SM/85/9

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INFORMATION

January 7, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Lebanon - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Lebanon. A draft decision appears on page 14.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Abed, ext. 7121.

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INTERNATIONAL MONETARY FUND

LEBANON

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Lebanon

Approved by A.S. Shaalan and Subimal Mookerjee

January 4, 1985

I. *Introduction*

The 1984 Article IV consultation discussions with Lebanon were held in Limassol, Cyprus during the period November 7-12, 1984. 1/ The Lebanese representatives included the Director of Research of the Bank of Lebanon, the Director of the Treasury of the Ministry of Finance, the Director of Planning of the Council for Development and Reconstruction, and other public officials. The Governor of the Bank of Lebanon, who could not leave Beirut for administrative reasons, 2/ communicated from Beirut with the staff representatives in Limassol. The staff representatives were Messrs. A.S. Shaalan (Head), G.T. Abed, R.H. Floyd, B.K. Short, (all of MED), P. Stella (ETR), and Miss M.M. Pirret (Secretary-MED). Lebanon continues to avail itself of the transitional arrangements of Article XIV.

II. Background

It is exceedingly difficult to form an accurate assessment of economic and financial developments in Lebanon as official statistics on production, prices, and on key elements of the balance of payments have not been compiled since 1975. The Government's fiscal position cannot be fully ascertained beyond 1979 as the security situation has delayed the closing of accounts by the Ministry of Finance. However, monetary data are available on a current basis and these, together with information on certain indicators, provide a reasonable basis for an overall assessment.

For nearly a decade, the Lebanese economy has suffered from armed conflict and, more recently, from the occupation of large parts of the country by foreign forces. The conflict has caused considerable loss of life and injury, the dislocation of large portions of the population,

1/ Since the UN had classified Beirut as phase V for security purposes ("evacuation of staff..."), the mission was unable to go to Lebanon.

2/ The law requires that at least the Governor or one deputy be in Beirut at all times. However, all three positions of Deputy Governor are vacant.

the destruction of infrastructure and a significant portion of the productive base, and the outflow of professional manpower and financial resources. Indications are that, after some real growth in 1979-80, output declined in 1981 and in the first five months of 1982, as the security situation gradually worsened. During the Israeli invasion in the summer of 1982, economic and financial activity came to a virtual halt in a number of areas including Beirut. After the multinational force was installed late in that year, security in the Beirut area improved and economic activity recovered somewhat. However, the renewed deterioration of security conditions since the spring of 1983 dimmed expectations and led to reduced activity, even in those areas not directly affected by the conflict. The result is that real output in 1984 is expected to be about half of the corresponding level before the conflict began in 1975.

During periods of relative calm, efforts have been directed toward reconstruction by the public and private sectors. The Government established the Council for Development and Reconstruction (CDR) in 1977 to formulate and supervise the public sector reconstruction program and to encourage private sector activity. Reconstruction was carried out intermittently, but was continuously subject to the vicissitudes of security conditions and the availability of financing. At the 1979 Conference of Arab League Heads of State, Lebanon received pledges of US$2 billion in reconstruction grants for the period 1980-84. However, disbursements from these commitments, which were made before mid-1982, were only about US$400 million. Since then, no further disbursements have been made. When security improved in Beirut toward the end of 1982, the IBRD became involved in assisting the CDR in formulating a new reconstruction plan and setting up a consortium of aid donors. In the event, the consortium was not held due to the renewal of fighting in the spring of 1983 and the plan was later revised by the Lebanese authorities, both by reducing its expenditure targets and altering its priorities toward immediate needs.

The inability of the Government to exercise full authority throughout the country has undermined public finances. Due to delays in closing public sector accounts, formulation of the budget has become increasingly difficult, and the large share of extrabudgetary accounts (about one fifth of budgetary expenditure in 1984) has eroded the usefulness of the government budget as an indicator of public sector activity. Banking and financial data indicate growing public sector deficits, probably equivalent to one third of GDP, and well in excess of published central government budget estimates. Domestic bank financing of the deficit has risen to the equivalent of 15 percent of the stock of broadly defined money at the beginning of the 12 months ended September 1984, compared with 7 percent in 1979. Domestic public debt, which is owed mostly to the banking system, has risen from a negligible amount in the prewar period to a level most probably exceeding GDP in 1984.

