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September 8, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Lebanon - Staff Report for the 1988 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with Lebanon, which is tentatively scheduled for discussion on Monday, October 17, 1988.

Mr. Sassanpour (ext. 6763) 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 1988 Article IV Consultation

Prepared by the Staff Representatives for the 1988 Consultation with Lebanon

Approved by A.S. Shaalan and A. Basu

September 2, 1988

I. Introduction

The 1988 Article IV consultation discussions with Lebanon were held in Paris, June 27-30, 1988 with officials from the Finance Ministry, Bank of Lebanon, and Council for Development and Reconstruction (an official body performing many functions of a planning ministry) as well as representatives from private sector organizations. 1/

The last Article IV consultation with Lebanon was concluded by the Executive Board on September 18, 1987. A summary of relations with the Fund is provided in Appendix I. 2/ Lebanon continues to avail itself of the transitional arrangements of Article XIV.

II. Background

Comprehensive assessment of macroeconomic developments is hampered by the lack of national income accounts and incomplete balance of payments records, which, together with shifting expectations, also preclude the preparation of meaningful medium-term balance of payments projections. Social and demographic indicators (Appendix II) are largely for the pre-war period.

The prolonged conflict in Lebanon has had a devastating effect on the population and the economy. Production has dropped well below the pre-war level due to emigration of skilled labor and entrepreneurs, destruction of physical assets, outflows of financial capital, and

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1/ The staff mission was composed of Messrs. B.K. Short (Head), D.B. Noursi, C. Sassanpour, and C.M. Towe (all MED). Mr. A.S. Shaalan (MED) participated in the policy discussions, which were also attended by Mr. M. Finaish, Executive Director representing Lebanon, and Mr. M.B. Chatah (OED).

2/ The World Bank has been inactive in Lebanon since 1983 due to the security situation. When security permits, the Bank expects to participate in the reconstruction effort.

disruption of work routines and transportation. Public investment (mostly for rehabilitation of schools, roads, ports, and the international airport as well as modernization of communications) has declined in real terms since 1984. Private investors have remained hesitant to undertake large or long-term commitments, with most private investment being for housing in secure areas. Nevertheless, the depreciation of the Lebanese pound, lagging adjustments in wages and other costs of domestic inputs, and improved security in some areas have encouraged a modest recovery in exports and production. However, rapid inflation has further skewed the distribution of income away from wage and salary earners as well as those with fixed incomes, exacerbating the drop in per capita real income since 1975. Unemployment is estimated to have risen to about one third and many of those who are employed do not work full time.

The conflict has also been the underlying cause of inflation and depreciation of the pound (Chart 1) by eroding confidence and undermining public finances. Infringement of government authority has been the main cause of the slow growth of public revenues, although the narrow tax base and inappropriate tax assessments have also been contributing factors. Despite the low level of revenues, the Government has tried to continue to provide public services and has made available substantial subsidies for energy, public utilities, and flour, resulting in massive fiscal deficits financed from the domestic banking system (Table 1 and Chart 2).

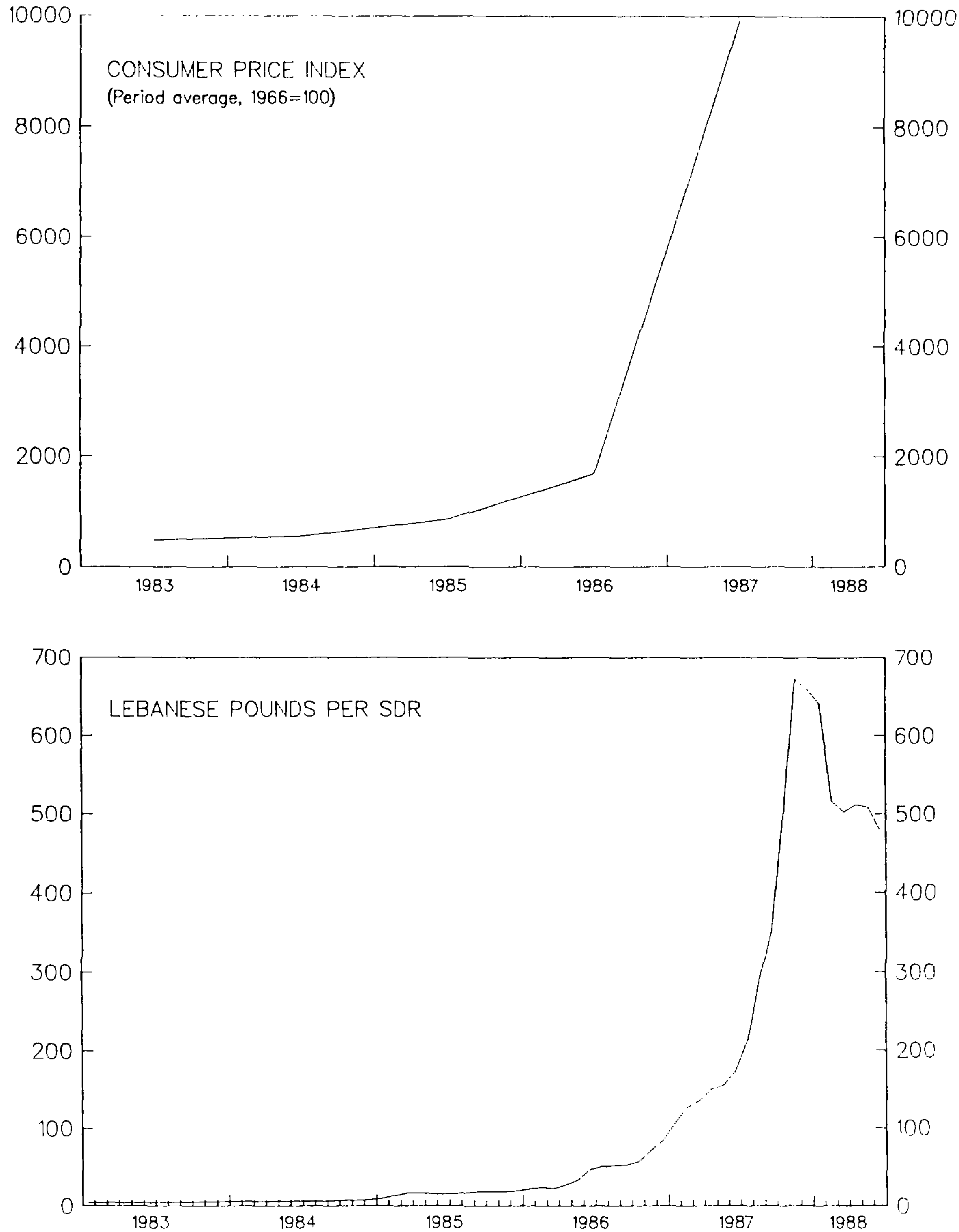
The growth rate of money and quasi-money (M2) doubled annually in 1985-87 (Table 1), mainly due to the effect of depreciation of the pound on the pound value of residents' foreign currency deposits with domestic banks, which increased these deposits' share of M2 from one third as recently as the end of 1985 to about 90 percent at the end of 1987. Although rising much less rapidly than M2, the Lebanese pound component of M2 (M2LL) exhibited significant growth in 1985-87, owing to bank financing of the public sector deficit, while sales of foreign exchange by the Bank of Lebanon in 1986-87 had a contractionary effect (Chart 3).

