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July 1, 1987

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is the staff report for the 1987 Article IV consultation with Lebanon, which will be brought to the agenda for discussion on a date to be announced.

Mr. Short (ext. 7118) or Mr. Noursi (ext. 7117) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

LEBANON

Staff Report for the 1987 Article IV Consultation

Prepared by the Staff Representatives for the 1987 Consultation with Lebanon

Approved by A. S. Shaalan and S. Kanesa-Thasan

June 30, 1987

I. Introduction

The 1987 Article IV consultation discussions with Lebanon were held in Paris, May 18-22, 1987. The Lebanese delegation was headed by the Honorable Edmond Naim, Governor of the Bank of Lebanon, and included officials from the Bank, the Treasury, and the Council for Development and Reconstruction (CDR). 1/

The last Article IV consultation with Lebanon was concluded by the Executive Board on April 25, 1986. During the Board's meeting, Executive Directors commended the Lebanese authorities for maintaining a free exchange system and for exercising prudence in foreign borrowing. They urged the authorities to make strong efforts to reduce the fiscal deficit and to continue to pursue steps to maintain the soundness of the banking system.

Lebanon continues to avail itself of the transitional arrangements of Article XIV. 2/

II. Economic Background

A comprehensive assessment of developments in Lebanon is hindered by the lack of national accounts and up-to-date sectoral and social statistics as well as incomplete external sector data. However, estimated actual fiscal figures and monetary statistics provide a satisfactory basis for assessing public sector finances as well as monetary and credit developments. The inadequacy of balance of payments statistics and the climate of uncertainty preclude the preparation of a medium-term balance of payments scenario.

1/ The staff representatives were Messrs. B.K. Short (Head), B.R.H.S. Rajcoomar, and M. Zavadjil (all MED). Mr. A.S. Shaalan (MED) and Mr. M.B. Chatah (OED) participated in the policy discussions.

2/ Details of relations with the Fund and the World Bank are provided in Appendices I and II, respectively.

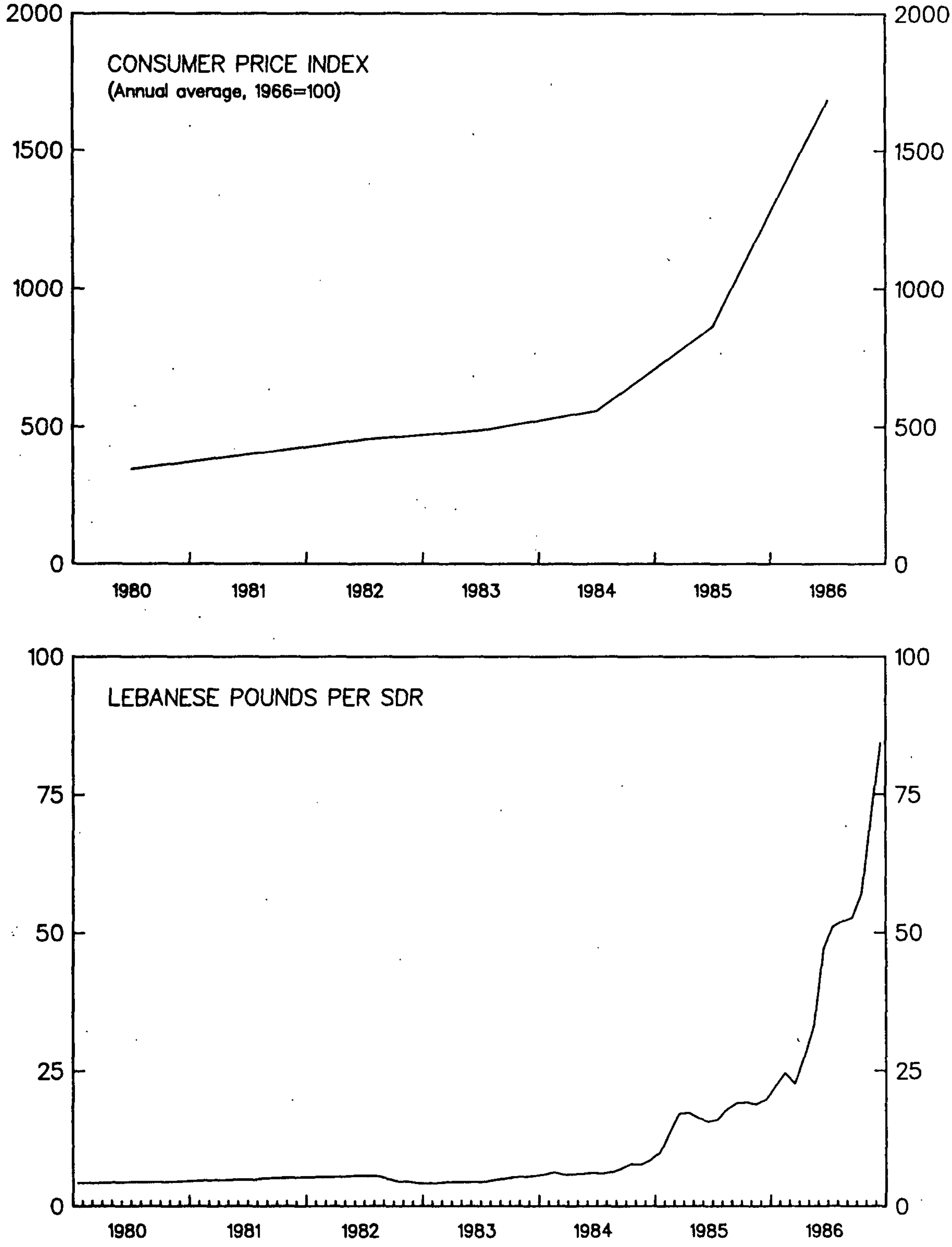
Armed conflicts in Lebanon for more than a decade have caused extensive human suffering and have come to dominate economic developments. Production has been reduced well below half of its prewar level by interruptions in working hours, disruption of transportation, and destruction of physical assets. By undermining public finances and eroding confidence, the deterioration in security has also lain at the root of inflation and depreciation of the pound. Although there has been some recovery in output since 1985, the situation has otherwise become more worrisome. Inflation has accelerated from a range of 10-20 percent per annum in 1981-84 to 95 percent in 1986 (Chart 1) and an annual rate as high as 400 percent in the first quarter of 1987. Simultaneously, the pound has depreciated at an increasing rate from LL 4-8 per SDR in 1982-84 to about LL 160 per SDR at end May 1987. In addition, not only has per capita real income decreased since 1974, but the recent acceleration in the rates of inflation and depreciation of the pound have further skewed the distribution of income away from middle- and low-income families whose nominal incomes have not kept pace with inflation and who lack the financial sophistication to protect themselves fully from rapid price and exchange rate changes. Finally, unemployment has risen due to the lower level of economic activity and the reduced mobility of factors of production within Lebanon during the last decade, as well as the recent decrease in the demand for labor in the region.

