular which has allowed Lebanon to defy gravity for so long—but it looks a strong assumption, particularly since September 11. If confidence began to erode, we could see not just a lessening of the diaspora inflow, but a burst of capital flight. I, therefore, entirely agree with the staff that there is "great vulnerability to the risk of an acute financial crisis in the case of a loss or even a mere erosion of confidence."

Third, economic growth picking up to 2.5 percent next year, despite the very strong budgetary adjustment–this is possible, but it will certainly be difficult; and fourth, interest rates for government borrowing will remain flat next year and then decline, despite the massive debt burden and all the regional uncertainties. The slowing world economy is indeed reducing rates and yields generally, but this assumption still looks strong in Lebanon's context.

A financial crisis would surely entail, in the first instance, a large devaluation. Inflows from the diaspora would collapse, if they had not already done so. Default on debt would be unavoidable. Inflation would rise very sharply and living standards of those paid in local currency—public servants and pensioners—would fall correspondingly. There would be a risk of serious problems in the banking sector, rippling out into the real economy. A financial crisis would become an economic and social one. For that matter, problems would not be confined to Lebanon. Syria would be affected directly in various ways. Other pegged currencies in the region might also come under pressure.

Aggressive fiscal adjustment is clearly absolutely essential for avoiding disaster—it is necessary, but is it sufficient? The staff's remarks at the outset on debt dynamics are very pertinent in this connection. Whether a planned devaluation would prove effective in stimulating growth is a matter of judgment—and I recognize that the authorities are unwilling to go down this route. Mr. Wong is right to point out that exports are only 4 percent of GDP—but to what extent does that reflect over-valuation of the exchange rate? And note that imports are 40 percent of GDP, and a devaluation would presumably encourage a shift of demand towards domestic suppliers, thus also helping growth.

Thus, the devaluation option should not be ruled out completely. Given the perilously low level of reserves, together with the erosion of competitiveness, being forced into such an outcome has to be a very real risk—and it would be far better to retain some control over the process. The staff report presents a fair analysis of the risks, as well as benefits of such a policy. The risks of a planned devaluation are certainly significant, but considerably lower than when the government is perceived to have lost control of the situation. In any event, as a final word, the authorities should exercise restraint in contracting dollar-denominated debt in the belief that it is a cheap option. It may be, but a prudent approach to policy would counsel against building up unhedged exposures to foreign currency risk where there is a non-negligible chance of a devaluation, whatever the authorities' best intentions.

Mr. Mafararikwa made the following statement:

We thank the staff for their candid analysis of economic developments in Lebanon and Mr. Chatah for his elaborate and very helpful statement. We commend the Lebanese authorities for aggressively embarking on reconstruction and economic rehabilitation after a prolonged and devastating conflict. This development effort, however, taken in the context of weak revenue performance, has contributed to growing macroeconomic imbalances, with the overall fiscal deficit projected at 24.5 percent of GDP in 2001, the debt ratio at 175 percent of GDP and significant erosion in external competitiveness. It is encouraging to note that the authorities are fully aware of the urgent need to tackle these imbalances and we welcome the measures that have been adopted in this regard and those that are underway. Let me, like others, seek to emphasize some of the challenges and risks that lie ahead.

Reducing the Fiscal Deficit

The authorities seem to be facing a structural deficit problem, with spending on wages and interest constituting a very large proportion of current spending. Although the authorities' fiscal strategy hinges rightly on reducing expenditures, introducing VAT, implementing structural reforms, and reducing the debt ratio, we would caution that the international economic environment and the regional security situation remain fragile and might not make the process of cutting government expenditures that easy. Also, civil service reform might require upfront expenditures, while many of the structural measures proposed may, in the short term, reduce revenue collection. For the authorities to achieve their fiscal goals, not only is regional peace necessary, but also a strong political resolve by the authorities to push ahead as early as possible with a comprehensive domestic reform agenda. We would also join others in encouraging the authorities to formulate contingency measures in order to reduce risks to their strategy.