The rapid growth of M2LL relative to the pace of economic activity, the erosion of private sector confidence, and speculation were mainly responsible for the pound coming under mounting pressure from the end of 1982 to November 1987. Despite US$1.9 billion of exchange market support by the Bank of Lebanon in 1983-84 which initially slowed the pound's depreciation, the exchange rate moved from LL 4 = SDR 1 at the end of 1982 to LL 714 = SDR 1 at the end of November 1987. Concurrently the consumer price index rose 3,800 percent, implying a depreciation of 80 percent in real effective terms.

CHART 1

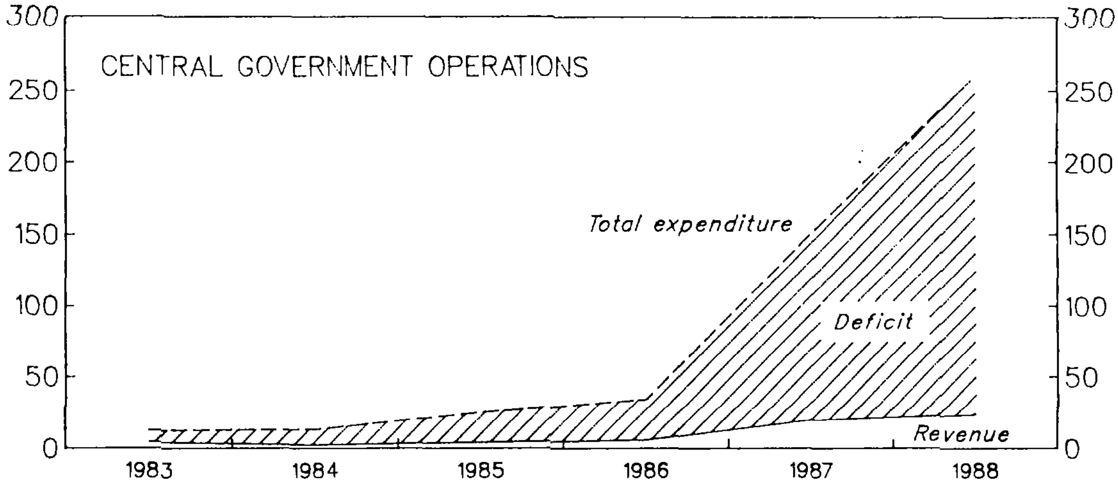
LEBANON

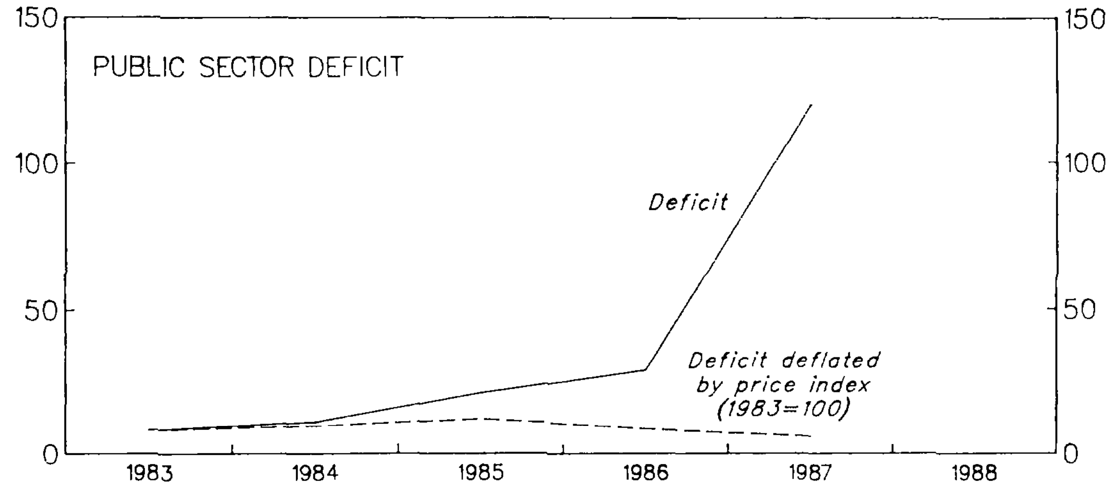
INFLATION AND DEPRECIATION OF THE LEBANESE POUND, 1983-88

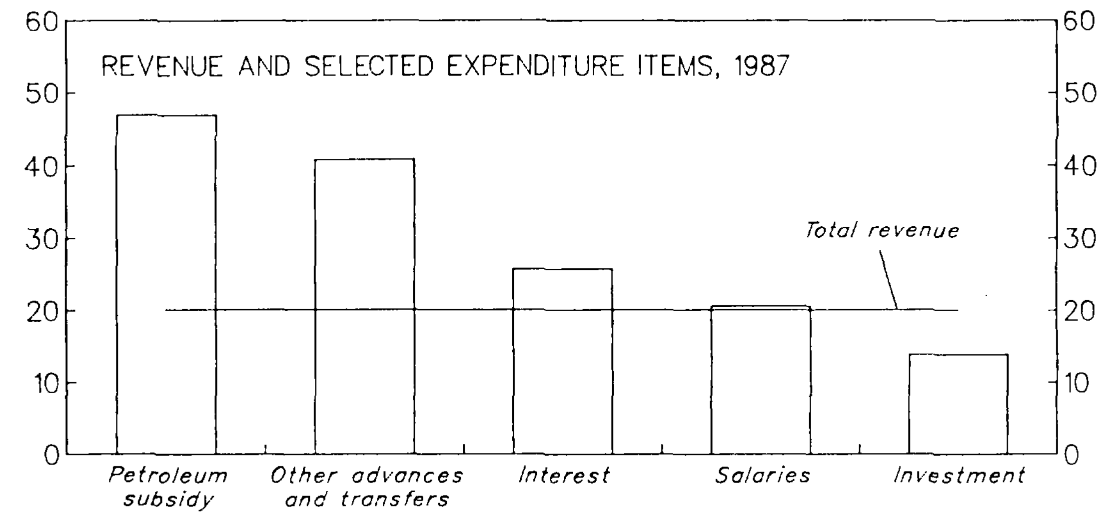


Sources: IMF, International Financial Statistics; and Beirut Chamber of Commerce and Industry.