The erosion of government authority has seriously undermined public finances. Although expenditures rose by 37 percent per annum in 1982-86 due to the Government trying to provide customary services and subsidizing bread and petroleum products, revenues grew by only 18 percent per annum because of the Government's inability to collect many taxes and fees (Chart 2 and Table 1). The resulting deficits exceeded 80 percent of expenditures in 1984-86. Because of the rapid depreciation of the pound, the extrabudgetary petroleum subsidy has increased to a high level (accounting for LL 9.3 billion out of LL 14 billion in government spending in the first four months of 1987). The large fiscal deficits, which have been financed from the domestic banking system, have rapidly raised domestic debt outstanding and annual interest payments by the Government. Public investment, which has recently been concentrated on improving interregional roads and telephone lines, declined in real terms by one third in both 1985 and 1986.

CHART 1

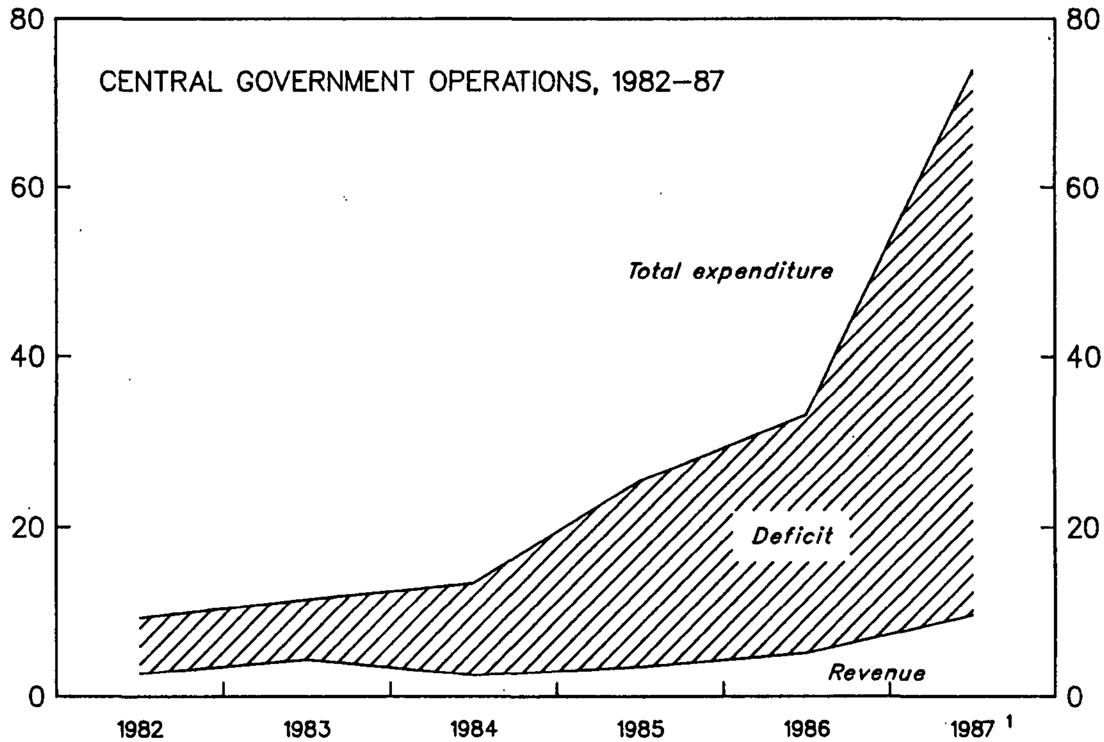
LEBANON

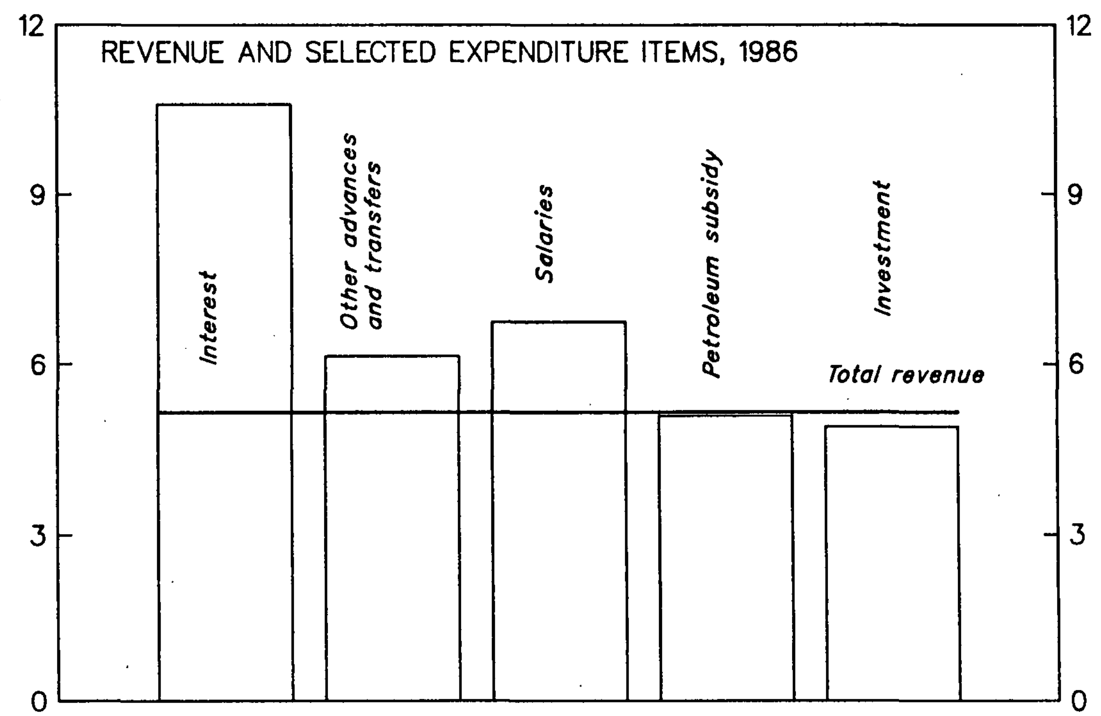
INFLATION AND DEPRECIATION OF THE LEBANESE POUND



Sources: IMF, *International Financial Statistics;* and Beirut Chamber of Commerce and Industry.

