LEBANESE REPUBLIC

LEBANON: PARIS II MEETING

November 23, 2002

BEYOND RECONSTRUCTION AND RECOVERY……
TOWARDS SUSTAINABLE GROWTH

A request for international support

Beirut, November 14, 2002

ABBREVIATIONS AND ACRONYMS

BdL	Banque du Liban (Central Bank of Lebanon)
CDR	Council for Development and Reconstruction
EdL	Electricité du Liban
EU	European Union
EIB	European Investment Bank
FATF	Financial Action Task Force
FX	Foreign Currency
GAFTA	Greater Arab Free Trade Area
GCC	Gulf Coordination Council
GDP	Gross Domestic Product
GNP	Gross National Product
GPRS	General Packet Radio Service
GSM	Global System for Mobile
IDAL	Investment Development Authority of Lebanon
IMF	International Monetary Fund
INSEE	Institut National de la Statistique et des Etudes Economiques
LL	Lebanese Pounds
MEA	Middle East Airlines
MW	Megawatt
NERP	National Emergency and Reconstruction Program
NDIF	National Deposit Insurance Fund
NSSF	National Social Security Fund
SME	Small and Medium Scale Enterprise
VAT	Value Added Tax
WTO	World Trade Organization

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PREFACE

At the time that the current Government took office in late 2000, Lebanon faced a difficult situation arising from debt accumulation that had its origins in a decade of reconstruction and recovery after 15 years of war and civil strife and amidst continued attacks from abroad. There had been a lack of national consensus on how to address an evolving debt problem and delays in domestic action. Fiscal deficits and debt had reached unsustainable levels and the economy was stagnating. On the occasion of the Paris I meeting in February 2001, the Government of Lebanon presented its strategy for addressing the situation with fiscal adjustment to reduce the rate of accumulation of debt, privatization to reduce the stock of debt, and structural and institutional reforms to lay the basis for growth. It requested support from the international community to complement the Government's effort and bring about a virtuous cycle of lower fiscal deficits, declining debt ratios, and lower interest rates that can unleash the potential of Lebanon's private sector. The meeting agreed to convene a follow-up meeting to assess the progress that Government had made towards the objectives of its strategy and to agree on external support to ensure its success.

This document presents the progress that has been made since the Paris I meeting and the program that the Government has adopted for the next years. In the meantime, the fiscal deficit has been reduced (with revenues now exceeding non-interest expenditures), major privatizations are about to be launched, and the structural reforms are largely in place, but debt ratios have continued to rise as a result of high interest rates, with interest payments on the net debt of about US$30 billion now absorbing about 80% of Government revenues. External support is the missing link to creating the virtuous cycle. The Government of Lebanon does not expect that the support it is requesting will be available mainly in the form of grants and soft loans. The Government requests external support to change the composition, reduce the cost, and lengthen the maturity of its debt through instruments such as sovereign guarantees, investments by Governments and Central Banks in new Lebanese Government foreign currency bonds, and similar arrangements that would allow Lebanon to borrow in supporting countries' markets at low spreads, using the proceeds solely to substitute such external debt for existing high interest short-term debt. Such substitution would result in a sharp reduction in the level of domestic interest rates, with a consequent further reduction in the overall fiscal deficit and Government financing needs, and lay the basis for solid private sector-led growth and recovery.

The Government is committed to its program of fiscal adjustment, privatization and structural reform. If the overall program was not to be successful in the absence of external support, economic and social stability in Lebanon could be undermined. The Government of Lebanon is therefore most appreciative of the initiative of the President Chirac of France to convene the Paris II meeting and the willingness of friends of Lebanon in the international community to participate and consider Lebanon's request for assistance.

INTRODUCTION

1. In early 2001, after a new Government had taken office in Lebanon, President Chirac of France convened a meeting in Paris, with the presence of the Presidents of the European Union (EU) and the World Bank and the Vice-President of the European Investment Bank (EIB) with a view to discussing support for the Government's economic program. The meeting indicated that support would be considered once progress had been made on the implementation of the program. It was agreed to convene a broader follow-up meeting to assess progress made and to agree on future external support to ensure successful implementation of the Government's program over the 2002-2004 period.

2. At the time of the Paris I meeting, Lebanon faced a difficult economic situation. Real Gross Domestic Product (GDP) growth had stagnated, the overall fiscal deficit had reached close to 25% of GDP in 2000, with interest payments on public debt absorbing the bulk of Government's total revenues, and total net public debt had reached about US$23 billion, equivalent to close to one and a half times Lebanon's GDP in that year. Facing the dual challenge of the need for fiscal adjustment and debt reduction and for stimulating economic growth, the Government took immediate steps to decrease the rate of accumulation of public debt through fiscal adjustment—in particular moving the primary balance from a deficit to a surplus—, and to prepare for debt stock reduction through privatization. It also initiated structural measures to stimulate economic growth and exports.

3. The Government's initial efforts, the progress achieved to-date, and its program for the next few years are discussed in the section "The Government's Program" below (page 6). During 2001-2002 there has been some recovery of growth and strong export performance resulting from the incentives and structural measures taken by Government since early 2001. Despite significant fiscal adjustment during 2001 and 2002—with an improvement in the primary fiscal balance[1] equivalent to about 10% points of GDP—, total net public debt has risen further, however, to US$30 billion[2] (of which the equivalent of US$17.8 billion is net domestic currency debt[3]), or 173% of Lebanon's estimated GDP[4]. At the same time, interest payments on the debt have reached a level of nearly 18% of GDP and absorbed about 80% of total Government revenues in 2002, even exceeding its tax revenues.

4. The graphs below present the evolution of fiscal and debt situation: (i) as of end-2000, after a decade of reconstruction and recovery, subsequent to 15 years of war; (ii) as of end-2002, after the fiscal adjustment that was implemented during 2001 and 2002; and (iii) the situation expected as of end-2003, after the planned continued fiscal adjustment, based on the budget for 2003, and the implementation of the privatization program, on the assumption that the external support that is requested will be forthcoming. Detailed information on fiscal developments and

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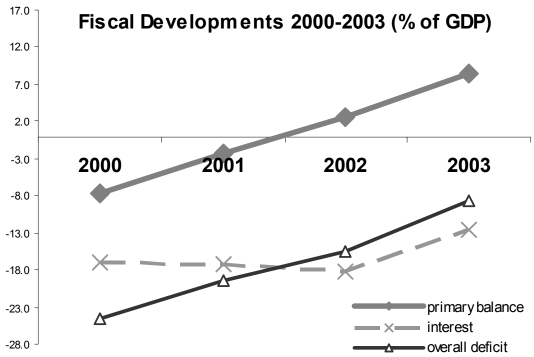
[1] Government revenues less non-interest expenditures.

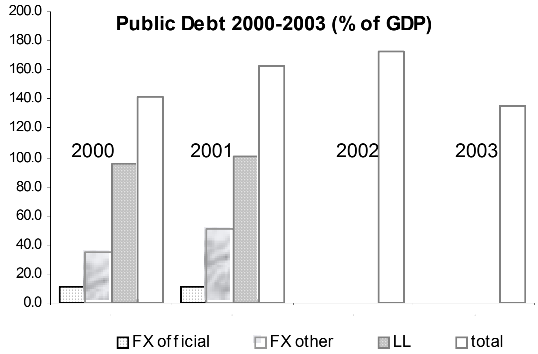
[2] This is the level of net public debt (as of end-2002), which includes net domestic debt (gross domestic debt, excluding accrued interest on discount Treasury bills, less public sector deposits with the Banque du Liban—BdL—and commercial banks) and total outstanding and disbursed foreign debt. Unless indicated otherwise, references to domestic and total debt in this document are to the net public debt, excluding accrued interest on discount Treasury bills.

[3] Debt denominated in Lebanese Pounds (LL)

[4] There is a broad consensus that Lebanon's GDP is likely to be higher than indicated in current estimates, and that the Gross National Product (GNP) is larger than GDP. Government will update GDP and GNP estimates in early 2003 with the help of Eurostat and INSEE and hence debt ratios would likely be smaller, but obviously still too high.

debt for 2000-2003 is presented in Table 1 (page 8). The Government's program for 2003 is presented in the section "The Program for 2003 and Beyond" below (page 11).





5. Despite the initial progress that the Government has made with fiscal adjustment, privatization and structural reforms, sustained growth will not be achieved unless Lebanon, with external support, is able to create a virtuous cycle of lower fiscal deficits, declining debt ratios, and lower interest rates that can unleash the potential of Lebanon's private sector supported by more efficient public institutions, in the context of stable economic and social conditions. The Government is committed to its program of continued fiscal adjustment, privatization and structural reform. If the overall program was not to be successful in the absence of external support, economic and social stability in Lebanon could be undermined.

6. Delays in policy actions to address the evolving debt issue during the 1990s, because of political or institutional constraints, or adverse external circumstances, undoubtedly have contributed to the situation that the country finds itself in today. Nevertheless, much of its origin goes back to the particular circumstances that Lebanon faced as it sought to reconstruct after 15 years of war and civil strife, with continued occasional external hostilities throughout the 1990s. This background is provided in the section "Indebtedness after a Decade of Reconstruction and Recovery" below (page 3) to set the stage for today's situation and the proposed Government response for which it seeks external support on the occasion of the Paris II Meeting.