CHART 2
LEBANON
FISCAL TRENDS, 1983-88
(In billions of Lebanese pounds)





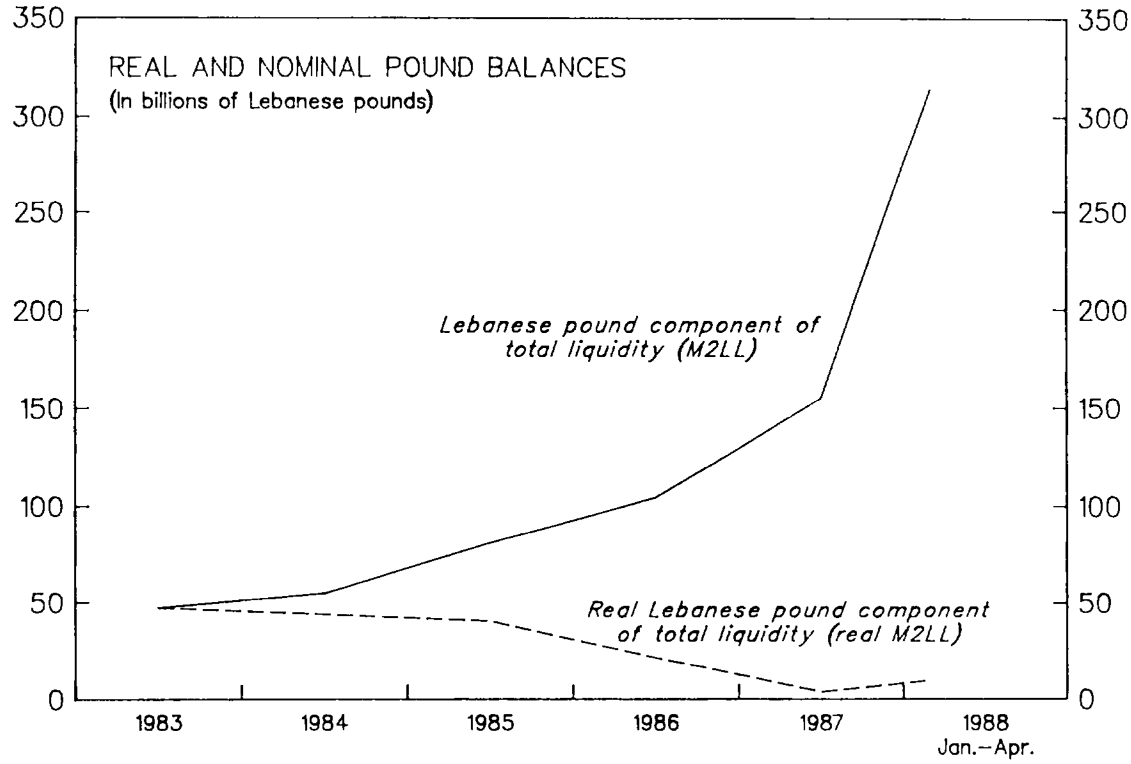


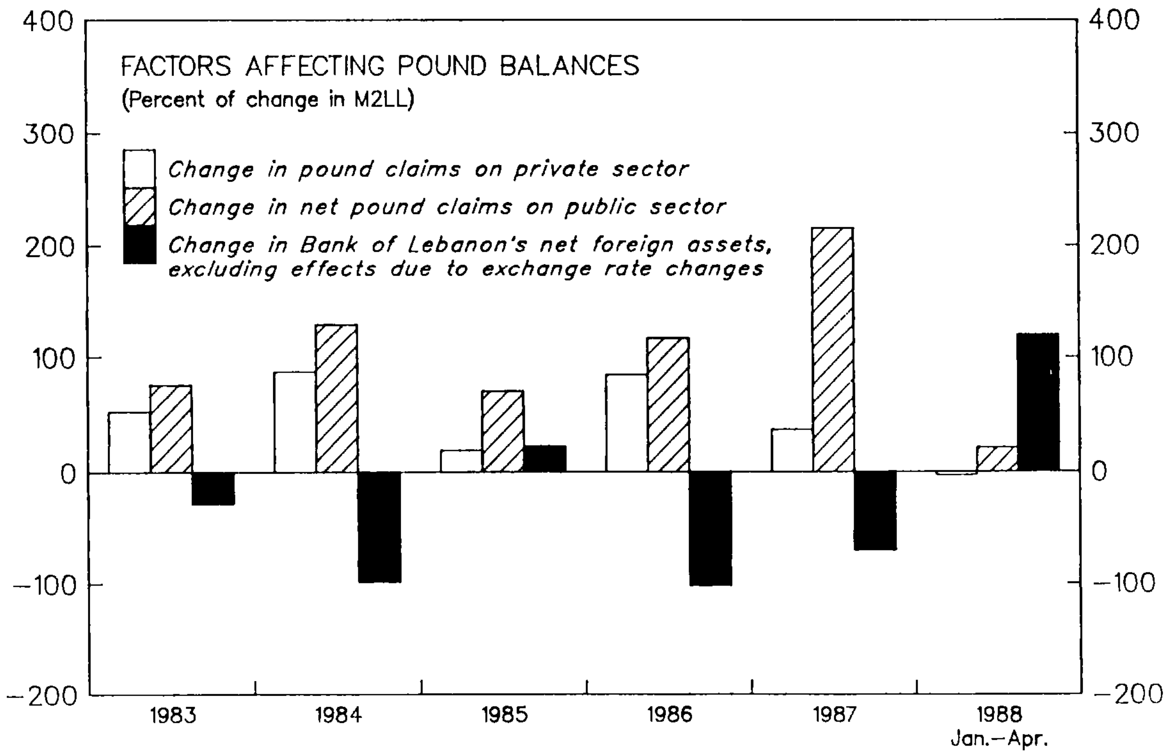
Source: Ministry of Finance.

CHART 3

LEBANON

MONETARY AND CREDIT DEVELOPMENTS, 1983-88





Sources: Bank of Lebanon, and Beirut Chamber of Commerce and Industry.