Structural Reforms

The structural reform agenda is comprehensive and ambitious and is rightly aimed at reducing the cost of doing business in Lebanon, enhancing competition and expanding the role of the private sector, improving competitiveness, and reducing public expenditures. As mentioned above, the pace of implementing some of the structural measures needs to be consistent with fiscal consolidation objectives, and others need strong political support for their timely implementation. In addition, projections for privatization receipts seem ambitious, in light of the depressed international environment, an outcome which might retard progress in reducing the debt ratio. Nevertheless, it is important to create an appropriate legal framework and enabling environment conducive to expediting large-scale privatization.

Monetary and Exchange Rate Policies

Box 4 of the staff report helps to put into proper perspective the implications of a devaluation. We share the authorities' concerns that at this stage, the costs of a devaluation might outweigh the benefits. The authorities are constrained in raising interest rates, given the implications on economic activity banking system and debt servicing costs. This will also compound the fiscal burden of debt, given the externalization of domestic debt that is under way. However, defending the exchange rate peg, in the context of declining reserves and erosion in competitiveness, require that the authorities be aggressive on fiscal and structural measures and that their strategy remain credible.

We commend the authorities for enforcing banking system compliance with the Basel Core Principles and for strengthening the regulatory and supervisory framework. It is encouraging that the Financial System Stability Assessment update has established that the banking system remains well capitalized, highly liquid and profitable, and we encourage the authorities to continue addressing areas of vulnerability, particularly the exposure of the banking system to public debt. The law on fighting money laundering offences has also been passed by Parliament and the efforts of the Lebanese authorities in this regard are being commended by the FATF.

Finally, we welcome the effort underway to improve reliability, timeliness, and availability of national accounts data and encourage the authorities to request more technical assistance if the need arises.

The staff representative from the Middle Eastern Department (Mr. Dhonte), on Mr. Wong's question on the balance of payments, said that, as an economic entity, Lebanon was not confined to the area defined by its geographic borders. Lebanese resident depositors frequently had bank accounts abroad, which explained why the business base or the banking system was so large relative to GDP. It was also evident in the fact that many Lebanese in Lebanon had houses abroad, and many Lebanese abroad had houses in Lebanon. The continuing attraction of Lebanon for the Lebanese diaspora was a powerful factor behind the continuing flow of FDI into the housing sector in Lebanon. As a result of this reality, the staff did not have a handle on most of the entries in the balance of payments, and the large errors and omissions item was a reflection of that fundamental reality.

On Mr. Maino's question on the state of discussions on the medium- and long-term scenarios, they had been fully discussed at the Board, the staff representative replied. The staff would reinitiate further contacts with the authorities and discuss proposals on other aspects of their policies following the Board meeting.

Regarding Mr. Maino's question on whether it would be desirable for Lebanon to develop some floating interest rate debt instruments, there was a technical angle and a deeper policy angle to the issue, the staff representative remarked. From the policy angle, there was a distinction between floating interest rates and market-based or market-sensitive interest rates. In Lebanon, there were market-sensitive interest rates—the central bank intervened heavily in the formation of the interest rates, but it did so in full consideration of the market response—and there was no regulation to interfere with the location of the demand schedule for government paper. This was currently operational through the issuance of treasury bills, which were nominally auctioned. The auction took place at a fixed price, which was determined by the central bank, but the central bank drew the consequences in terms of the quantities that could be issued, and the volumes of other papers that could be issued. There was a maturity mismatch between certain assets and liabilities of the banks in Lebanon, and this maturity mismatch, in the relatively unsettled context of Lebanon, created an interest risk for the banks. The staff had, therefore, advised the authorities that it would be desirable to have floating interest rate instruments that could be repriced more quickly than was currently the case.

The Associate Director of the Policy Development and Review Department (Mr. Geithner) said that the quality of a country's policy response should be judged, not only against the quality of policies in the past, but also against the challenges in the current situation, which had to be the measure of what would constitute a credible and viable policy response. The risks for the Fund and for the authorities in this context were, in some ways, similar—to allow hope to triumph over reality, and consider sustainable a trajectory that would unlikely be sustainable, and to not move quickly to reduce the risks in the current path by strengthening the policies at hand.