INDEBTEDNESS AFTER A DECADE OF RECONSTRUCTION AND RECOVERY

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Box 1 Lebanon 1990: After Fifteen Years of War

In the early 1990s, Lebanon faced the multiple challenges of post-war reconstruction and economic stabilization after fifteen years of war and civil strife. The hostilities had left massive destruction of infrastructure and housing, displacement of population and weakened institutions:

- Damage to physical assets was estimated, by the United Nations, at US$25 billion—with much of the physical infrastructure destroyed or inoperative
- A quarter of the population was displaced, with their houses destroyed, and one in five Lebanese—many professionals and skilled workers—left the country
- Public institutions were severely weakened
- Per capita income—at the level of Portugal in 1974—had fallen by two-thirds in real terms by 1990 and stood at US$1000—one seventh of Portugal's

7. Initial circumstances were not conducive to rapid reconstruction. Domestic conditions were chaotic as national reconciliation took hold and the regional situation remained highly unsettled. With a revenue base and institutional capacity that had been eroded after 15 years of war, and limited external support, Government initially relied heavily on domestic currency financing for its expenditures, with increased recourse to monetary financing in the course of 1992. By late 1992 (before major reconstruction had even started), total public debt already stood at the equivalent of 40% of GDP. This was the background to the severe economic instability in that year with sharp exchange rate fluctuations and inflation at triple digit levels.

8. To address the unstable situation that had evolved in 1992, a new Government that took office in late 1992 adopted exchange-rate based stabilization policies that helped restore confidence, caused a rapid decline in the rate of inflation to single digit level by 1994, and encouraged private capital inflows. The reconstruction program took off in earnest in 1993. The Government's initial National Emergency and Reconstruction Program (NERP), initiated with support from external donors, was expanded into a broader and larger program for reconstruction and infrastructure expansion in 1994 as Lebanon sought to reposition itself as an international economic and services center in the Arab region that had increasing prospects of prosperity based on developments ongoing at the time. The Government's program focused in particular on rehabilitating, reconstructing, and expanding infrastructure with a view to providing the basis for the private sector to lead the reemergence of Lebanon as a regional hub for trade and services and a link between the region and Europe.

9. In addition, in the aftermath of the war, the Government took on the task of investing in social peace, taking care of the incorporation of the war militia, and providing for resettlement and social assistance to the displaced, many of whom could not return to their homes as a result of the continued occupation of the South. At the same time, regional security conditions remained unsettled throughout the 1990s, requiring expenditures for security as well as the repair of damages that were caused by bombings, particularly on the occasion of the major Israeli attacks in 1993 and, again, in 1996 and 1999. On the latter occasions, part of the rehabilitated infrastructure was again destroyed or damaged.

10. As domestic normalization took hold and rehabilitation and reconstruction took off, there were great expectations in Lebanon for sizable external support in the form of grants for the reconstruction program to supplement the role of the Lebanese Diaspora in reviving Lebanon's private sector. In the event, the magnitude of the support, while important, fell far short of those expectations, and was mainly in the form of soft loans from the countries and institutions of the Gulf Coordination Council (GCC) and Europe, and loans from international financial institutions. Undoubtedly, some of this was a consequence of the emergence of other priorities that arose in the region for potential donors from 1990 onwards and the absence of progress on a comprehensive settlement, beyond Lebanon's control. The shortfall in external funding was compounded by Lebanon's failure to rapidly utilize the support that was provided (mainly in the form of project-specific loans for the NERP from GCC funds and countries, European institutions and a number of EU countries, and the World Bank) as the weak public institutions often found it difficult to meet the requirements associated with these loans.

11. Moreover, access to medium-term external loans at market terms was initially limited, even though Lebanon had a solid track record of meeting its external debt obligations throughout its history, even at war times, during the darkest days of violence, and the option of borrowing in foreign currency domestically was not available to Government at the time. Nevertheless, from 1994 onwards Lebanon was increasingly successful in tapping international capital markets, with lengthening maturities, declining spreads, and diversification of sources, but the amounts available fell short of the overall financing needs that were rising rapidly.

12. Finally, a greater role for the private sector in the reconstruction and expansion of infrastructure was limited by a host of factors. These included not only the absence of a appropriate legal framework and of institutions or political consensus, but also the state of the devastated infrastructure and public institutions operating it, and most importantly, the reluctance of the private sector to take on major infrastructure investments in Lebanon in the aftermath of the war, amidst continuing insecurity in the region, including bombings of infrastructure facilities. Thus, the Government undertook most of the task of restoring basic services to support private sector recovery. In the cases were public private partnerships were feasible, such as in the case of the cellular phone system, Government did proceed on this path.

13. Against the above background, Government initially relied heavily on borrowing in local currency in the domestic market for its overall financing requirements. The domestic currency debt had average maturities of less than a year with high interest rates as a consequence of the stabilization policies and the risk premia that investors demanded. With high cost of borrowing, the overall fiscal deficit expanded rapidly, even though as a result of the revenue effort initiated in 1993 the ratio of Government revenues to GDP had by the mid-1990s risen nearly three-fold from the post-war level. The rise in the overall fiscal deficit not only reflected the reconstruction outlays and the post-war social and security expenditures, and high interest rates on the budget's financing, but also the fiscal costs of the occasional sterilizations by the Central Bank (Banque du Liban—BdL) of short term financial capital inflows as part of the stabilization policy, in order to avoid exchange rate volatility, in particular a sharp appreciation of the currency. Thus, the stabilization policy that had major benefits in terms of confidence, capital inflows, replenishment of reserves, and price stability, had its unavoidable fiscal costs. The overall fiscal deficit reached about 20% of GDP by the mid-1990s, with interest payments absorbing about three-quarters of total revenues.

14. With fiscal deficits rising, Lebanon's public debt increased rapidly and by 1996, total net debt stood at US$11 billion, equivalent to about 85% of GDP, with all but about US$2 billion in the form of local currency domestic debt. In the meantime, the reconstruction and recovery program that was underway and the stabilization policies contributed to rapid economic recovery, with real GDP increasing to about 80% over its 1990 level by 1996, with a per capita income of around US$3000— equivalent to about one-third of Portugal's. Indeed, the International Monetary Fund (IMF) was quoted in that year as "Lebanon has made considerable progress since 1992. Economic growth was sustained….inflation brought down…basic infrastructure restored…As a result, the economy is much better placed now to exploit its considerable potential through adjustment and reform. Looking forward, there is considerable potential for the Lebanese economy."[5]

15. During the latter part of the 1990s, Lebanon entered into a cycle of rising deficits and debt and lower growth. International developments made it increasingly difficult for Lebanon to access international capital markets, particularly in the aftermath of the East Asia financial crisis and its effects on emerging markets debt, and Government turned increasingly to borrowing domestically in foreign currency, tapping the significant pool of financial savings, including those of the Lebanese Diaspora, in the domestic banking system. With increasing concerns over rising fiscal deficits and levels of public debt, spreads on this borrowing steadily increased. The steady rise in interest cost accelerated the increase in the level of fiscal deficits and debt

Box 2 Lebanon 2000: After Ten Years of Reconstruction and Recovery

By 2000, Lebanon's war-damaged physical infrastructure had been substantially rehabilitated and reconstructed, although new rehabilitation challenges evolved with the liberation of the occupied South. Public services were operating, basic education and health care was being provided, internal security was fully restored, and the displaced had returned to their homes. Real GDP had about doubled from the post-war level.

However, after the rapid growth during the first half of the 1990s, the economic situation had worsened in the latter part of the decade. The overall fiscal deficit had reached close to 25% of GDP in 2000, with even the primary balance (revenues less non-interest expenditures) in deficit (by 7.5% of GDP), Lebanon's total public debt had risen further to US$23 billion (or close to one and a half times Lebanon's GDP), real GDP had stagnated, and per capita real income had declined. Private sector confidence was at low levels and private investment was depressed, in part because of the effect that the fiscal deficits and public debt accumulation had on availability of credit and domestic interest rates. It was against the background of worsening trends that Government set out in late 2000 to develop a comprehensive strategy to resolve the debt dilemma through a sustained domestic effort with external support, and that the Paris I Meeting took place in early 2001.

[5] From a World Bank publication on Lebanon (September 1996)

THE GOVERNMENT'S PROGRAM

16. ***Introduction.*** Government initially faced a dilemma with respect to fiscal adjustment in the context of a stagnating economy, and declines in per capita real income. With an economy drifting into a recession, and thus threatening the already narrow Government revenue base, and stagnating exports in 2000, Government took a number of fiscal stimulus measures to revive domestic production and exports, and also initiated structural reforms aimed at further liberalizing and deregulating the economy. At the same time it began to develop a program for medium term fiscal adjustment and privatization so as to reverse the trend of rising public debt. The Government's program was presented on the occasion of the Paris I Meeting (see Annex II: Paris I Meeting—A Matrix of Structural Reforms), during which it was agreed that external support would be considered once Lebanon had demonstrated progress in the implementation of its program. Progress made during 2001-2002 and the Government's program for 2003 and beyond are presented below.