Table 1. Lebanon: Selected Economic Indicators, 1983-88

	1983	1984	1985	1986	1987	Prelim. Jan.-April 1988	Proj. 1988
				(Percentage changes)			
Inflation							
Consumer price index 1/	7	15	54	95	487	...	...
Fiscal operations							
Receipts	63	-43	75	40	231	...	20
Expenditures	34	7	91	34	339	...	73
Petroleum subsidy	2	27	482	-12	819	...	-25
Advances and transfers	-33	37	52	48	770	...	47
Interest	35	28	143	85	126	...	169
Salaries and wages	39	13	31	53	206	...	94
Investment	...	40	1	53	142	...	...
				(Ratios as a percent)			
Public sector deficit as a percentage of total expenditures	65	82	83	85	78	...	91
Domestic bank financing as a percentage of							
(i) Lebanese pound component of money and quasi-money at beginning of period	21	21	33	34	109	...	...
(ii) change in Lebanese pound component of money and quasi-money during period	76	129	71	116	226	...	...
				(Percentage changes)			
Monetary developments							
Money and quasi-money (M2)	27	24	56	172	354	-20 2/	...
Lebanese pound component of M2 (M2LL)	27	16	47	29	48	730 2/	...
Real Lebanese pound balances	25	6	-14	-30	-76	1,635 2/	...
U.S. dollar value of residents' foreign currency deposits with Lebanese banks	-13	-9	-12	20	15	-2 2/	...
Net pound claims on public sector	52	30	83	49	317	...	...
Credit to private sector	30	27	25	136	317	-38 2/	...
Lebanese pound component of credit to private sector	25	26	14	52	33	-17 2/	...
External sector							
Exchange rate (percent change in average for last quarter of year) (appreciation +)							
Nominal effective exchange rate	-15	-27	-60	-73	-89	29	...
Real effective exchange rate	-17	-15	-38	-39	-13	1	...
				(In billions of U.S. dollars)			
Balance of payments							
Exports	0.7	0.6	0.6	0.7	1.0	...	...
Imports	-3.7	-3.0	-2.2	-1.9	-1.5	...	...
Other items, net	2.4	1.2	2.0	0.6	0.3	...	...
Overall balance 3/	-0.6	-1.2	0.4	-0.6	-0.2	0.4	...
Central bank reserves							
Foreign exchange reserves (end of period) 4/	1.9	0.7	1.1	0.5	0.4	0.7	...

Sources: Ministry of Finance, Bank of Lebanon, Beirut Chamber of Commerce and Industry, and Fund staff estimates.

1/ Percent change in annual average of the index.
2/ Compound annual rate.
3/ Excluding valuation changes to Bank of Lebanon's net foreign assets.
4/ Excluding gold holdings which have been constant over the period at 9.2 million fine troy ounces.

Since November 1987 the pound has made a remarkable recovery, appreciating to about LL 455 = SDR 1 at the end of July 1988, for reasons that are discussed in the next section. The level of consumer prices is estimated to have dropped simultaneously by about 10 percent. In the first seven months of 1988, the Bank of Lebanon purchased US$750 million of foreign exchange to slow the pound's appreciation, raising its reserves to US$1.1 billion (excluding gold holdings of 9.2 million fine ounces which have been unchanged since the early 1970s), equal to about nine months of imports.

After decreasing for several years, Lebanon's external nonmilitary public debt rose by US$47 million in 1986-87 to US$227 million at the end of 1987 (equal to 23 percent of estimated commodity exports). No information is available on military debt. Debt service effected was US$27 million annually in 1986-87 (less than 5 percent of commodity exports). In both years, payment delays occurred, amounting to US$14 million and US$30 million at the end of 1986 and 1987, respectively. Those arising in 1986 were fully settled early in 1987, while US$11 million of delayed payments from 1987 were settled in 1988 with the balance expected to be settled at an early date. Debt service in 1988 (excluding settlements for amounts due in 1987) is projected to rise to US$56 million.

III. Report on Discussions

During the Executive Board meeting for the 1987 Article IV consultation with Lebanon, Directors, expressing concern that the immense fiscal deficit would cause accelerating depreciation of the pound and inflation, urged that efforts be made to tighten fiscal policy, especially eliminating the petroleum subsidy. They also encouraged continuation of measures to slow monetary growth and avoidance of large-scale exchange market intervention to support the pound. Despite the recent appreciation of the pound, these recommendations remain relevant as the public sector deficit and M2LL have continued to increase rapidly and the appreciation of the pound could be reversed quickly by a shift in market sentiment.

In meetings with Fund staff during the last few years, the Lebanese authorities have expressed overriding concern over the depreciation of the pound due to its impact on the cost of living and economic confidence as well as the difficulty that rapid depreciation adds to efforts to achieve a political compromise. In the most recent discussions, the Lebanese representatives explained that the prospect of the election of a new president of Lebanon by the national legislature by September 22, 1988 had contributed to renewed economic as well as political optimism. The authorities' immediate objective was to nurture this confidence by forestalling large exchange rate movements or other unsettling economic changes until after the election. Thereafter, it was hoped that a political consensus could be developed that would enable the public sector to collect revenues fully and allow better control of outlays while embarking on a full-fledged reconstruction program. Once security has improved, there will be a need to rehabilitate infrastructure and initiate policies to encourage investment so as to raise output and employment while containing aggregate demand imbalances, particularly those arising from the fiscal deficit. Discussions focused on the recent behavior of the pound as well as feasible fiscal and other measures to support the pound by slowing the growth of the public deficit and M2LL until an improvement in security would enable a strong, comprehensive package of measures to be implemented. The mission indicated that, once security permits, the Fund would be prepared to respond promptly with technical assistance directed toward strengthening public finances and promoting reconstruction, including helping to mobilize external aid.