The Deputy Director for the Monetary and Exchange Affairs Department (Mr. Sundararajan), on the perspective of the banking sector balance sheet, added that there had been a slight increase in the exposure to the real estate sector, but that the risks were minimum at this point. However, there had been an increase reflecting the balance of payments flows. The staff did not have the most recent data, but believed that this trend was continuing, and that it needed to be monitored carefully.

The introduction of floating interest rate debt instruments would effectively reduce the vulnerability to the interest rate risks of the banking sector in a technical sense, the staff representative stated. The instruments would match the duration and, therefore, would bring down the risks facing the banking sector, should there be an increase in interest rates across the yield curve. However, at this juncture, floating rate instruments would shift the risks from banks to the government, which would face greater volatility in its interest costs. Therefore, the authorities needed to introduce more floating interest rate debt instruments as part of the overall debt management strategy, implemented in the larger context of a fiscal adjustment to increase confidence and reduce interest rates.

On Mr. Quarles's question on the use of the financial soundness indicators for banks, the staff had discussed how to introduce such tables in all country reports, the staff representative responded. The staff would continue to work with the Policy Development and Review Department and the Statistics Department on this matter and issue a progress report to the Board soon.

Ms. Vtyurina asked the staff to clarify if the interest rate on government instruments was market-determined, because she had read that there was an interest rate cap on the government paper due to fiscal problems.

The staff representative from the Middle Eastern Department (Mr. Dhonte) replied that the interest rate on the aggregate of government instruments was market determined, in the sense that there was no regulation that required the banks to hold government debt instruments. The banks would only hold government bonds to the extent that they found the return on risk to be satisfactory. If the government were unable to issue a certain category of financial instrument at a certain interest rate, it would shift to another category at another interest rate. However, the staff believed that at present the market was increasingly unwilling to hold additional government debt instruments, and that the authorities would not be able to place additional debt in the market by accepting higher interest rates. The authorities would also not appear credible to the bondholders by constantly accepting higher interest rates on government debt. In a broad sense, the authorities were of the view that increasing interest rates was not a solution to the current funding problem. The authorities were also keenly aware of the short-term mechanics of increasing interest rates and the problem of the interest rate mismatch in the balance sheets of the commercial banks.

Mr. Chatah made the following concluding statement:

> This has been an interesting and useful discussion. The Lebanese authorities have always viewed these discussions positively and look forward to receiving the details of what was said today. They have also worked with the staff closely outside of the Article IV discussion.
>
> I thank the staff for many of their answers. On Mr. Dhonte's remarks regarding the nature or the structure of the Lebanese economy and the diaspora, I think most Directors are generally aware of those issues. The magnitude of Lebanon's economic difficulties should be realized because, although it does not change the essential nature of the policy advice, it gives the situation a more realistic perspective.
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> The presence of a large expatriate community, with strong economic links to the local economy and to the banking system, is not unique If we look at, for example, the income of Lebanese expatriates who are connected to the Lebanese economy, I would estimate it to be a multiple of Lebanon's GDP, perhaps a few hundred percent. That does not mean it should be considered as part of the local economy. Looking at the demarcation line of what is local and what is not in the Lebanese economy has implications for the balance of payments and the growth of M3. As Lebanon restored civil peace in the early 1990s, we saw the banking sector attracting a large amount of deposits from overseas, mainly from the Lebanese abroad, with rates of increase approaching 25 to 35 percent annually. That led to a M3-to-GDP ratio of 210 percent today and has provided a large pool for financing. However, the deposits from overseas Lebanese cannot keep growing, and the authorities are aware that they are now in different situation. The gap between exports and imports is not only capital inflows and direct investment. A large part of the gap are services which are not recorded in the balance of payments. These happen to be services in the leading sectors in the country. Lebanon has always been a service economy and its exports have been mainly services, and increasingly so. If we look at the merchandise sectors, we find them dwindling. Agriculture in Lebanon accounts only for about 5 percent of GDP.

The statistics should be improved, and the balance of payments should reflect better the various sectors and the inflows coming from service receipts, in order to gain a better understanding of the economy. There is no good excuse for the fact that Lebanon's statistics are not as good as they should be, and maybe this is another manifestation of the gap between government sector and the private sector in Lebanon. The government sector has been lagging behind the potential of the private sector, including the basic functions of providing information and statistics. However, there are enough indications and facts to give us a broad understanding, which begins to explain the apparent contradiction between the figures and sustainability of the economy.

