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January 30, 1991

To: Members of the Executive Board
From: The Secretary
Subject: Lebanon - Staff Report for the 1990 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1990 Article IV consultation with Lebanon, which is proposed to be brought to the agenda for discussion on Wednesday, February 27, 1991.

Mr. Knöbl (ext. 8821) 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 1990 Article IV Consultation

Prepared by the Staff Representatives
for the 1990 Consultation with Lebanon

Approved by A. Shakour Shaalan and M. Edo

January 29, 1991

I. Introduction

The 1990 Article IV consultation discussions with Lebanon were held in Paris during December 10-12, 1990. The Lebanese representatives included three deputy governors of the Bank of Lebanon, the Director General of the Finance Ministry, and the Chairman of the Banking Control Commission, as well as senior officials from these institutions and representatives of the private sector. 1/

The last Article IV consultation was concluded by the Executive Board on November 2, 1988. Interim Article IV consultations were held during November 27-30, 1989. A summary of relations with the Fund is provided in Appendix 1. 2/ Lebanon continues to avail itself of the transitional arrangements of Article XIV. The World Bank Group has recently been inactive in Lebanon.

II. Background

A civil conflict has been raging in Lebanon for 15 years. In addition to the human losses, the economy has suffered as a result of the destruction of physical assets, outflows of labor and capital, and financial instability. 3/ Nevertheless, sectors such as agriculture and industry have proved resilient, and free market pricing of almost all goods and services has allowed entrepreneurs to respond flexibly to

1/ The mission was composed of Messrs. A.S. Shaalan (Head), A. Knöbl, M. Zavadjil, and A. MacArthur (all MED). Mr. M. Finaish, Executive Director for Lebanon and/or Mr. M. Chatah, Advisor to the Executive Director, also attended the policy meetings.

2/ Basic data on economic, social, and demographic indicators are shown in Table 1. Tables 2-4 include data on fiscal operations, domestic currency liquidity growth, and the balance of payments. Statistical issues are outlined in Appendix II.

3/ Analysis of macroeconomic developments is complicated by the poor quality and limited availability of national income and employment data, and by the lack of detail in the balance of payments statistics.

changing business conditions. Thus, improved external competitiveness and security resulted in rapid expansion of both output and exports in 1987-88. However, renewed intense fighting in 1989 caused an estimated 15 percent drop in economic activity.

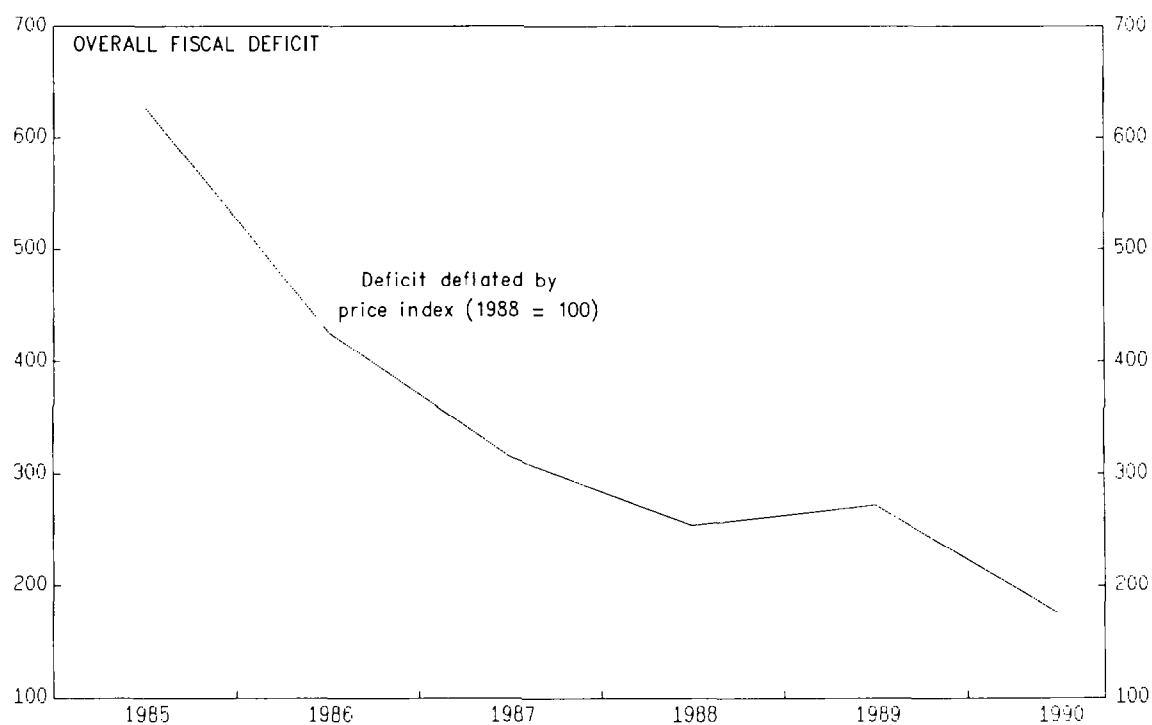
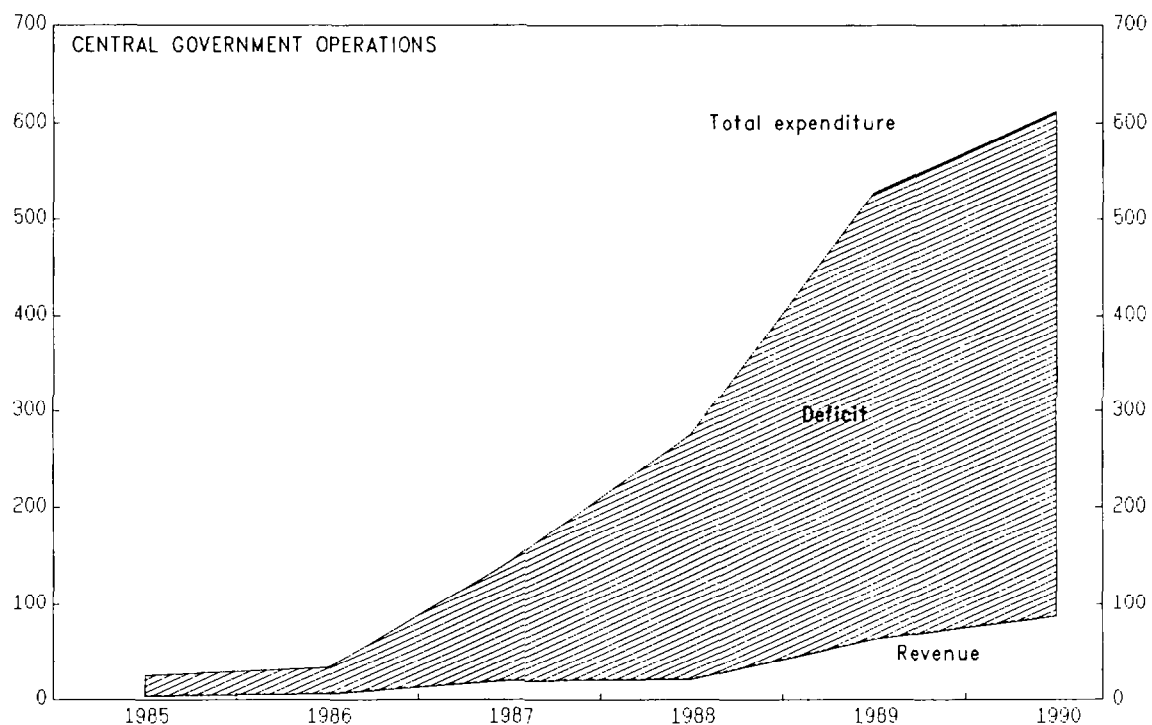
The lack of central government authority has seriously undermined public sector finances, the banking sector, and confidence in the Lebanese pound. The Central Government collected only minimal revenues (2 percent of estimated GNP in recent years), while attempting to provide basic public services and subsidies for energy, flour, and some public utilities (Chart 1). Thus, the public sector deficit exceeded 17 percent of GNP during 1988-89, despite substantial drops in outlays in real terms, and was financed largely through bank borrowing. In the absence of adjustments to official interest rates (18 percent per annum on three-month treasury bills (TBs)) since 1986, the Bank of Lebanon attempted to limit the growth of the Lebanese pound component of money (M2LL) through increases in the requirements of commercial banks to hold TBs. ^{1/} Nevertheless, M2LL expanded at an average of 90 percent per annum in 1986-89; given the large share of foreign currency in broad money (M2), this aggregate has largely reflected exchange rate movements.