1. External sector

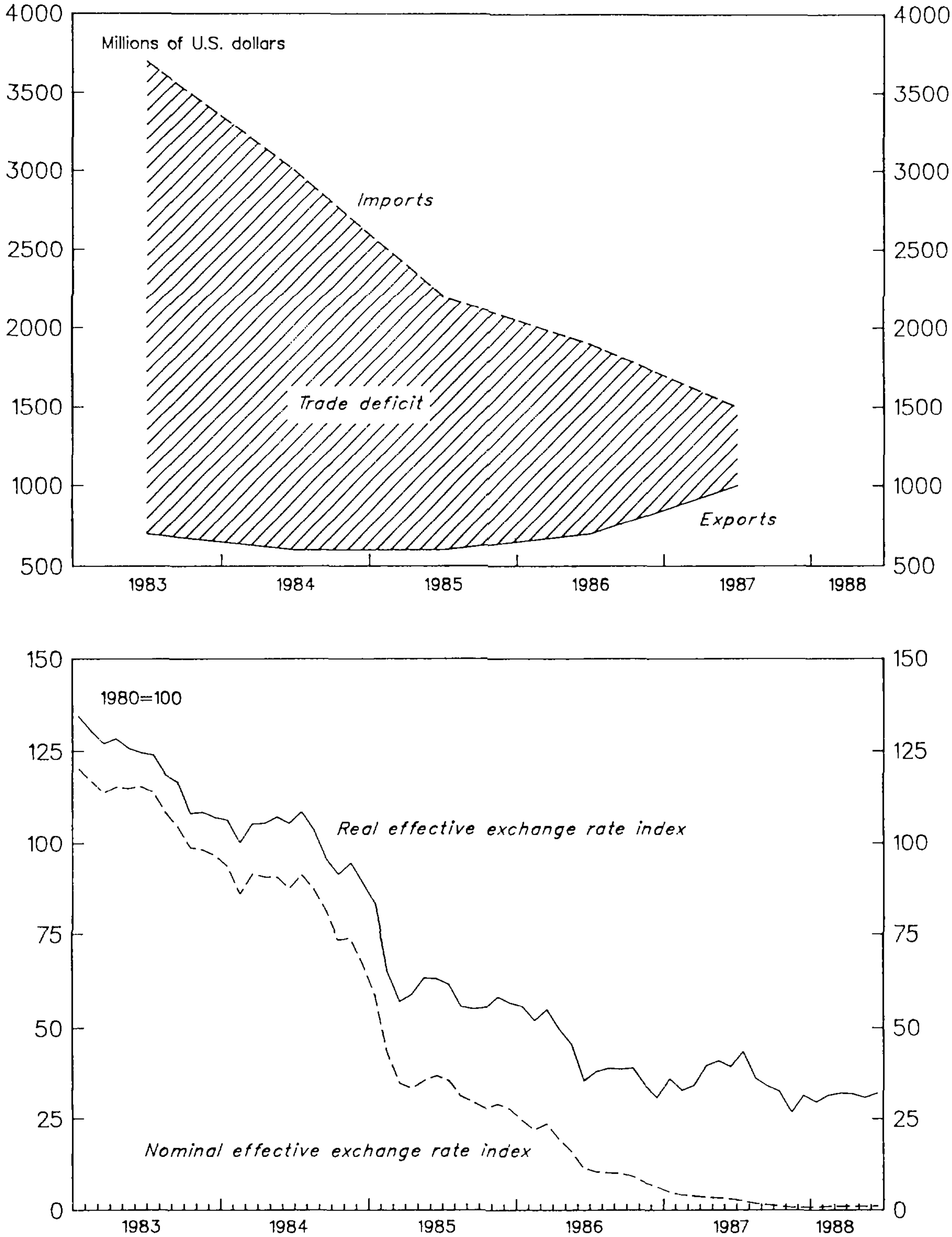
A favorable development in 1987 was the 43 percent growth in the U.S. dollar value of merchandise exports due to the stimulus afforded by the depreciation of the pound as well as some improvement in security (Chart 4). Simultaneously, merchandise imports continued the decline in U.S. dollar terms which had begun in 1984, with non-oil imports declining by nearly 30 percent in 1987 due to the effects of the depreciation on domestic prices and real incomes. As a result, the trade deficit, which had been contracting steadily from over US$3 billion in 1983, dropped further to US$0.5 billion in 1987. As for other unrecorded transactions the Lebanese representatives believed that workers' inward remittances had been lower and capital outflows higher, partly in response to the rapid depreciation of the pound. During 1987 the overall deficit in the balance of payments declined to US$160 million with most of the resolution of external sector pressures coming instead through depreciation of the pound as the Bank of Lebanon's low holdings of foreign exchange precluded extensive support for the pound.

During January-November 1987 the pound depreciated very rapidly reflecting the continued unwillingness of the private sector to hold the expanding stock of pounds. The Lebanese representatives attributed this trend to declining confidence, expectations of further depreciation, speculation, and irregular practices by some commercial banks, accentuated by the perception that the Bank of Lebanon had limited scope to counter speculation or otherwise support the pound. From the end of November 1987 to mid-1988 the pound appreciated by 57 percent in terms of the SDR. While it was difficult to ascertain the reasons for this appreciation, several factors stood out. The Lebanese representatives believed that perhaps most important was the growing perception in the second half of 1987 that the continuing depreciation was excessive in relation to the sharp drop in real pound liquidity, the Bank of Lebanon's large gold stock (valued at over 12 times M2LL at the end of 1987), and better economic performance including the improvement in the trade balance. Other significant factors included optimism regarding the presidential election as well as greater foreign exchange receipts from remittances and capital inflows. The turnaround was also aided by commercial banks gradually taking steps to comply with regulations issued early in 1987 to stem speculation and limit the growth of pound credit to the private sector, following initial resistance (see subsection 3). Also, during 1988, in the environment of an appreciating pound and decreasing prices, interest rates on pound instruments had become highly remunerative, encouraging conversion of foreign currency into pounds by both residents and nonresidents.

The Lebanese representatives reported that the Bank of Lebanon was pursuing two objectives by intervening to slow the appreciation of the pound in 1988. First, the Bank's reserves were being rebuilt with a view to re-establishing its credibility and capacity to ensure orderly market conditions. However, it was not the authorities' intention to use the reserves for sustained exchange market intervention in the event of a reversal in market sentiment. Moreover, to curb speculation, they preferred to use regulations to halt inappropriate activity. Second, the authorities were presently attempting to prevent the pound from appreciating excessively and thereby avoiding renewed expectations of depreciation and speculation. Their concern was that, should the pound start to depreciate, a "band-wagon" effect and speculation would cause excessive depreciation again. Export competitiveness was not a primary concern as surveys of exporters indicated that the current level of the exchange rate was still some way above the range where their competitiveness would be affected.

The mission expressed the view that the expansion of M2LL as well as expectations, confidence, and speculation had been the main determinants of the exchange rate. Thus, it was uneasy whether the large injections of pound liquidity and reserve money from the Bank of Lebanon's purchases of foreign exchange in the first half of 1988, if sustained, could be absorbed by continued growth of the demand for pounds. The Bank's intervention needed to be undertaken cautiously in a manner consistent with the authorities' view of appropriate liquidity growth. The pound's appreciation offered the opportunity to gradually restore the Bank's reserves so as to be able to meet the needs of the public sector in the period ahead as well as to re-establish the Bank's authority in the market. While the Bank might also intervene to protect export competitiveness by slowing the pound's appreciation, it should not try to fix the rate at any particular level. The mission expressed concern that the persistence of the massive fiscal deficit, a change in expectations, or profit-taking by those who had brought funds into Lebanon in 1988 to take advantage of the yield on the pound could resume pressure on the pound. Thus it welcomed the representatives' reassurance that the Bank of Lebanon would not engage in sustained exchange market intervention when pressure was firmly against the pound, as experience in Lebanon in 1983-84 had shown that even strong intervention in this situation could only deflect the rate briefly from its trend. The best way to support the pound was to implement all feasible fiscal and monetary measures to slow the growth of M2LL. The mission agreed that the Bank's firm stand taken in March 1986, not to guarantee

CHART 4
LEBANON
EXPORTS, IMPORTS, AND EXCHANGE
RATE MOVEMENTS, 1983-88



Sources: Bank of Lebanon and Fund staff estimates.

repayment of any foreign loans contracted by the public sector thereafter (except trade credits for wheat and petroleum) was, under current circumstances, an appropriate means of controlling foreign borrowing by the public sector.