One leading sector in Lebanon is media and television broadcasting, which is now a regional product. Lebanon has six to seven television stations, many of which are leading in the Arabic speaking satellite market. This is an important market. We have one government station, and it was the only one that was over staffed and losing money. It was almost impossible to address this problem in the last few years because many of the staff were recruited during the years of uncertainty and chaos. The government television station was shut down. It returned only recently in a skeletal fashion with only limited functions for a few hours a day. The Information Ministry had hundreds of redundant employees laid off. Increases in gasoline prices, which was difficult in a recession, was implemented. The political landscape for economic policy-making has changed significantly. Earlier in the year, the chamber of commerce and bankers warned the government that a credible economic reform program was needed or Lebanon would encounter serious difficulties. I am convinced that a strong and decisive qualitative shift in policy has occurred.

The risks are there, even in the best of circumstances. Mr. Collins talked about assumptions. Clearly, there are factors—both policy factors and outside exogenous environmental factors—that will determine the success or failure of the reform program. There is no other choice, and the fact that reform is difficult is not a reason not to do it. I think the authorities are demonstrating that they are ready to do more than their best.

I want to repeat that there is nothing sacred about adjusting the exchange rate. There are different views in the world. Some of my colleagues found it a useful tool for improving competitiveness, others did not. Some perceived that it will give way if appropriate policies are not followed. Overall, we are not far from the view that exchange rates cannot be maintained unless you follow policies that can maintain stability. I think that is the essential message that the authorities agree with.

I want to focus on the real impediments to competitiveness. The Lebanese private sector, in many areas, is competitive. The focus of the government is to remove certain impediments in the public sector that impede its full potential. The public sector is the only sector that is Lebanese pound-based, and thus, quasi-taxation through an exchange rate adjustment is, in our view, not a good public policy. It also increases the burden on policies elsewhere, both structural and fiscal.

Some structural measures were commented on, such as privatization. It is always difficult to be specific on privatization. The telecom sector in Lebanon is important in relative magnitude to the economy. Currently, the gross profits of the telecom sector amount to about $800 million dollars annually. This includes transfer to the government, as well as retained profits, because the cell phone companies, which are private companies, transfer part of their profits to the government. The global telecom market is under pressure. However, we are talking about a large sector compared to the current economy. The two cell phone companies, which are already private, have made investments in the telecom sector. All the legal and the financial work is under way and is expected to be finished by spring or early summer.

On the medium term debt issue, the government fully realizes that the reference scenario in the staff report, irrespective of whether it is GDP or M3, needs to be improved. The strategy is basically full fiscal adjustment and other policy measures that can be done in consultation with the staff. Structural adjustment is moving ahead, thus increasing growth, and improving the ratios. Privatization is an important part of debt reduction, because it is geared toward debt reduction. When everything comes together, and when the strength of the authorities' policies is demonstrated both internally and abroad, not only through design, but also through implementation, we expect the international community to support and to be part of this global package that has a credible chance for success.

The Acting Chair made the following summing up:

Directors agreed with the thrust of the staff appraisal. In their view, Lebanon faces formidable economic challenges in a context of severe fiscal imbalances and a particularly difficult external environment. Over the past few years, the government deficit and real interest rates have been extremely high, the public debt ratio has risen sharply to unsustainable levels, and real GDP growth has slowed. Directors considered that nothing short of a major and sustained adjustment effort in the public finances in the short and over the medium term would help restore confidence, lower real interest rates, and begin to address the debt dynamics.

Implementation of structural reforms also would be critical. In this regard, Directors welcomed the authorities' efforts in the past twelve months to develop a series of wide-ranging reforms aimed at reducing the cost of doing business, and thus encouraging private investment and reinvigorating the economy. They stressed the key role that privatization may play in this regard, and highlighted the urgency of putting promptly in place an appropriate regulatory framework for each of the activities to be privatized. The importance of good governance and transparency in the implementation process was also emphasized.