The condition of the Lebanese banking system has deteriorated as a result of the war-related weakness of many borrowers, the lack of bank supervision, lax lending standards, and in some cases management fraud. The capital/assets ratio has fallen to below 1 percent (compared with the statutory requirement of 3 percent) in large part reflecting the rapid increase in banks' foreign currency assets in Lebanese pound terms due to the depreciation of the pound; capital is largely denominated in pounds. Although the banking system as a whole was liquid, in early 1989 the Bank of Lebanon started to provide assistance to some banks that were experiencing unmanageable deposit outflows.

The expansion of M2LL and the general lack of confidence engendered by the security situation have been the underlying sources of pressure on the exchange rate, which has depreciated from an average of LL 16 per U.S. dollar in 1985 to about LL 500 in 1989. During this period there have been sharp swings that have largely reflected changing expectations with regard to the security situation and the prospects of peace. As a result of the openness of the economy, consumer price movements have largely reflected (with a lag) exchange rate changes. After reaching 487 percent per annum in 1987, consumer price inflation decreased to 70 percent in 1989 (Charts 2 and 3).

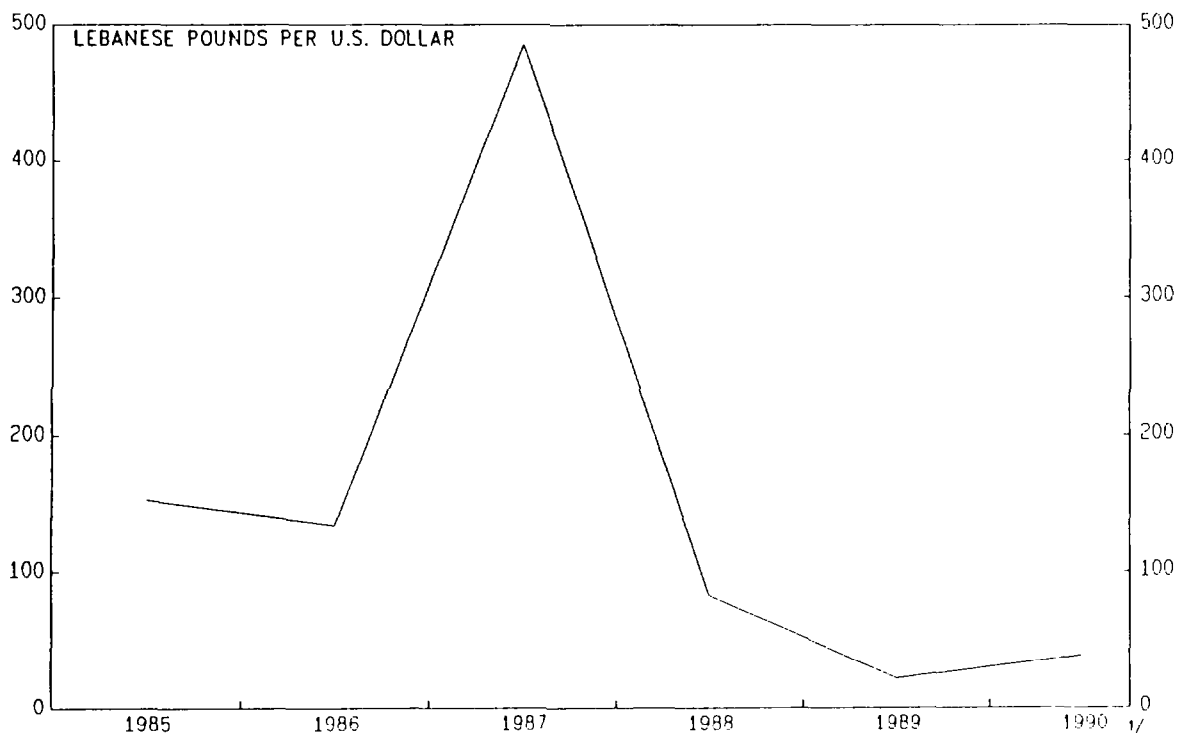
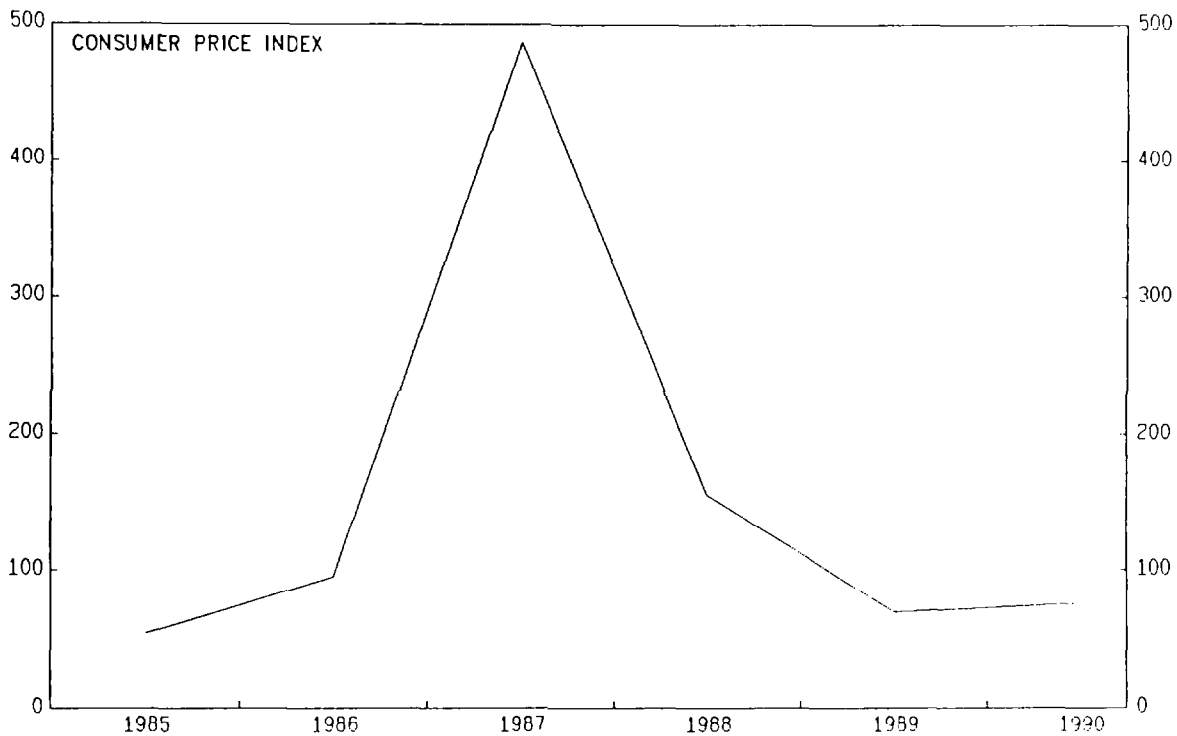
^{1/} Banks are currently obliged to hold about 60 percent of their Lebanese pound deposits in TBs, in addition to a 13 percent reserve requirement.

