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700 19th Street, NW
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IMF Executive Board Concludes 2009 Article IV Consultation with Lebanon

On April 15, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Lebanon.[1]

Background

The Lebanese financial system has so far weathered the global financial crisis. Deposit inflows decelerated briefly in the aftermath of the Lehman Brothers bankruptcy, but have resumed at a rapid pace since then, and deposit dollarization has been declining steadily. Consequently, the Bank of Lebanon (BdL) has continued to accumulate international reserves at a swift pace. Eurobond spreads have come down markedly since spiking following the Lehman bankruptcy, and are now below the emerging market average. Helped by strict financial oversight, the domestic financial system has had very little exposure to distressed financial products or markets and remains liquid.

Despite its vulnerabilities, the Lebanese economy has shown a remarkable macroeconomic performance. Lebanon's public debt-to-GDP ratio remains very high, its large banking system is highly exposed to the sovereign and dependent on nonresident deposit inflows, and the country lies at the crossroads of regional political tensions. Nonetheless, Lebanon has achieved a strong macroeconomic performance, helped by prudent policies and an improvement of the

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

political and security situation after the May 2008 Doha agreement. Real GDP growth exceeded 8 percent in 2008. CPI inflation dropped to 4 percent in January 2009, down from the double digits briefly reached last summer in the wake of soaring international food and fuel prices. With a primary fiscal balance of 0.5 percent of GDP, the debt-to-GDP ratio declined by 6 percentage points to 162 percent of GDP in 2008. All end-December quantitative targets under the Emergency Post-Conflict Assistance -supported program were met with substantial margins.

The global recession and tight international capital markets weigh on the economic and financial outlook. Lower global liquidity and economic growth, particularly in the Gulf, are likely to affect merchandise exports, tourism, remittances, foreign direct and portfolio investment, and deposit inflows. Economic growth in Lebanon is likely to slow to 3 percent this year, and deposit growth could decline to about 10 percent from over 15 percent in 2008. Nonetheless, helped by a reduced oil import bill and ongoing deposit dedollarization, international reserves are likely to increase further. Inflation will likely remain low, in line with international price trends.

Executive Board Assessment

Executive Directors welcomed the remarkable resilience of the Lebanese economy in the face of the global financial crisis, and commended the authorities for their macroeconomic policy discipline and strict oversight of the financial system. Their implementation of the program supported by EPCA has contributed to a strong economic and financial performance and a reduction in the government debt-to-GDP ratio.

Directors considered that the deepening global recession, unsettled international credit markets, and Lebanon's exposure to regional spillovers underscore the importance of making further progress in addressing Lebanon's macroeconomic and financial vulnerabilities. Near-term policies should aim at mitigating downside risks by safeguarding the recent progress made toward achieving debt sustainability and strengthening the external position. This will involve continued prudent fiscal and monetary policies, vigilant financial supervision, proactive contingency planning, and a resumption of the Paris III reform policy agenda to reduce structural vulnerabilities.

Directors supported the authorities' monetary policy aimed at safeguarding the exchange rate peg and facilitating a further buildup of international reserves. The large currency mismatches in the debt held by the governmental, corporate, and household sectors, along with the high level of government foreign currency debt and debt-service obligations, underscore the central role played by the peg in maintaining financial stability. Given heightened near-term risks, Directors agreed that there is little scope for lowering interest rates over the coming months. They took note of the staff assessment that the real effective exchange rate of the Lebanese pound appears to be broadly in line with fundamentals.

Directors cautioned that Lebanon's still very-high level of government debt and the need to support the exchange rate peg leave little room for countercyclical fiscal policy. A number of Directors encouraged the authorities to aim for a higher primary fiscal surplus than implied in the draft budget to reduce the debt burden, while a few others saw the planned pause in fiscal consolidation as justified by the slowdown in economic activity. Directors recommended that any revenue overperformance or capital spending shortfall in the 2009 budget be saved. They were encouraged by the authorities' assurance that implementation of the 2009 budget will be prudent, and their readiness to consider additional measures if needed to maintain the government debt-to-GDP ratio unchanged, and ensure government financing in the event of a shortfall in deposit inflows.

Directors welcomed the reintroduction of gasoline excise taxes, which will help bolster the revenue position. They considered that carefully targeting social expenditures would lead to a more efficient allocation of public resources and achieve social and development objectives better than generalized public sector wage increases.

Directors were encouraged by the resilience and profitability of the banking sector in the face of the global crisis. They commended the authorities for their prudent regulation and supervision of the sector, and the progress they have made in strengthening the bank resolution framework. At the same time, banks’ large exposure to the sovereign, maturity mismatches, and the still-high degree of dollarization constitute vulnerabilities. Directors therefore stressed the need for continued vigilance in bank regulation and supervision.

Directors considered that progress on structural reforms under the Paris III reform agenda, especially in the energy sector, will warrant heightened attention in the period ahead. This should include a revision of electricity tariffs to ensure cost recovery, which will boost Lebanon’s growth potential and reduce a large drain on budgetary resources. The privatization of the mobile telecommunications providers as soon as market conditions allow would promote private sector growth and reduce debt-related vulnerabilities. Directors underscored that fiscal reforms, including an increase in the VAT, will be needed to achieve the desired sizeable primary fiscal surplus in the medium term. They stressed the importance of timely and full disbursement of donor commitments to support Lebanon’s reform agenda, including through the provision of budgetary support.