PROGRESS MADE DURING 2001-2002

17. ***Fiscal adjustment.*** On the revenue side, the fiscal measures taken in late 2000 to stimulate the stagnating economy and exports included a targeted reduction in import duty rates. Since customs revenues accounted for more than half of tax revenues in 2000 (and about one-third of total revenues), tax revenues rose only modestly in 2001, with increases in income taxes offsetting the decline in customs revenues. Government overall revenues declined by about 2% in 2001, as non-tax revenues were also lower because of the weak economy. The lowering of duty rates was not only aimed at reviving a stagnating economy, but was also consistent with the overall objective of relying relatively less on international trade related taxes for fiscal purposes, and improving the efficiency of domestic production, in line with undertakings envisaged under the international agreements that were being prepared, in particular the Association Agreement with the EU. During the first three quarters of 2002, however, total revenues rose at a rate of about 28%, with a major contribution from the Value Added Tax (VAT) that was introduced in early 2002, after careful administrative preparation in the course of 2001. As a result, the revenue to GDP ratio has risen from 19.2% of GDP in 2000 to 22.3% in 2002 to-date, with the ratio of tax revenues to GDP rising from 11.9% in 2000 to 15.4% in 2002.

18. Fiscal adjustment in 2001 was achieved primarily through strict control over non-interest expenditures. Despite the need for fiscal outlays to address critical needs in the South after its liberation in 2000, and selective incentives to stimulate the stagnating economy and exports, overall non-interest expenditures were as much as 22% lower in 2001 than they had been in the previous year. Part of this outcome reflected a spillover of expenditures against the 2001 budget and some delayed payments to private contractors into 2002. However, even without this, the reduction in expenditures in 2001 would still be sizable. Moreover, despite the spillover of expenditures from 2001 and the payment of the end-2001 arrears during 2002, the ratio of non-interest expenditures to GDP is expected to be further reduced to less than 20% of GDP in 2002, from more than 27% of GDP in 2000.

19. The fiscal adjustment during 2001 and the first three quarters of 2002, as measured by the primary fiscal balance, amounted to the equivalent of 9.8% points of GDP, with the primary balance moving from a deficit of 7.6% of GDP in 2000 to a surplus of 2.2% in 2002 to-date (and an estimated 2.6% for the year as a whole). This is well in line with the Government's target of a 20% points cumulative fiscal improvement over a five year period, with frontloading. The reduction in the overall fiscal deficit was somewhat smaller than the improvement in the primary balance as interest payments rose further from 17.0% of GDP in 2000 to an estimated 18.1% in

2002, even though average rates on outstanding debt moderated somewhat with a further shift from domestic currency debt to US$ denominated debt, within the limits that existed. For 2002 as whole, the overall fiscal deficit is estimated at 15.6% of GDP[6], or about 9% points below the 2000 level. The actual fiscal performance in 2001 and 2002 exceeded the targets envisaged in the informal Medium Term Economic Framework that had been developed in collaboration with the IMF 2001 Article IV Consultations mission.

20. The improvements on the revenue side are a result of a range of revenue measures. By far the most important recent development was the introduction of the VAT (at a rate of 10% on goods and services, with few exemptions), which accounts for a significant part of the increases in revenue in 2002, as well as the increases envisaged for 2003. Taxes on income and profits in 2002 are expected to be up by 60% over the 2000 level, in part as a result of tax audits of large tax payers carried out in 2001 and the tax regularization law that was adopted in 2001. Gasoline taxes were raised three times during 2001-2002 and this year are yielding 50% more than in 2001. The results on the revenue side are also a reflection of the institutional strengthening that has taken place in the area of tax administration, including the establishment of automated customs and land registration administrations, and a widening of the income tax base and a strengthening of tax administration.

21. The efforts to reduce Government expenditures also reflected the results of the initial structural measures taken to rationalize public sector employment and redefine the role of the state. The Government's television station, Tele-Liban, and the national airline, MEA, were restructured, with layoffs totaling about 2000 staff. Surplus employees in a number of public institutions are being redeployed to fill civil service vacancies elsewhere. At the same time, basic legislation is being updated to modern standards to improve public sector efficiency and transparency. A new public accounting law, which streamlines budgetary procedures and strengthens treasury controls, and a new procurement law, which would establish a public procurement regime based on international standards, were approved by Cabinet and are now before Parliament. The major reduction in the role of the public sector that is envisaged by Government underlies the privatization drive that is now underway (see paragraph 25 below).

22. Major improvements in the performance of the public power company (Electricité du Liban—EdL), which now covers its operating costs before debt service, contributed to the fiscal outcome for 2002 and facilitates the planned privatization. The focus of the company's new management has in particular been on improving revenue collections, with the installation of new meters and inspection of existing ones, resulting in revenues increasing by close to 40% over last year. The privatization of EdL and other public companies now planned for 2003 and beyond will also play a key role in reducing the stock of public debt.

23. ***Public debt***. With the overall fiscal deficit still at high levels, driven in large part by very high levels of interest payments, the accumulation of debt continued, albeit at a somewhat slower rate. Whereas financing during the latter part of the 1990s had relied heavily on intermediation of the deposits of the domestic banking system, a considerable part of which is held by the Lebanese Diaspora, this pool of domestic financial savings (amounting to about twice the level of Lebanon's annual GDP), became increasingly difficult to tap during 2001 and the first half of 2002, and, instead, the Central Bank increasingly provided resources to the Government for the financing of its deficit.

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[6] The overall fiscal deficit includes the operations of public enterprises and municipal finances. The overall public sector deficit for 2002 is about 0.8% of GDP lower than the fiscal deficit, equivalent to the surplus of National Social Security Fund (NSSF).

Table 1 Fiscal Developments and Public Debt 2000-2002 and Budget 2003

	2000	2001	2002 Jan-Sep	2002 Estimate	2003 Projected
	Fiscal Developments				
% of GDP					
Revenues and grants	19.6	18.7	22.3	22.3	23.7
Tax Revenue	11.9	11.8	15.4	15.6	16.1
Non-tax Revenue	7.3	6.7	6.9	6.7	7.6
Grants	0.4	0.1	0.0	0.0	0.0
Expenditures	44.2	38.1	36.9	37.9	32.4
Non-Interest	27.2	20.9	20.1	19.7	19.5
Interest	17.0	17.2	16.8	18.2	12.6
Primary Balance	-7.6	-2.3	2.2	2.6	4.2
Overall Deficit	-24.6	-19.4	-14.6	-15.6	-8.4
	Public Debt				
US$ billion					
Domestic Currency Debt (net) [a]	15.7	16.8	17.3		
Domestic Currency Debt (gross)	17.4	18.1	18.6		
Banks and Private Sector	14.5	11.9	12.7		
Public Sector	3.0	6.2	5.9		
BdL	1.1	4.1	3.8		
Other	1.8	2.0	2.1		
Public Sector Deposits	-1.7	-1.3	-1.3		
Foreign Currency Debt	7.5	10.3	12.3		
Official Creditors	1.7	1.8	1.8		
Other [b]	5.8	8.5	10.5		
Total Public Debt (net), incl. accr. interest	23.2	27.0	29.6	30.7	25.0
Total Public Debt (net) [c]				30.0	24.7
% of GDP					
Domestic Currency Debt (net)	95.7	100.8	100.9		
Foreign Currency Debt	45.9	61.6	71.9		
o/w Official Creditors	10.6	10.6	10.7		
Total Public Debt (net)	141.6	162.4	172.8	173.0	135.8
Composition (%)					
Domestic Currency Debt (net)	67.6	62.1	58.4		
Foreign Currency Debt	32.4	37.9	41.6		
o/w Official Creditors	7.5	6.6	6.2		
Total Public Debt (net)	100.0	100.0	100.0		

(a) The net domestic debt equals gross domestic debt less Government deposits with the BdL and commercial banks. It includes accrued interest on discount Treasury bills.
(b) This includes about US$1.0 billion in Eurobonds held by BdL at end September 2002
(c) Excluding accrued interest on discount Treasury bills

24. Total net debt outstanding is projected at the equivalent of US$30 billion at end-December 2002 (equivalent to 173% of GDP). This includes debt held by public institutions in amount of US$5.8 billion equivalent gross, or US$4.8 billion net[7], so that the net consolidated public sector debt is about US$25.2 billion, or 145% of GDP at end-December 2002. Net domestic currency debt, at the equivalent of US$17.8 billion, represents about 60% of total debt, and foreign currency debt amounts to US$12.2 billion. The latter amount includes both debt owed to Lebanese residents and resident financial institutions, and outstanding and disbursed public debt owed to foreign creditors. Debt owed to foreign creditors, i.e. external public debt as normally defined, is still relatively modest, accounting for a little over one-third of the total foreign currency debt. Of this amount, only US$1.8 billion represents outstanding debt to official creditors (multilateral and bilateral). In the meantime, at current levels, interest payments on the public debt are absorbing the bulk of Government revenues (and exceed all of tax revenues), indicating the need to both reduce the stock of debt and the cost of servicing it.

25. ***Privatization***. Government has set out to undertake a major program of corporatization and privatization of public infrastructure to bring about a reduction in the stock of debt, as well as improvements in efficiency of operations, that will also have a positive fiscal effect (by reducing Government outlays for infrastructure operations and investment or increasing net contributions to the budget) and will reduce the cost of services to business. This program will also lay the basis for a deepening of Lebanon's capital markets. Reflecting an evolving national consensus, and recognizing the need for privatization as an integral part of a comprehensive effort to address an increasingly difficult fiscal and debt situation and of a viable growth strategy, Parliament had adopted a framework privatization law in 2000 that formed the basis for developing sector specific laws to underpin specific privatization operations in various sectors. The law provided for the establishment of a Higher Privatization Council, in the Office of the Prime Minister. The Council became operative in 2001. Three specific laws were enacted in 2002 to set the stage for privatization of two existing cellular phone systems, to corporatize and privatize the fixed line telecommunications, and to corporatize and privatize the power sector. These two sectors represent by far the largest components of public infrastructure, other than roads, in terms of assets. Both laws provide for the establishment of regulatory bodies for the respective sectors.