CHART 1
LEBANON
FISCAL TRENDS, 1985-90
(In billions of Lebanese pounds)



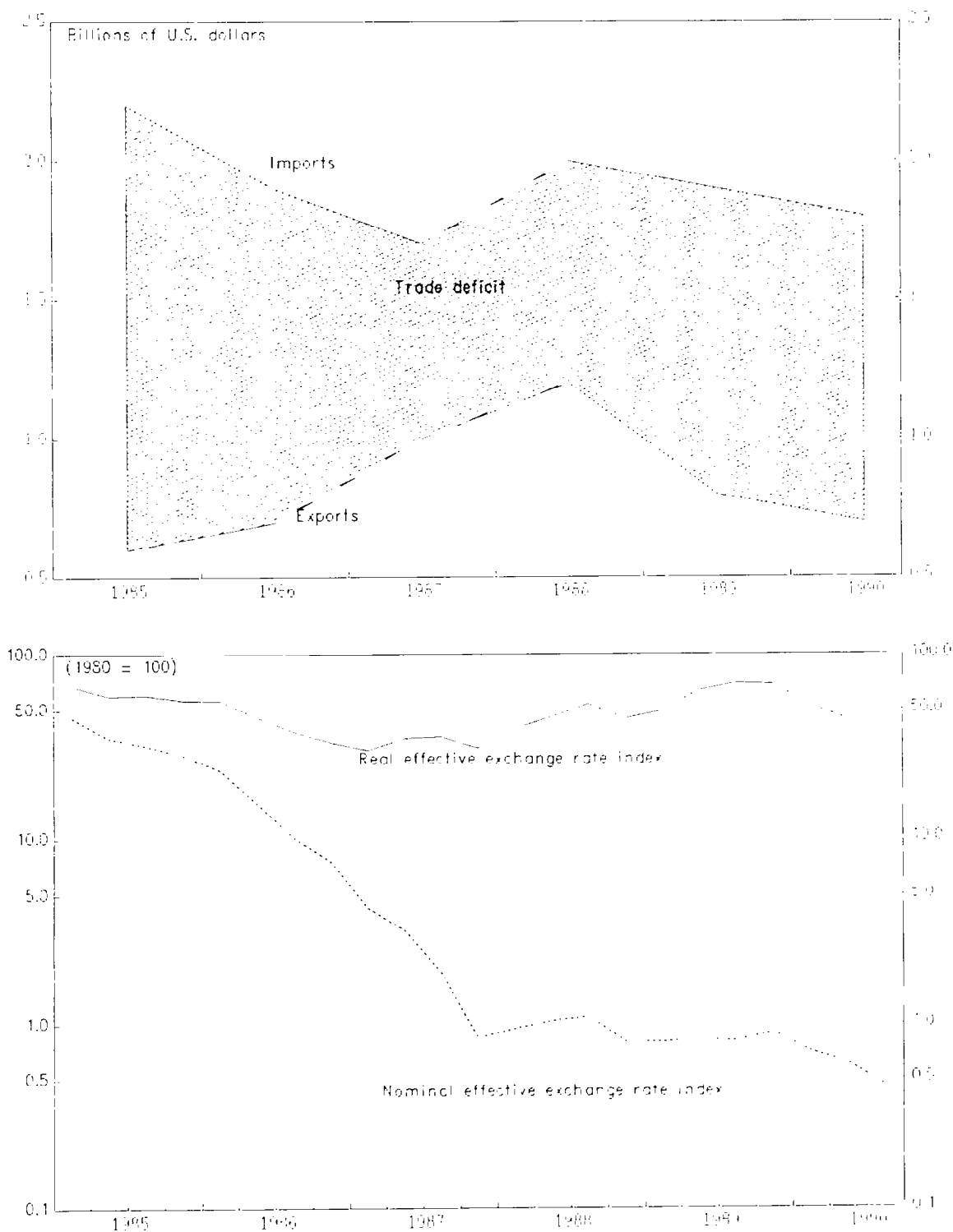
Source: Ministry of Finance.

