SM/86/68

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March 28, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Lebanon - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Lebanon. A draft decision appears on page 14.

It is proposed to bring this subject to the agenda for discussion on Friday, April 25, 1986.

Mr. Zavadjil (ext. 7115) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

LEBANON

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Consultation with Lebanon

Approved by A. Shakour Shaalan and J.T. Boorman

March 27, 1986

I. Introduction

The 1986 Article IV consultation discussions with Lebanon were held in Paris during the period January 20-24, 1986. 1/ The Lebanese delegation was headed by The Honorable Edmond Naim, Governor of the Bank of Lebanon, and included the Directors of the Treasury and the Minister's Office from the Ministry of Finance, and officials from the Council for Development and Reconstruction (CDR). The last Article IV consultation with Lebanon was concluded by the Executive Board on February 20, 1985. 2/ Lebanon continues to avail itself of the transitional arrangements of Article XIV.

II. Economic Background

Due to the lack of reliable data, quantitative assessment of macroeconomic developments in Lebanon is difficult. Official national accounts and balance of payments statistics have not been compiled since 1975 and the Ministry of Finance has not been able to finalize the budget accounts since 1979. However, monetary statistics are issued at regular intervals and provide the basis for an overall assessment of financial developments. The lack of data on the external sector as well as the climate of uncertainty prevent the preparation of medium-term balance of payments and debt scenarios.

Over the past decade, the Lebanese economy has been buffeted by armed conflicts that have resulted in considerable loss of life, dislocation of people, an exodus of professional manpower, capital flight, and widespread destruction of physical assets. The fragmentation of the country has also disrupted the flows of goods and of factors of production

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1/ Since the U.N. has classified Lebanon as phase V for security purposes, the mission was unable to go to Beirut. The staff representatives were Messrs. A.S. Shaalan (Head), P.L. Joyce, B.K. Short, and M. Zavadjil (all of MED).

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

while frequent interruptions of activity and transportation difficulties have constrained the level of utilization of the remaining productive capacity. Beirut has lost its position as the pre-eminent center of trade and services in the Middle East. According to IBRD and UNDP estimates, real GDP in 1980 was some 40 percent below the 1974 level. Output stagnated until 1982 and then declined further following a worsening of political prospects and security conditions in the spring of 1983.

During the periods of relative calm, there have been efforts toward reconstruction mainly through public sector investment under the aegis of the CDR; 1/ recently about 70 percent of total investment has been undertaken by that sector. However, these efforts have been hindered by the lack of financial resources as well as by recurrent hostilities. There have been no disbursements since mid-1982 from the US$2 billion pledged for the reconstruction of the country at the 1979 Conference of Arab League Heads of State and the hoped for meeting of the aid consortium that was to have been organized by the IBRD in 1983 did not take place.

The security situation has weakened the Government's ability to collect adequately taxes and user charges, while at the same time the Government has attempted to provide the customary services to the community and to subsidize a few consumer goods. As a result, the public sector deficit has increased steadily from LL 6.6 billion in 1982 to LL 9.8 billion in 1984. 2/ The latter amount was equivalent to 80 percent of total expenditures and the bank financing thereof was 19 percent of the Lebanese pound component of domestic liquidity at the beginning of 1984 (Chart 1, Table 1, and Appendix III). In 1983-84 government revenues declined at a compound annual rate of 3 percent in nominal terms (9 percent in real terms) as customs receipts, formerly the main source of government revenues, fell due to the frequent closures of the Port of Beirut and the operation of illegal entry points. Meanwhile, expenditures, including

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1/ The Government established the CDR in 1977 to formulate and supervise the public sector reconstruction and development program and encourage private sector activity. Capital spending is undertaken by both the Central Government and the CDR.

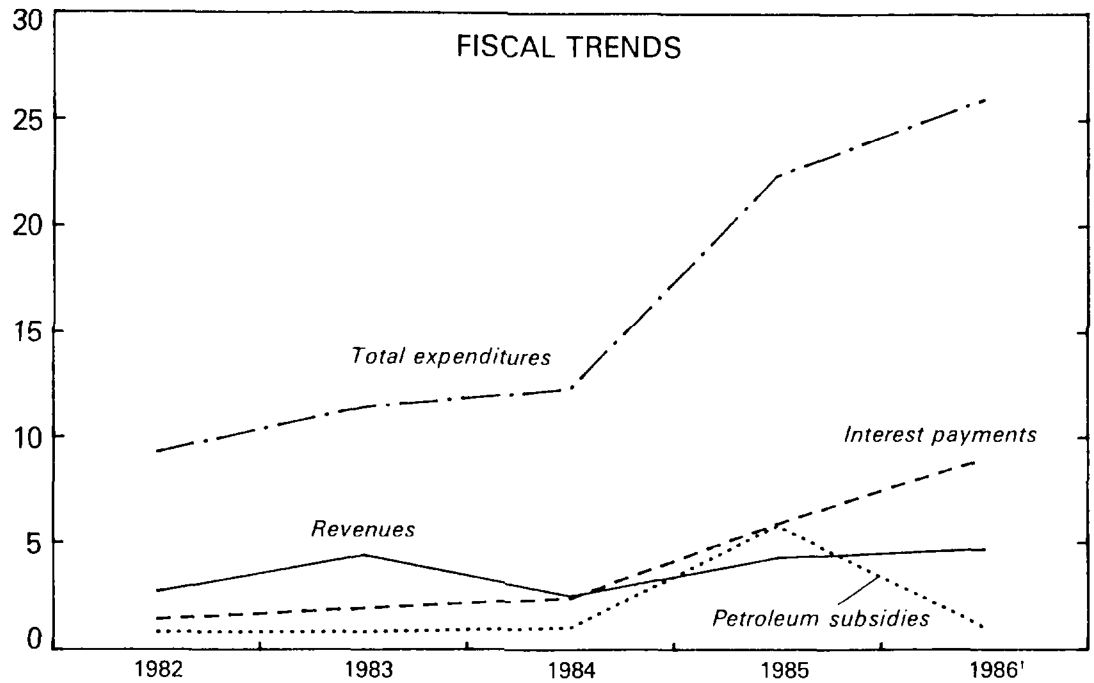
2/ Fiscal trends are best analyzed by comparing 1982 and 1984 as complete data are not available for 1981 while 1983 was an exceptional year in that relatively favorable security conditions in the first half of the year helped government finances somewhat.