Fiscal developments over the last few years have shown a disturbing pattern of slow growth in receipts and of rapidly rising expenditures. Customs duties, which had always formed a major element of government revenue, fell even relative to imports, due to frequent closings of the

Beirut port, the use of illegal entry points outside the control of the Central Government, and the spread of smuggling in general. Although customs receipts rose early in 1983, they dropped thereafter due to a renewed shift of imports to channels outside government control.

Central government expenditures have risen fivefold in absolute terms, growing from 117 percent of government revenue in 1979 to an estimated 333 percent in 1984. Although employment has remained more or less constant, the Government's salary costs have more than tripled over the same period, and an overall increase of 7 percent became effective January 1, 1984. Interest on domestically held debt has surged from only 6 percent of government revenue in 1979 to an estimated 51 percent in 1984. Capital outlays in the budget quadrupled between 1979 and 1984 but remained rather low, accounting for about 16 percent of budgeted government spending in 1984. Extrabudgetary spending, mainly on account of the autonomous public authorities, increased two-and-a-half times between 1979 (when it was equivalent to 45 percent of government revenue) and 1984 (68 percent of revenue).

Monetary developments need to be viewed with caution as the Lebanese pound value of residents' foreign currency deposits with banks in Lebanon fluctuates according to the prevailing exchange rate. The growth rate of money and quasi-money denominated in Lebanese pounds (i.e., excluding foreign currency deposits) peaked at 45 percent in 1982 (see Table 1). In the latter half of that year, expectations of improved economic conditions led to a large increase in demand for Lebanese pound deposits by residents and a corresponding shift by them out of foreign currency deposits. Thereafter, residents' increasingly negative expectations of economic prospects slowed the growth of money and quasi-money denominated in Lebanese pounds to 27 percent in 1983 and to 17 percent during the 12 months ended September 1984. Measured in terms of the U.S. dollar, residents' foreign currency deposits in Lebanese banks fell by 13 percent in 1983 and by a further 17 percent over the 12 months ended September 1984. The slower growth of residents' Lebanese pound deposits, combined with a decrease in their foreign currency deposits with banks in Lebanon, suggests a steady shift of deposits abroad. Credit to the public sector, which grew by 51 percent in 1983 and 54 percent in the 12 months ended September 1984, has become the most important factor in monetary expansion. Bank credit to the private sector has continued to grow at rapid rates, although these have slackened in the most recent period. The bulk of commercial bank credit to the private sector in this period has been to help finance interest payments on existing debt. Reflecting the openness of the economy, monetary expansion in excess of money demand has led to a continued high level of imports and capital outflows leading to depreciation of the pound and reduction in the banking system's net foreign assets. The last development has been a counterweight to the expansionary effect on money and quasi-money caused by the growth in the banking system's net domestic assets. Despite the high rates of monetary growth at a time when real output was declining, inflation has remained only moderate, but is reported to have risen in the early months of 1984 to about 7-10 percent, and may have accelerated since then. The relatively low rates of inflation reflect the openness of the Lebanese economy, excess capacity, and the ready availability of smuggled goods.

Table 1. Lebanon: Summary of Economic Developments, 1981-84

	1981	1982	1983	Sep. 30, 1983- Sep. 30, 1984	Staff Proj. 1984
			(Percentage changes)		
Fiscal operations					
Receipts	24	-2	24	...	-11
Expenditures and net extrabudgetary spending	39	28	18	...	24
			(Ratios as a percent)		
Public sector deficit as a percentage of total expenditures	57	67	65	...	75
Domestic bank financing as a percentage of					
(i) M2 1/ at beginning of period (percent)	12	14	14	15	15
(ii) change in M2 1/ during period (percent)	30	69	51	82	...
			(Percentage changes)		
Monetary developments					
Money and quasi-money (M2)	40	20	27	19	...
M2 held in Lebanese pounds	29	45	27	17	...
U.S. dollar value of residents' foreign currency deposits with Lebanese banks	30	-6	-13	-18	...
Net claims on public sector	93	78	51	54	...
Credit to private sector	32	21	31	19	...
External sector					
Exchange rate					
Lebanese pounds per U.S. dollar (end of period)	4.61	3.81	5.49	7.27	7.50 2/
Percentage change (-depreciation)	-21	21	-31	-33	-32 3/
Overall position of balance of payments (i.e., change in net foreign assets of central bank --in millions of U.S. dollars)	-66	1,094	697	...	-1,000

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

1/ Money and quasi-money.
2/ End of October 1984.
3/ End of October 1983 to end of October 1984.