26. Preparation for privatization in two key sectors—telecommunications and power—, with the help of international investment banks and financial and legal advisors, are thus well underway by now. The specific privatization plans and next steps and timetable are discussed in the Section on the "Program for 2003 and Beyond" below. As mentioned above, Government has already implemented a program of restructuring of the national airline, providing the basis for attracting a strategic investor. Preparations are also underway for legislation to support privatization in the water and waste water sectors, through concessions, following the consolidation of the sector which established four regional companies from as many as 21 entities existing before. In the case of ports and the Beirut Airport initial preparations are underway for privatization through concessions. Finally, legislation has been adopted in 2002 that authorizes the establishment of special accounts for privatization proceeds, which, in accordance with the 2000 framework privatization law, can be used exclusively for purposes of debt reduction. The same legislation also authorizes Government to establish special accounts for certain revenues to be used for securitization, and for the receipt of loans to be used solely for debt payment and servicing.

[7] This includes both LL and US$ denominated debt, held by the BdL, the NSSF, and the National Deposit Insurance Fund (NDIF).

27. The stage has thus been set for privatization to make a significant contribution to the resolution of the current debt dilemma. Yet, the combined effects of the major fiscal adjustment together with the comprehensive infrastructure privatization program that is underway will not be sufficient by themselves to reverse the current cycle of fiscal deficits, rising debt and slow growth, into a virtuous one of declining debt, lower interest rates and growth. Such growth would be underpinned by the structural reforms that the Government is undertaking.

28. ***Structural Reforms.*** The privatization strategy aims not only to reduce the current stock of debt and help achieve the fiscal adjustment targets, but is also to improve the reliability and quality of provision of public services and reduce costs through increased efficiency of operations. As such, it is an integral part of the Government's broader program of structural reforms, which are aimed at promoting growth by further liberalizing the economy, in particular trade, modernizing the legal framework for production and trade, and removing administrative obstacles and disincentives. These reforms are expected to reduce the cost of doing business and hence improve competitiveness of the economy.

29. The reforms focus in particular on promoting exports of goods and services. While Lebanon has traditionally had an open economy, the legal framework, dating from the 1950s and 1960s, had become outdated. In addition to membership in the Greater Arab Free Trade Area—GAFTA (since 1997), in early 2002 Lebanon entered into an Association Agreement with the EU, which, as part of a broader partnership and program of cooperation, provides for free access of Lebanon's industrial exports, most agro-industrial exports and a large number of agriculture exports. In view of the difficult fiscal situation, the EU granted a five-year grace period on the dismantling of Lebanese tariffs (in any event, most categories of imports—86% of the number of all items—have rates of 0 and 5% only). At the same time Lebanon is advancing towards membership of the World Trade Organization (WTO), with the first Working Party meeting held in Geneva in October 2002 and membership now expected in late 2003. These agreements are being underpinned by an updating of legislation, including a WTO-compatible customs law that came into effect in December 2000, and trade liberalization measures, including the introduction of an open skies policies in late 2000, liberalization of oil products in early 2002 and the planned liberalization of pharmaceutical imports and elimination of exclusive agencies for which draft laws are now in Parliament. Further legislation now under preparation includes a competition law, a law on licensing procedures to streamline trade licensing and abolish ad-hoc administrative requirements, a consumer protection law, and further legislation required in connection with WTO accession.

30. In order to promote private investment, and in particular to attract more foreign investment, an investment promotion law was adopted in 2001 that establishes a one-stop agency for investors and selective tax incentives, while another law eased limitations on foreign ownership of land. The adoption of strict new law for fighting of money laundering in 2002, enhanced the international standing of Lebanon's banking system, and encourages bona-fide foreign financial investments. With a view to reducing labor cost and enhancing formal employment creation, employer's contributions to the NSSF were reduced in 2001 from 38.5% to 23.5%. Government subsidies for production and trade, at low levels overall, have been reoriented to enhance their impact. While subsidies for sugar beet production were abolished, selective and transparent subsidies are being provided for reducing transportation cost of fresh produce exports, and lowering interest rates, particularly for small and medium size enterprises (SMEs), complemented with a guarantee scheme to facilitate their access to bank financing. These subsidy measures must been seen as temporary as the structural reform measures lead to a reduction in the cost of doing business in Lebanon. The structural reform measures, which are summarized in Annexes I and II, have already had positive effects, but their full impact on growth will be not be felt as long as the issue of the public debt overhang with its consequent effects on private investment is not resolved with external support.

31. ***Growth and Exports.*** The incentives that Government introduced in late 2000 and the reforms undertaken during 2001 and 2002 to stimulate growth and exports have helped to reverse the downward trends. While overall growth has remained modest— with real GDP growth of about 2% in 2001 and 2002—, export performance has been encouraging, with exports increasing by 25% in 2001, despite a weak international economy following the nine-eleven events, and at a rate of 19% during 2002 to-date.

32. Although exports grew from low levels, the increases registered over the past two years (in the context of a sluggish world economy) suggest that Lebanese exports can be competitive provided structural constraints are addressed, as Government is committed to doing. In this context, the Association Agreement with the EU that was concluded in early 2002 will greatly help Lebanon realize its export potential. By far the greatest constraint now remaining to accelerated growth are the high levels of public sector borrowing which crowd-out the private sector and the high levels of interest rates that deter non-financial investments. Building on the progress that has been made during 2001-2002, the Government's program for 2003 and beyond aims at removing this key constraint to growth.

33. ***Recent Developments***. Despite the signs of some recovery in terms of GDP growth and exports, the economic and financial situation has been difficult in 2001 and the first part of 2002. A host of factors contributed to significant pressures on BdL's international reserves and pushed interest rates on new Government debt upward. On the domestic side, delays in enacting the legislation required for the privatizations, and the increased Central Bank financing of the Government, reduced confidence that Lebanon's debt situation would be resolved notwithstanding Government's stated commitments. A number of external factors compounded the situation, including the perception that the Paris I meeting had not resulted in specific commitments to support Lebanon, as well as the 9-11 events and their immediate aftermath and impact on economies and financial markets around the world.

34. Since about the middle of 2002, there has been a reversal of the negative trends, resulting again from a combination of domestic and external factors, with some recovery of reserves. The fiscal outcome for 2001 and for 2002 to-date (including in particular the successful introduction of the VAT) and the enactment of legislation allowing for privatization in the telecommunications and power sectors, reflecting the national consensus that had finally evolved, demonstrated the seriousness of Government's intentions with respect to fiscal adjustment and privatization. Geopolitical developments subsequent to the 9-11 events increased the interest of regional investors in Lebanon, and the de-listing of Lebanon by the Financial Action Task Force (FATF), after the adoption of a strict new law for fighting of money laundering, enhanced the international standing of Lebanon's banking system. Finally the successful Francophone Summit in October 2002 and indications that a Paris II meeting would indeed be convened before year's end further improved market sentiment and enhanced confidence. Nevertheless, these recent trends can only be sustained if public debt levels are reduced by a combination of further fiscal adjustment, as envisaged in the 2003 budget, major privatizations and external support, as was also concluded by the recent IMF 2002 Article IV Consultations Mission (paragraph 36 below).

THE PROGRAM FOR 2003 AND BEYOND

35. ***Introduction.*** Government's strategy for addressing the debt situation reflects a major domestic effort to further increase public savings (increasing the primary surplus), while protecting expenditures for basic social services, and to reduce the stock of debt through privatization, complemented with a change in the composition of debt in order to reduce interest rates on the public debt and domestic interest rates generally, so as to encourage private investment and growth. Lower interest rates will complement the public savings effort in brining down the overall fiscal deficit, and thus the rate of accumulation of further debt. The Government also plans further reforms to underpin a resumption of growth, which would help bring down debt to GDP ratios. Structural reforms are also aimed at improving public sector performance, which would also lead to improved utilization of external project support already committed. External support is needed to ensure reductions in the cost of servicing the debt so as to bring the rate of growth of the stock of debt remaining after privatizations to levels that are lower than the rate of GDP growth.

36. The IMF Article IV Consultations mission that visited Lebanon in October 2002 has reviewed recent developments and the Government's program. The mission indicated that economic performance and confidence have improved significantly in recent months. It also noted that in the absence of actions to materially reduce the stock of debt and its servicing cost, these improvements would be short-lived and trends in the economy would remain unsustainable. In this context the mission noted that privatization and external support of the type requested at the Paris II meeting would be critical to the future evolution of the economy. The illustrative five-year scenario prepared by the mission based on the Government's program (with external support) indicated a significant upfront reduction in public debt and a downward path of the public debt ratio in the medium term. The mission stressed that the Government's strategy of fiscal adjustment and privatization would lead to a viable scenario only if external support of the magnitude and type requested at the Paris II Meeting would be forthcoming. It indicated that with the domestic effort and the external support in the magnitudes envisaged, public debt would be put on a downward path, and reductions in interest rates would contribute to a sustained improvement in growth performance. It noted that a viable alternative scenario to the Government's program with external support is not available. In this respect the mission welcomed the Government's planned approach to the Paris II Meeting.