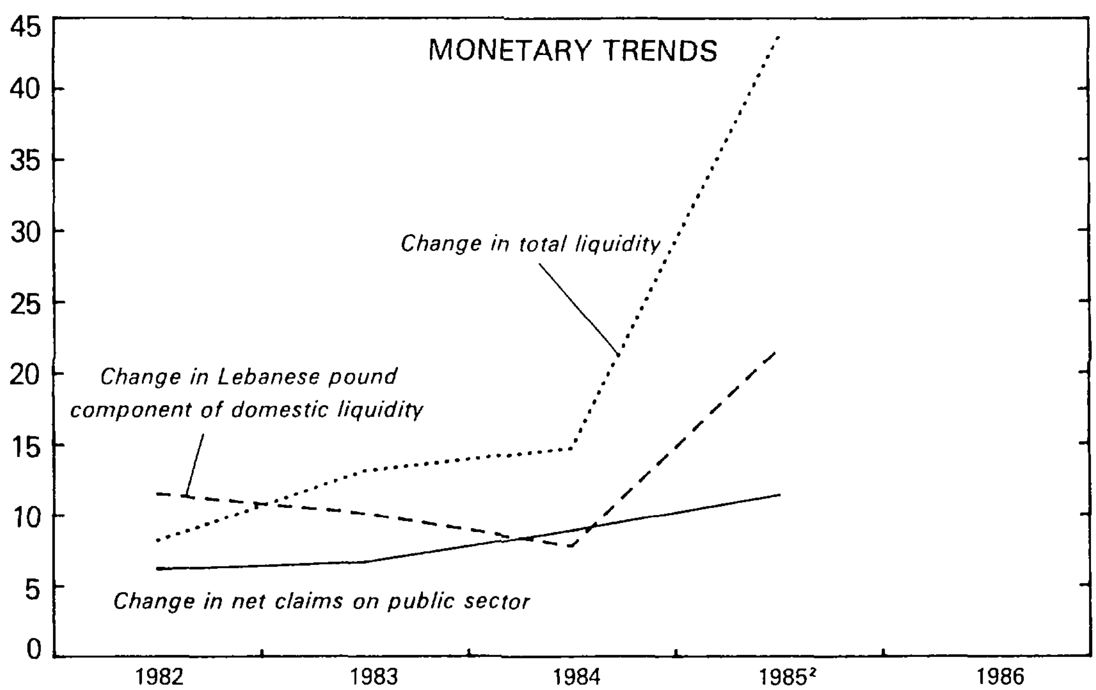
CHART 1

LEBANON

FINANCIAL TRENDS, 1982-86

(In billions of Lebanese pounds)





[1] Projections.
[2] 12 months ended September 1985.

Table 1. Lebanon: Selected Economic Indicators, 1982-86

	1982	1983	1984	1985	Staff Proj. 1986
			(Percentage changes)		
Fiscal operations					
Receipts	... 1/	62.7	-43.3	74.9	7.6
Expenditures and net extrabudgetary spending	... 1/	23.3	7.5	82.3	16.2
			(Ratios as a percent)		
Public sector deficit as a percentage of budgetary expenditures and net extra-budgetary spending	71.0	61.7	79.8	80.6	82.1
Domestic bank financing as a percentage of					
(i) Lebanese pound component of money and quasi-money at beginning of period	24.1	18.1	18.8	32.9	...
(ii) change in Lebanese pound component of money and quasi-money during period	53.7	66.1	114.3	83.4	...
			(Percentage changes)		
Monetary developments					
Money and quasi-money (M2)	20.2	26.9	23.8	63.6 2/	...
Lebanese pound component of M2	44.8	27.3	16.4	41.6 2/	...
U.S. dollar value of residents' foreign currency deposits with Lebanese banks	-5.8	-12.9	-8.7	-8.3 2/	...
Net claims on public sector	91.4	51.9	45.3	46.6 2/	...
Credit to private sector	21.2	30.3	26.7	33.2 2/	...
External sector					
Exchange rate (period average, percent change) (appreciation +)					
Nominal effective exchange rate	3.6	16.7	-21.5	-58.0	...
Real effective exchange rate	7.0	15.5	-16.4	-39.4	...
			(In millions of U.S. dollars)		
Balance of payments (US$ billions)					
Exports	0.9	0.6	0.5	0.4	...
Imports	-3.5	-3.7	-2.9	-1.8	...
Other items, net	3.0	2.3	1.2	1.6	...
Overall balance	1.2	-0.6	-1.2	0.4	...

Sources: Ministry of Finance, Bank of Lebanon, and Fund staff estimates.
1/ *Complete fiscal data for 1981 are not available.*
2/ Twelve months ended September 1985.

net extrabudgetary spending, 1/ rose at a compound annual rate of 10 percent (2 percent in real terms); the major increases were on account of interest payments (which rose at a compound annual rate of 20 percent), mainly reflecting a rapid expansion of the domestic debt, and of wages and salaries (16 percent), even though employment remained essentially unchanged. Investment expenditures also rose substantially in 1983-84 reflecting work on projects started in late 1982-early 1983.