CHART 2
LEBANON
FISCAL TRENDS
(In billions of Lebanese pounds)





Source: Ministry of Finance.
[1]Fund staff projections.

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

	1982	1983	1984	1985	1986	Fund Staff Estimates 1/ 1987
			(Percentage changes)			
Inflation						
Consumer price index	14	7	15	54	95	...
Fiscal operations						
Receipts	... 2/	63	-43	43	46	86 3/
Expenditures and net extrabudgetary spending	... 2/	34	8	75	39	126 3/
			(Ratios as a percent)			
Public sector deficit as a percentage of budgetary expenditures and net extra-budgetary spending	71	65	82	85	84	87 3/
Domestic bank financing as a percentage of						
(i) Lebanese pound component of money and quasi-money at beginning of period	24	21	21	31	32	62 3/
(ii) change in Lebanese pound component of money and quasi-money during period	54	76	129	66	110	...
			(Percentage changes)			
Monetary developments						
Money and quasi-money (M2)	20	27	24	56	172	...
Lebanese pound component of M2	45	27	16	47	29	...
Real Lebanese pound balances	32	23	-7	-8	-48	...
U.S. dollar value of residents' foreign currency deposits with Lebanese banks	-6	-13	-9	-12	20	...
Net claims on public sector	91	52	47	49	36	...
Credit to private sector	21	30	27	25	136	...
Lebanese pound component of credit to private sector	23	25	26	15	52	...
External sector						
Exchange rate (percent change in average for last quarter of year) (appreciation +)						
Nominal effective exchange rate	27	-15	-27	-60	-73	...
Real effective exchange rate	31	-11	-14	-39	-39	...
			(In billions of U.S. dollars)			
Balance of payments						
Exports	0.9	0.7	0.6	0.6	0.7	...
Imports	-3.5	-3.7	-3.0	-2.2	-1.9	...
Other items, net	3.0	2.4	1.2	2.0	0.6	...
Overall balance	1.2	-0.6	-1.2	0.4	-0.6	...
Central bank reserves						
Gross official reserves (end of period) 4/	2.6	1.9	0.7	1.1	0.5	...

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

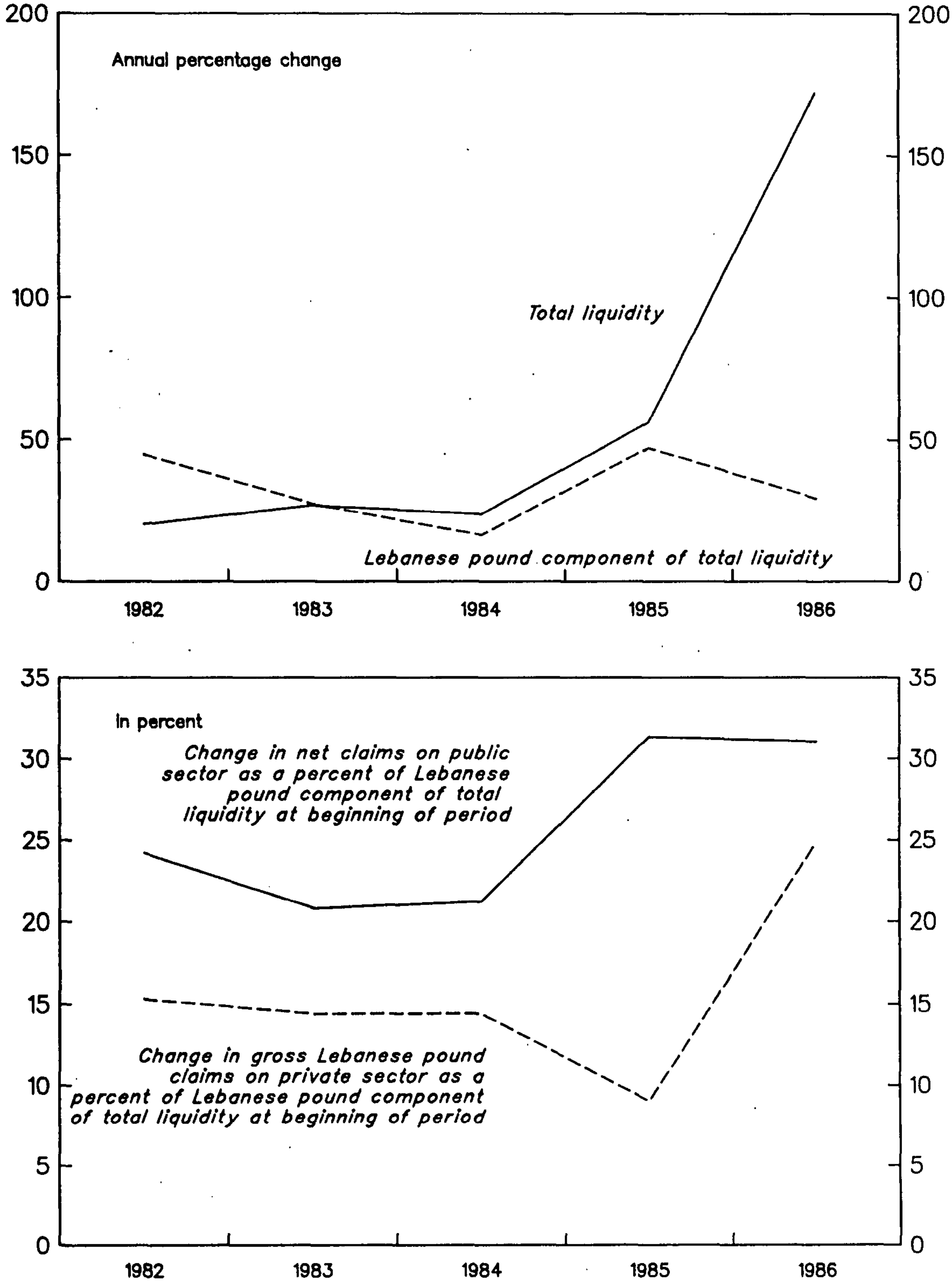
1/ Projections are without new measures, i.e., assuming that the recent proposals to link retail petroleum product prices to pound costs is not implemented in 1987.
2/ Complete data for 1981 are not available.
3/ Projections made prior to the 45-62 percent increase in petroleum products prices on June 20, 1987; only a modest further depreciation of the Lebanese pound is assumed.
4/ Excluding gold holdings which have been constant over the period at 9.2 million fine troy ounces.