37. ***Fiscal Adjustment.*** As mentioned above, the Government has set out to undertake a major fiscal adjustment, resulting thus far in an improvement in the primary fiscal balance by about 10% points of GDP since 2000. For 2002 as a whole the overall fiscal deficit is estimated at 15.6% of GDP, comprising a primary surplus of 2.6% of GDP and interest payments of 18.2% of GDP.

38. The budget for 2003 that has already been submitted to Parliament is an austerity budget that envisages a further 11% increase (from the estimated actual 2002 level) in Government total revenues, and a further reduction in the ratio of non-interest expenditures to GDP[8]. Expenditures are being reduced across the board, except for social sectors expenditures so as to protect those most affected by the worsening of the economic situation in recent years.

39. As in other countries, raising revenues in the context of slow economic growth is not an easy task, and it is compounded in the case of Lebanon by the inability to rely on additional import duties because of the commitments made in the context of the Association Agreement with the EU, and the high level of international oil prices which initially limits the scope for raising taxes on petroleum products beyond the increases already effected during 2001 and 2002. Nevertheless, with the full implementation of the VAT for the whole year in 2003, the effects of the income tax measures taken in 2001 and 2002 and the improved administrative and collection

[8] The Government's budget does not include certain revenues and expenditures (e.g. expenditures by the Council for Development and Reconstruction—CDR—that are funded by external project loans). However, unless indicated otherwise, all references to revenues and expenditures in this document are to total revenues and expenditures (both budget and non-budget) as per definitions used in the IMF's Article IV Consultations Reports. The targets for fiscal adjustment and the various fiscal ratios are based on this comprehensive coverage of revenues and expenditures.

capacity for income taxes, additional property taxes, and a number of other measures, including increases in fees, a strong revenue effort will be undertaken in 2003. The Government is committed to further reducing expenditures in case of any shortfall in projected revenues in 2003. As a result the overall primary surplus is expected to rise further to 4.2% of GDP (representing an overall improvement in the primary balance by 11.8% points over 2000), and the overall deficit would be reduced further to 8.4% of GDP, predicated on a reduction in interest payments resulting from the implementation of the other components of the Government's program and the availability of external support.

40. The Government's target for 2004 is to reduce the overall fiscal deficit by more than half from the 2003 level, which would bring it down to below the level of nominal GDP growth[9], while the target for 2005 is to bring the overall fiscal deficit down to about 1%, with overall balance in the budget[10], (or well below the EU Maastricht Treaty target level). This compares to a deficit of close to 25% of GDP in 2000. With declining debt levels, it is envisaged that the overall fiscal deficit would be eliminated by 2006. These targets reflect significant further increases in the primary surplus—which is already high by international standards—, but at a somewhat more moderate rate after 2004 as public expenditures cannot be reduced much more if Government is to carry out, and improve, its basic functions, as well as the decline in interest rates that would result from debt reduction and substitution on account of the implementation of the privatization plans and the external support that is being requested for 2003. Whereas the improvement in the primary balance accounted for all of the reduction in the deficit during 2001-2002, the further reductions during 2003-2007 would result mainly from lower interest payments (see Table 2 below).

41. ***Privatization.*** Apart from the other benefits associated with the planned privatizations as discussed above, privatization is the main vehicle for initially bringing down the level of outstanding debt and the debt to GDP ratio. The components of the privatization program that are expected to contribute directly to a reduction in the stock of debt during 2003 include the telecommunications and power sectors.

42. In the case of telecommunications, the sale of licenses for two existing mobile systems to provide GSM and GPRS services for a period of 20 years is now underway. An information memorandum has been approved by Cabinet on October 24 and pre-qualification of bidders[11] is to take place in November with a view to inviting bids to be submitted before the end of 2002, and the transaction to be completed before the end of the first quarter of 2003. Bidders will be asked to offer for the license either without or with revenue sharing (of 40%) with the Government. The latter option has been added in part in view of the current difficult situation in the international telecommunications industry, so as to enhance investors' interest. While this option may bring disproportional lower privatization proceeds, it would allow Government to benefit to a larger degree from the future potential of the sector in Lebanon. Government would proceed to securitize its 40% share of revenues under offshore arrangements and the overall effect on the stock of public debt could well be greater than under the first option.

43. The ongoing fixed line operations of the Ministry of Telecommunications will be transferred to a new commercial corporation (Liban-Telecom) to be established in the second half of 2003, once the regulatory agency is operative. The (initially) public corporation will have a monopoly for five years and also receive a license for providing mobile services, using the

[9] Based on a conservatively projected recovery of real growth (see Table 2 below) with continued low inflation. Inflation as measured by the CPI is estimated at 4% in 2002, most of which reflects the one-time effect of the introduction of the VAT. Inflation as measured by the GDP deflator is about 2%. Inflation (GDP deflator) forecasts of about 2% for 2003 and beyond are based on the IMF mission forecast.
[10] The budget excludes foreign financed expenditures by the CDR of about 1% of GDP.
[11] A total of 19 international and regional companies or consortia have expressed interest.

infrastructure of the existing two systems. Government intends to sell a 40% share (the initial maximum envisaged under the law) to a strategic investor before the end of 2003. Once a track record has been established, Government would proceed to sell additional shares to private investors, as allowed for under the law. This is expected to enhance the value of the shares that initially remain with Government.

44. In the case of the power sector, Government will proceed to establish a commercial public corporation for power generation and distribution and one for transmission, transferring the assets of the EdL which currently owns and operates all of Lebanon's 2000 MW generating capacity and transmission, as well as most of the distribution. The generation and distribution company would have a monopoly on generation for seven to ten years, after which the sector would be opened up in line with current EU Directives. Establishment of the two companies, and a regulatory agency for the sector, is to take place during the first quarter of 2003, subsequent to which the Government intends to sell a 40% share (the initial maximum envisaged under the law) of the generation and distribution corporation to a strategic private investor before the middle of 2003. Government intends to contract operations of the transmission corporation with the same strategic investor. As in the case of telecommunications, Government would subsequently proceed to sell additional shares to private investors, as allowed for under the law, once a track record has been established.

45. Overall, based on current estimates, which are supported by the analytical work carried out by specialist firms engaged by Government, the total privatization proceeds, including a combination of outright sales and securitization, are expected to reach about US$ 5 billion in 2003, which would be applied in full to Government debt reduction. As the privatizations are now underway, specific estimates of each transaction are not provided, as it could affect the bidding process. For 2004 and 2005, privatization proceeds in the order of US$1 billion per year are envisaged, primarily from the subsequent sales of shares in the telecommunications and power corporations, as discussed above. These subsequent sales would result in further reducing the total debt to GDP ratio. Moreover, they would promote a deepening of Lebanon's capital market.

46. ***Cost of Debt.*** Levels of total public debt that exceed GDP are not unique to Lebanon, and indeed can be found also in a number of EU countries. What is unusual however is an interest burden equivalent to 18% of GDP (at current levels of debt and interest rates), which is simply not sustainable. The origin to this situation that evolved during a decade of reconstruction and recovery after a fifteen year war has been discussed above. At present, the average interest rate on outstanding domestic currency debt is close to 14%, while the average interest rate on foreign currency debt is a little over 9%, with a higher rate for domestic foreign currency debt. The average interest rate on total debt is about 12%, equivalent to a spread of around 1000 basis points over US$ and Euro LIBOR rates. Given current rates in the domestic market, the cost of new debt is even higher.

47. As indicated in Table 1 above, domestic currency debt held by public institutions accounts for nearly one-third of total net domestic currency debt, and about one-fifth of total gross public debt as of end-September 2002, or about US$6.9 billion. This debt currently carries full market rates, and, as all domestic debt, has relatively short maturities. The BdL held the equivalent of about US$4.8 billion of this debt. The Government and the BdL have agreed to reduce the level of this debt by the equivalent of US$1.8 billion as of early 2003 as an offset against a special Government account held at the BdL representing the difference between the market and book value of Government assets, and to convert a similar amount (comprising a combination of domestic and foreign currency short term debt) into a long-term debt in US$ at an interest rate of 4%.

48. ***Private Sector Contribution***. In addition to the envisaged agreement with the BdL, the Lebanese private banking community has indicated its willingness to contribute to the major ongoing macroeconomic adjustment initiative through an interest cost reduction effort that complements the Government's program of fiscal adjustment, privatization and the external support. This could be achieved through voluntary reverse swap operations that reduce the rates on the existing stock of debt held by banks, and through a proactive role, on their part, in the Treasury paper market that would result in rates on new Government issues that reflect the impact of the overall adjustment. The mechanics of this contribution as well as its effect on interest rates and debt service will be detailed in a separate paper.

49. ***Debt Reduction, Growth and External Support***. Lebanon's total net public debt is expected to reach US$30.0 billion by the end of 2002, equivalent to 173% of GDP. With the implementation of the Government's plans for further fiscal adjustment (increases in the primary surplus), privatization, and the above-mentioned agreement with the BdL, debt reduction would take place in 2003 even in the absence of external support. As a result, rates on domestic currency borrowing could decline somewhat and spreads on foreign currency borrowing ease a little in 2003, but in the absence of external support, average interest rates on the debt would remain high (above 10%), and remain so after 2003. Therefore, only a very modest further reduction in the overall fiscal deficit would be feasible in 2004 and beyond, and the stock of debt would rise again from 2004, with the debt to GDP ratio remaining at close to one and half times GDP. Thus, the reductions in the debt to GDP ratio and in the cost of servicing the debt as a result of the Government's plans for fiscal adjustment and privatization, while sizable, are not enough, by itself, to create a virtuous cycle of debt reduction, lower interest rates, and growth, enabling sustained economic and social development. Table 2 below shows the scenarios that would evolve if the domestic effort is or is not complemented by external support in the amount and of the type requested as indicated in the section "External Support" below (page 18).