Lebanon's exchange system remains virtually free of restrictions with rates for the Lebanese pound being determined by supply and demand in the market. The Bank of Lebanon's interventions in the exchange markets have been intended to smooth random fluctuations, counteract speculation, and slow unduly rapid changes in exchange rates. Until 1982, these interventions were infrequent and limited in magnitude. However, in the latter half of 1982, the Bank intervened more determinedly to slow the sharp appreciation of the pound, following the installation of the multinational security force in Beirut. Whereas the Lebanese pound had depreciated by 57 percent against the U.S. dollar (50 percent against the SDR) from February 1975 to the end of July 1982, it appreciated by 35 percent against the U.S. dollar (34 percent against the SDR) in the last five months of 1982. Since then, general disappointment over the lack of improvement in security conditions, has contributed to the depreciation of the pound by 50 percent in terms of the U.S. dollar (44 percent in terms of the SDR) to the end of October 1984. In the first ten days of October 1984, there was a rapid depreciation of the pound (which for a short period reached the level of LL 9.30 per U.S. dollar), followed by a substantial appreciation to LL 7.50 per U.S. dollar by the end of the month. The pound's recovery during this period was brought about in part by the package of fiscal and monetary measures taken at the time (see below).

The Lebanese pound's depreciation from 1975 through 1981 occurred at a time when the overall balance of payments (defined as changes in the net foreign assets of the Bank of Lebanon) was usually in near balance, reflecting the Bank of Lebanon's policy of nonintervention in exchange markets. The Bank of Lebanon's objective was to hold its net foreign assets more or less constant and, if the opportunity arose, to add modestly to its reserves without disturbing the exchange market. When the Lebanese pound came under pressure in the first half of 1982, the Bank committed US$350 million of its reserves to slow the depreciation of the pound. Conversely, when the pound appreciated in the second half of 1982, the Bank acquired US$1,450 million of reserves to moderate the appreciation. Thus, the balance of payments showed an overall surplus of US$1,100 million in 1982. At the end of 1982 the Bank's reserves, excluding gold, amounted to US$2.6 billion, a historically high level. 1/ From the beginning of 1983 to October 1984, the Bank generally satisfied the public sector's foreign exchange requirements from its own reserves rather than from the market, and as a result, the overall balance of payments showed deficits of US$700 million in 1983 and US$1,150 million through the first ten months of 1984. At the end of November 1984, the Bank of Lebanon's foreign exchange reserves stood at US$715 million, equivalent to about 2.5 months of imports. Lebanon's non-military public debt, which has always been low, was less than US$200 million at the end of 1984, with corresponding service payments of US$64 million in 1984, more than half of which is for payment of principal.

1/ The Bank of Lebanon's gold holdings have been practically unchanged at 9.2 million fine ounces for over ten years. Valued by the Bank at US$42.22 per fine ounce, these holdings were equivalent to US$389 million at the end of October 1984. The Bank's foreign liabilities have traditionally been extremely small, amounting to less than US$2 million at the end of October 1984.

Lebanon has a bilateral payments agreement with one non-member (Poland) which is being terminated. The outstanding balances are modest. Two bilateral payments agreements with Fund members (Guinea and Romania) and one with a non-member (Czechoslovakia) were terminated in 1984.

III. Report on Discussions

The continuation of unsettled political and security conditions in Lebanon poses the single most serious challenge to the effective management of the Lebanese economy. The consultation discussions focused on measures already taken, especially in the fiscal and monetary fields, and those that were contemplated by the Lebanese authorities to deal with the deteriorating financial situation. It is clear, however, that the feasibility of a more comprehensive approach to economic stabilization in the country remains contingent upon a fundamental improvement in security conditions.