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

The exchange rate for the pound has come under pressure since 1982 from the expansion of the Lebanese pound component of liquidity during a period of falling production and low pound interest rates; the decrease in foreign exchange receipts from workers' remittances; and waning confidence. On the other hand, some pressure has been relieved by the reduction in imports in response to lower real incomes and, in 1986, lower international oil prices. In 1983-84, despite strong exchange market support from the Bank of Lebanon, the pound depreciated by 23 percent in real effective terms (Chart 5). Since November 1984, the Bank has resumed pursuit of its traditional policy of infrequent and limited intervention, with the exception of February-March 1986 when exchange market intervention was timed to coincide with concerted efforts to reach a political settlement. From November 1984 to the end of 1986, the pound depreciated by over 60 percent in real effective terms. Since then the pound has depreciated from LL 7.8 per SDR to about LL 160 per SDR at the end of May 1987. The Bank's foreign exchange reserves stood at US$0.6 billion at the end of April 1987 1/ (equal to four months of imports in 1986), about US$0.1 billion lower than when extensive support for the pound ceased at the end of 1984.

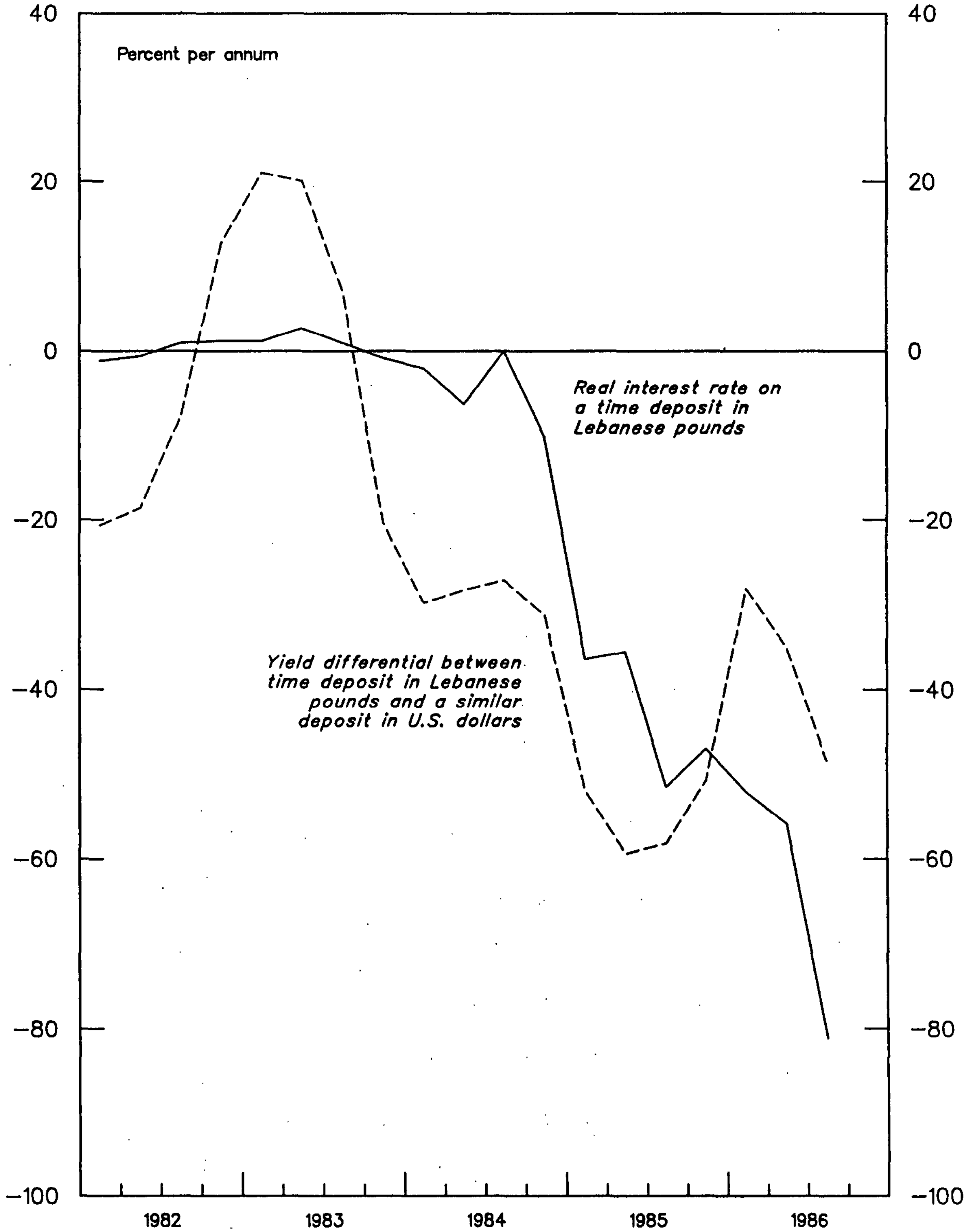
1/ Excluding gold holdings of 9.2 million fine ounces; gold holdings have been constant at this level since the beginning of the 1970s.