2. Public finances

The Lebanese representatives pointed out that, in real terms, the deficits in public finances had declined since 1985 (Chart 2) although they agreed that deficits of about 80 percent of spending were clearly excessive. During 1987 the deficit had quadrupled, as the sharp increase in outlays with a high foreign cost component (notably the petroleum subsidy) raised the growth of spending above that of revenue. Government revenue grew by 230 percent in 1987 mostly due to a large increase in profit transfers from the Bank of Lebanon and a few public sector agencies. Otherwise, most receipts were again adversely affected by the Government being unable to exert its authority fully. Customs receipts, which had formerly constituted the largest part of government revenues, remained low (equal to 2 percent of revenues) mainly due to the diversion of imports to illegal channels. Virtually all customs duties were collected from imported automobiles which were brought through customs so as to be able to register them for proof of ownership. Growth of government revenues had also been slowed in 1987 by the Finance Ministry postponing the imposition of penalties for late payment of certain fees and dues until August 1988, in the hope that an improvement in security would allow taxpayers to avoid concurrent levies by the various militias.

The Lebanese representatives noted that the authorities' effort to control the growth of public spending could be seen by expenditures in 1987 having grown by less than the rate of inflation for the second consecutive year. The Bank of Lebanon was scrutinizing public agencies' requests for payment and credit. One difficulty was that spending categories that had a high import component had been growing rapidly. Hence, the petroleum subsidy had become the largest spending item in 1987 (more than twice government revenues--Chart 2) despite three increases in retail prices in the last half of 1987, which cumulatively raised prices by 175 percent (for LPG) to 637 percent (for gasoline).

Advances and transfers to public utilities, municipalities, and the Cereal Board were almost nine times larger in 1987 than 1986. For these organizations, as for the Government itself, revenue collections were impaired by the security situation, while salaries, costs of imported materials (including wheat), and debt service rose rapidly. Although the electricity and water utilities had raised their tariffs twice in 1987 (the former by 300 percent), rates remained as low as 20 percent of costs. Moreover, some users had illegally tapped into electric and water lines while others would not or could not pay the bills sent to them. As a result, the Government was making transfers to the electric utilities to cover fuel oil and other costs.

Salaries and wages, although raised three times in 1987 (once retroactively to 1986) by a cumulative amount of 300 percent, lagged behind the rapid increases in the cost of living. Likewise, capital spending by the Government and Council for Development and Reconstruction (CDR), despite being particularly vulnerable to sharp increases in imported capital goods, also rose less than prices, for the third year in succession.

The authorities expected that in 1988, if the exchange rate remained at its current level, the public sector deficit would double mostly due to the impact for a full year of cost increases which had taken place in the last half of 1987 and interest payments on the rising stock of public debt. The main reasons for projecting government receipts to rise by 20 percent were a proposal to raise the exchange rate for customs valuation from LL 6 = US$1 (about 2 percent of the prevailing market rate) to LL 11 = US$1 as well as collection of the fees and dues from 1987 on which the Finance Ministry would not impose penalties until August 1988.

The appreciation of the pound in 1988, by reducing the pound cost of imported crude oil, had, in principle, eliminated the petroleum subsidy. However, the domestic refineries were not fully reimbursing the Government for the cost of imported crude oil which it had paid for on their behalf. Moreover, to keep the domestic refineries' sales of gasoline and fuel oil competitive with private imports of these products, retail prices of gasoline and fuel oil were lowered in February. Nonetheless, the petroleum subsidy was expected to decline by 25 percent in 1988. However, advances and transfers were expected to rise by almost 50 percent in 1988. Although consideration was being given to raising utilities' tariffs further in 1988 and the prospect was for a decline in the electric utilities' fuel costs, advances and transfers to them were projected to increase as no quick resolution was foreseen to their difficulties in collecting revenues.

Domestic interest expenses were growing in pace with the increases in internal public debt. To reduce government interest costs, consideration was being given in some quarters to retiring domestically held public debt by selling part of the Bank of Lebanon's foreign assets. However, most officials recognized that this would monetize the domestically held debt and wanted instead to minimize the expansion of pound liquidity from financing the public deficit. The mission discouraged the retirement of internal public debt by selling the Bank of Lebanon's foreign assets because this would not only monetize the debt but could also affect confidence in the pound by reducing official reserves.

The mission was encouraged that the authorities had been able to contain the growth of government spending below the rate of inflation but emphasized its concern over the size and consequences of the unwieldy fiscal deficit. Whatever steps could be implemented in the current security situation to improve public finances should be expedited. Revenue measures which appeared feasible (and which would also have most effect on persons who were more able to pay) were (1) relating the exchange rate for customs valuations to the prevailing market rate (as was done until 1985), (2) removing the option for car importers to pay duties on the basis of the vehicle's weight instead of its value, and (3) combining a capital gains tax on sales of real estate (structures as well as land) with the current fee for registration of real estate transactions as well as perhaps raising the latter fee. In addition, the Treasury needed to pursue collection of the fees and dues that had not been paid in 1987.

The mission urged the utmost restraint in determining the level and priorities for public spending. In particular, effort needed to be made to curtail outlays that were not directly productive or did not provide other highly desirable social benefits, especially expenditures with a high import content. The authorities should take advantage that retail prices for petroleum products currently exceeded their costs to introduce a mechanism automatically relating prices to pound costs. This would prevent re-emergence of subsidies on these products if the pound were to depreciate and, with an appropriate margin, could provide revenues to the Government. In view of the high and rising transfers to public utilities, further increases in rates charged by the utilities would be welcome if they would not be offset by greater delinquency. In this regard, consideration should be given to selling the utilities, or at least their distribution networks, to the private sector.

3. Monetary and credit policies

The Bank of Lebanon's ability to control M2 has become constrained by the high proportion of M2 in the form of foreign currency deposits and large fluctuations in the pound value of these deposits caused by exchange rate movements. The 350 percent rise of M2 in 1987 and its 20 percent decline in the first four months of 1988 reflected exchange rate shifts. Moreover, the Bank's capacity to control the growth of M2LL has been limited by the need for bank financing of the public sector. This was the situation again in 1987 when financing of the fiscal deficit was mainly responsible for M2LL growing by 48 percent (Chart 3). However, in 1988, the authorities were taking advantage of the recent shift of preference in favor of the pound and the higher expected yield on pound assets to absorb pound liquidity. In the first five months, sales of treasury bills to commercial banks and especially the nonbank private sector had exceeded the Government's needs by about LL 60 billion, with the proceeds being deposited with the Bank of Lebanon. Simultaneously, the Bank had lowered its gross claims on the public sector by LL 47 billion by selling treasury bills from its own portfolio. Nevertheless, M2LL had doubled in the first four months of 1988 mainly due to the Bank's purchases of foreign exchange (Chart 3). While confident that this large increase was being accommodated by the shift in demand for M2LL, the Lebanese representatives agreed that such rapid growth of M2LL could not be sustained without renewing exchange rate and inflationary pressures.