1. Impact of the war and reconstruction planning

The Lebanese economy has continued to suffer from the devastating impact of a decade of war and, since early in 1983, from severe recessionary conditions brought on, in part, by diminished expectations of a political settlement. The prolonged periods of fighting and the accompanying destruction and dislocation have brought about profound structural changes in the Lebanese economy. These include large-scale population relocation, fragmentation of the national market, the emigration of large numbers of professional and skilled manpower, and the decline of Beirut's role as a regional trade and banking sector. Partly in response to the highly volatile conditions, the Lebanese authorities have maintained a flexible approach to reconstruction and development planning. In 1983 the CDR was reorganized and earlier plans were revised to take account of the structural changes in the economy, reduced expectations of external assistance, and the need for greater pragmatism in the choice and implementation of reconstruction and development projects. Medium-term plans are now being implemented through annual programs devised on the basis of urgent basic needs, the availability of external resources, and internal absorptive capacity. In order to avoid excessive pressures on domestic resources, the Lebanese authorities have scaled down earlier expenditure targets and, in the context of the revised plans, have sought to secure foreign grants to the extent possible. They have also sought to stimulate the role of the private sector through concessionary loans and other incentives aimed at reactivating productive capacity.

An expenditure program of CDR amounting to LL 6.7 billion had been approved for the two-year period 1983-84, but because of prevailing security conditions only LL 1.5 billion was committed in the first year and LL 763 million was actually disbursed. About 43 percent of disbursements was for various credit programs aimed at financing housing, industry, and hospital repair and construction, while 10 percent was targeted for reconstruction in the south. The expenditure program was revised in November 1984 and a target of LL 4.3 billion was established for the period November 1984 to October 1985. Approximately 38 percent of this program would be for various basic needs, such as housing, health care, and education; 37 percent for agricultural and industrial investment; and 25 percent for basic infrastructural investments--mainly water supply, waste management, and roads.

While recognizing the unquestionable need for rehabilitation and reconstruction, the staff expressed concern that the associated program appeared to exceed the capacity of the public sector to provide non-inflationary sources of finance, especially in light of the tight budgetary situation and the paucity of external financial support. The staff also urged the Lebanese authorities to consolidate the expenditure program of CDR with the government accounts in order to improve the monitoring of public sector operations and their impact on the domestic economy. The Lebanese representatives recognized the possible inflationary impact of a sizable reconstruction program but stated that given the openness of the economy and the extensive idle capacity, expenditures at current levels could be financed without undue pressures on domestic prices. They added that CDR would continue to coordinate its programs with the annual budgetary process, although complete consolidation with the budget would be difficult in the circumstances (as it requires new legislation).

The occupation of the south has had an adverse impact on production, as well as on the movement of goods between that region and the rest of the country. In addition to the destruction caused by the Israeli invasion in 1982 and by continued breakdowns of security in the region, a significant portion of agricultural land has been put out of production, and cumbersome and costly restrictions have been placed on the movement of people and goods from and to the region. Similar, but less severe problems appeared to exist in the northern and eastern parts of the country. The presence of foreign forces in these regions and the frequent outbreak of hostilities have served to deepen recessionary conditions and hamper the Government's effort to achieve economic recovery. Moreover, large-scale emigration of professional and skilled manpower and the decline in financial and banking activity on account of prevailing uncertainties have frustrated the efforts by the private sector to restore activity in the basic productive sectors.

2. Fiscal policy

The difficult security situation has also hampered effective fiscal management as the added burdens of reconstruction and security have increased public sector outlays, while limited progress in restoring government authority to all parts of the country has deprived the Government of a substantial portion of its domestic revenue base. The mission expressed serious concern about the size of the fiscal deficit, and especially about increased reliance on central bank borrowing to finance it. Not only does the larger deficit signal a marked expansion in the relative size of the public sector in what has been traditionally a laissez-faire economy, but the domestic public debt service, which was nonexistent in Lebanon before the initial outbreak of hostilities, now absorbs one half of total budget receipts. An additional troubling aspect of the financing of the deficit is that with the depreciation of the Lebanese pound since early in 1983, the domestic currency value of the central bank's foreign assets has risen considerably and the resulting bookkeeping "profits" have been treated by the Government as ordinary budget receipts. The mission urged the discontinuation of this practice as the utilization by the Government of these bookkeeping "profits" constituted a destabilizing element in the economy. Use of these funds as revenues leads to the budgeting of higher expenditures, thus causing the underlying deficit to rise. As the resulting expansionary effect is reflected in further depreciation of the pound, the domestic book value of the central bank's foreign assets rises, thereby making additional "funds" available to the Government to finance further increases in spending.

