particularly given the authorities' commitment to rely on central bank credit only as short-term bridge financing.

- The upward revision in oil prices relative to those assumed in the Article IV report will adversely affect the financial position of the loss-making power utility (EdL). However, the budgetary impact is likely to be felt only starting in 2008 because of lags in the financial support provided by the government to EdL.

- The 2007 budget target remains achievable. Early action to increase the gasoline excise would enhance the chances of meeting the target, and is also key to meeting the authorities' medium-term fiscal objectives, as spelled out in the Paris III program.

- While a resolution of the political impasse is expected to lower Eurobond spreads, Lebanon's financing costs are likely to have increased on account of the global re-assessment of risk. The adverse impact on debt sustainability reinforces the need for a prompt implementation of the adjustment and reform measures planned for 2008. Realizing the expected privatization receipts and securing donor disbursements will be important to meet projected foreign currency debt service payments of over $4 billion in 2008 (of which $3.6 billion for Eurobond debt service).

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IMF Executive Board Concludes 2007 Article IV Consultation with Lebanon

On October 3, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Lebanon.[1]

Background

Economic developments in 2006 were significantly affected by the July–August conflict with Israel. Real GDP is estimated to have been flat, with strong growth in the first half of the year offset by the disruptions during and after the conflict. Inflation increased, mainly reflecting supply shortages during the conflict and the ensuing blockade. Financial pressures associated with the conflict were managed effectively owing to the banking system's strong liquidity position. Immediately after the conflict, donors pledged US$1.7 billion for relief and recovery (including at the Stockholm conference in August 2006), with disbursements in 2006 roughly offsetting the immediate fiscal costs of the conflict. Nonetheless, the overall fiscal deficit increased in 2006 because of rising interest expenditures and higher than expected transfers to the power company, Electricité du Liban. Government debt rose to over US$40 billion (178 percent of GDP) at end-2006.

The economic situation continues to be overshadowed by the political stalemate and episodes of violence, including the assassination of a member of parliament in June 2007 and a fifteen-week long battle between the army and Fatah al-Islam militants in northern Lebanon. In this environment, economic activity, including tourism, remains

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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subdued, and real GDP is expected to rebound only slowly in 2007. Inflation as measured by the Consumer Price Index declined through mid-2007 from its 2006 peak, notwithstanding the depreciation of the U.S. dollar to which the currency is pegged. Trade flows have recovered from the near- standstill during and after the conflict, with the trade deficit in the first half of 2007 deteriorating slightly relative to the same period in 2006.

The financial system has remained resilient to the political uncertainty. Owing to moderate capital inflows and slow deposit growth as well as limited donor disbursements, international reserves declined by US$300 million to US$11 billion in the first quarter. However, deposit growth accelerated subsequently, and by end-June broad money was already 4½ percent higher than prior to the conflict with Israel, with international reserves more than recovering to US$11.6 billion at end-June 2007. Still, the political deadlock has increased risks, as reflected by Eurobond spreads of 495 basis points as of end-August and deposit dollarization of around 76 percent, significantly higher than prior to the 2006 conflict. The recent turbulence in international financial markets has not had, up to now, a significant impact on Lebanon. While spreads have increased by around 80 basis points between mid-July and mid-August, there has been no pressure on the currency, and deposit inflows have remained robust, though at a more moderate pace than in the second quarter.

Executive Board Assessment

Directors commended a good policy performance under the program supported by the Fund's Emergency Post-Conflict Assistance. The economy is recovering despite the persistent high oil price and political uncertainty, inflationary pressures have eased, and gross international reserves have increased further.

At the same time, Directors underscored that major challenges remain, including the large debt overhang, financial and macroeconomic vulnerabilities, and high energy costs. They considered the authorities' 2007–12 reform program to be an ambitious and credible strategy for meeting these challenges. They acknowledged that implementation of the program will be a challenging task given the difficult political and security situation. While Directors were encouraged by the authorities' reiterated commitment to reform, they noted that the authorities will need to pay close attention to the timing of the reform process. Directors stressed that donor support is an important pillar of the reform strategy, and called for timely disbursement of such support.

Directors welcomed the authorities' success in containing the primary fiscal deficit in the first half of 2007. They emphasized the need for determined action to achieve the 2007 budget deficit target and the medium-term debt reduction objectives. In this regard, Directors commended the steps taken to initiate reforms in the social security and power sectors. They encouraged the authorities to give priority to raising gasoline excises as soon as the political situation allows.

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Directors welcomed the fiscal adjustment and privatization plans for 2008. They noted the planned increases in the value-added tax and the tax on interest income in 2008, the preparations for the introduction of a global income tax in 2008, and the administrative reforms underway. Directors emphasized that further progress is needed on energy sector reforms to realize the expected medium-term expenditure savings. They supported the planned privatization of the telecom sector as crucial to the success of the reform strategy.

Directors stressed the importance of strengthening public financial management. They encouraged the authorities to follow up on their action plan to improve the cash and budget management functions. While they called for expenditure restraint, Directors advised against across-the-board expenditure cuts, and recommended that efforts focus instead on curtailing low-priority current spending rather than capital spending. Directors also emphasized the need to strengthen the social safety nets. They welcomed the establishment of a debt management office.

Directors noted that the monetary policy framework has served Lebanon well, especially in helping to maintain financial stability in the face of disruptions in international financial markets. They underscored that central bank financing of the government will need to be gradually reduced in order to safeguard the central bank's balance sheet, and supported the authorities' intentions to rely increasingly on market finance.

Going forward, Directors supported the planned introduction of transparent short-term monetary instruments, and underscored the importance of allowing greater interest rate flexibility in Treasury bill auctions. Directors advised that the central bank refrain from quasi-fiscal activities, and supported the establishment of a joint working group in the Ministry of Finance and the central bank to better coordinate interventions in the financial market.

Directors considered that the exchange rate peg to the U.S. dollar has helped maintain financial stability without impairing competitiveness. They noted that gross international reserves, combined with the banking system's liquidity cushion, appear to be sufficient to meet temporary pressures on the exchange rate. Directors agreed that the real effective exchange rate appears broadly in line with fundamentals. Going forward, Directors stressed that continued sound macroeconomic policies and structural reforms, particularly full implementation of fiscal adjustment plans, will be essential to support the exchange rate peg.

Directors noted that the banking sector, though profitable and well capitalized, faces vulnerabilities associated with high sovereign exposure, maturity mismatches, and the high degree of dollarization. They agreed that a reduction in the government debt will be crucial to reduce these vulnerabilities, but also emphasized the need to strengthen risk

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management, diversify loan portfolios, and enhance cross-border supervision. Directors welcomed commercial banks' readiness to adopt Basel II requirements in 2008.

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