CHART 2
LEBANON
INFLATION AND DEPRECIATION OF THE LEBANESE POUND, 1985-90
(Percentage change)



Sources: IMF, International Financial Statistics, and Consultation and Research Institute, Beirut.
1/ Eleven months.

CHART 3
LEBANON
EXPORTS, IMPORTS, AND EXCHANGE RATE MOVEMENTS, 1985-90



Sources: Bank of Lebanon, and Fund staff estimates.

Table 1. Lebanon: Selected Economic, Social and Demographic Indicators, 1985-90

I. Social and Demographic Indicators

<u>Area</u>	<u>Population (1988)</u>	<u>Density (1988)</u>	
10.4 thousand sq km	3.1 million	270 per sq km	
	Rate of growth	910 per sq km	
	(percent): 0.4	of arable land	
<u>Population characteristics (most recent) 1/</u>		<u>Health (most recent) 1/</u>	
Life expectancy at birth	65 years	Population per physician	500
Infant mortality (aged under 1 year, percent)	4.3	Population per hospital bed	200
Child death rate (aged 1-4 years, percent)	0.2	<u>Nutrition (most recent) 1/</u>	
<u>Income distribution (most recent) 1/</u>		Per capita calorie intake (per day)	3,046
Percent of private income received by:		Per capita protein intake (grams per day)	80
Highest quintile	55	<u>Access to electricity (most recent) 1/</u>	
Lowest quintile	4	Percent of dwellings	98
<u>Access to safe water (most recent) 1/</u>			
Percent of population - urban	98		
- rural	77		

II. Economic Indicators, 1985-90

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
	<u>(Percentage changes)</u>					
Inflation						
Consumer price index	54	95	487	155	70	75
Fiscal operations						
Receipts	75	42	229	6	198	37
Expenditures	91	34	318	92	91	16
	<u>(Ratios as a percent)</u>					
Overall deficit as percentage of expenditures	78	97	71	88	88	86
Domestic bank financing as a percentage of Lebanese pound component of money and quasi-money at beginning of period	31	40	95	110	73	54

Table 1. Lebanon: Selected Economic, Social and Demographic Indicators, 1985-90 (concluded)

	1985	1986	1987	1988	1989	1990
	(Percentage changes)					
Monetary developments						
Money and quasi-money (M2)	56	172	354	48	13	53 <u>2/</u>
Lebanese pound component of M2 (M2LL)	47	29	48	252	72	18 <u>2/</u>
U.S. dollar value of residents' foreign currency deposits with Lebanese banks	-12	20	15	6	-2	-5 <u>2/</u>
Net pound claims on public sector	49	36	29	183	179	52 <u>2/</u>
Credit to private sector	25	136	317	39	19	101 <u>2/</u>
Lebanese pound component of credit to private sector	14	52	33	32	67	43 <u>2/</u>
External sector						
Exchange rate (annual averages) (appreciation +)						
Nominal effective exchange rate	-58	-60	-82	-62	-14	-30 <u>3/</u>
Real effective exchange rate	-39	-29	-24	39	37	5 <u>3/</u>
	(In billions of U.S. dollars)					
Balance of payments						
Exports	0.6	0.7	1.0	1.2	0.8	0.7
Imports	-2.2	-1.9	-1.7	-2.0	-1.9	-1.8
Other items, net	2.0	0.9	0.7	1.4	0.8	0.7
Overall balance <u>4/</u>	0.4	-0.6	-0.2	0.6	--	-0.2
Central bank reserves						
Foreign exchange reserves (end of period) <u>5/</u>	1.1	0.5	0.4	1.0	0.9	0.7 <u>6/</u>

Sources: IMF, International Financial Statistics for 1988 population. World Bank and International Finance Corporation, Social Indicators of Development 1987 and 1988, for other social and demographic indicators. Ministry of Finance, Bank of Lebanon, Beirut Chamber of Commerce and Industry, and Fund staff estimates.

1/ Except for population (1988), refers to various years before 1975.

2/ Change in first nine months.

3/ Percent change in average for first ten months of 1990 over the same period in the previous year.

4/ Excluding valuation changes to Bank of Lebanon's net foreign assets.

5/ Excluding gold holdings which have been constant over the period at 9.2 million fine troy ounces.

6/ End-November 1990.

In concluding the 1988 Article IV consultation with Lebanon, Executive Directors noted that the economic situation remained grave and that the rapid growth of domestic currency liquidity could further intensify exchange market pressures and consequently inflation. They called for continued efforts to reduce the fiscal deficit and to slow the growth of domestic currency liquidity, as well as for the maintenance of attractive yields on pound assets. Directors welcomed the Bank of Lebanon's determination to avoid large-scale sustained intervention in the foreign exchange market in support of the pound.

III. The Policy Discussions

The policy discussions took place in the context of an improving outlook for a political settlement to the conflict in Lebanon as a result of parliamentary approval for constitutional changes in August 1990 the fall of an alternative government in East Beirut in October, and the consequent withdrawal of the militias from the Greater Beirut area. Reflecting this optimism, the Lebanese pound appreciated during October-November and economic activity showed signs of reviving, although the recovery was tempered by difficulties in forming a Government in December. ^{1/} However, this improvement followed a sharp decline in output in the first half of 1990 when most financial and industrial activity in Beirut was severely affected by intense fighting. A 10 percent decrease in output is estimated for 1990 following an estimated 15 percent fall in 1989, with inflation averaging 75 percent for the year as a whole. The Middle East crisis exacerbated the difficult economic situation through the loss of export markets and remittances, and added to pressure on the pound which fell to record lows in September 1990.

The discussions focused on the challenges the Lebanese authorities would face in managing the transition to a peace economy. As viewed by the staff, the fiscal imbalance would need to be reduced substantially at a time when there would be increased demands for reconstruction and public services expenditures. In addition, immediate measures were required to restore confidence in the weakened banking sector which traditionally has played a key role in the Lebanese economy. The appropriate stance of monetary and exchange rate policies was also discussed.

^{1/} Since the conclusion of the discussions, the recently formed government has been facing political difficulties, and coupled with the outbreak of war in the Middle East, a mood of gloom has again set in. As a result, the pound has depreciated by almost 30 percent since mid-December.

1. Fiscal policy

There was an improvement in the fiscal position in 1990 largely due to a nonrecurrent fall in real outlays. The overall deficit was estimated to have fallen to 14 percent of GNP (from 20 percent in 1989) and bank financing to 54 percent of M2LL (down from 73 percent) (Table 2). The modest growth of the overall deficit in absolute terms reflected the containment of expenditure growth to only 16 percent. Revenues were estimated to have risen by 37 percent due to increased transfers of profits by the Bank of Lebanon, but from a very low base.