As a significant portion of domestic liquidity consists of foreign currency deposits (28 percent at end-1984), exchange rate fluctuations have a considerable impact on the growth and composition of liquidity measured in domestic currency terms. In 1982-84 the annual growth rate of liquidity fluctuated in the range of 20-27 percent. The growth of the domestic currency part of liquidity peaked at 45 percent in 1982 when expectations of a political settlement led to a shift by the private sector out of foreign into domestic currency financial assets. However, growing pessimism as to political and economic prospects not only slowed the growth of the domestic currency component of liquidity to 27 percent in 1983 and 16 percent in 1984 but also led to a decline in foreign currency deposits, measured in U.S. dollar terms, at a compound annual rate of 7 percent in 1983-84. However, because of the depreciation of the Lebanese pound, the value of foreign currency deposits, in Lebanese pound terms, increased at a compound annual rate of 36 percent during the period. A major determinant of the growth of domestic liquidity in 1982-84 was domestic bank financing of the public sector deficit which rose from 54 percent of the change in the Lebanese pound component of liquidity in 1982 to 114 percent in 1984. Credit to the private sector rose at a compound annual rate of 26 percent in 1982-84, reflecting in part capitalization of interest on existing loans.

The balance of payments came under substantial pressure in 1983-84 reflecting Lebanon's reduced capacity of export goods and services, strong credit expansion and capital flight by Lebanese residents. Merchandise exports declined from US$0.9 billion in 1982 to US$0.5 billion in 1984 while imports averaged US$3.4 billion per annum in 1982-84, about the same level as in the preceding three years (see Table 1). The high level of imports, together with the relatively small depreciation of the Lebanese pound until end-1984, helped to contain the rate of inflation to less than 10 percent in 1982-83 and 25 percent in 1984.

1/ Net extrabudgetary spending is the difference between the budget deficit and the public sector deficit as indicated by the monetary and financial statistics. In addition to reflecting the net operations outside the budget of the autonomous agencies and enterprises, this category also encompasses extrabudgetary spending by the Government (most notably the subsidy for petroleum products).

The trade deficit was financed by a surplus on "other items, net" and net sales of foreign exchange by the Bank of Lebanon amounting to US$1.8 billion in 1983-84. The former mainly reflected private inward remittances by Lebanese employed in the oil producing countries of the region, exports of services, and private capital movements. Because of the reversal of capital inflows that occurred in 1982 and declining workers' remittances, the surplus on "other items, net" was reduced by US$1.8 billion in 1982-84 to US$1.2 billion.

Lebanon's exchange system remains free of restrictions. Traditionally, the Bank of Lebanon's intervention in the exchange market has been infrequent and limited in magnitude. But, in late 1982, when there was capital repatriation as a result of expectations of a political settlement, the Bank used that opportunity to build up its foreign exchange reserves by US$1.1 billion to an historically high level of US$2.6 billion (nine months of imports in that year). However, as the likelihood of a political settlement and economic recovery diminished, the exchange rate came under increasing pressure in 1983 and 1984. Despite large-scale support from the Bank of Lebanon, the Lebanese pound depreciated by about 30 percent in real effective terms (Chart 2). From November 1984, the Bank of Lebanon refrained from large-scale intervention in defense of the pound and rebuilt its foreign exchange reserves by US$0.4 billion to US$1.1 billion at the end of 1985, equivalent to seven months of 1985 imports. As a result of the growing financial imbalances and the change in exchange rate policy, the Lebanese pound depreciated a further 40 percent in real effective terms between November 1984 and the end of 1985 (from US$1 = LL 8.9 to US$1 = LL 18.1).

Lebanon's external nonmilitary public debt amounted to US$178 million at the end of 1985 and debt service averaged US$62 million in 1982-85. Lebanon has a bilateral payments agreement with a nonmember country (Poland) that is not subject to Fund approval.

III. Policy Discussions

In concluding the 1984 Article IV consultation, the Executive Board recommended to the Lebanese authorities the adoption of policies involving the reduction of the fiscal deficit, nonintervention in the exchange market, and the maintenance of a free and liberal exchange system. Notwithstanding the numerous constraints placed on policy formulation and implementation, the Lebanese authorities took several measures in 1985 to deal with the worsening financial situation. The 1986 consultation discussions focused on these measures as well as on exploring further means to reduce the financial imbalances, taking due account of security conditions, so as to slow the deterioration in the economy until a political settlement can be reached.