50. <u>Without external support</u>, the debt to GDP ratio would decline in 2003 as a result of the privatizations that are envisaged (albeit that privatizations are likely to yield less because of the greater country risk to be perceived by investors in the absence of external support), and the agreement with the BdL. The ratio would barely decline further thereafter, however, as interest rates would not decline further. Consequently, notwithstanding the improvements in the primary balance, further reductions in the overall fiscal deficit would be limited, and the overall deficit as a % of GDP would remain in excess of the rate of nominal GDP growth. Similarly private investment would remain constrained on account of the debt overhang and level of domestic interest rates, and consequently growth would be low, at best.

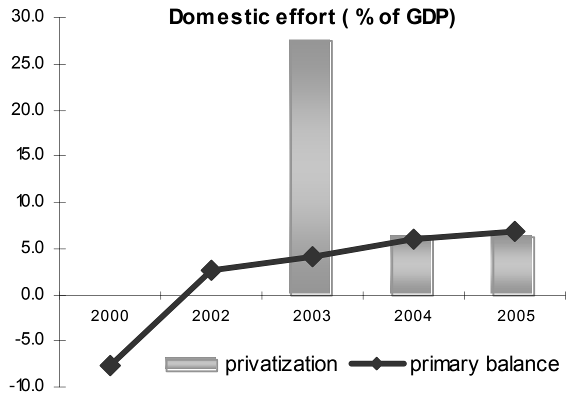
51. The above "without external support" scenario is a positive perspective on possible outcomes in the absence of external support. With large gross borrowing needs of the Government in 2003—because of the short term maturity of existing debt—, financial markets may in the absence of demonstrated external support again turn negative, and consider the Government's program not to be feasible in terms of reaching its basic objective of resolving the debt dilemma. The resulting Government reliance on financing of part of its deficit by the Central Bank could put further pressure on reserves and interest rates. Subsequently, this could undermine financial and economic, as well as social and political, stability.

Table 2 Fiscal Developments and Public Debt, 2002-2007

	2002	2003	2004	2005	2006	2007
	without external support [a]					
GDP (US$ billion)	17.3	18.0	18.8	19.6	20.4	21.2
real GDP growth	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
fiscal deficit (% of GDP)	15.6	13.0	8.5	7.0	5.7	4.6
total net debt (US$ billion) [b]	30.0	26.3	26.9	27.2	27.8	28.2
net debt to GDP ratio (%)	173	146	143	139	136	133
	with external support [c]					
GDP (US$ billion)	17.3	18.2	19.2	20.3	21.4	22.7
real GDP growth	2.0%	3.0%	3.0%	3.5%	3.5%	4.0%
nominal GDP growth	4.0%	5.1%	5.6%	5.6%	5.6%	6.1%
as % of GDP						
Primary fiscal surplus	2.6	4.2	6.1	7.4	8.3	9.1
Interest on public debt	18.2	12.6	9.5	8.2	7.4	6.4
fiscal deficit	15.6	8.4	3.4	0.8	-0.9	-2.7
budget deficit [d]	**14.9**	**7.6**	**2.6**	**0.0**	**-1.6**	**-3.4**
US$ billion						
fiscal deficit	2.7	1.5	0.6	0.2	-0.2	-0.6
privatization	0.0	5.0	1.2	1.3	0.7	0.7
total net debt [b]	30.0	24.7	24.2	23.1	22.2	21.0
consolidated net debt	25.2	21.7	21.2	20.1	19.2	18.0
net debt to GDP ratio (%)	**173**	**136**	**126**	**114**	**104**	**92**
consolidated net debt (%)	**138**	**113**	**104**	**94**	**85**	**74**
Interest rate public debt % [e]	12.0%	8.0%	7.0%	6.5%	6.5%	6.5%
Interest savings (US$ million)		1144	1286	1369	1316	1257
o/w from external support		704	729	803	741	673

(a) This scenario assumes the same improvement in the fiscal primary balance as the scenario with external support, but privatization proceeds at 15% less because investors are likely to reflect a greater country risk in their offers.
(b) Excluding accrued interest on discount Treasury Bills
(c) The scenario that is presented here for 2003-2007 is basically the same as the scenario developed by the IMF Article IV Consultations mission based on the Government's program, except that: (i) privatization and securitization proceeds are US$250 million higher in 2003, and include the further sale of all remaining shares in the telecommunications and power corporations during 2004-2007; (ii) the debt is US$1.8 billion lower in 2003 on account of the agreement with the BdL; and (iii) most importantly, that overall fiscal adjustment is greater, as the average rate of interest on public debt is projected to decline more in 2003 and to continue to decline through 2004-2006, and hence, reductions in the debt are at a faster rate.
(d) Equals fiscal deficit less foreign financed expenditures by the CDR
(e) The 2002 rate is of end September.

52. With external support, the request for which is summarized on page 18, Lebanon would be in a position to substitute US$5 billion in external debt, contracted at terms (interest rates and maturities) available to prime sovereign borrowers, for existing public debt (with an average rate of 12% as of end-September 2002). Just by itself, this substitution would have an immediate effect of savings in interest in the order of US$400 million per annum (over 2% of GDP)[12]. However the combination of continued fiscal adjustment and privatization, in 2003 and beyond, along the lines discussed above (and shown in the graph above), and the external support would bring about a steady reduction in the debt to GDP ratio and interest rates on the public debt. While the total interest savings in the order of US$1.25 billion a year on average during 2003-2005 are the result of the combined and mutually reinforcing effect of the domestic effort and the external support, the with and without external support scenarios indicate that over half of it, or around $725 million a year on average during 2003-2005, is attributable to the external support. Underpinned by the structural measures that have been taken, the reduction in interest rates of the magnitude that would result with external support would contribute to a recovery of growth to at least the conservatively projected levels indicated in Table 2 on the left, thus further enforcing the downward trend in debt indicators.



53. Except for the projected real GDP growth rates, which are modest, the scenario of steadily declining interest rates (during 2003-2005), sharp reductions in the overall fiscal deficit and declining debt stocks and ratios, as discussed above and presented in Table 2, represents a achievable and sustainable outcome in the case that external support is provided in the magnitude and nature envisaged (paragraph below)[13]. If the amount of the support in 2003 were to be much less, or the terms much harder, larger public borrowing in the domestic market and higher interest rates would limit the decline in the overall fiscal deficit and the stock of public debt could not be reduced after 2003, while private investment and growth would not take off. Lebanon would find itself in a "muddling through" situation at best, unable to realize its growth potential, and vulnerable to possible shocks arising from changes in confidence, with its effects on domestic financial markets, or exogenous events.

[12] This estimate is based on the average interest rate on debt of 12% as of end-September 2002 and an interest rate of 4% on the debt instruments of the external support. The immediate impact would be larger (as much as $500 million) to the extent that these instruments substitute for domestic currency debt that had an average rate of 14%.

[13] To check the robustness of the scenario a sensitivity analysis was done that assumed interest rates at 0.5% point higher, privatization proceeds at 10% less, and the improvement in the primary fiscal balance at 1% of GDP less in 2004 and 2005. With a combination of all those factors, the fiscal deficit would be eliminated by 2007, debt stocks would not rise after 2003, and the debt to GDP ratio decline, albeit slower.

54. Table 3 below shows the composition of the total gross public debt as of end-September 2002 in some detail. The projected end-2002 public debt is US$31.3 billion gross (and US$30.0 billion net). The stock of debt will be reduced by US$1.8 billion in early 2003 on account of the agreement with the BdL (paragraph 47). For 2003, Government's financing needs for its budget (a fiscal deficit equivalent to $1.5 billion) would be met primarily by new, mainly domestic, debt contracted at lower rates (in addition to disbursements from existing external project loans). *The external support that is requested and the privatization and securitization proceeds would be earmarked for paying off debt held by the private sector (primarily commercial banks) that matures in 2003 and other high interest debt.* In particular paying off maturing domestic debt is expected to contribute to the projected decline in interest rates that would underpin the recovery of growth in conjunction with the structural measures that are in place and underway.

Table 3 Composition of Public Debt (end-2002)
(US$ billion)

Total gross public debt [a]	31.3
Total gross debt held by public sector	5.8
o/w BdL	3.7
o/w Other institutions	2.1
Total gross debt held by private sector	25.5
FX debt, excl. public sector	11.8
LL debt, excl. public sector (gross)	13.7
LL debt, excl. public sector (net)	13.4
Consolidated public sector debt (net)	25.2

(a) The net public debt (gross less public sector deposits) is US$ 30 billion, excluding accrued interest on discount Treasury bills .

EXTERNAL SUPPORT

55. In order to create a virtuous cycle leading to sustained economic and social development, Lebanon needs the support of the external community to complement its major domestic effort now underway. The domestic effort includes a 16% of GDP fiscal improvement during 2001-2003 and privatizations, to be applied to Government debt reduction, in an amount of about US$5 billion in 2003. This reduction in debt is separate of Paris II proceeds.

