

January 02, 2007



Lebanese Republic

RECOVERY, RECONSTRUCTION, AND REFORM

“International Conference for Support to Lebanon”

**25 January 2007
Paris**

ABBREVIATIONS AND ACRONYMS

| | |
|----------------|--|
| BdL | Banque du Liban (Central Bank of Lebanon) |
| BOT | Build-Own-Transfer |
| CDR | Council for Development and Reconstruction |
| EdL | Électricité du Liban |
| EU | European Union |
| GDP | Gross Domestic Product |
| HCP | Higher Council for Privatization |
| HRC | Higher Relief Commission |
| INSEE | Institut National de la Statistique et des Etudes Economiques |
| LL | Lebanese Pounds |
| MEA | Middle East Airlines |
| MOF | Ministry of Finance |
| NGO | Non-Governmental Organization |
| NSSF | National Social Security Fund |
| PMO | Prime Minister's Office |
| SME | Small and Medium Scale Enterprise |
| UN | United Nations |
| UNDG | United Nations Development Group |
| UNDP | United Nations Development Program |
| UN MACC | United Nations Mine Action Coordination Center |
| VAT | Value Added Tax |

“International Conference for Support to Lebanon”

RECOVERY, RECONSTRUCTION AND REFORM

| Contents | Page |
|--|--------|
| RECOVERY, RECONSTRUCTION AND REFORM..... | - 1 - |
| Prelude | - 1 - |
| I. Background..... | - 1 - |
| II. Developments during 2001-05 | - 2 - |
| A. The Reform Program Prior to the Israeli July War | - 4 - |
| B. The Impact of the July Israeli War..... | - 5 - |
| C. The Cost of the July Israeli War and International Support for Recovery & Reconstruction | - 6 - |
| III. The Government’s reform program | - 7 - |
| A. Growth-Enhancing Structural Reforms | - 9 - |
| Governance | - 9 - |
| Financial Sector Reform and Debt Management..... | - 10 - |
| Improving the business environment..... | - 11 - |
| B. Social Sector Reforms..... | - 13 - |
| Main elements of the social plan | - 14 - |
| Specific social interventions | - 15 - |
| C. Pension Reform | - 16 - |
| D. Fiscal Adjustment and Structural Reform..... | - 17 - |
| Expenditure Measures..... | - 17 - |
| Revenue Measures | - 21 - |
| E. Privatization Program..... | - 23 - |
| F. Monetary and Exchange Rate Policies | - 25 - |
| G. Banking Sector's Contribution to the Domestic Effort | - 25 - |
| IV. Medium-Term macroeconomic Framework..... | - 26 - |
| A. Macroeconomic scenario with domestic adjustment | - 26 - |
| B. Macroeconomic Scenario with External Support..... | - 27 - |
| C. Implementation of the reform program..... | - 28 - |
| V. Conclusion | - 29 - |



Lebanese Republic

RECOVERY, RECONSTRUCTION AND REFORM

Preface

In April 2005, Lebanon reclaimed its democracy and independence through a popular uprising triggered by the assassination of late Prime Minister Rafic Hariri. The international community rallied in support of Lebanon and, on the occasion of the Core Group meeting in New York in September 2005, vowed to support the new government and help Lebanon reduce its debt to sustainable levels so it can achieve growth, equity, and political stability.

Following that meeting, the Government prepared a comprehensive reform program that was to be presented to a Donors Conference in Beirut with a request for international support to complement the significant domestic effort that was envisaged in this program. Following extensive consultations with domestic and international stakeholders, the government was on the verge of adopting this program when Lebanon once again came under a massive Israeli attack.

The direct and indirect costs of the July 2006 war far exceed the capacity of any middle-income country to bear, let alone a country that has been saddled with a very large public debt and a country that had just come out of a major setback associated with the assassination of Prime Minister Hariri, which has left deep scars on the economic and political landscape. As a result, the burden of Lebanon's public debt—largely a legacy of the 1975-92 war and its aftermath—has become even heavier.

While the July war and its devastating consequences have shifted the government's short term attention to immediate major relief efforts and reconstruction needs, the government remains fully committed to pursue economic reforms, although some changes to the timetable and to the size of adjustment are needed. These changes are necessary to take into account the impact of the war on the macroeconomic situation, and to spread the burden of reform over time so as to give the suffering population a breathing space following this year's tragic events.