The mission noted that some of the factors that had contributed to the containment of expenditures in 1990 were temporary in nature and would burden the fiscal position in 1991. In particular, domestic interest payments fell due to a shift in government borrowing from TBs to an overdraft account with the Bank of Lebanon (with an interest rate of only 1 percent), and an extension in the maturity of TBs which pushed interest payments forward into 1991. This reduced interest payments from 8 percent of estimated GNP in 1989 to 2 percent in 1990.

The discussions of fiscal prospects for 1991 were based on the assumption that there would be some improvement in the security situation, though a high degree of uncertainty remained. For this reason, the Lebanese representatives considered, and the mission agreed, that a quantification of these prospects would not be useful at this stage. Nevertheless, the mission stressed that even with a large rise in revenues from their very low base, pressures for additional expenditures in the event of peace pointed to a substantial deterioration in the fiscal position unless strong measures were taken.

Revenues would depend crucially on the collection capacity of the Central Government. Customs duties had the greatest potential if collection could be improved through government control of all ports (currently a large portion of imports enters through ports controlled by the militias). The Lebanese representatives said their objective was eventually to use the market exchange rate for levying customs duties (currently the customs rate is LL 6 per U.S. dollar), but in the next six months the customs rate could only be raised to LL 100-150 per U.S. dollar so the impact on revenues could be assessed before further increases were undertaken. The mission considered that the best prospects for revenue diversification at this stage were through increases in some indirect taxes and fees and charges that could be easily collected; even before the conflict, direct taxes had been a limited source of revenue due to collection difficulties. Since the return of the mission, the Lebanese authorities have requested Fund fiscal technical assistance to help them develop a strategy for improving revenue generation and collection. The staff is currently looking into how best to provide such assistance.

Table 2. Lebanon: Summary of Fiscal Operations, 1985-90
(In billions of Lebanese pounds unless otherwise indicated)

	Estimated Actuals					
	1985	1986	1987	1988	1989	1990
Receipts ^{1/}	4.3	6.1	20.1	21.4	63.8	87.4
Of which: Bank of Lebanon profits	1.0	2.5	11.1	3.9	28.5	48.4
Total expenditures	25.6	34.3	143.5	275.8	527.7	612.4
Of which: Salaries and wages	4.4	6.7	20.6	61.6	96.9	215.0
Chapter II (capital expenditures)	2.1	1.4	5.1	18.5	32.7	34.5
Domestic interest	5.8	10.7	23.5	78.8	151.5	56.4 ^{2/} ^{3/}
Petroleum subsidy	5.8	5.1	46.8	39.6	99.3	12.0
Extrabudgetary advances ^{4/}	2.1	3.8	36.5	48.3	61.1	156.0
Overall deficit (from banking and financial statistics)	20.0	33.4	101.8	241.6	464.1	525.0
Foreign financing (net)	-0.2	--	...	-2.1	-2.0	-10.0 ^{3/}
Domestic financing (net)	20.2	33.4	101.8	243.7	466.1	535.0
Treasury bill sales to nonbanks	3.1	1.1	3.0	73.5	66.5	25.0
Banking system	17.1	32.3	98.8	170.2	399.6	510.0
Bank of Lebanon ^{5/}	(0.5)	(27.0)	(86.4)	(-101.1)	(120.4)	(...)
Commercial banks ^{6/}	(16.6)	(5.3)	(12.4)	(271.3)	(279.2)	(...)
Memorandum items:						
Growth (percent per annum) of:						
Receipts	75	42	229	6	198	37
Total expenditures	91	34	318	92	91	16
Public sector deficit as a percent of total expenditures	78	97	71	88	88	86
Domestic bank financing as percentage of Lebanese pound component of money and quasi-money (beginning of period)	31	40	95	110	73	54

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

^{1/} Excluding drawings by the Government on the Bank of Lebanon's foreign exchange revaluation account, which is treated as financing by the Bank.

^{2/} Due to refinancing of TBs of three-month maturity with TBs of one-year maturity, and the recording of interest payments as they come due, interest payments fell in 1990, but will rise in 1991.

^{3/} External debt service payments of LL 19 billion previously unrecorded have been split evenly between interest and amortization payments.

^{4/} Mainly payments to municipalities and other public sector entities arising from subsidies such as that for bread.

^{5/} Data have been adjusted to exclude valuation changes resulting from the effect of the depreciation of the Lebanese pound on public sector foreign currency deposits.

^{6/} Including Societe Financiere du Liban.

Some of the areas in which pressures for substantial additional expenditures could arise were highlighted by the mission. First, increased outlays to repair infrastructure and lay the basis for economic recovery were badly needed. Second, the need for expanded provision of public services could require an increase in government employment. At the same time, low government wages brought into question whether employees could be recruited, or even retained, unless substantial raises were granted (particularly if expansion of private sector activity was reflected in large pay rises). Third, the rise in domestic interest payments in 1991 could have a potentially devastating impact on the budget, particularly if a large part of the fiscal deficit was to be financed through TBs (a requirement for a more active monetary policy). If the overdraft with the Bank of Lebanon was repaid, and all new financing was through TBs, interest outlays could reach LL 375 billion (equivalent to 10 percent of estimated GNP in 1990).

The Lebanese representatives were aware of the growing expenditure pressures, but felt that spending in most categories could be contained. Specifically, an improvement in security and greater confidence in the Lebanese pound would allow a reduction in interest rates and would lessen pressures for wage increases. Also, the petroleum subsidy had already been reduced from LL 100 billion in 1989 (5 percent of estimated GNP) to LL 12 billion, as all products (except fuel oil for the public electricity company) were now imported by the private sector and freely priced. In addition, if security was restored, and the electricity company began collecting charges, the subsidy for electricity could be reduced sharply given the recent tenfold increase in tariffs. The Lebanese representatives also believed that the bread subsidy (estimated at LL 70 billion in 1990) could be removed as it was not benefiting the consumer but various intermediaries. They noted that unless there was a further large depreciation of the Lebanese pound, removal of the subsidy would not be a heavy burden on the consumer, although it would still require a difficult political decision. Noting that only 15 percent of the paid government workforce was currently able to report to work, the representatives said that enhanced public services could be provided through better utilizing existing employees rather than new employment.

The Lebanese authorities were in the process of introducing tighter budgetary procedures. After a number of years without a budget (when spending had been on the basis of the previous year's budget with considerable extrabudgetary spending), committees were preparing the budget for 1991. Clear guidelines had been established with regard to which officials could approve spending above certain limits. Thus, the Lebanese representatives expected that extrabudgetary expenditure would be curtailed in 1991, although some of the outlays now classified as extrabudgetary would enter the budget. Finally, the representatives hoped that the overwhelming portion of capital expenditures could be financed from foreign sources, particularly grants.