1. Impact of the war and reconstruction planning

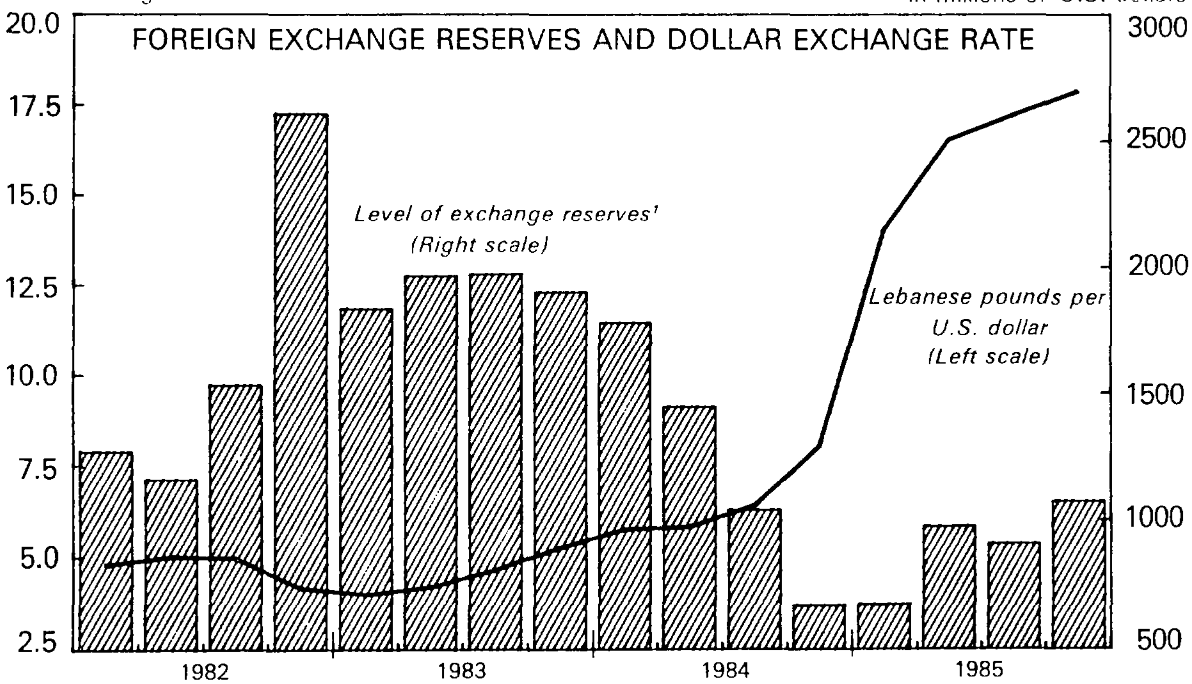
The Lebanese representatives informed the mission that frequent breakdowns of law and order in many parts of the country made 1985 possibly the worst year for the economy since the conflicts began ten years earlier. For example, in 1985 industry had operated at no more than 20 percent of capacity and it was estimated that a third of the labor force had not been productively employed. However, there were some indications of a modest recovery of economic activity in the second part of the year brought about by expectations (that once again proved to be temporary) of a political settlement. The Lebanese representatives added that economic activity in the south of the country had still not recovered from the effects of intense conflicts in that area; for instance, agriculture continued to suffer from the damage to orchards and agricultural infrastructure, the restrictions placed on the movement of goods, and competition from imports. Similar, but less severe, problems also appeared to exist in the northern and eastern parts of the country. However, on the positive side, two power plants in the south which had been disconnected from the Lebanese power system in 1982--resulting in a substantial decrease in electricity production in 1982-84--had been reintegrated into the system in 1985. Under present circumstances, a more comprehensive and quantitative assessment of the effects of the repeated fighting upon the population and the economy was not feasible.

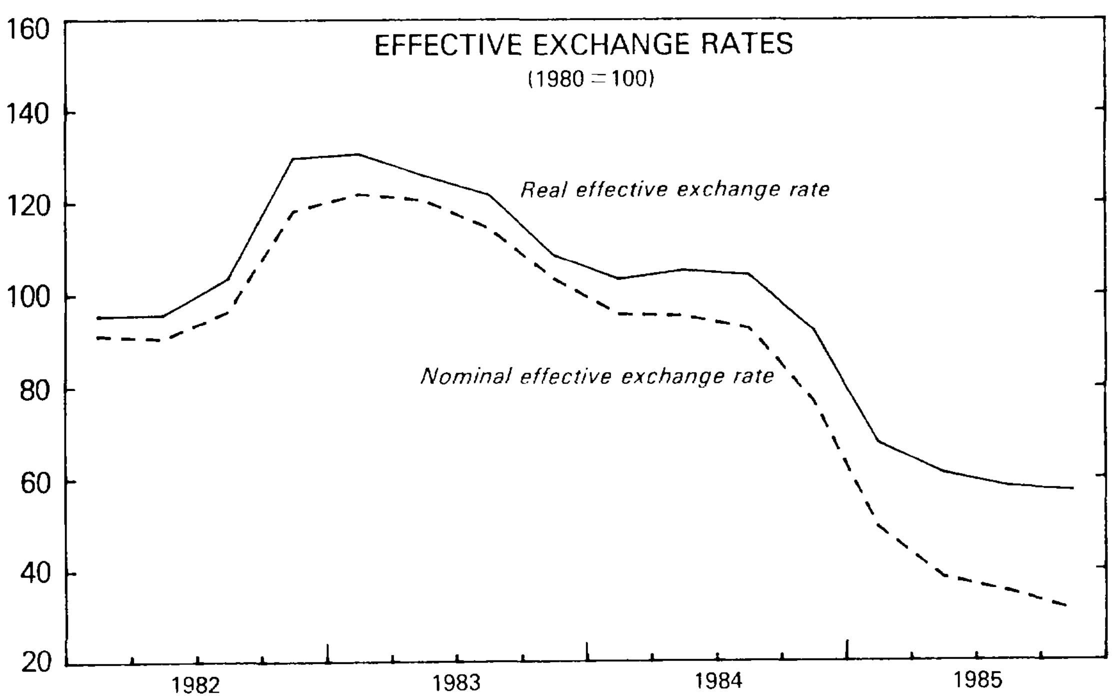
The Lebanese representatives said that in the absence of a considerable improvement in security conditions, the outlook for economic recovery was not promising as private investors' confidence was presently low. However, they were confident that, should security improve, capacity utilization and private investment would increase, particularly since many nationals now living abroad would return, and there would be inflows of financial resources, as had occurred in late 1982-early 1983. For 1985, it was estimated that public sector investment had declined from LL 3.7 billion in 1984 to LL 3.4 billion (a fall of 40 percent in real terms) as the same factors constraining investment in previous years continued to prevail. In particular, external financing had declined to only 16 percent of reconstruction spending in 1985 (against the 70 percent originally planned and 24 percent in 1983-84), with the Government providing most of the balance. The Lebanese representatives could not give an indication of public investment spending in 1986 since this depended considerably on the security situation, although they hoped that it could be increased. Efforts were now being made to direct public investment toward the industrial and agricultural sectors, which would strengthen the country's external position over the medium term. While recognizing the need for investment to restore basic services (education and health facilities, in particular) as well as vital infrastructure, the mission noted that a careful balance still had to be maintained between the requirements of reconstruction and development on the one hand and the desirability of avoiding an increase in the pressures on budgetary resources on the other hand. In this respect, it would be useful to consolidate the expenditure program of the CDR with the government accounts.