The Lebanese representatives shared the mission's concern about the fiscal situation and explained that a number of measures had been taken to rectify, if not completely correct, the underlying fiscal imbalance. Effective October 28, 1984 the domestic prices of all petroleum products were raised so as to eliminate the annual subsidy of about LL 800 million (about 8 percent of the entire fiscal deficit). In addition, the authorities took the politically courageous step, early in November 1984, of closing all illegal ports and restoring government authority to overland customs points. The Lebanese representatives emphasized that the latter measure had had a positive psychological impact by manifesting the Government's readiness to act decisively to promote economic stability. They estimated that this action, together with increases in customs duties introduced in earlier years and the expected decline in smuggling of certain high tariff goods, would raise customs receipts severalfold, although the impact on the overall fiscal gap would be small. In addition, a number of excise duties have been raised in the past two years and charges for electricity and water have been increased. Administrative procedures aimed at improving the collection of income and profit taxes from corporations have been strengthened and the outreach of the Ministry of Finance has been expanded through branch offices in all districts, including the occupied areas of the country. The Lebanese representatives stated that there were still some difficulties in collecting taxes in the occupied areas of the country but measures were being taken to deal with them.

The Lebanese representatives also shared the concern of the mission with regard to the domestic bank financing of the public sector deficit, and agreed with the mission's view that the Government's drawings from the Bank of Lebanon's exchange revaluation account had the same effect as bank borrowing. They added, however, that to terminate this latter practice would require an amendment to the Code of Money and Credit, a procedure which could be lengthy and less than fully effective in the circumstances. However, to encourage the general public to buy treasury securities the authorities had recently reduced the minimum denomination to LL 5,000 and had taken other administrative steps to improve their marketability to the public. Furthermore, with the aim of raising the structure of domestic interest rates, the authorities increased the effective yield to 18.3 percent per annum on 12-month treasury bills. The mission observed that, while the increase was desirable in the short run, the authorities could not continue to pay such high interest rates indefinitely without real growth in the economy.

Concerning the outlook for 1985, the Lebanese representatives assured the mission that all efforts were being made to keep the overall spending target at or below the corresponding level for 1984. The Cabinet had already trimmed LL 1.6 billion (about 12 percent) from the proposals presented to it, mainly by cutting defense spending and postponing new capital projects, while reconstruction expenditures under CDR would be kept under review, especially in light of the availability of foreign financing. In addition, stricter procedures were being introduced in the new budget to limit treasury advances to autonomous authorities; these had permitted the authorities to run operational deficits for lengthy periods of times. Finally, increases in wages and salaries would be kept to the minimum level required to retain public sector employees for basic government services.

3. Monetary policy

The budget deficit has been by far the main source of growth in domestic liquidity in the past several years. The deficit's liquidity-creating impact has accelerated in the past two years, although the net expansionary impact of the deficit has been substantially offset by a rapid decline in net foreign assets during this period. The growth of money and quasi-money in domestic currency peaked at nearly 45 percent in 1982 (when a large balance of payments surplus contributed to the growth of domestic liquidity) but has declined to about 17 percent in the 12-month period ended in September 1984. The rapid expansion of domestic liquidity has been far in excess of corresponding demand levels, causing a steady shift of funds by the private sector into foreign currency deposits, first with domestic banks and increasingly with banks abroad. These shifts have aggravated the underlying pressures on the exchange rate.