CHART 3
LEBANON
MONETARY AND CREDIT TRENDS



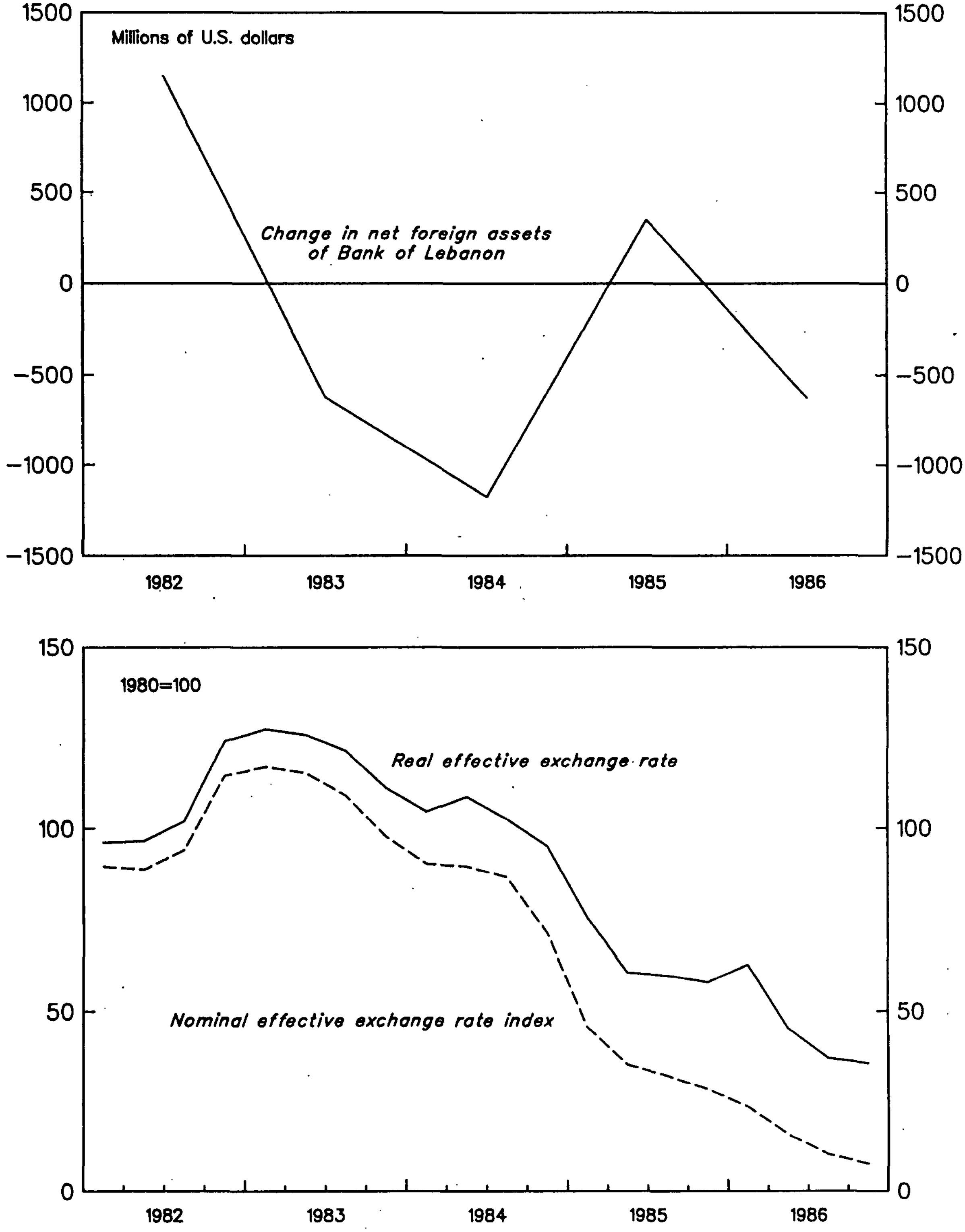
Source: Bank of Lebanon.

CHART 4
LEBANON
REAL RATE OF INTEREST



Source: Fund staff estimates.

CHART 5
LEBANON
CHANGES IN NET FOREIGN ASSETS AND
EXCHANGE RATE MOVEMENTS



Source: Fund staff estimates.

Lebanon's external nonmilitary public debt amounted to US$207 million at the end of 1986 (equal to 30 percent of commodity exports). Net borrowing (of US$27 million) was positive in 1986 for the first time in several years, mainly due to drawings by the Council for Development and Reconstruction (CDR) on earlier commitments to finance telecommunication projects. Debt service effected in 1986 declined to US$27 million (equal to 4 percent of commodity exports) from an annual average of US$62 million in 1982-85; US$14 million in payment delays of a technical nature which arose at the end of the year were resolved early in 1987.

III. Policy Discussions

A comprehensive set of economic policies cannot be implemented in the present security situation. Thus, the discussions focused on feasible fiscal and other measures to slow the economic deterioration until a political settlement could enable a broad package of more vigorous policies to be implemented, thereby bringing about a fundamental improvement.

1. Public finances

The mission emphasized its apprehension over the impact of the deterioration in public finances on the rates of inflation and depreciation of the pound, pointing to the adverse effects of two self-reinforcing "cycles" in government spending. First, given that government interest payments far exceeded revenues, the compounding of interest on the debt incurred to finance the fiscal deficit was automatically increasing the deficit further. Second, the domestic bank financing of the growing fiscal deficit, by expanding the pound component of domestic liquidity, was laying the basis for additional inflation and more depreciation of the pound. Inflation and depreciation, in turn, pushed up the costs of government domestic and foreign purchases, respectively, thereby increasing further the fiscal deficit. Effort aimed at improving public finances deserved the highest priority so as to slow the speed of the latter cycle.

The discussions centered on several possible areas where steps could be taken to slow the growth of the fiscal deficit. Of particular concern was the re-emergence of the extrabudgetary petroleum subsidy which could, by itself, double the fiscal deficit in 1987, even on the assumption of only moderate further depreciation of the pound. The Lebanese representatives, who shared the mission's concern about the rapid growth of the petroleum subsidy, reported that the Finance Ministry had recently proposed to the legislature to eliminate it by automatically linking retail prices to pound costs so as to avoid the need for highly politicized, discontinuous administrative price adjustments. Following the return of the mission to Washington, the staff was informed that on June 20, 1987 petroleum product prices had been raised by 45-62 percent. The representatives added that the wheat subsidy (budgeted in 1987 at the equivalent of 3 percent of the mission's projection of public sector spending) was politically untouchable.