By the end of 2006, Lebanon's debt will be around US\$40.5 billion, or about 180% of GDP. Despite its resiliency, Lebanon cannot shoulder this price on its own. The re-phasing of some measures necessitated by the latest Israeli war will fail to achieve growth, equity, and debt sustainability in the absence of sizeable external support. Failure to achieve these objectives could well jeopardize Lebanon's broader goals of political and social stability, and the strengthening of its democracy. Lebanon is therefore hopeful that on the occasion of the "International Conference for Support to Lebanon", the international community will invest in Lebanon's future and democracy.

The Lebanese people are determined to build a strong state: a state which can reclaim the position of Lebanon as a haven of moderation where individual initiative and potential can be fulfilled. In our part of the world, Lebanon represents indeed a unique phenomenon of diversity, multi-confessionalism, democracy, and freedom of expression. We will strive to preserve and keep these ideals alive, but our friends' help is critical. We strongly believe that what happens in Lebanon will have repercussions that transcend Lebanon's borders and far exceed Lebanon's size. Our success in strengthening our democracy and building a strong economy is in the interest of all.



Lebanese Republic

RECOVERY, RECONSTRUCTION AND REFORM

PRELUDE

1. On the eve of July 12, 2006 the government of Lebanon was on the verge of adopting a comprehensive and bold economic reform program, which had set ambitious targets to address the main vulnerability of the Lebanese economy represented by the high level of public debt and to create the right environment for stimulating growth and creating employment. The program aimed also at mitigating the impact of adjustment on the less fortunate in the context of a well defined social action plan to be implemented in conjunction with economic reforms.

2. The July-August Israeli war shifted the government's attention to managing the humanitarian crisis, providing for massive rehabilitation needs, and rebuilding physical infrastructure especially that related to the country's productive capacity. Despite the difficult economic environment, the government remains fully committed to pursuing the kind of reform efforts included in the pre-war program. Naturally, the new reality on the ground imposes a different set of conditions and additional constraints that should be taken into account.

3. In this document, the government of Lebanon presents its reform program that aims primarily at stimulating growth, creating employment, and putting Lebanon's large public debt on a downward trend. The core elements of the program have not changed and were subject to wide and extensive consultations and discussions with domestic and international stakeholders prior to the July-August 2006 Israeli war.

4. The rest of the document is organized as follows. First, a brief background is presented along with an overview of recent developments. In the following section, a summary of the impact of the war will be presented as well as the financial assistance provided by the international community for immediate recovery and reconstruction needs. The government's reform program and the medium-term outlook are then discussed in detail.

I. BACKGROUND

5. In mid-1970s, Lebanon was a democratic upper-middle income country prospering as a regional service center on the crossroads between Europe and the Middle East. Lebanon barely had any debt, reflecting prudent economic management and an economy that was driven mainly by a dynamic private sector and supported by a small size public sector. But Lebanon was also at the crossroads of international politics and regional conflicts, which have contributed to the outbreak of the war in 1975. Seventeen years of internal strife caused massive destruction. The UN estimated damage to physical assets at US\$25 billion, equivalent to about six to seven times the Gross Domestic Product (GDP) in 1990.

6. Prior to the outbreak of the civil war in 1975, Lebanon had a liberal, open, and dynamic economy led by a dominant and vibrant private sector. The fifteen years of hostilities, however, had a debilitating effect on the private sector which struggled to regain its previous role as an engine for growth in providing employment and basic services. Given this fact, and the enormous need for physical reconstruction coupled with an inability to raise sufficient revenues, the public sector

resorted to borrowing to reverse the impact of hostilities and provide the basic platform for the private sector to regain its previous role. This led to a change in the basic nature of the Lebanese economy that saw a rise in the role and the size of the public sector.

7. In the early 1990s, the government undertook the task of reconstruction of public infrastructure, and of investing in social peace, including incorporating the war militia, and providing for resettlement and social assistance to the displaced. Also, the government had to deal with the social consequences of the continued Israeli occupation of the South notwithstanding the recurring Israeli aggressions that necessitated additional outlays for reconstruction and special allocations to the Council of the South. With an eroded revenue base and limited access to external financing, the government relied heavily on borrowing domestically to finance sharply rising budget deficits. Given the magnitude of destruction, the government had to provide all basic services including education, health, water, and electricity. While there was significant international support for reconstruction, primarily in the form of concessional loans, overall more than two-thirds of all capital expenditures during the 1990s were funded by market borrowing at high interest rates. Total public sector interest payments were double the size of capital expenditures during the 1990s.