In looking at the period immediately ahead, Directors expressed concern about the vulnerability of the economy, particularly in light of the economic slowdown, the size of the fiscal deficit, the real appreciation of the local currency, the serious deterioration in the external reserve position, the negative perception of rating agencies, and the difficulties in placing domestic currency debt with banks. They stressed that it was essential to build confidence to avert a serious problem and create conditions for implementation of the authorities' medium-term strategy. To this end, key elements would be steeped-up efforts now to reduce fiscal imbalances, and parliamentary approval and full implementation of the fiscal adjustment envisaged for 2002. In this regard, Directors were encouraged by the authorities' recent measures to strengthen fiscal performance during the remainder of this year, and they welcomed the measures included in the 2002 budget, in particular the decision of the cabinet to introduce the VAT. They urged the authorities to press for timely passage of the VAT law, and to proceed to implement the tax swiftly. Directors welcomed the planned cuts in non-interest expenditure as well as the containment of public sector wages and capital spending. Timely steps to strengthen the management of the electricity company, so as to phase out its reliance on budget transfers, were also viewed as critical.

Directors welcomed the authorities' commitment to reviving economic growth and consolidating the public finances over the medium term. They considered, however, that even if fully implemented and consolidated in subsequent years, the envisaged fiscal adjustment would stabilize the debt ratio at a still extremely high level. Moreover, they saw a risk in that a more manageable ratio was expected to be achieved mainly through the realization of uncertain privatization proceeds. Directors, therefore, urged the authorities to develop as rapidly as possible a convincing strategy to bring down the debt ratio. In this connection, some Directors also recommended keeping open the option of an exchange rate adjustment, in conjunction with appropriate fiscal and monetary policies and ambitious structural reforms. While acknowledging the need for strong macroeconomic and structural policies, other Directors, pointing to Lebanon's circumstances, and the risks involved, saw however, little merit in pursuing the option of exchange rate action.

Directors commended the authorities for having effectively addressed previously identified issues in banking supervision. They were encouraged with the FSSA report that indicated that the banks are relatively well capitalized, liquid, and profitable, and that the continuing growth of private financial savings rewards the emphasis of the authorities on the soundness and credibility of the banking system. Moreover, strong steps had been taken to reform the provisions of bank secrecy and meet FATF recommendations for money laundering. While confidence in the banking system is strong, Directors concurred with the conclusion of the FSSA update that the banking system remains vulnerable to interest rate risk and its large exposure to government debt, until macroeconomic imbalances and the debt overhang are fundamentally addressed.

In other areas of structural reforms, progress on regional trade agreements and on negotiating an association agreement with the European Union was welcomed as were the initial steps taken toward reforming the National Social Security Fund.

Directors regretted that the paucity of hard economic data seriously hindered Fund surveillance and policy design, and could affect market confidence. Accordingly, they welcomed the ongoing administrative rehabilitation of the Central Administration of Statistics, and noted the need for quick progress, particularly in the areas of national accounts and balance of payments data. In addition, Directors urged the authorities to make productive use of IMF technical assistance in order to enhance data quality in general.

Directors expressed the view that financial support from the international community for Lebanon's adjustment efforts would have to be predicated on the implementation of a strong fiscal and structural adjustment strategy, including measures to enhance competitiveness, and on the development of a policy framework for the medium term that would effectively reduce the debt ratio. In this context, Directors recommended that the authorities intensify their close cooperation with the Fund.

It is proposed that the next Article IV consultation with Lebanon shall be conducted on the standard 12-month cycle.

Mr. Collins asked if the authorities have agreed to publish the staff report or a Public Information Notice (PIN).

Mr. Chatah replied that he had not yet received clearance from the authorities on this issue, but would inform the Board of their decision.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/104 (10/15/01) and EBM/01/105 (10/17/01).

2. HONDURAS—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT—REVIEW, EXTENSION, AND WAIVER OF PERFORMANCE CRITERIA

The Fund decides that the World Bank has concluded that the PRSP submitted by Honduras provides a sound basis for World Bank concessional assistance. Accordingly, the Fund's decision set forth in EBS/01/167 (9/21/01) shall become effective on the date of this decision. (EBS/01/167, Sup. 1, 10/12/01)

Decision No. 12599-(01/105), adopted
October 12, 2001

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 01/32, 01/47, 01/51, 01/54, and 01/57 are approved.