CHART 2

LEBANON

EXCHANGE RATES AND EXTERNAL RESERVES, 1982-85





[1] Excluding gold.

2. Fiscal policy

The public sector deficit nearly doubled between 1984 and 1985 reaching LL 18.1 billion, equivalent to 33 percent of the Lebanese pound component of liquidity at the beginning of the year; the deficit was financed almost entirely by the banking system. With the exception of transfers of Bank of Lebanon profits to the budget, there was no increase in government revenues in 1985; customs receipts were well below the budgeted level due to the re-emergence of illegal ports which had temporarily been closed in late 1984. On the expenditure side, interest payments on the government debt were two and one-half times as large as their level in 1984 as a result of the further expansion of the government debt and, for the first time, exceeded government revenues. Petroleum subsidies, which had been virtually eliminated by the increase in petroleum prices of November 1984, had grown to almost six times their level in 1984--accounting for over one fourth of total expenditure--due to the sharp depreciation of the Lebanese pound and the delay in adjusting prices. The mission tentatively projected that in the absence of vigorous measures the deficit would expand to LL 21-22 billion in 1986.

The Lebanese representatives explained that, given the weak revenue performance and the need to provide essential services, the growth of the fiscal deficit and its associated bank financing were unavoidable until a political solution to the armed conflict was reached. Nevertheless, the Government had taken a number of measures in 1985, whose positive effects would mainly be felt in 1986. For instance, the prices for petroleum products were increased by 68-73 percent in November 1985, thereby greatly reducing projected petroleum subsidies in 1986; imports of petroleum products were projected to decline by 30 percent in 1986 as the elimination of the price differential vis-a-vis neighboring countries was expected to bring illegal re-exports of these products to an end. The decline in international oil prices would also work toward reducing the petroleum subsidy in 1986, although part of this positive effect could be offset by the continued depreciation of the Lebanese pound. The mission urged the complete elimination of any remaining subsidies on petroleum products, as well as on other subsidized products and public services, and the flexible adjustment of prices thereafter to prevent their re-emergence. The Lebanese representatives explained that the pricing of petroleum products had become highly politicized so that a fully flexible pricing policy, or the privatization of petroleum activities, was excluded; however, they hoped that prices could be adjusted twice a year. For the same reasons, the prospects for eliminating the small wheat subsidy were not favorable. Subsidies on government services were inadvertent as they arose not because user charges were set too low but because the responsible government entities were unable to collect charges.

Turning to other expenditures, the Lebanese representatives explained that the freeze on the hiring of new government employees begun in 1984 continued to be enforced. A 20 percent increase in wages and salaries had been granted in 1985 and it was expected that the wage and salary adjustment would be about 34 percent in 1986, just over half of the estimated rate of inflation for 1985. The mission welcomed that budgetary investment spending had been cut significantly in 1985 and suggested that greater discipline also be exerted in approving current spending in 1986. Moreover, extrabudgetary spending by the public sector, often on the basis of treasury advances, should also be closely scrutinized.

On the revenue side, the Lebanese representatives said that increases of tax rates and user charges would be largely ineffective in view of the public sector's inability to collect revenues fully. However, the exchange rate used to value imports for customs purposes had been changed from US$1 = LL 6 to US$1 = LL 10 in November 1985. As the level still remained well below the market rate of US$1 = LL 19.45 at the end of February 1986, the mission urged the use of current exchange rates to value imports for customs purposes as many bulky imports still had to pass through the official ports. Other revenue measures taken by the authorities in 1985 were of lesser importance. 1/

In 1985 the fiscal deficit was financed mainly by selling treasury bills to commercial banks, rather than borrowing from the Bank of Lebanon. Although this practice increased interest costs to the Government, it absorbed bank liquidity and, by reducing the need for financing from the Bank of Lebanon, slowed the growth of bank reserves and, hence, the growth of domestic currency denominated liquidity. The mission indicated that even though interest rates on treasury bills were well below the rate of inflation the Government could not continue to borrow indefinitely at these rates in the absence of expanding revenues generated by real growth. Furthermore, unless the banks retained some confidence that the fiscal deficit would eventually be controlled, treasury bills would become a less attractive investment so that the Government would have to resort once again to reserve money creation. The mission welcomed that the Treasury had not drawn on the "profits" in the Bank of Lebanon's exchange revaluation account in 1985. As there was no cash flow corresponding to these "profits," drawing on them had the same economic impact as government borrowing from the Bank of Lebanon. Moreover, such a practice, by understating the size of the fiscal deficit, encouraged further spending.

3. Monetary policy

The effectiveness of monetary policy in recent years has been undermined by the large fiscal deficits and the growth of the share of foreign currency deposits in total liquidity. Measures intended to slow the rate of monetary expansion--such as the increase in reserve requirements, the imposition of private sector credit ceilings, and the financing of almost the entire fiscal deficit through sales of treasury bills to commercial banks--were offset by the acceleration in the growth of claims on the public sector, the increase in reserve money from the Bank of Lebanon's acquisition of foreign assets, and the depreciation of the Lebanese pound. As a result, domestic liquidity increased at an annualized rate

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1/ See the forthcoming report on Recent Economic Developments.

of 68 percent in the first three quarters of 1985 (compared with 16 percent during the same period in 1984). The increase in liquidity and the depreciation of the Lebanese pound contributed to an acceleration in the rate of inflation to 60 percent in 1985 from 25 percent in 1984.