As regards public investment, reconstruction needs were immense not just to replace damaged capital but also to update the capital stock which had depreciated since 1974. On the other hand, the level of public investment needed to be consistent with real resource availability, as there were also severe social costs from inflationary financing. The Lebanese representatives explained that, although the CDR's program for 1987 had not yet been approved by the Council of Ministers, it would be guided, inter alia, by the need for austerity and efficiency as well as a rapid return in the form of output and employment.

Recent salary increases for public employees have lagged well behind the rate of inflation. The public sector wage bill had also been restrained by a freeze since 1985 on filling most positions that became vacant from resignations and retirements. The exceptions were the judiciary, a few similarly essential positions, and the armed forces. The mission felt that, given the substantial decrease in civil servants' real incomes, little additional restraint in real terms could be exercised in this area or on public investment. Rather, expenditure restraint should focus on spending for activities that were not directly productive, especially spending abroad which was subject to cost-push from the depreciation of the pound. The Lebanese representatives reported that the Bank of Lebanon had endeavored to limit the growth of public agencies' spending by carefully scrutinizing requests for credit and payment so as not to give the agencies cartes blanches for spending.

On the revenue side, the Lebanese representatives stated that no new revenue measures had been taken since 1984, as the legislature had not approved a budget for any year since then.

The mission inquired whether the exchange rate for customs duty valuations (fixed at LL 6 = US$1 since early 1985) could not be raised to a more realistic level, as 80 percent of customs duties were presently generated by car imports, which could not be diverted to illegal ports because customs duties had to be paid on cars before owners could register them. While this change in valuation would encourage other imports to be shifted to illegal ports as well as reduce the number and value of cars imported, it would raise receipts from the remaining vehicle imports, not only by increasing their dutiable value, but also by raising the average duty rate since the duty rates for cars ranged from 20 percent to 90 percent according to the value of the automobile. Finally, it was noted that persons able to afford to buy a car were also more likely to be able to bear the burden of additional taxes. The Lebanese representatives were cautious about raising the exchange rate used for customs duty valuations as they felt that this might make importers firm supporters of the continued operation of the illegal ports.

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

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

2. Monetary and credit policies

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

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

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

3. <u>External sector policies</u>

The Lebanese representatives believed that psychological considerations and speculation were the main factors determining the exchange rate for the pound, which had depreciated more than was justified by economic realities (such as the size of the Bank of Lebanon's total reserves, equal to over US$4.5 billion when valuing gold at current market prices). Given the small volume of daily transactions in the exchange market, fluctuations in security conditions and speculative forays caused excessive depreciation, which was subsequently not reversed because of the general mood of pessimism. One avenue for speculation was the Euro-Lebanese pound market, which had evolved to avoid the reserve and treasury bill requirements on pound deposits with banks in Lebanon and to evade the prohibitions on speculative lending by banks.

The Lebanese authorities believed that the most effective means of reducing the rate of depreciation of the pound were by stabilizing market psychology, maintaining high reserve and treasury bill requirements on banks, preventing speculative lending by banks, and discouraging the growth of the Euro-Lebanese pound market. To curb this market, the Bank of Lebanon had prohibited banks in Lebanon from (i) accepting pound deposits from banks and other financial institutions located abroad and (ii) extending pound loans to foreign residents. The authorities remained committed to maintaining a free exchange system, with no intervention in the exchange market by the Bank of Lebanon, except briefly to dampen sharp fluctuations of a speculative nature. In fact, the Bank's objective was to take advantage of periods when the pound was appreciating to buy foreign currency to meet forthcoming foreign payments by the public sector and to build its own reserves. Although the authorities did not have a specific reserve objective, a high level of central bank reserves was regarded as having a calming influence on the exchange market.

The authorities believed that an effective way of reversing the pessimistic psychology was to create an autonomous fund from deposits by a few central banks of friendly countries. The psychological impact of the fund would stabilize exchange expectations without intervention. The fund would be fully invested in conventional foreign assets and would pay a competitive yield to the contributing central banks. To reassure contributors that the fund would not be dissipated by intervention, such action would be prohibited except by unanimous approval of all participating central banks.

The mission accepted that speculation and expectations reflecting the security situation were important factors in the depreciation of the pound. However, it emphasized that the depreciation was also the outcome of domestic bank financing of the massive fiscal deficit during a decade in which real output had fallen substantially. Exchange market intervention in 1983-84 and at the beginning of 1986 demonstrated that intervention could only briefly divert the exchange rate from the path determined by economic fundamentals and entrenched expectations. It was impossible for intervention to influence expectations shaped by the political and security situation. Thus, the mission welcomed the authorities' determination not to engage in exchange market intervention as well as the steps taken to discourage the Euro-Lebanese pound market. With regard to the autonomous fund, the mission felt that, to slow the depreciation of the pound, the plan would also need to include firm actions to restrain the growth of the fiscal deficit, especially permanently ending the petroleum subsidy, as well as a continuation of tight monetary and credit policies. It agreed that the fund should not be used for exchange market intervention.

The Lebanese representatives reported that, although Lebanon's outstanding nonmilitary external public debt and debt service were small, in March 1986 the Bank of Lebanon had decided that henceforth it would not extend guarantees on any newly contracted public loans (except trade credits for wheat and petroleum imports). Drawings by CDR since then were related to previously contracted commitments and thus would likely taper off.

The Lebanese representatives expressed their preference for full annual consultations given that the economic situation was so changeable and that a political settlement would have to be quickly followed by the formulation of a comprehensive financial and economic program.

The staff is continuing to look into the nature of a commercial agreement between Lebanon and Poland (which has existed since before the latter became a Fund member) as it is not known whether the agreement is subject to Article VIII.