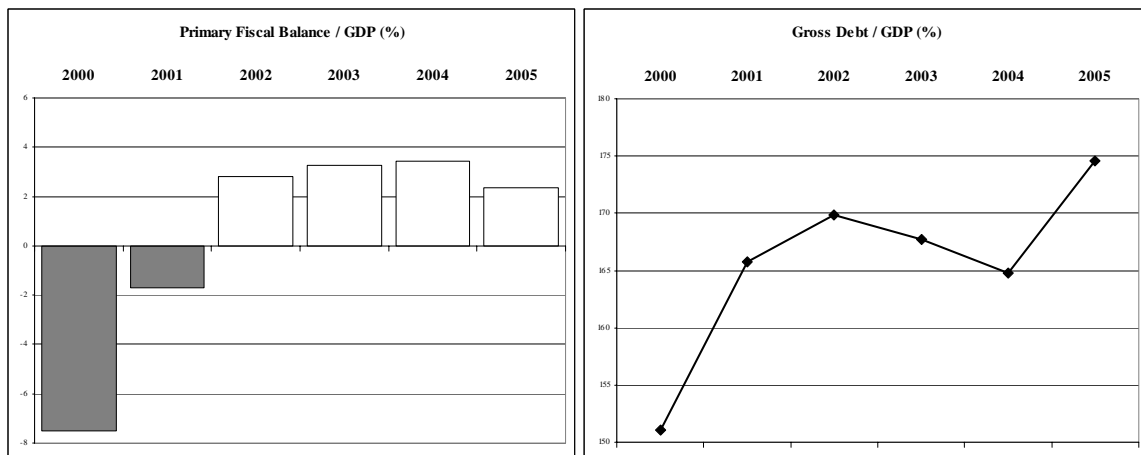
8. By 2000, when south Lebanon was liberated, except for Shebaa farms, essential reconstruction was substantially completed, and real per capita income had more than doubled from the 1990 level, but still stood a quarter below its pre-war level. However, with ballooning interest payments (absorbing over three-quarters of revenues), the overall fiscal deficit reached nearly 25% of GDP in 2000. Gross public debt, which a decade earlier stood at about US\$2 billion, had grown to US\$25 billion, equivalent to 150% of GDP, and the economy was stagnating.

II. DEVELOPMENTS DURING 2001-05

9. Against the background of a vicious cycle of rising fiscal deficits and debt and a stagnating economy, the government of late Prime Minister Hariri that came back to office in late 2000 developed an economic reform program, for which it sought external support in the context of the Paris II Meeting in 2002. On that occasion, the international community provided US\$2.4 billion in direct financial support (non-project financing)¹. This, combined with a financial contribution from Lebanon's financial sector (Banque du Liban and commercial banks²), and the effects that the external support had had on confidence in financial markets, resulted in a significant decline in interest rates.

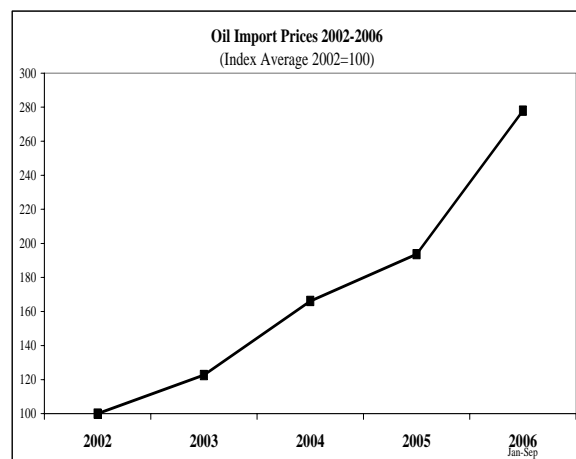
¹ At a maturity of 15 years and an interest of 5% .Three-quarters of the amount has a grace period of five years and the remainder has a grace period of 3 years.