The mission considered that the overall deficit would rise substantially in 1991, as the recovery of revenues was likely to take time. In addition, it was difficult to assume that the entire reconstruction effort could be financed through foreign sources as some international institutions required significant domestic cofinancing. Moreover, foreign financed domestic expenditures could also put pressure on domestic resources. The mission added that while increased confidence in the Lebanese pound would lead to increased demand for pounds by the public, and thus temporarily alleviate the inflationary impact of the fiscal deficit, continued liquidity injection would lead to renewed depreciation of the pound and accelerating inflation.

2. Monetary policy and the condition of the banking system

The growth of M2LL slowed to 18 percent during the first nine months of 1990 (Table 3). This was due to less rapid growth of credit to the Government, reflecting the apparent improvement in the fiscal position noted above, and substantial official exchange market intervention in support of the pound which resulted in a reduction in the net foreign assets of the Bank of Lebanon equivalent to 29 percent of the opening money stock. Official interest rates remained unchanged. Indeed, the earlier policy of increasing the share of the fiscal deficit financed by the commercial banks and the nonbank public through TBs was reversed in 1990. The Lebanese representatives noted that, as the interest costs of borrowing exceeded revenues, greater interest payments linked to TBs were financed through advances from the Bank of Lebanon, thus tending to defeat the purpose of issuing securities outside the Bank of Lebanon.

The mission accepted the authorities' position on interest rate policy under current circumstances, but stressed that a more active policy was imperative once the security and fiscal situations improved. A smaller fiscal deficit would allow less inflationary finance through the Bank of Lebanon, and greater reliance on market-related borrowing. Interest rate management by the Bank of Lebanon could be used to control domestic liquidity, reverse dollarization, and contribute to the stabilization of the exchange rate. Lower exchange rate volatility would also provide a basis for developing medium- and long-term capital markets.

The lower growth of M2LL in 1990 did not result in a weakening of inflationary pressures, as the willingness to hold Lebanese pounds was undermined by the difficult security situation and by the uncertainties facing the banking system as a whole. In addition to the reluctance to hold Lebanese pounds, there was movement of foreign currency assets out of Lebanon. Thus, foreign currency deposits in the domestic banking system fell by 5 percent in U.S. dollar terms in the first three quarters of 1990, contributing to a substantial rundown of commercial banks' foreign assets.

Table 3. Lebanon: Factors Affecting Lebanese Pound Component of Domestic Liquidity, 1985-90

(In percent of Lebanese pound component of liquidity at beginning of period)

	1985	1986	1987	1988	1989	Jan.-Sept. 1990
Lebanese pound component of liquidity (M2LL)	<u>47.2</u>	<u>29.2</u>	<u>48.4</u>	<u>252.3</u>	<u>71.8</u>	<u>17.5</u>
Bank of Lebanon net foreign assets due to balance of payments	10.6	-30.2	-33.1	165.4	-3.9	-28.8
Lebanese pound claims on public sector (net)	31.3	32.1	85.6	81.4	71.2	36.7
Lebanese pound claims on private sector	8.7	24.9	18.4	16.2	12.7	7.9
Other items (net)	-3.5	2.5	-22.6	-10.7	-8.1	1.7
Memorandum item: Total liquidity (M2)	56.1	172.0	354.2	47.8	13.1	53.1

Sources: Bank of Lebanon; and staff estimates.

The decline in confidence in Lebanese banks in 1990 was due to the closure of several small- and medium-sized banks and fears about difficulties in the banking system as a whole. Four smaller banks (out of a total of some 80 banks) are currently unable to return depositors' funds, and have closed their doors through the device of a workers' strike. Another 11 banks have had significant recourse to Bank of Lebanon financing to replace deposit outflows. The Lebanese representatives also noted that a third group of banks, whose difficulties were not as severe, were nevertheless considered to be at risk.

The authorities' initial response to the banking crisis was to extend Bank of Lebanon credit to replace deposit outflows, with shareholders' real estate serving as collateral. Bank of Lebanon claims on commercial banks had reached LL 145 billion in September 1990 (equivalent to 31 percent of reserve money). However, a more permanent approach had yet to be developed. The authorities were also considering several further schemes, with differing distributions of the losses

between depositors, bank shareholders, and the Government. The mission urged that a comprehensive package of responses to the banking crisis be developed immediately and announced in order to help restore confidence. The package needed to be formulated to meet the following objectives. First, public confidence in Lebanese banks had to be bolstered to avoid the crisis spreading to sound institutions. Second, any program to bail out banks in difficulty should be designed with adequate controls to prevent abuse by other banks. Finally, such a program must include incentives and controls to prevent future problems from arising. Elements of this package should include: (1) closing of insolvent banks; (2) loss of capital by shareholders; and (3) prosecution of managers in cases of fraud. To prevent future problems, bank supervision had to be strengthened, which would require strong political support for the Banking Control Commission. In this context, the authorities' intention to raise bank capital to the levels set out in the Basle standards by 1993 was welcome, but for this to be meaningful, doubtful loans needed to be provisioned and written off. Under consideration was a plan whereby the banks would revalue their real estate assets (reportedly valued at only a fraction of their market price) and credit the counterpart to their capital account. In order to qualify for this increment in capital, the banks would have to add cash in an amount equal to the revaluation of the real estate. The mission cautioned that revaluing assets already in the books did not provide new resources to strengthen the solvency and liquidity positions of banks, although it was not inconsistent with the Basle standards.

Regarding compensation for depositors of the failed banks, the mission noted that confidence in the banking system was at risk and losses by depositors could lead to runs on healthy banks. Government support would be needed even if only a part of deposits was to be repaid, ^{1/} but the difficult fiscal situation militated against such a course of action. Any decision would certainly need to be based on the authorities' perception of depositors' behavior. To the extent that depositors had already adjusted their portfolios to reflect reduced confidence in Lebanese banks, a bailout was not necessary to prevent further losses of deposits. However, as depositors had largely been compensated in previous cases of bank failure in Lebanon, a new precedent could have an unfavorable impact on the banking system over the medium term.

3. External policies

The trade deficit is estimated to have remained unchanged in 1990 with both exports and imports declining by US\$100 million. ^{2/} These declines, which came on top of reductions in both categories in 1989,

^{1/} The small deposit insurance scheme did not have the capacity to perform this function.