The Lebanese representatives shared the mission's concern about the high rates of liquidity expansion and pointed to a number of measures they had taken in recent months to contain the growth of money supply. First, the effective yield on all treasury bills was raised in October 1984, thereby inducing a general increase in the structure of domestic interest rates. The Societe Financiere du Liban (SFL), which had been established in 1983 primarily to develop a secondary market in treasury bills, began active operation in May 1984 and was seeking to facilitate the authorities' interest rate policy. Supported by a line of credit from the central bank, the SFL was absorbing excess bank liquidity by borrowing funds in the interbank market for investment in treasury bills. The object is to reduce bank liquidity and keep an upward pressure on interest rates for Lebanese pound deposits. In addition, effective October 5, 1984, the obligatory reserve requirement was raised from 15 percent to 17 percent (legal restrictions on increases in this ratio above 15 percent required that the circumstances be judged as "exceptional"). As before, banks were allowed to hold 7.5 percent in the form of special, low interest-bearing treasury securities. The mission held that these measures may have had a partially stabilizing effect on the economy but that, in the current circumstances of Lebanon, monetary measures alone were insufficient for containing the expansionary impact of the budget deficit. The staff emphasized that the fundamental cure to the widening imbalances continued to lie in reducing the fiscal deficit itself.

The unsettled security conditions and the deepening recession of the more recent period, have placed the private sector in a precarious financial position with an adverse impact on the liquidity and solvency of the domestic banking system. Commercial banks have become increasingly reluctant to extend new credit to the private sector, as a rising portion of existing loans has become nonperforming. The bulk of new bank credit has been extended to finance private borrowers' interest payments on existing debt. The mission emphasized that in light of the banking system's vital role in the Lebanese economy, this weakening of the banking system should be viewed as a serious development. The Lebanese representatives agreed with the mission's assessment and stated that measures had been taken, both by the banks themselves and by the authorities, to strengthen the commercial banks' financial position. The banks have for some time refrained from distributing any profits and have been adding to their reserves and loan loss provisions. In October 1983 the Bank of Lebanon had introduced two requirements on commercial banks aimed at strengthening their liquidity position and improving their solvency. First, from December 31, 1984 each bank's liquidity ratio was not to fall below 25 percent. Second, as of December 31, 1985 banks would be required to have paid-up capital equal to at least 3 percent of their total assets and contingent liabilities. In the period from October 1983 to December 1985 no bank was to permit its solvency ratio to fall below 3 percent if initially above this level, or to fall at all if initially below 3 percent. The Lebanese representatives added that increased holdings of treasury securities by commercial banks had strengthened the banks' balance sheets and improved their earnings. The mission welcomed the measures taken by the authorities to improve the condition of banks and urged that, as a supporting measure, the capacity of the Bank Control Commission be further strengthened so as to enable it to carry out its bank supervisory functions more effectively.

4. External sector policies

The balance of payments of Lebanon has been traditionally in near balance with a deficit on the trade account being offset by service receipts and unrequited transfers, the last two having been more volatile and strongly influenced by political factors. As noted earlier, the appreciation of the pound in the latter half of 1982 has been followed since then with worsening security conditions and a substantial depreciation of the pound. During this period the central bank met the Government's rising import requirements for security supplies and for reconstruction from its own reserves rather than from the exchange market. As a result, the overall balance of payments outcome recorded a deficit of about US$700 million in 1983. The central bank's policy of providing the Government with its foreign exchange needs continued through most of 1984 and the Bank of Lebanon's reserves declined to US$715 million by November 30, the lowest level in several years. In the absence of progress toward a political settlement in the country, the central bank has become convinced that the weakening of the pound rate in exchange markets reflected fundamental weaknesses in external accounts and has ceased to draw down its external reserves.

The Lebanese representatives emphasized that the objective of the authorities throughout this turbulent period had been that of maintaining a freely floating exchange rate with occasional intervention only to smooth out short-term fluctuations in the rate. They concurred with the mission's view that the provision of foreign exchange directly to the Government was a form of intervention in the exchange markets and that the termination of this practice was appropriate. The mission emphasized that the level of foreign exchange reserves of the Bank of Lebanon, which had been historically high and had often provided an important sign of the strength of the Lebanese financial system, had declined to a perilously low level and that efforts must be made to prevent any further deterioration.