² Government's debt to BdL was reduced by US\$1.8 billion and US\$2.3 billion in debt was converted into a long-term loan at concessional rates. Commercial banks subscribed to a two-year Government security at 0% interest in an amount equivalent to 10% of their deposits (US\$3.6 billion).



10. The financial package helped improve substantially the structure of the public debt and sharply reduced its cost. As a result, interest payments on the debt fell sharply from 17% of GDP in 2002 to about 10% of GDP in 2005. In 2004, macroeconomic performance exceeded all expectation with real growth reaching more than 7%, the overall budget deficit declining to less than 8% of GDP (from 25% in 2000), and the primary budget surplus improving to 2.3% of GDP. The fiscal adjustment benefited considerably from the introduction of a Value Added Tax (VAT) in 2002. However, political squabbling prevented the full implementation of the structural components of the program, mainly privatization, and hence the full benefits of Paris II could not be realized. As a consequence, by end-2004, the level of gross public debt reached 165% of GDP and 175% of GDP by end-2005.

11. Strong economic performance in 2004 was cut short by political tensions that began in late 2004 with the extension of the Presidential mandate and the assassination of Prime Minister Hariri in February 2005. Economic activity declined sharply in the first half of the year to recover somewhat in the second half leading to an estimated real growth of 1% for the year. In addition, Lebanon was particularly hard hit by rising oil prices—given its heavy dependence on oil imports—for as much as 98% of its energy needs—of which about half is for power generation. This was compounded by the reduction in tax revenue since the government had to cap the price of gasoline at its pre-May 2004 level in an attempt to shield the population from the sharp, and what was believed to be a temporary, increase in oil prices. At the same time, government transfers to the Electricity Company (EdL) increased substantially to cover the additional cost of fuel, and to cover the company's large technical and non-technical losses. In 2005, transfers to EdL from the budget reached about US\$650 million.



12. With parliamentary elections in mid-2005 and the formation of a new Cabinet with broad support in July 2005, Lebanon was witnessing a new dawn. Despite the serious economic difficulties that followed the assassination of Prime Minister Hariri in February 2005, the Siniora government exerted significant efforts to redress the fiscal situation and rejuvenate the economy. Between July 2005 and June 2006, all public finance indicators were showing strong improvements: the real growth rate for 2006 was expected to reach 5-6%, with a record high tourist season in the making and an

increase of exports by more than 30%; the primary surplus in the budget more than quadrupled; and the balance of payments, that showed a deficit of US\$1.5 billion in June 2005, recorded a surplus of US\$2.6 billion twelve months later on the eve of the July Israeli war.

A. The Reform Program Prior to the Israeli July War

13. The Siniora government prepared a comprehensive reform program that was about to be adopted before the July war. At that time, Lebanon's prospects were looking good. Signs of an excellent tourist season were very strong—flights to Beirut for the summer were over booked—foreign direct investment was on the rise, large private capital inflows had increased liquidity in the banking sector and helped the central bank build a comfortable international reserves position, and some early signs of a possible “brain drain” reversal were on the horizon.

14. Although the main elements of the reform program were part of the government's statement to parliament in July 2005, the Government decided to first seek broad national consensus on this program before holding the Beirut Conference. This was in order to ensure ownership of the reform program and therefore its implementation, and to avoid the situation that had arisen after the Paris II Meeting when the government was unable to implement the full range of reforms (namely privatization). Given the nature, the magnitude and the scope of the reform measures of the actions that were envisaged, more time than had originally been anticipated was needed to complete the consensus building process, which was also complicated by some political tensions early in the year. The process was reaching its final stages when the war took place in July 2006.

15. The medium-term scenario under the pre-war program envisaged an average real GDP growth of about 5%, strong fiscal adjustment with an improvement in the primary surplus by about 6% points of GDP during the years 2006-10, and privatization going forward, particularly the telecommunications sector. Yet, it showed that without external support, the debt to GDP ratio would decline from 175% at end-2005 to about 135% by 2010. But with interest payments still absorbing about 50% of government revenues. This level of debt would not be sustainable over the long run. It was therefore hoped that with sufficient external support in the form of grants and concessional loans, and a financial contribution from the domestic financial sector, the ratio of debt to GDP could be brought down to a level that could be sustained in the long run.