Reserve money expanded at an annualized rate of 65 percent during the first three quarters of 1985 (against no growth during the same period in 1984), largely reflecting the Bank of Lebanon's acquisition of foreign exchange reserves. Unlike in the preceding two years, net credit to the public sector was not a source of reserve money growth; the high liquidity of commercial banks and the increasing liquidity of treasury bills as a result of the growth of the operations of the discount house encouraged commercial banks to increase their purchases of government debt in 1985, thus eliminating the need for the Government to borrow from the Bank of Lebanon. While welcoming this development, the mission noted that ideally the expansionary effect of the Bank of Lebanon's foreign transactions on reserve money should have been sterilized by a corresponding reduction in net credit to the Government. However, in practice, the large fiscal deficit was a constraint to the pursuit of such a policy. The mission also welcomed the two increases in reserve requirements to 17 percent in October 1984 and 18 percent in March 1985. 1/ These measures were an important factor in halting the upward drift in the ratio of total liquidity to reserve money that had taken place since 1981. The mission encouraged the authorities to raise the reserve requirement further in order to absorb bank liquidity and thus ensure that any increase in interest rates on treasury bills would be reflected in deposit rates. Following the consultation discussions, the staff was informed that reserve requirements would be raised to 22 percent and that the sales of treasury bills directly to the public had been approved.

The authorities imposed ceilings on the growth of private sector credit in February 1985 limiting the increase in the domestic currency component of credit to 30 percent for the 12 months ended September 1985; thereafter quarterly increases were not to exceed 7.5 percent. The increase had actually been 47 percent in the 12 months ended September 1985, partly because of the relaxation of the ceilings through the introduction of certain exemptions. 2/ The mission noted that even though a part of the expansion was on account of the capitalization of interest on nonperforming loans, the rate of credit expansion was excessive in view of the low level of economic activity and the pressures on the balance of payments. A tightening of credit ceilings should therefore be considered, especially if interest rates continued to be lower than the rate of inflation.

1/ After March 1985 commercial banks were allowed to hold 8.5 percentage points in special, low-yielding treasury bills, compared with 7.5 percentage points before.

2/ For details of the exemptions, see report on Recent Economic Developments (to be issued shortly).

Real interest rates on Lebanese pound deposits and loans remained substantially negative in 1985. Nominal interest rates on three-month treasury bills fluctuated narrowly in the 15-16 percent range for most of 1985, as against 10-12 percent in early 1984. The mission urged the authorities to increase interest rates in order to discourage a further shift out of Lebanese pound deposits, reduce the demand for credit by the private sector (including credit for exchange and commodity speculation), prevent excessive inventory buildup, and allocate credit to the most efficient borrowers. The mission noted that the beneficial effect of the increase in interest rates on liquidity growth would outweigh the effects stemming from the additional borrowing cost to the Government, which was the main concern of the authorities; however, for interest rate policy to be fully effective there would have to be a simultaneous reduction in the fiscal deficit.

The Lebanese representatives said that given the difficult economic conditions of the recent past, the capacity of many private sector establishments to service bank loans had been eroded. However, concerns about the banking system as a whole were unfounded. The Bank of Lebanon had occasionally given support to a few banks, on a case-by-case basis, and thus succeeded in maintaining confidence in the system. Also, in order to improve the liquidity and solvency of commercial banks, the Bank of Lebanon had announced in October 1983 that from December 31, 1984 each bank's liquidity ratio was not to fall below 25 percent, 1/ and that as of December 31, 1985 each bank was required to have capital and reserves equal to at least 3 percent of total assets and contingent liabilities. The behavior of banks' liquidity ratios had been generally satisfactory. Compliance with the solvency ratio regulation had initially been good, but by June 1985 half of the banks were below the minimum ratio, a development which the Lebanese representatives attributed to the rapidly increasing book value, in Lebanese pound terms, of assets denominated in foreign currency on account of the depreciation of the Lebanese pound; the banks' capital and reserves (denominated in Lebanese pounds) were growing more slowly. Therefore, the Bank of Lebanon announced in December that the application of the solvency ratios would be suspended until June 1986 in order to re-examine the application of the solvency ratio in conditions of rapid exchange rate depreciation. The mission expressed the view that the depreciation of the Lebanese pound had materially affected banks' solvency and that regulations on solvency ratios should not be relaxed; the strict application of liquidity and solvency ratios and their careful monitoring was important in maintaining confidence in the banking system. Furthermore, where needed, banks should be encouraged not to distribute their profits as dividends but to add to their provisions for bad and doubtful debts or to their retained earnings.

1/ The definition of liquidity and solvency ratios are described in detail in the forthcoming report of Recent Economic Developments.

4. External sector policies

As a result of the growing financial imbalances, pressures on Lebanon's external position persisted in 1985. Exports, net services receipts, and private inward remittances are estimated to have stagnated at best, while outward capital flows continued. However, unlike the situation in the second half of 1983 and in 1984 when these pressures were partly absorbed through sales of foreign exchange by the Bank of Lebanon, in 1985 a sharp depreciation of the Lebanese pound occurred as the Bank made small net purchases in the foreign exchange market. In response to the steep depreciation, as well as weak business activity and lower personal incomes which more than offset the impact of the expansionary credit policy, imports decreased from US$2.9 billion in 1984 to US$1.8 billion in 1985.