In response to these external sector developments, the Lebanese authorities have taken a number of measures aimed at improving the supply of foreign exchange to the markets and undercutting speculative forces. Effective October 18, 1984, the maximum allowable net foreign currency position of commercial banks was reduced from the equivalent of 50 percent to 15 percent of each bank's capital, and daily monitoring of this ratio was introduced. To prevent speculation in the market, the Bank of Lebanon also placed a 100 percent reserve requirement on Lebanese pound holdings of nonresident banks and institutions. The central bank has also required all commercial banks to provide daily information on overdrafts made by large depositors and on all trade-related credit with the aim of ensuring that the borrowing of foreign exchange is not used for speculative purposes. As a supportive monetary measure, the central bank has encouraged a policy of higher interest rates on government debt instruments as well as reductions in their minimum denomination to increase direct subscriptions by the nonbank public.

The mission welcomed these measures as well as the redirection of government demand for foreign exchange to the free market. The mission emphasized that the depreciation of the pound was fundamentally linked to the destabilizing impact of the large fiscal deficits brought on by the deteriorating security conditions. In the present circumstances, the Lebanese authorities therefore had no alternative but to let the exchange rate carry the bulk of the adjustment burden. The mission noted with satisfaction that the Lebanese authorities intended to continue with a free exchange and trade system and to abstain from the introduction of any restrictions on current payments or transfers. The Lebanese representatives agreed with the mission that the introduction of such restrictions would not only be contrary to the long-established tradition of Lebanon but would also be ineffective in the circumstances.

IV. Staff Appraisal

The unsettled security conditions in Lebanon and the unavailability of current data on key developments in the economy make it unusually difficult to form an accurate assessment of the magnitude of the necessary policy adjustments. Nevertheless, the Lebanese authorities have tackled the financial, monetary, and external sector problems with courage, and have taken commendable measures in what must be exceptionally difficult circumstances.

In the area of reconstruction and development planning, the staff notes that the Lebanese authorities have scaled down earlier expenditure targets so as to take account of reduced availability of foreign financing, and have exercised flexibility in the choice and implementation of reconstruction and rehabilitation projects. The emphasis on meeting the population's basic needs, especially in the most adversely affected parts of the country, and on incentives to revitalize private sector activity is appropriate. The staff is concerned that because of a shortfall in anticipated levels of external financial assistance, the authorities have relied heavily on budgetary resources for the bulk of the reconstruction program. In the absence of an increase in external aid, a careful balance will need to be struck between the requirements of reconstruction and rehabilitation on the one hand and the need to avoid undue pressures on budgetary resources on the other hand.

The staff appreciates that the adverse impact of current security conditions has eroded the Government's tax revenue base. The staff welcomes the measures taken by the Lebanese authorities to reduce expenditures and improve revenues, and urges that current efforts to increase direct and indirect tax revenue be pursued vigorously. In the meantime, efforts should be focused on a reduction in the rate of growth of expenditures, especially for extrabudgetary purposes, and on promoting nonbank financing of the overall fiscal deficit. In this regard, the staff urges that the use of the central bank's exchange revaluation "profits" by the Government be terminated and that the necessary steps be taken to consolidate all budgetary accounts of the public sector so as to improve the Government's capacity to set priorities and to monitor the impact of its operations.

The pursuit of an effective monetary policy has been especially burdened by the sizable fiscal deficit and the mounting domestic public debt. Nevertheless, the Lebanese authorities have taken steps to control the liquidity-creating impact of the fiscal deficit, principally through action on commercial banks' reserve requirements and on interest rates. The staff considers these measures as appropriate and necessary, but they remain insufficient in light of the very large fiscal deficit. The condition of commercial banks, traditionally an important sector in the Lebanese economy, needs to be monitored closely and bank supervision may need to be strengthened.

The Lebanese authorities' balance of payments and exchange rate policies are broadly appropriate. The staff considers that the pressure on the exchange rate is a reflection of the underlying fiscal imbalance caused in large part by the prevailing security situation. The staff therefore endorses the policy of non-intervention in the exchange market, as reaffirmed during the consultation discussions, and hence no further diminution of the central bank's foreign exchange reserves should be permitted. The staff supports the authorities' decision to cease supplying the Government with its foreign exchange requirements, and to direct the Government's demand to the open market. The prevailing security situation places severe strains on the budget and the balance of payments and the staff concurs with the authorities' views that in these circumstances there is no alternative but to let the exchange rate carry the burden of adjustment. The Lebanese authorities have reaffirmed their continued adherence to a free exchange and trade system and continue to reject the imposition of any restrictions whatsoever on current payments or transfers. They have been commendably prudent in incurring external debt and external debt service payments remain within manageable levels. The staff notes the recent termination of two bilateral payments agreements with Fund members.