IV. Staff Appraisal

Although there have been some increases in output and exports, economic prospects for 1987 are extremely worrisome. The petroleum subsidy constituted a heavy drain on government resources in the first half of 1987, while the dynamics of the interrelationships among the fiscal deficit, domestic interest payments, and monetary expansion could well accelerate the rates of inflation and depreciation of the pound. If no political solution is found, the economy could be caught in a cycle of ever increasing inflation, depreciation, and redistribution of income as well as further weakening of central administration.

The Lebanese authorities face a difficult task since the security situation narrows the range of policies which can be implemented and since frequently shifting expectations formed on the basis of transient political developments and the prevailing security situation play a disproportionate role in some aspects of private sector behavior. However, the authorities have made efforts in implementing economic and financial policies although more progress on the budgetary front is needed. Sound economic policies can slow economic deterioration until an improvement in security fosters settled expectations and enables more vigorous policies to be implemented.

The size of the fiscal deficit makes it imperative to determine both the level and the priorities of the public sector's current and capital spending with utmost care. As the resurgence of the petroleum subsidy is an overriding concern, the Finance Ministry's proposal to link petroleum product prices automatically to their pound costs, so as to eliminate the subsidy, needs to be enacted promptly. In this context, the recent increase in petroleum products prices, although not sufficient to eliminate the subsidy, is welcome. Equally urgent are efforts to curtail spending on activities that are not directly productive, particularly those in which foreign expenditures form a large component. The freeze on hiring new government employees, the wage adjustments during the past 12 months which were well below the rate of inflation, and the resolve to refrain from drawing on the exchange revaluation account also deserve full support. Although the scope for expanding revenue is relatively limited in the current situation, the authorities must utilize every opportunity to raise revenue (such as using the market exchange rate for customs valuation and increasing the land registration fee).

The prospect of the Government's borrowing from banks doubling in 1987 and the continued shift from pounds to foreign currency deposits foreshadow further erosion in the effectiveness of monetary policy. Nevertheless, efforts should continue to be made to slow the growth of credit to the private sector and to obtain as much of the financing of the fiscal deficit as possible from the commercial banks rather than the Bank of Lebanon. In this regard, the imposition of higher reserve and treasury bill requirements on commercial banks at the end of 1986 was a step in the right direction as it will help to slow the growth of reserve money. However, the anticipated reduction in the growth of pound credit to the private sector resulting from these measures should be made more certain by placing a ceiling on such credit. High priority should also be assigned to enforcing bank compliance with banking regulations so as to ensure their effectiveness.

With the more rapid depreciation of the pound and the acceleration of inflation, the level of pound interest rates has become less effective in encouraging the private sector to hold pounds. However, raising interest rates even by substantial margins, at present, would not overcome the weakening confidence resulting from the security situation. Moreover, higher interest rates would accentuate the dynamic cycle linking government interest payments and the fiscal deficit. Thus, the Bank of Lebanon should continue to pursue a flexible approach to the determination of interest rates, probing the responsiveness of banks and the general public so as to slow the growth of reserve money and to encourage holding of the pound.

In view of the importance of the soundness of the banking system to maintaining confidence, the discussions between the Bank of Lebanon and commercial banks to establish capital adequacy standards are welcome.

Banks should continue to retain profits and take other steps to strengthen their capital positions and to follow prudent banking practices.

Concerning the marked depreciation of the Lebanese pound, the staff believes that financial imbalances have been a major factor. The other essential ingredient has been the role of volatile expectations mainly determined by changeable political and security conditions. The experiences in the last few years have shown that, in this milieu, exchange market intervention can only have very limited impact. Thus, the staff welcomes the Bank of Lebanon's determination not to intervene in the exchange market to support the pound, as well as the authorities' resolve to maintain the present free exchange system.

Finally, as the utmost caution should be exercised regarding foreign borrowing, the Bank of Lebanon's decision to stop external public borrowing by not guaranteeing any public external debts contracted after March 1986 (except financing for wheat and petroleum imports) was appropriate.

It is recommended that the Article IV consultation discussions be maintained on a full 12-month cycle as requested by the Lebanese authorities.

Lebanon: Fund Relations
(As of May 31, 1987)

(In millions of SDRs, unless otherwise indicated)

I. Membership Status:

(a)	Date of membership:	April 14, 1947
(b)	Status:	Article XIV

A. Financial Relations

II. General Department (General Resources Account):

(a)	Quota:	78.7
(b)	Fund holdings of Lebanese pounds:	59.87 (76.07 percent of quota)
(c)	Fund credit:	--
(d)	Reserve tranche position:	18.83
(e)	Current operational budget:	--
(f)	Lending to the Fund:	--

III. Current Stand-by or Extended Arrangement and Special Facilites:

(a)	Current stand-by or extended arrangement:	--
(b)	Previous stand-by or extended arrangement:	--
(c)	Special facilities:	--

IV. SDR Department:

(a)	Net cumulative allocation:	4.4
(b)	Holdings:	3.0 (68.1 percent of net cumulative allocation)
(c)	Current Designation Plan:	--

V. Administered Accounts:

(a) Trust Fund loans: --

(b) SFF Subsidy Account: --

VI. Overdue Obligations to the Fund:

(a) General Department: --

(b) SDR Department: --

(c) Trust Fund: --

VII. Country has not used Fund resources to date.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangement:

The Lebanese pound has been freely floating since 1952. The Bank of Lebanon intervened persistently in the exchange market during 1983-84, spending US$2 billion in reserves. Since then, the Bank's interventions have been less frequent and more aimed at moderating short-term fluctuations.

IX. Last Article IV Consultation:

Discussions were held by the staff during the period January 20-24, 1986. The Staff Report (SM/86/68) was discussed by the Executive Board on April 25, 1986; it was agreed that the next consultation would be held on the standard 12-month cycle.

The Executive Board's decision adopted April 25, 1986, was as follows:

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Lebanon in the light of the 1986 Article IV consultation with Lebanon conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Lebanon maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

X. Technical Assistance:

CBD has recently reviewed the adequacy of solvency ratio regulations. CBD and LEG have reviewed the adequacy of banking legislation.

XI. Resident Representative/Advisor: None

Lebanon: Summary of World Bank Operations

1. Previous World Bank lending to Lebanon has included four operations, one each in the tourism, highways, and education sectors, and one for reconstruction of telecommunications, water supply, and port systems (US$50.0 million). The tenuous security situation in the country had periodically delayed implementation of the latter three operations: nevertheless, substantial progress on these projects had been made, and all were essentially completed to the extent that circumstances permitted. These loans have now all closed, following several extensions.