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/01/108, Supplement 2 (10/15/01), EBAM/01/113 (10/11/01), and EBAM/01/114 (10/15/01), and by Advisors to Executive Directors and Assistants to Executive Directors as set forth in EBAM/01/114 (10/15/01) is approved.

APPROVAL: January 7, 2002

SHAILENDRA J. ANJARIA
Secretary

Tables Appended to Mr. Chatah's Statement
STRUCTURAL MEASURES, IMPLEMENTED AND UNDER WAY

I. Measures already implemented

MEASURE	ACTIONS	IMPACT
1. State Media Reform	• Lay off 500 workers from Tele-Liban, cancel workers collective bargaining contracts and restructure the sector	• Contain public expenditures
2. Civil Service Reform	• Reassign surplus workers to Civil Service Board and fill new civil servants posts through the Board	• Restrict the growth of public sector employees and contain expenditures
3. Customs Tariff Reduction	• Reduce effective customs tariff from 12% to 6%	• Liberalize trade and reduce the price level in the economy
4. Customs Law	• Simplify and streamline customs procedures	• Facilitate trade
5. Investment Law	• Create a one-stop-shop for investors, provide tax breaks and financial incentives to projects, and create investment zones	• Attract and raise the level of investments
6. Open Skies Policy	• Introduce competition and provide unrestricted entry into Lebanon	• Render Beirut International Airport as regional travel hub • Lower airfares
7. Land Acquisition by Non-Lebanese	• Provide greater access for non-Lebanese to acquire real estate property and lower registration fees	• Enhance investment in the real estate sector
8. Public Accounting Law	• Streamline and simplify budgetary procedures and strengthen treasury functions • Currently in Parliament	• Facilitate Central Government financial activities
9. Money Laundering Law	• Take new measures to guard against money-laundering activities	• Comply with international standards and regulation for combating money laundering activities
10. Sugar Beet Subsidies	• Terminate subsidies on sugar beet and wheat production	• Liberalize agricultural sector and reduce expenditures
11. VAT Law	• VAT Law approved by Council of Ministers, currently in Parliament	• Enhance revenue collection and widen the tax base
12. Telecom Law	• Finalize Telecom Law, currently in Parliament	• Liberalize the sector and prepare it for privatization
13. Social Security Reform	• Reduce social security contributions	• Retire contingent liabilities, lower cost of labor and promote employment
14. Reform of the Army Pension Scheme	• Readjust army retirement benefits and settle accrued retroactive benefits	• Reduce current expenditures and drop in future liabilities

II. Measures in the pipeline

MEASURE	ACTIONS	IMPACT
1. Competition Law	• Develop an advanced and modern competition law	• Allows for market liberalization and increased competition thereby lending to price level reduction and improvement in quality of goods and services
2. Trade Law	• Amend the existing trade law to reflect developments in the communications sector	• Enhances trading and commercial activity and integrates Lebanon further within the International trading community
3. Trade Liberalization	• Sign the Euro-Med Trade Agreement, accede to the WTO and execute GAFTA	• Liberalize trade and generate economic growth
4. Electricity Law	• Finalize the law, currently at its end stage at the Council of Ministers	• Liberalize the sector and provide the legal platform for privatizing the electricity sector • Accelerate the privatization process
5. Privatization	• Privatize state owned entities such as Middle East Airline, Liban Telecom, Electricite du Liban and Beirut and Tripoli Water Authorities	• Enhance productivity and efficiency and retire debt
6. Tax Reform	• Introduce Value Added Tax and a Global Personal Income Tax	• Enhance revenue collection and widen the tax base
7. Social Security Reform	• Reassess the overall administrative structure, settle arrears and provide alternative schemes	• Retire contingent liabilities, lower cost of labor and promote employment
8. Municipality Law	• Promote decentralization and normalize financial accounts of municipalities	• Provide efficient municipal services with positive fiscal externalities
9. Rental Law	• Modernize rental procedures and remove bottlenecks from the real estate market.	• Activate the rental market