The Lebanese authorities have agreed to maintain the Article IV consultation discussions on a regular 12-month cycle and have requested more frequent discussions with the staff on required policy adjustments.

V. Proposed Decision

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

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.

Lebanon - Fund Relations
(As of November 30, 1984)

(Amounts 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:*	76.07
(b)	Fund holdings of Lebanese pounds:	59.9
(c)	Fund credit:	--
(d)	Reserve tranche position:	18.8
(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:	0.8 (18.75 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 central bank 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 December 15-20, 1982. The Staff Report (SM/83/32) was discussed by the Executive Board on May 13, 1983. It was agreed that the next consultation would be held on the standard 12-month cycle. However, security conditions in Beirut precluded any subsequent missions to Beirut.

The Executive Board's decision (Decision No. 7396-(83/69)) adopted May 13, 1983, was as follows:

> 1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Lebanon in the light of the 1982 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 and is in the process of terminating the outstanding bilateral payments agreement with a Fund member.

X. Technical Assistance:

(a) In March-April 1982 a joint MED/CBD mission visited Beirut to assess the feasibility of issuing government bonds to the nonbank public; it was expected that a follow-up visit would be undertaken by CBD, but due to security conditions no visit has been possible.

(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 - Basic Data

	1981	1982	1983	Proj. 1984
Growth (percent change)				
Real GDP 1/	-3.0	-9.0	-22.5	-12.5
Inflation				
CPI (end of year, percent change)	16.0	13.8	7.2	--
				Staff Est.
Public sector finances				
Government revenue (growth in percent)	23.7	-2.3	23.7	-11.2
Expenditure (growth in percent) 2/	39.2	27.7	18.2	23.9
Overall public sector deficit				
(Percent of total expenditure)	56.5	66.8	65.2	75.1
Borrowing by the public sector from the banking system				
(Percent of change in M2)	30.1	69.3	50.7	99.1 3/
(Percent of beginning of period M2)	12.1	14.0	13.6	15.3
Money and credit (percent change, end of of period)				
Total domestic credit	43	36	37	32 3/4/
Credit to private sector	32	21	31	27 3/4/
Credit to public sector	93	78	51	35 3/4/
Total liquidity (M2)	40	20	27	16 3/4/
Interest rate (percent, end of period) on:				
Average on savings and term deposits	12.2 5/	11.7	10.1	12.0 3/
Discounts and advances	16.2 5/	16.7	14.0	16.0 3/
Balance of payments (US$ millions)				
Exports	989	873	767	600
Imports	3,792	3,480	3,659	3,000
Overall balance	-66	1,094	-697	-1,000
Reserves (US$ millions, end of year)				
Gross official reserves (excluding gold)	1,516	2,608	1,903	906
(In months of imports)	5	9	7	4
Net position of banking system	4,623	4,891	3,971	2,371
Net central bank reserves	(1,515)	(2,590)	(1,900)	(904)
Net foreign assets of commercial banks	(3,108)	(2,301)	(2,071)	(1,467)
External debt (end-of-year stock)				
Medium- and long-term, nonmonetary (US$ billions))	0.2	0.2	0.2	0.2
Short-term, nonmonetary (US$ billions))				
Debt service (US$ millions)	53.5	69.3	67.0	63.7

1/ Staff estimates.
2/ Including net extrabudgetary spending.
3/ Nine months.
4/ Compound annual rate.
5/ At end of January 1982.

Lebanon: Summary of World Bank Staff Statement on Reconstruction and Development

1. Current Bank Group operations in Lebanon include two ongoing projects; one in the education sector (US$6.6 million), and a reconstruction project with telecommunications, water supply, and port components (US$50.0 million). While the tenuous security situation in the country has periodically delayed implementation, satisfactory progress on these projects has nevertheless been made, and both projects are expected to be completed in 1985.

2. Additional Bank efforts in Lebanon have been inhibited primarily because security has precluded the possibility of continuous Bank supervision and appraisal activities. Security permitting therefore, the Bank would expect to participate fully in further reconstruction activities, initially probably with the processing of several small projects.