Concerning exchange rate and reserve management policies, the Lebanese representatives reported that since 1984 the primary objective of exchange market intervention was to smooth short-term fluctuations in the rate. However, when unusually large amounts of foreign exchange were offered on the market, the secondary objective was to purchase these so as to rebuild official reserves which had fallen at end-1984 to their lowest level since the conflicts began; the level of reserves had traditionally had an important impact on confidence in Lebanon and high reserve levels had tended to discourage speculation against the pound. Reflecting the almost continuous pressure on the exchange rate in 1985, only a limited reconstitution of reserves was achieved. The mission welcomed the exchange rate policy followed in 1985 of allowing the pound to respond to supply and demand, and encouraged the authorities to maintain this stance in 1986. As the pressures on the exchange rate are a reflection of the security conditions, the resulting fall in production, and the growing fiscal deficit, they cannot be alleviated more than temporarily through exchange market intervention. It should be noted that the Bank of Lebanon once again intervened substantially in the exchange market to defend the pound in the first two months of 1986, resulting in a decrease in foreign exchange reserves of US$0.5 billion to US$0.6 billion.

The Lebanese representatives reiterated their commitment to maintaining a free exchange system, as it had served the economy well. Any restrictions, aside from probably being unenforceable, would impair the efficient functioning of the economy. There had been no significant change in the exchange and trade system since the last discussions. The Lebanese representatives added that the authorities continued to exercise caution in borrowing from abroad. Under present circumstances, they did not favor an increase in foreign borrowing to finance reconstruction or support the exchange rate since the outcome of either additional investment or exchange market intervention was highly uncertain.

IV. Staff Appraisal

Over the past decade, the armed conflicts and the chronic lack of security in Lebanon have had severe repercussions on economic performance. Output has dropped to less than half its level in the mid-1970s, the fiscal deficit has grown relentlessly, monetary growth and inflation have accelerated, and the value of the Lebanese pound in terms of the major currencies has fallen. The Lebanese authorities have tackled the problems facing the economy with perseverance and courage but numerous constraints have limited their capacity to devise and implement some of the needed policies effectively.

Fundamentally, a revival of economic activity on an enduring basis depends on a restoration of peace and security. In the meantime, greater adherence to sound financial discipline could mitigate the adverse effects of the current upheavals. While lack of data and uncertainty as to future security conditions make it difficult to quantify the needed policy adjustment, it is clear that the present stance of fiscal and monetary policies is not compatible with reductions in the rates of inflation and depreciation of the Lebanese pound.

The contraction of output and difficulties in collecting revenues on the one hand, together with the maintenance of basic services and certain consumer subsidies on the other hand, have resulted in a massive and growing fiscal deficit. The authorities have recently taken certain measures which the staff welcomes and supports, including the substantial increase in prices for petroleum products, the continued freeze on the hiring of new employees by the Government, and the termination of the Government's drawing on the Bank of Lebanon's exchange revaluation account. Over the short term, the most promising area for restraining the growth of the fiscal deficit lies on the expenditure side, in particular in a further curtailment of subsidies and greater scrutiny of budgetary and extrabudgetary expenditures, including investment expenditures. Although the need for restoration of basic services is undeniable, investment priorities should be carefully established and adhered to so that public sector investment does not add excessively to pressures on prices and the balance of payments. While the current security problems have reduced the scope for enlarging the Government's revenues, the authorities should consider every possibility to raise revenues, including the adoption of the prevailing exchange rate to value imports for customs purposes, as was the practice before 1985.

Expanding fiscal deficits, which have been largely financed by the banking system, and the increase in the share of foreign currency deposits in total liquidity have reduced the effectiveness of monetary policy. In order to counter this development the staff urges the authorities to increase interest rates and maintain them at a level that encourages the private sector to hold domestic currency deposits (or treasury bills) rather than to convert them into foreign currency deposits or to accelerate spending on goods and services. The staff welcomes the recent increases in reserve requirements for commercial banks and recommends that bank liquidity and interbank interest rates be monitored closely. A tightening of ceilings on private sector credit also appears necessary. To maintain confidence in the banking system there should be no relaxation in the application of solvency and liquidity ratios; in addition, banks with non-performing loans should add to their provisions for bad and doubtful loans rather than distribute dividends.

The staff fully supports the change in exchange rate policy that occurred in late 1984 when the Bank of Lebanon abandoned its policy of large-scale intervention in the exchange market in support of the pound. The modest increase in foreign reserves in 1985 is also welcome since a high level of external reserves helps to maintain confidence in the banking system and the currency, but the expansionary effect of the external reserve buildup on reserve money should be sterilized. The staff urges the authorities to refrain from supporting the Lebanese pound through exchange market intervention as they did in the first two months of 1986. So long as the present security, economic, and financial conditions prevail, there is little alternative but for real incomes to adjust downward through the depreciation of the Lebanese pound. The staff welcomes the Lebanese authorities' resolve to maintain the present free and liberal exchange system and to remain cautious in foreign borrowing.

It is recommended to maintain the Article IV consultation discussions on a regular 12-month cycle. The Lebanese authorities concur with this recommendation.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

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

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

Lebanon - Fund Relations
(As of February 28, 1986)

(In millions of SDRs, unless otherwise indicated)

I. Membership Status

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

A. Financial Relations

II. General Department (General Resources Account)

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

III. Current Stand-by or Extended Arrangement and Special Facilities

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

IV. SDR Department

(a)	Net cumulative allocation:	4.4
(b)	Holdings:	2.0 (45.4 percent of net cumulative allocations)
(c)	Current Designation Plan:	--

V. Administered Accounts

(a) Trust Fund loans: --

(b) SFF Subsidy Account: --

VI. Overdue Obligations to the Fund

(a) General Department: --

(b) SDR Department: --

(c) Trust Fund: --

VII. Country has not used Fund resources to date.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangement:

The Lebanese pound has been freely floating since 1952. The Bank of Lebanon occasionally intervenes, usually in U.S. dollars, to moderate short-term fluctuations.