The Lebanese representatives reported that the interest rate on primary sales of treasury bills had not been raised during 1987, 1/ notwithstanding the severe pressure on the pound, because the authorities were convinced that the forces depreciating the pound, notably expectations, confidence (based on noneconomic considerations), and speculation, were insensitive to interest rate considerations. In addition, they believed that raising primary treasury bill rates would have added to government spending, the fiscal deficit, and the growth of M2LL without generating a corresponding increase in demand for M2LL. The sharp appreciation of the pound at the end of 1987 was consistent with the authorities' view that interest rates were not a primary determinant of the private sector's choice between pounds and foreign currency as the appreciation began while the yield differential favored foreign currencies. However, the authorities recognized that, since the appreciation of the pound, the yield differential was reinforcing demand for the pound. In view of the strong demand for treasury bills, consideration was being given to reducing their interest rates on primary sales in order to lower government interest costs. As a step toward adjusting these rates, the Bank of Lebanon decreased the yield on secondary sales in June and July 1988, by a cumulative 13 percentage points to 32 percent on one year bills.

To generate financing for the Government as well as to contain the growth of credit to the private sector, the Bank of Lebanon had required banks to hold treasury bills equal to 60 percent of their new pound deposits from the beginning of 1987 (of which 12 percentage points could be in the form of higher yielding bills acquired from the secondary market). 2/ However, many banks had initially resisted complying with this requirement, prefering to incur penalties so as to continue other activities in 1987. Compliance improved toward the end of 1987 when an agreement was reached for a substantial reduction of penalties for delinquent banks that moved to comply. While the immediate effect of the new treasury bill requirement had been limited, the Lebanese representatives believed that the gradually improving compliance in 1987 had reduced the availability of funds for speculation and slowed the growth of M2LL. In 1988, exchange rate expectations reinforced the banks' resolve to comply with the treasury bill requirement.

1/ The effective interest rate on primary sales (i.e., initial issues) of treasury bills remained at 20 percent on one-year bills. The Bank of Lebanon raised the effective interest rate on secondary sales of treasury bills from its own portfolio (from 35 percent to 45 percent on one-year bills) in June 1987 to encourage bank compliance with the treasury bill requirements introduced at the beginning of 1987.

2/ Banks have also been obliged to hold reserves with the Bank of Lebanon equal to 13 percent of their Lebanese pound deposits, of which up to 3 percentage points may be held in special (low yielding) treasury bills.

The mission encouraged perseverance in efforts to slow the growth of M2LL as increases at the rate experienced so far in 1988 could not be sustained without soon jeopardizing the authorities' exchange rate and price objectives, especially if the rapid growth of M2LL caused sentiment to move toward foreign currency again. Consequently, the Bank of Lebanon's recent action to shift the holding of government debt from itself to commercial banks (to slow the growth of reserve money) and the rest of the private sector (to slow the growth of M2LL) was a positive development. However, care needed to be taken that the proceeds from the overissue of the treasury bills were not used to expand public spending. While there appeared to be scope at present for scaling down interest rates on treasury bills, the authorities needed to proceed cautiously due to the support that the current yield differential afforded to the pound, as well as its role in changing the holding of government debt. Moreover, past experience suggested that it could be difficult to reach agreement to raise treasury bills' interest rates on primary sales when necessary. In view of this "stickiness" in their interest rates and the high degree of liquidity of treasury bills (which the nonbank private sector can redeem before maturity with an interest penalty of only one eighth of one percentage point), the mission suggested that consideration be given to developing an instrument with greater discretion for the Bank of Lebanon to set the interest rate and no redeemability on demand, such as certificates of deposit issued by the Bank. Such a device could also be used to absorb bank liquidity beyond the amounts subject to the cash and treasury bill requirements.

The ratio of banks' capital and reserves relative to total assets (in pound terms) had fallen as the pound had depreciated because a sizable part of banks' assets were denominated in foreign currency while their capital and reserves were mainly denominated in pounds. Nevertheless, the authorities felt that there had been no fundamental change in the soundness of the banking system. The banks' profitability had remained strong as a large share of their profits arose from foreign currency operations and, in their pound business, banks worked with spreads that took adequate account of the reserve and treasury bill requirements. The depreciation of the pound had benefited the banks due to their substantially positive net foreign currency position which partly arose from overprovisioning for losses on their foreign assets. Finally, because many banks were keeping some of their own funds off their balance sheets, the latter were not completely accurate portrayals of their positions. Since the ratio of capital to assets averaged less than 1 percent for all banks, the mission urged the authorities to give further attention to the adequacy of banks' capital. Banks could be strengthened by issuing subordinated debt or by retaining profits earned in foreign currency as special reserves denominated in foreign currency.

III. Staff Appraisal

Domestic output has risen since 1985 due to somewhat improved security conditions as well as the incentive given to production of tradable goods by the depreciation of the pound. At the same time, the trade deficit has continued to narrow. The appreciation of the pound since November 1987 has afforded relief from accelerating inflation and, indeed, contributed to a decrease in prices without affecting the productive incentives arising from the earlier depreciation. Other positive developments have been the transfer of government debt from the Bank of Lebanon to the commercial banks and nonbank public, as well as the overissue of treasury bills to absorb bank and private sector liquidity.

The most important reason for the extraordinary recovery of the pound in the exchange market since November 1987 was perhaps that the accelerating depreciation during the preceding period came to be perceived as excessive and this reappraisal combined with a revival of confidence to shift market sentiment in favor of the pound. Other significant factors were the drop in real pound balances caused by the preceding depreciation, the large contraction in the trade deficit, greater remittances, larger capital inflows, and improved compliance by commercial banks with regulations issued at the beginning of 1987. Once the appreciation was underway, support for the pound was reinforced by the yield differential in its favor.

Despite the favorable developments outlined above, the economic situation remains tenuous as exchange market sentiment and capital flows could easily be reversed; the fiscal deficit remains immense; and pound liquidity has grown rapidly so far in 1988. Hence, prudent policies are called for to preserve the recent exchange rate and price improvements. Although the present security situation does not allow a wide range of measures to be implemented, there are steps, especially in the fiscal area, that should be taken so as to preserve the recent economic gains and lay the basis for more far reaching policies. In addition, with the prospect of a durable improvement in security, the authorities must consider a broader range of measures. The Council for Development and Reconstruction has kept up to date a well formulated set of projects mainly for rehabilitation and modernization of infrastructure. Policy considerations need to extend beyond this list of investments, to macroeconomic policies. While capital repatriation and inflows may make available considerable financial resources during the post-war period, real resources will have to be carefully allocated. As consumption has been compressed during the conflict, there could be a release of pent-up consumer demand. However, at the same time, there will be an urgent need to rehabilitate infrastructure and rebuild productive capital so as to raise output and generate employment. Fiscal action will need to be taken to collect and enhance revenues while continuing to provide incentives to production. In addition, priorities will need to be carefully established for public spending so as to provide resources for investment without adding to inflationary pressures. The Bank of Lebanon will have to undertake measures to preserve the soundness of the banking system, to mobilize resources through the financial system, and to restrain inflationary and exchange rate pressures. At present, measures should be initiated along these lines, wherever possible, to consolidate the recent economic improvements and lay the groundwork for more comprehensive measures once security improves.