56. Lebanon devotes 80% of rising Government revenues to pay interest on its net debt of about US$30 billion. The Government of Lebanon realizes that the support it is requesting will not be available in the form of grants and soft loans from bilateral and multilateral sources in the magnitude that would be required and for the purpose of changing the composition of its debt. Government therefore requests external support to change the composition, reduce the cost, and lengthen the maturity of its debt through instruments such as sovereign guarantees, investments by Governments and Central Banks in new Lebanese Government foreign currency bonds, and similar arrangements, for a total amount of US$5 billion in 2003, that would allow Lebanon to borrow in supporting countries' markets at low spreads, using the proceeds solely to substitute such external debt for existing high interest short-term debt. Such substitution would result in a sharp reduction in the level of domestic interest rates, with a consequent further reduction in the overall fiscal deficit and financing needs. It would sharply reduce the Government's gross financing needs for 2003 and 2004 and significantly improve the maturity profile of the debt. It would, through lower interest rates and increased availability of financial sector domestic financial savings for the private sector, also help trigger a revival of private investment to underpin a recovery of GDP growth.

57. *In order to allow Government to achieve a sustainable reduction of its fiscal deficit and a recovery of growth, the request for the terms of the support in the amount of US$5 billion is for long term maturities, with a grace period of five years (for principal only), during which time the Government intends to eliminate the overall fiscal deficit, and a repayment period of 10 years, during which time Governments expects to generate fiscal surpluses in the amount of the support, at interest rates similar to the supporting countries' cost of domestic or external borrowing, which are estimated at around 4% on average. These surpluses will be used to repay the obligations arising from Paris II.*

58. ***Special Account for debt service.*** Government has established by law a special treasury account at the Central Bank that is earmarked exclusively to service the interest and principal of outstanding debt obligations including forthcoming resources from the Paris II process. The above-mentioned law stipulates that all privatization and securitization proceeds must be channeled fully to this account for the exclusive purpose of debt reduction. Also, the law stipulates that all primary surpluses will be channeled to this special account for the purposes of meeting Lebanon's debt service obligation. In addition, Government is committed, fully, to introduce additional revenue measures to ensure that debt service obligations are met in a timely and orderly fashion. This special account provides a transparent and moniterable mechanism of Government's ability to meet its outstanding obligations.

59. The International Monetary Fund has reviewed the Government's program on the occasion of the recent Article IV Consultations. It has indicated that the Government's strategy of fiscal adjustment and privatization would lead to a viable scenario only if external support of the magnitude and type requested at the Paris II Meeting would be forthcoming. It concluded that with the domestic effort and the external support in the magnitudes envisaged, public debt would be put on a downward path, and reductions in interest rates would contribute to a sustained improvement in growth performance. It also noted that a viable alternative scenario to the Government's program with external support is not available. The Government of Lebanon therefore hopes that participants at the Paris II Meeting will agree to ensure that a viable scenario of stability and growth will ensue in Lebanon.

POSTSCRIPT

Lebanon 2005

After Five Years of Adjustment, Reforms, and External Support—A Vision

By the time of the Paris II Meeting in late 2002, Lebanon faced the prospect that economic stability could be undermined, notwithstanding the adjustment and reforms that had been undertaken since late 2000, arising from a large debt overhang that had accumulated as the country had recovered during the 1990s from 15 years of war. Rising outlays for interest on public debt absorbed an increasing share of rising revenues and of Government expenditures. There was a possibility that, in the absence of a reversal of trends with external support, sustained social stability could be at risk. The Government's program for further fiscal adjustment, large privatizations, and reforms, despite its scope and depth, by itself was unlikely to result in a resolution of the debt dilemma and sustainable growth.

The external support that was provided in late 2002 and early 2003 (mainly in the form of financial instruments that enabled Lebanon to substitute debt at market terms of the supporting countries for part of its high interest short term, mainly domestic, debt), in conjunction with the implementation of the Government's program for further fiscal adjustment, privatization, and structural reforms, had led to a steady reduction in the cost of servicing the debt and declining debt ratios from 2003 onwards.

By 2005, the budget was in balance and the overall fiscal deficit had been nearly eliminated, and the debt to GDP ratio had fallen since 2002 by the equivalent of more than to half of total GDP. Most of the public infrastructure services were operated by the private sector, which owned large parts of them. Government no longer required access to concessional external loans or to the Central Bank, and did not need to absorb the bulk of savings in Lebanon's financial system, to meet its steadily declining financing needs. Interest rates had fallen sharply and, with the private sector no longer crowded out by public sector borrowing needs and structural reforms to liberalize the economy and support the private sector in place, private investment was booming. International trade and services blossomed in a liberal trade environment, with close ties to the EU, and regional investors had put their confidence in a modern version of the Lebanon they had known in the 1960s and early 1970s. GDP growth was accelerating and per capita incomes were steadily rising, and with Government focusing on its basic functions and essential social programs, sustainable broad based socio-economic progress was being made. There were good prospects that in real terms Lebanon's per capita income would by about 2010 recover to the pre-war level.

Annex I Paris II Meeting

The Government's Program for 2003 and Beyond

Objectives	Background and Status	Key Targets
Reducing Public Debt and Interest Rates	Rising levels of public debt, much of it accumulated during 10 years of reconstruction and recovery, have created a vicious circle of high fiscal deficits, rising interest rates, declining private investment, and economic stagnation.	Fiscal deficit was 25% of GDP and real GDP growth 0 in 2000.
Fiscal Adjustment	The primary fiscal balance has improved by 10% points of GDP during 2001-2002 on account of a major revenue effort, particularly with the introduction of the VAT and expenditure control, including restructuring of public entities. Further increases in primary surplus, particularly in 2003 (budget approved by Cabinet) on account of continued revenue effort (in particular VAT and income taxes) and reductions in expenditures (including reductions in public employment), facilitated by planned privatizations, so as to reduce the overall fiscal deficit to below EU norms by 2005 and eliminate it by 2006. Reduction is predicated on reducing interest rates on public debt with external support to complement the fiscal adjustment and privatization.	Primary balance from deficit of 7 ½% of GDP in 2000 to surplus of 5% in 2003 Overall fiscal deficit: -10% in 2003 -1% in 2005 -surplus in 2006
Privatization	Public sector had traditionally operated basic public services, and reconstructed infrastructure after the war. Level of services has remained substandard, cost recovery has been insufficient, and all sectors, except for telecommunications have been a significant drain on the budget. An outdated legal framework and lack of political support were not conducive to privatization. A national consensus on an increased role of the private sector has now evolved. Telecommunications and power sector are key to short-term debt reduction on account of privatization because of size of assets and investors' interest. --Sale of two mobile system licenses is now underway --Corporatization of telecommunications company, and unbundling and corporatization of power company, and establishment of regulatory agencies is now being prepared prior to privatization Privatization of water sector and ports and airports through concession arrangements are being planned for 2004-2005	Parliament adopted legislation in 2002 to allow privatization in telecommunications and power sectors Target of US$5 billion in privatization and securitization proceeds in 2003, and about US$1 billion per year 2004-2005: -Sell mobile licenses first quarter 2003 -Sell 40% of power corporation first half 2003 -Sell 40% of telecom corporation second half 2003 -Sell remainder 2004-2007 Award concessions during 2004-2005 following establishment of legal framework in 2003
External Support	Substitution of US$5 billion in external debt at prime market terms for existing high interest debt, through guarantees, Central Bank deposits, investments in Lebanese Government bonds and bills, and similar arrangements requested at Paris II meeting	During first half 2003 Reduction in interest rate on public debt by about one-third in 2003 and 1% more in 2004

Objectives	Background and Status	Key Targets
Promoting Growth	After a rapid recovery of the economy during the first half of the 1990s, GDP growth slowed down, reflecting the effects of the evolving fiscal deficit and debt situation, as well as the structural constraints. Concurrently with the implementation of a debt reduction strategy, Government is taking structural measures that lay the basis for a recovery of sustained growth, once the key constraint to private investment—excessive public sector domestic borrowing and high interest rates—is removed as a result of the fiscal adjustment, privatization and external support.	Real GDP growth at 0 in 2000 and low growth in 2001-2002
Trade Liberalization	Lebanon's traditional liberal and open trade regime, a model in the 1950s and 60s, had not adapted to the global developments in trade that had taken place during the war, and the legal framework had become outdated. This limited the effort to reestablish Lebanon as a center for regional trade and provision of services and a link between the region and Europe.	
International Agreements	Lebanon became a member of the <u>Greater Arab Free Trade Area</u> (GAFT) in 1997, which is now in its 6th year of tariff dismantling.	Increase in exports to GAFTA area
	An <u>Association Agreement with the EU</u> was completed in January 2002 and signed in June 2002. Pending ratification of the agreement by all States, an interim trade agreement is already in effect which provides for duty free access of all industrial exports, and most agricultural and agro-industrial exports from Lebanon. Because of the heavy reliance on import tariffs for fiscal purposes, and the difficult fiscal situation, Lebanon has a five year grace period for dismantling its tariffs.	Increase in exports to EU
	Lebanon is seeking membership to the <u>World Trade Organization</u>. The first Working Party meeting was held in October 2002	WTO membership
Modernizing Legal Framework	A new, WTO-compatible Customs Law was enacted in June 2001 which, among others, simplifies procedures and introduces modern information technology for customs declarations, and international standards for clearance.	
	Imports of oil were liberalized in 2001 and legislation to liberalize imports pharmaceuticals was submitted to Parliament	
	Legislation is under preparation to abolish exclusive agencies and commercial representation, which limit competition, and to streamline licensing requirements for trade. Competition law and consumer protection law being prepared	Present to Parliament early 2003
	A number of other laws are being prepared in line with requirements for WTO membership	Present draft legislation in conjunction with WTO membership to Parliament