IX. Last Article IV Consultation:

Discussions were held by the staff during the period November 7-12, 1984. The Staff Report (SM/85/9) was discussed by the Executive Board on February 20, 1985. It was agreed that the next consultation would be held on the standard 12-month cycle.

The Executive Board's decision adopted February 20, 1985, was as follows:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Lebanon in the light of the 1984 Article IV consultation with Lebanon conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Lebanon maintains an exchange system which is virtually free of restrictions on payments and transfers for current international transactions. The Fund also notes the termination of bilateral payments agreements with two Fund members.

X. Technical Assistance

(a) CBD: In March-April 1982 a joint MED/CBD mission visited Beirut to assess the feasibility of issuing government bonds to the nonbank public. CBD and LEG are currently engaged in a review of the adequacy of banking legislation. Simultaneously, CBD is conducting an appraisal of the financial condition of the banking system.

(b) FAD: In May 1983 an FAD mission visited Beirut to establish a framework for a consolidated statement of government expenditure.

(c) Other: None.

XI. Resident Representative/Advisor: None.

Lebanon: Summary of World Bank Operations

1. The World Bank Group's remaining two operations in Lebanon, one in the education sector (US$6.6 million), and the other for reconstruction of telecommunications, water supply, and port systems (US$50.0 million), have come to an end after several extensions. The tenuous security situation in the country had periodically delayed implementation. Nevertheless, partial progress on these projects had been made, and both were essentially completed to the extent that circumstances permitted.

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

Lebanon - Basic Data

	1982	1983	1984	1985	Proj. 1986
Inflation					
Consumer price index 1/ (end of period, percent change)	9.6	3.8	25.3	60.1	...
Public finances (LL billions)					
Revenues	2.7	4.4	2.5	4.3	4.7
Expenditures, 2/ of which	9.3	11.4	12.3	22.4	26.0
Investment	(...)	(2.7)	(3.7)	(3.4)	(...)
Overall deficit	6.6	7.0	9.8	18.1	21.4
Borrowing from the banking system	6.2	6.7	8.9	18.1	...
Monetary survey (annual change in LL billions)					
Domestic liquidity, of which	8.2	13.1	14.7	43.7 3/	...
Foreign currency deposits	(-3.3)	(3.0)	(6.9)	(22.0) 3/	
Net foreign assets 4/	2.0	-3.5	-7.9	-0.2 3/	...
Domestic claims	10.7	14.6	17.9	24.8 3/	...
Net claims on public sector	(6.2)	(6.7)	(8.9)	(11.4) 3/	...
Claims on private sector	(4.6)	(7.9)	(9.0)	(13.3) 3/	...
Other items (net)	-4.6	2.0	4.6	19.1 3/	...
Balance of payments (US$ billions)					
Exports	0.9	0.6	0.5	0.4	...
Imports	-3.5	-3.7	-2.9	-1.8	...
Other items (net)	3.0	2.3	1.2	1.6	...
Overall balance	1.2	-0.6	-1.2	0.4	...
Reserves (US$ millions) (end of period)					
Gross official reserves	2,608	1,903	672	1,074	...
(in months of imports)	(9)	(6)	(3)	(7)	(...)
Net position of banking system 5/	2,691	2,223	849	1,129 6/	...
External debt (US$ millions)					
Medium- and long-term (end of period)	271	243	182	178	157
Debt service	71	68	63	45	47
Exchange rate					
Lebanese pounds per U.S. dollar (end of period)	3.81	5.49	8.89	18.10	19.45 7/

1/ Estimates provided by the Beirut Chamber of Commerce and Industry.
2/ Including net extrabudgetary spending.
3/ Twelve months ended September 1985.
4/ Excluding valuation changes.
5/ Gross official reserves, less Bank of Lebanon foreign liabilities, plus commercial banks' net positions in foreign currency (including positions with residents).
6/ September 1985.
7/ February 1986.

Lebanon - Statistical Issues

1. Outstanding statistical issues

a. Prices and trade

Official prices or trade statistics are not expected to be compiled in the foreseeable future.

b. Government finance

No reply to the GFS questionnaire has ever been received and no data are published in the *GFS Yearbook* and in *IFS*. An official of the Central Bank of Lebanon is attending a GFS French Course.

c. Monetary accounts

Lebanon reports monetary data by cable. These series, however, have been reported in the form of main aggregates only and until recently with considerable delay.

d. Balance of payments

Balance of payments statistics have not been compiled since the conflicts began in 1975.

e. International banking statistics

In January 1984, Lebanon agreed to join the Fund's international banking statistics project. In January 1985, Lebanon's first contribution, providing a geographic analysis of the external positions of banks in Lebanon as of end-June 1984, was received by cable. Since then, no further reports have been received.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Lebanon in the February 1986 issue of the *IFS*. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Lebanon, which during the past year have been provided only for the monetary accounts and on an infrequent basis. In other areas of statistics virtually no data were reported during the past year.

Status of IFS Data

			Latest Data in March 1986 IFS
Real Sector	-	National Accounts	n.a.
	-	Prices	n.a.
	-	Production	n.a.
	-	Employment	n.a.
	-	Earnings	n.a.
Government Finance	-	Deficit/Surplus	n.a.
	-	Financing	n.a.
	-	Debt	n.a.
Monetary Accounts	-	Monetary Authorities	August 1985
	-	Deposit Money Banks	April 1985
	-	Other Financial Institutions	n.a.
External Sector	-	Merchandise Trade: Value	Q2 1985 1/
		Prices	n.a.
	-	Balance of Payments	n.a.
	-	International Reserves	January 1986
	-	Exchange Rates	January 1986

1/ Data are derived from previous country information in the Direction of Trade Statistics database.