The authorities have taken steps to restrain public spending and decrease the petroleum subsidy. Nevertheless, although some indicators suggest that the fiscal deficit has been reduced both relative to GDP and in real terms, it remains excessive. Therefore urgent action is called for to implement feasible measures to slow the deterioration in public finances, including (1) linking retail prices for petroleum products automatically to their pound costs with a margin to generate net revenue for the Government, (2) relating the exchange rate for customs valuation automatically to the prevailing market rate, (3) levying customs duties solely on vehicles' value, (4) combining a capital gains tax on real estate sales with the fee for their registration, and (5) restraining spending that is not directly productive or does not contribute straight-forwardly to social welfare. In addition, the Finance Ministry must act promptly to collect the overdue revenues from 1987. Further increases in public utilities' charges would be appropriate if they did not worsen the problem of delinquency. If this would worsen delinquency, consideration could also be given in the medium term to privatizing all or parts of the utilities for which there are difficulties collecting revenues.

Efforts to slow the growth of pound liquidity need to be continued. In this regard, the shifting of government debt to commercial banks and the private sector as well as the overissue of treasury bills are welcome. For the latter to remain effective, the proceeds placed with the Bank of Lebanon must not be used to finance additional government spending. Consistent with the effort to encourage widespread holding of government securities, no action should be taken to retire internal government debt by selling part of the Bank's foreign assets. Development of an instrument to complement treasury bills that would give the Bank greater discretion over the level of interest rates and other terms, such as certificates of deposit issued by the Bank, deserves consideration as a means to absorb bank and private sector liquidity.

In the recent past, speculation, expectations, and confidence have been the main determinants of the demand for pounds, with interest rates having played only a secondary role. However, the level of interest rates currently is a factor supporting the pound. Although a lower level of interest rates would reduce government interest costs and promote private sector activity, caution must be exercised so that the action does not initiate a shift in sentiment against the pound. Moreover, in the event that the pound comes under pressure, achieving consensus to raise treasury bill rates again could prove difficult and, with the attendant delay, the increase might not succeed in reversing momentum against the pound.

When the pound is appreciating, exchange market intervention to rebuild the Bank of Lebanon's foreign assets for meeting the public sector's needs or to protect export competitiveness should proceed cautiously. Intervention should not aim at fixing the rate at a predetermined level and the additional pound liquidity injected by these purchases of foreign exchange should be consistent with the overall objectives for growth of pound and total liquidity. If depreciation resumes, the Bank should only intervene briefly to curb speculative diversions or smooth daily fluctuations. It should not try to resist market trends as experience in Lebanon indicates that even heavy intervention can only briefly deflect the rate from its trend.

The authorities' determination to avoid contracting new external debt is appropriate under present circumstances.

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 the bilateral payment agreement with Poland (described in the accompanying report on Recent Economic Developments--SM/88/--), which is subject to Fund approval under Article VIII, Section 2(a). In the absence of a time frame for the elimination of the restrictive feature of the agreement, the staff does not recommend approval of this restriction at this time.

The Lebanese authorities have agreed for Article IV consultations with Lebanon to be placed on a bicyclic consultation cycle. It is recommended that the next full Article IV consultation be completed within 24 months.

Lebanon: Fund Relations

(As of July 31, 1988)

(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:	3.8 (86.1 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 freely floating since 1952. The Bank of Lebanon intervened persistently in the exchange market during 1983-84, spending US$1.9 billion in reserves. From then until 1988, the Bank's interventions were less frequent and more aimed at moderating short-term fluctuations. In 1988 the Bank has intervened more frequently to rebuild its reserves and stabilize the appreciating pound.

VI. Last Article IV Consultation:

Discussions were held by the staff May 18-22, 1987. The Staff Report (SM/87/150) was discussed by the Executive Board on September 18, 1987; it was agreed that the next consultation would be held on the standard 12-month cycle.

VII. Technical Assistance:

In August 1987 and April 1988, Lebanese officials met with the staff of MED to discuss financial and exchange rate policies.

VIII. Resident Representative/Advisor: None

Lebanon: Basic Data

Social and Demographic Indicators

Area	Population (1986)	Density (1986)
10.4 thousand sq km	2.7 million Rate of growth (percent): 0.4	260 per sq km 880 per sq km of arable land

Population characteristics (most recent) 1/

Life expectancy at birth	65 years
Infant mortality (aged under 1, percent)	4.7
Child death rate (aged 1-4, percent)	0.3

Income distribution (most recent) 1/

Percent of private income received by

highest quintile	55
lowest quintile	4

Access to safe water (most recent) 1/

Percent of population - urban	98
- rural	85

Nutrition (most recent) 1/

Per capita calorie intake (per day)	2,589
Per capita protein intake (grams per day)	68

Health (most recent) 1/

Population per physician	1,300
Population per hospital bed	200

Access to electricity (most recent) 1/

Percent of dwellings	98

Education (most recent) 1/

Primary school enrollment (percent)	121

Sources: IMF, International Financial Statistics for 1986 population. World Bank and International Finance Corporation, Social Indicators of Development 1987 for other social and demographic indicators.

1/ "Most recent" refers to any year during 1970-76.

Lebanon--Statistical Issues

1. Outstanding statistical issues

a. Real sector

The available price data are unofficial indices which 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 questionnaires has been received; no data are published in the GFS Yearbook and IFS because final audited data do not exist.

c. Monetary accounts

Data on monetary accounts are reported in the form of main aggregates only. The Bank of Lebanon has recently introduced a new call report form system for commercial banks and it is expected that these banks will commence reporting on the new basis shortly.

d. International banking statistics

Lebanon is a participant in the Bureau's International Banking Statistics Project. In January 1985, the Bank of Lebanon reported the geographic distribution of external assets and liabilities of resident commercial banks for June 1984. Since then, no data have been received. The Bureau of Statistics is in contact with the authorities on this matter.

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 August 1988 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 uncurrent and incomplete.

STATUS OF IFS DATA

		Latest Data in August 1988 IFS
Real sector	- National accounts	n.a.
	- Prices: CPI	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	October 1987
	- Deposit money banks	July 1987
	- Other financial institutions	n.a.
Interest rates	- Discount rate	January 1988
	- Bank lending/deposit rate	n.a.
	- Bond yields	n.a.
External sector	- Merchandise trade: Values	Q2 1987 1/
	Prices	n.a.
	- Balance of payments	n.a.
	- International reserves	May 1988
	- Exchange rates	May 1988

1/ Data are derived from Direction of Trade Statistics.