^{2/} Full balance of payments data for Lebanon are not available, so the analysis is limited to the categories shown in Table 4. Due to the absence of a full balance of payments, as well as the uncertainty with regard to the security situation, it has not been possible to prepare medium-term balance of payments scenarios.

were the result of heavy fighting in Beirut which disrupted activity in industry and in the country's main port. Thus, despite their strong competitiveness, exports (in U.S. dollar terms) in 1990 were estimated at less than 60 percent of their 1988 level. A decrease in commercial banks' net foreign assets by US\$250 million in 1990 had resulted from residents moving their foreign exchange deposits out of Lebanese banks in response to difficulties encountered by some of these banks. At the same time, there was a nonbank private sector capital outflow of US\$400 million. Reflecting intervention by the Bank of Lebanon to slow the depreciation of the pound at various times during 1990, the overall balance of payments was estimated to have recorded a deficit of US\$150 million.

Given the very limited balance of payments data, the Lebanese representatives could provide little quantification of the impact of the Middle East crisis. Nevertheless, they felt the country had been severely affected. Based on estimates subject to confirmation, exports to Iraq and Kuwait had constituted 40-50 percent of total exports, and exports to Jordan had also been affected by the economic slowdown in that country. Some 40,000-50,000 Lebanese (mainly artisans and small businessmen) had returned from Kuwait, having lost most of their assets (estimated at US\$500 million). Another 15,000 may have returned from Iraq. Annual remittances from Lebanese workers in Kuwait were very roughly estimated at US\$150 million. Additionally, higher oil prices could cost Lebanon annually US\$250 million.

The Lebanese pound has been highly volatile during 1990 despite substantial intervention by the Bank of Lebanon both in selling and buying foreign exchange. From end-1989 to August 2, the pound depreciated from LL 505 to LL 670 per U.S. dollar. ^{1/} Almost US\$400 million in foreign exchange reserves were sold in defending the pound, reducing reserves to about US\$540 million. After the invasion of Kuwait, the authorities judged that the pressure on the Lebanese pound could not be resisted considering the low level of reserves remaining, and the pound fell to a low of LL 1,250 in September. Late in September, the Bank of Lebanon re-entered the market to defend a rate of approximately LL 1,200 per U.S. dollar as it was felt that pressures for further depreciation had lessened and the social cost of further depreciation was very high. Subsequently, the pound appreciated to about LL 700-800 per U.S. dollar, at which rate there was some rebuilding of reserves. Two events were crucial in first stabilizing and subsequently appreciating the rate: (1) word of a grant of US\$100 million from Saudi Arabia and (2) the fall of the alternative government in East Beirut on October 13.

^{1/} Movements in the nominal and real effective exchange rates are shown in Chart 3.

Table 4. Lebanon: Estimated Balance of Payments, 1985-90

(In millions of U.S. dollars)

	1985	1986	1987	1988	1989	1990
Trade balance	<u>-1,600</u>	<u>-1,200</u>	<u>-700</u>	<u>-800</u>	<u>-1,100</u>	<u>-1,100</u>
Exports	600	700	1,000	1,200	800	700
Of which: industrial exports	(372)	(478)	(690)	(850)	(500)	(450)
Imports	-2,200	-1,900	-1,700	-2,000	-1,900	-1,800
Commercial banks' net foreign assets (- increase) <u>1/</u>	6	-336	-186	17	266	250
Private nonbank short-term capital (net) <u>2/</u>	-159	-452	-326	138	-40	-400
Other items (net)	1,950	899	732	1,410	791	700
Overall balance	<u>356</u>	<u>-637</u>	<u>-154</u>	<u>627</u>	<u>-43</u>	<u>-150</u>
Bank of Lebanon's net foreign assets (- increase) <u>1/</u>	-356	637	154	-627	43	150

Sources: Bank of Lebanon; Ministry of Finance; IMF, International Financial Statistics; Beirut Chamber of Commerce and Industry estimates; and staff estimates.

1/ Differs from changes in end-period stocks by excluding estimates of exchange rate valuation changes.

2/ Data on the flow of international bank lending to nonbank residents of Lebanon and on the flow of deposits by residents of Lebanon with international banks are derived from the IMF's International Banking Statistics stocks, adjusted for variations in U.S. dollar/nondollar exchange rates. These data are highly provisional, since there are particular difficulties for international banks in distinguishing between residents of Lebanon and persons of Lebanese nationality resident outside Lebanon. In addition, there may be some double-counting between these items and others identified in the accounts.

The Lebanese representatives said that the main objective of the Bank of Lebanon in intervening in the exchange market was to reduce short-term volatility. While there had been no attempt to maintain a particular rate, intervention had also taken into account the social impact of devaluation, the maintenance of confidence in the Lebanese pound and, in the case of pressures to appreciate, the competitiveness of the traded goods sector. Concerning the last point, it was estimated that an exchange rate of LL 400-500 per U.S. dollar would continue to ensure profitability. The mission noted that intervention to support the pound had on several occasions resulted in a rundown of foreign reserves to very low levels, including in 1990. Market perception of the authorities' inability to intervene further may have contributed to exchange rate volatility during these periods.

As noted above, the Lebanese authorities hoped to finance the overwhelming part of any reconstruction effort from foreign sources, particularly grants, though this may prove to be overly optimistic. The mission noted that some limited additional foreign borrowing could be accommodated in view of Lebanon's relatively low debt burden; the stock of external official debt was estimated at US\$280 million at end-1990, indicating that significant repayments had taken place in recent years. However, new borrowing should be undertaken with a view to maintaining a sustainable balance of payments position and avoiding excessive domestic liquidity creation. The mission also cautioned that the recording of foreign borrowing had not been centralized, leading to uncertainty over the size of outstanding debt and scheduled debt service payments. A mechanism for centralizing the recording, monitoring, and control of the external debt was needed.

IV. Staff Appraisal

The year 1990 was one of the worst years for the Lebanese economy since the conflicts began in 1975. As a result of heavy fighting, economic activity declined sharply; the budgetary situation continued to be very weak; the progress made in 1988-89 in curbing inflation halted; and at times the Lebanese pound came under heavy pressure. The Middle East crisis exacerbated these developments through the loss of important export markets and remittances, which in turn intensified the pressure on the pound.