Objectives	Background and Status	Key Targets
Promote Private Investment	A new Investment Promotion Law was adopted in August 2001. The Investment Development Authority of Lebanon (IDAL) has been designated as a "one-stop shop" to support investors. The law provides financial and tax incentives depending on the location (in one of three investment zones in the country), size of investment, and type of activities, with the most incentives for information technology projects	Increase in investments in sectors other than real estate by regional investors, and, supported by the Association Agreement, a major increase in number of European investors
	The laws for the telecommunications and power sectors that were adopted in 2002 (see above), and the laws that are being prepared for the water sector will increase private investment in basic infrastructure	Establish regulatory agencies in first half of 2003. Limit role of Government in public services to regulator only by 2005
	A Foreign Ownership Law was adopted in March 2001 that eases limits on foreign ownership of land	
	A Money Laundering Law was adopted in April 2002 to meet requirements of FATF, resulting in Lebanon being de-listed. This enhanced international standing of Lebanese banking system. Law on bank shares (April 2002) facilitates trading in shares of Lebanese banks.	Increased financial investments, particularly from region
	Private investment is limited by access to domestic credit and high interest rates, as well as conservative nature of Lebanese banking system. In particular SMEs, which offer the largest potential for employment growth, are affected. In early 2001 Government increased loan limits in "Kafalat" guarantee scheme and introduced interest rate subsidies for SMEs.	Increase share of private sector in total banking system credit, with sharp increase in credit to SMEs
	Large segments of the public coast around the Beirut area have been illegally developed during the war. This had had negative environmental effects and discouraged new investments in tourism. Government is preparing legislation for the settlement of violations of public coastal properties, which will also result in additional Government revenues.	Government revenues from 2003, and new tourism investment in areas concerned from 2004.
Improve Public Services and Reduce Cost of Business	The privatization of basic public services will improve the quality of services, and through greater efficiency and improved cost recovery from non-business consumers, reduce the costs of provision of basic services to business	No claims on budget for basic public services from 2004
	Public institutions remain weak. A program of administrative reform supported by the EU, the Arab Fund and the World Bank is underway. The more limited role of Government in the economy will allow Government to deploy its scarce human and financial resources to improving the provision of basic functions of the State. This is a medium term endeavour.	
	A new public accounting law, streamlining budgetary procedures and strengthening treasury controls, and a procurement law, incorporating best international practices, so as to increase transparency and competition, have been presented to Parliament.	
	Employers' contributions of 38.5% of wages to the National Social Security Fund have been reduced in March 2001 to 23.5% so as to encourage employment creation and reduce business cost	
	Temporary subsidies are being provided under the "Export Plus" program adopted in June 2001 to exporters of fresh produce to reduce transportation costs. At the same time, subsidies to sugar beet production were abolished in early 2001	

ANNEX II PARIS I MEETING

GOVERNMENT OF LEBANON

A MATRIX OF STRUCTURAL REFORMS[1]

Measures Already Adopted (December 2000-February 2001)

MEASURE	ACTIONS	IMPACT	STATUS
1. State Media Reform	• Lay off 500 workers from Tele-Liban, cancel workers collective bargaining contracts and restructure the sector	• Contain public expenditures	done
2. Civil Service Reform	• Reassign surplus workers to Civil Service Board and fill new civil servants posts through the Board	• Restrict the growth of public sector employees and contain expenditures	done
3. Customs Tariff Reduction	• Reduce effective customs tariff from 12% to 6%	• Liberalize trade and reduce the price level in the economy	done
4. Customs Law	• Simplify and streamline customs procedures	• Facilitate trade	done
5. Investment Law	• Create a one-stop-shop for investors, provide tax breaks and financial incentives to projects, and create investment zones	• Attract and raise the level of investments	done
6. Open Skies Policy	• Introduce competition and provide unrestricted entry into Lebanon	• Render Beirut International Airport as regional travel hub • Lower airfares	done
7. Land Acquisition by Non-Lebanese	• Provide greater access for non-Lebanese to acquire real estate property and lower registration fees	• Enhance investment in the real estate sector	done
8. Public Accounting Law	• Streamline and simplify budgetary procedures and strengthen treasury functions	• Facilitate Central Government financial activities	done
9. Money Laundering Law	• Take new measures to guard against money-laundering activities	• Comply with international standards and regulation for combating money laundering activities	done
10. Sugar Beet Subsidies	• Terminate subsidies on sugar beet and wheat production	• Liberalize agricultural sector and reduce expenditures	done

[1] As presented to Paris I Meeting. Page 2 provides the status of measures that were to be adopted during March 2001-December 2002, and Page 3 lists other measures taken during March 2001-October 2002, not included in Matrix as presented to Paris I Meeting

Measures To be Adopted (March 2001-December 2002)

MEASURE	ACTIONS	IMPACT	STATUS
1. Value Added Tax	• VAT draft law approved by COM • VAT law ratified by parliament • VAT Implementation	• Enhance revenue collection and widen the tax base	Implemented VAT first quarter 2002
2. Global Income Tax	• Draft law presented to COM • Law ratified by parliament (2003) • Implementation of law (2004)	• Improve tax collection capabilities • Expand taxpayer base • Streamline tax collection	Draft law being prepared. Tax to be effective 2004
3. Privatize Middle East Airlines	• Strategy presented to COM • Staff redundancy package • Initiation of privatization of MEA	• Resolve MEA high-wage bill • Limit expenditure drain	Restructuring, including lay-offs completed. Airline now profitable.
4. Privatize Telecom Sector	• Telecom law approved by COM • Telecom law ratified by parliament • Settlement of contractual disputes with Cellular Operators • Convert BOT into licenses • Parliamentary approval of license agreements • Initiate privatization of Liban Telecom	• Improve efficiency • Allow for the introduction of state-of-the-art technology • Lower rates • Generate revenues for debt retirement	Law approved. Sale mobile licenses underway. Liban Telecom and regulatory agency being created. Privatization 40% 2003.
5. Privatize Electricite du Liban	• Approval by COM of draft law to convert EDL into a joint stock company • Ratification of draft law by Parliament • Initiate tender for management contract and 10% equity share	• Limit expenditure drain • Improve provision of services • Generate revenues • Eliminate leakages	Law approved. Companies and regulatory agency being created. Privatization 40% 2003
6. Privatize Water	• Beirut Water Authority concession approved by COM • Beirut Water Authority concession ratified by Parliament • Tripoli Water Authority concession approved by COM • Tripoli Water Authority concession ratified by Parliament	• Enhance effective cost recovery • Revenue generation • Enhance efficiency	Draft legislation allowing concessions approved by Cabinet
7. Reform of the Army Pension Scheme	• Readjust army retirement benefits and settle accrued retroactive benefits	• Reduce current expenditures and drop in future liabilities	Done
8. Social Security Reform	• Reduce social security contributions, settle arrears and provide alternative schemes	• Retire contingent liabilities, lower cost of labor and promote employment	Done (from 38.5 to 23.5%)
9. Municipality Law	• Promote decentralization and normalize financial accounts of municipalities	• Provide efficient municipal services with positive fiscal externalities	Draft legislation presented to Parliament
10. Euro-Med Trade Agreement	• Sign the Euro-Med Trade Agreement, accede to the WTO and execute GAFTA	• Liberalize trade and generate economic growth	EU agreement signed June 2002 WTO Working Party

			held Oct. 2002 GAFTA being executed

Other Measures Adopted (March 2001-October 2002)

MEASURE	ACTIONS	IMPACT	STATUS
1. Establish Special Accounts for Debt Management	Law adopted May 2002 allowing Government to open special accounts for privatization proceeds and revenues to be used for securitization, and for loans, all to be used solely for debt reduction and substitution	• Reduce stock of debt • Improve structure of debt • Lower interest rates	done
2. Settlement of violations of public coastal properties	Draft law presented to Parliament (September 2002)	• Environmental protection of coast • Promote tourism investment • Additional fiscal revenues	done
3. Liberalize oil imports	Government decision effective February 2002	• Reduce cost of imports of oil and oil products	done
4. Liberalize imports of pharmaceuticals	Draft Law approved by Cabinet (February 2002), now being considered in Parliament	• Lower prices through increased competition • Lower cost of private and public health care	done
5. Abolish Exclusive Agencies	Draft legislation approved by Cabinet, now being considered in Parliament	• Lower prices resulting from increased competition	done
6. Guarantee scheme for loans to SMEs	Approved by Cabinet in February 2002 and operative for selected loans by private banks	• Increased access by SMEs to investment credits • Increase in SME investments • Employment generation	done
7. Interest rate subsidies for SMEs	Effective January 2002 for limited amounts in selected sectors	• Increase in SME investments • Employment generation	done
8. Export Plus Program	Effective August 2001. Provides limited subsidies to exports of fresh produce to compensate for high cost of transportation and provides for quality control	• Increased exports • Employment generation, particularly in rural areas	done
9 Law on banks shares	Effective April 2002. Facilitates trading in shares of Lebanese banks	• Increased foreign investment in financal sector	done