2. Further Bank efforts in Lebanon are inhibited because the security situation precludes the possibility of continuous Bank supervision and appraisal activities. When security permits, the Bank would expect to participate fully in further reconstruction activities, initially probably with the processing of several small projects.

Lebanon: Basic Data

Part 1. Lebanon: Social and Demographic Indicators

Area	Population (1983)	Density (1983)
10.4 thousand sq km	2.6 million Rate of growth (percent): 1.2	250 per sq km 722 per sq km of arable land

Population Characteristics (1983)

Life expectancy at birth	
Male	63 years
Female	67 years
Infant mortality (aged under 1, percent)	5
Child death rate (aged 1-4, percent)	1

Income Distribution (1970)

Percent of national income	
highest quintile	55.0
lowest quintile	4.0

Access to Safe Water (1980)

Percent of population - urban	97.0
- rural	90.0

Nutrition (1982)

Calorie intake as percent of requirements	121.0
Per capita protein intake (grams per day)	76.2

Health (1980)

Population per physician	540
Population per hospital bed	175

Access to Electricity (1980)

Percent of dwellings - urban	99.0
- rural	82.0

Education (1982)

Adult literacy rate (percent)	75.0
Primary school enrollment (percent)	118.0

Sources: World Bank, World Development Report, 1986; World Bank, Lebanon: Reconstruction Assessment Report, Report No. 4434-LE, March 25, 1983; and Fund staff estimates.

Lebanon - Basic Data (Concluded)

Part 2. Economic Series

	1982	1983	1984	1985	1986	Proj. 1/ 1987
Public finances (LL billions)						
Revenues	2.7	4.4	2.5	3.5	5.2	9.6
Expenditures, 2/ of which	9.3	12.5	13.5	23.6	32.8	73.9
Petroleum subsidy	(0.8)	(0.8)	(1.0)	(5.8)	(5.1)	(30.0)
Interest	(1.4)	(1.9)	(2.4)	(5.9)	(10.8)	(20.3)
Overall deficit	6.6	8.1	11.0	20.0	27.6	64.3
Borrowing from the banking system	6.2	7.7	10.0	17.2	26.0	64.7
Monetary developments (annual change in LL billions)						
Domestic liquidity, of which	8.2	13.1	14.7	42.8	204.9	...
Foreign currency deposits	(-3.3)	(2.9)	(6.9)	(16.9)	(181.2)	(...)
Net foreign assets, due to balance of payments	2.0	-3.2	-6.7	4.1	1.2	...
Domestic claims	10.7	14.6	18.4	25.1	88.8	...
Net claims on public sector	(6.2)	(6.7)	(9.2)	(14.3)	(15.6)	(...)
Claims on private sector	(4.6)	(7.9)	(9.1)	(10.9)	(73.3)	(...)
Other items (net), including valuation effects of change in exchange rate	-4.6	1.7	3.0	13.6	115.7	...
Interest rates (end of year, in percent per annum)						
Three-month treasury bills 3/	10.0	9.8	15.5	16.0	18.0	...
Average on savings and time deposits	11.7	10.1	13.0	13.4	18.0 4/	...
Average on newly granted bank loans	16.8	14.0	17.1	17.7	23.7 4/	...
Reserves (end of period, US$ millions)						
Gross official reserves 5/	2,608	1,903	672	1,074	488	...
(in months of imports)	(9)	(6)	(3)	(6)	(3)	(...)
External debt (US$ millions)						
Medium- and long-term (end of period)	271	243	182	180	207	...
Debt service	71	68	63	45	27	46
Exchange rate						
Lebanese pounds per SDR (end of period)	4.2	5.7	8.7	19.9	106.4	...

1/ Projections are in the absence of new measures, i.e., they assme that the recent proposal to link retail petroleum product prices to pound costs is not implemented in 1987. Projections were made prior to the 45-62 percent increase in the prices of petroleum products in June 1987; only a modest depreciation of the Lebanese pound in the second part of 1987 is assumed.

2/ Including net extrabudgetary spending.

3/ Discount rate on newly issued bills.

4/ At September 30, 1986.

5/ Excluding gold.

Lebanon--Statistical Issues

1. Outstanding Statistical Issues

a. General economic data

The available price data are unofficial indices prepared by the confederation of labor unions and the employers' association and are not published in IFS. Trade and national accounts data are not compiled by the authorities at present.

b. Government finance

No reply to the GFS questionnaire has ever been received and no data are published in the GFS Yearbook and IFS. However, fiscal data are available even though finalized accounts currently have a seven-year lag. The Bureau of Statistics will explore the possibility of publishing on a preliminary basis data provided by Lebanon for inclusion in Recent Economic Developments.

c. Monetary accounts

Lebanon reports monetary data by cable and relatively regularly. These series, however, have been reported in the form of main aggregates only. The Bank of Lebanon has shown interest in improving the production of detailed data for money and banking and is in the process of introducing a more detailed balance sheet for the commercial banks. However, it is also important for the authorities to review the balance sheet of the Central Bank.

d. Balance of payments

Lebanon does not compile balance of payments data.

e. International banking statistics

Lebanon is a participant in the Fund's International Banking Statistics Project. In January 1985, the authorities sent the mid-1984 data. Since then, no data have been received.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Lebanon in the June 1987 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Lebanon, which during the past year have been provided on an infrequent basis.

Status of IFS Data

		Latest Data in June 1987 IFS
Real Sector	- National Accounts	n.a.
	- Prices	n.a.
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	December 1986
	- Deposit Money Banks	October 1986
	- Other Financial Institutions	n.a.
Interest Rates	- Discount Rate	Q3 1985
	- Bank Lending/Deposit Rate	n.a.
	- Treasury Bill Rate	Q3 1985 1/
External Sector	- Merchandise Trade: Values	Q4 1986 2/
	Prices	n.a.
	- Balance of Payments	n.a.
	- International Reserves	April 1987
	- Exchange Rates	April 1987

1/ Incomplete series.
2/ Data are derived from previous information in the DOT data base.