Against this unfavorable background, some cause for optimism appeared in late 1990 with improved prospects for domestic political stability. These developments are welcome as they provide the proper setting for re-establishing control over the economy and restoring financial stability and growth. This is a daunting challenge, however. It will require a broad package of macroeconomic policies aimed at reconstruction within the constraints of domestic resource availability and of foreign financing on terms consistent with maintaining a sustainable balance of payments. However, of immediate concern is that the fiscal situation is in danger of deteriorating substantially in 1991

unless strong measures are taken, as political uncertainty could continue to constrain revenue collection in the short term, while strong pressure to increase government expenditure to rebuild the economy and improve public services will arise. Moreover, the spill-over of interest expenditures deferred from 1990 to 1991 on account of the lengthening of maturities in TBs will add to the fiscal imbalance.

In view of the uncertainties over fiscal revenues, the Government will have to resist pressures to increase expenditures. In this context, the re-emergence of the petroleum subsidy should be avoided through continued market pricing. The subsidy on electricity could be eliminated or greatly reduced with an improvement in the collection of charges. Since the wheat subsidy is not benefiting consumers but various middlemen, it should be eliminated. Given the likely substantial pressures for pay and employment increases, civil service pay should be limited to those actually reporting to work. This could provide substantial help in limiting the pay bill. The reinstatement of the budget process is welcome, as is the tightening of spending approval procedures. The objective, however, should be to eliminate all extra-budgetary expenditures. In the area of capital expenditures, the authorities' intention to finance the overwhelming portion from foreign sources may prove overly optimistic. Moreover, even if foreign finance for the domestic component of expenditures were available, care will need to be taken that domestic spending does not strain available resources.

Over the medium term, the only way to reduce the fiscal deficit and provide an increased level of public services is through an intensified revenue effort. In particular, the customs valuation rate will need to reflect fully the market exchange rate as soon as the authorities establish control of the ports. In addition, as the political situation stabilizes, revenues need to be diversified, although reliance on indirect taxes and user charges will probably have to continue given the historical difficulties of collecting direct taxes.

Some Lebanese banks have recently been facing serious solvency and liquidity problems that could spread to the rest of the banking system. A comprehensive package of measures to deal with these difficulties needs to be announced and implemented immediately if public confidence is to be enhanced and such problems are to be avoided in the future. The latter in particular requires enforcement of current laws and regulations and improvement of bank supervision. In addition, the intention to raise bank capital as set out in the Basle standards by 1993 is welcome. Regarding the compensation of depositors of the failed banks, the Lebanese authorities are in the best position to decide to what extent it is necessary to avoid further losses of deposits by banks. In the event of such a bailout, consideration could be given to issuing tradable government securities to control liquidity creation.

In recent years, use of an active monetary policy has been severely constrained by the excessive fiscal deficit, and by the large share of foreign currency deposits in broad money. In the future, if the security situation continues to improve and the fiscal deficit becomes manageable, monetary policy should be made an important tool in overall economic management. An active interest rate policy will be crucial in attracting greater nonbank financing of the budget deficit, thereby reducing inflationary pressures, and helping to reverse the process of dollarization.

The rapid expansion of Lebanese pound liquidity and lack of confidence have been the underlying sources of pressure on the exchange rate in recent years. In these circumstances, any intervention should be limited to, at most, smoothing day-to-day fluctuations in the market, while not resisting any sustained trend toward depreciation. Resistance of such trends has proved fruitless in the past, and by depleting reserves and reducing the authorities' capacity to intervene may have exacerbated exchange rate variability. When market sentiment favors the pound, the authorities should rebuild official foreign exchange reserves and prevent an excessive appreciation that would undermine external competitiveness. In a more stable political environment, however, fiscal and monetary policy should be used to achieve greater stability in the exchange market.

The small size of the Lebanese external debt is a favorable factor in looking at the future. There is room for a limited amount of foreign borrowing, but it should be undertaken with a view to maintaining a sustainable balance of payments position.

Lebanon maintains an exchange system which is free of restrictions on payments and transfers for current international transactions, except for a restriction on transfer of balances outstanding under a bilateral payment agreement with Poland, which is subject to Fund approval under Article VIII, Section 2(a). In the absence of a schedule for the elimination of restrictive features of the agreement, the staff does not recommend approval of this restriction at this time.

Lebanon is on the biennial consultation cycle, and the next full Article IV consultation is to be completed within 24 months.

Lebanon: Fund Relations

(As of December 31, 1990)

(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: 59.9 (76.1 percent of quota)
- (c) Fund credit: --
- (d) Reserve tranche position: 18.8
- (e) Current operational budget: --
- (f) Lending to the Fund: --

III. SDR Department

- (a) Net cumulative allocation: 4.4
- (b) Holdings: 6.9 (157.4 percent of net cumulative allocation)
- (c) Current Designation Plan: --

IV. Country has not used Fund resources to date.

B. Nonfinancial Relations

V. Exchange Rate Arrangement

The Lebanese pound has been floating since 1952. The Bank of Lebanon intervened persistently in the exchange market during 1983-84, spending US\$1.9 billion in reserves. Subsequently, the size of the foreign reserves did not permit large-scale intervention in support of the pound, and with some exceptions Bank of Lebanon intervention was limited to moderating short-term fluctuations. On the other hand, when the pound was appreciating, the Bank has intervened to rebuild its reserves and stabilize the appreciating pound.

VI. Last Article IV Consultation

The last full consultation was concluded by the Executive Board on November 2, 1988 (SM/88/211). Interim consultation discussions were held during November 27-30, 1989.

VII. Technical Assistance

None since 1988.

VIII. Resident Representative/Advisor

None.

Lebanon--Statistical Issues

1. Outstanding statistical issues

a. Real sector

Trade and national accounts data are not compiled by the authorities at present. The Bureau of Statistics is engaged in correspondence with the Bank of Lebanon concerning the possible use of privately collected consumer price indices.

b. Government finance

No data are reported for IFS

c. Balance of payments

Lebanon does not report balance of payments data to the Bureau of Statistics. The authorities are not in a position to compile full balance of payments statistics, although some partial indicators are available.

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 November 1990 issue of IFS. They are based on reports sent to the Fund's Bureau of Statistics by the Bank of Lebanon, but the data are generally not current and incomplete.

Status of IFS Data

		Latest Data in Jan. 1991 IFS
Real sector	- National accounts	n.a.
	- Prices: CPI/WPI	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	Sept. 1990
	- Deposit money banks	Dec. 1989
	- Other financial institutions	n.a.
Interest rates	- Discount rate	Oct. 1990
	- Bank lending/deposit rate	n.a.
	- Bond yields	n.a.
External sector	- Merchandise trade: Values	Sept. 1990 <u>1/</u>
	Prices	n.a.
	- Balance of payments	n.a.
	- International reserves	Nov. 1990
	- Exchange rates	Nov. 1990

1/ Data are derived from Direction of Trade Statistics.