16. The current government has embarked on a series of reforms since it took office in July 2005. These included growth, privatization, public finance and debt management and financial and capital market reform measures. The growth-enhancing structural reforms have covered competition regulation, consumer protection, SME support, intellectual property rights and trade facilitation. The government has proceeded steadily with privatization, after appointing a Secretary General for the Higher Council for Privatization through a transparent and competitive process. Two mobile licenses were prepared for tendering with the help of two investment banks. The corporatization of Liban Telecom is currently underway. An IPP (Independent Power Producer) Law for the power sector was also ratified by parliament. Under public finance and debt management, the government established the Large Taxpayer's Office, and introduced new reforms for tax and public finance management. The government facilitated tax filing by mail and settlement through commercial banks. In addition, the government submitted more than fifty draft laws to parliament, among them: the Capital Market Reform Law, Tax Procedure Code, Treasury Single Account Law and Debt Management Office Law. Under financial and capital market reform, the government enacted a modern Securitization Law and a Fund Management Law, and is discussing other reform measures with the relevant parliamentary committees pending their ratification.

B. The Impact of the July Israeli War

17. Attacks by land, sea and air resulted in tragic loss of human life, large-scale displacement and massive damage to private and public infrastructure, and a complete dislocation of the economy. The blockade that continued for a month after the cessation of hostilities further deepened the negative impact on the economy. By the time of cessation of hostilities, nearly 1,200 people had died as a direct result of the attacks, of which nearly one-third were children, and about 4,400 were injured. About a quarter of Lebanon's population was displaced during the war, and about 500,000 people saw their houses destroyed or damaged³. There were additional deaths and dozens of injured by unexploded ordinances (UXOs) after the war ended as a consequence of the estimated 1.2 million cluster bombs that were fired into Lebanon during the final days of hostilities⁴. Many professionals and entrepreneurs left the country, among them persons that had returned to Lebanon after the end of the 1975-1992 war, and about 30,000, many of them youth, lost employment.

18. The economic impact of the conflict is substantial in the short term and is likely to constrain Lebanon well beyond 2006 given the time it will take for the economy to recover from this significant setback. Based on assessments carried out by independent consultants retained by the Prime Minister's Office, the total **direct cost** of early recovery and reconstruction is now estimated at around US\$2.8 billion. The cost of reconstruction includes the cost of rebuilding and repairing private and public infrastructure, replacing lost assets, and compensating for private housing, which is by far the largest component of the losses.

19. The **indirect** impact of the war is much more significant. Real GDP growth, which was estimated at 5-6% during the first half of 2006, (according to INSEE⁵, the growth during the first half of the year might have been even higher than 7%), is likely to end the year at a negative 5%. This represents **a loss in output and income for 2006 in the order of US\$2.2 billion** (at 2005 prices). The loss in output in the medium term (as compared to the levels that were envisaged) is a multiple of this amount.

20. The impact of the July war on the fiscal situation is severe. Due to the strong performance of the first half of 2006, the primary surplus was expected at 3% of GDP for 2006, but is now expected to shift to a deficit of 0.4% of GDP⁶ (US\$90 million) after four consecutive years of surpluses. The overall fiscal deficit could reach 14% of GDP due to a revenue loss of around US\$180 million (the magnitude of the loss would have been much more severe had the US\$537 million of grants⁷ not been received), and to about US\$740 million increase in conflict-related expenditures (includes expenditures financed by grants that have been pledged). On this basis, total gross public debt is expected to reach US\$40.5 billion by the end of 2006—equivalent to 180% of estimated post war 2006 GDP⁸.

21. The increase in the government's financing needs as a result of the Israeli war comes at a time when the government is already facing very large debt obligations in the short term.

³ The total number of housing units affected is estimated at more than 100,000.

⁴ Based on estimates of the UN's Mine Action Coordination Center (UN MACC), it is estimated that around one-third of the bomblets had not exploded upon impact.

⁵ INSEE is providing technical assistance to the Lebanese government for national accounts statistics

⁶ Note that this figure may differ slightly from the fiscal primary balance figure in paragraph 70 due to the two different methodologies for compounding debt service payments and foreign financed capital expenditures.

⁷ Note that US\$537 million is the grant amount that is projected to be disbursed in 2006 only

⁸ For further details, please refer to the "Impact of the July War on Public Finances in 2006" and to the "Impact of the July War on Public Finances in 2006, Updated Figures, Explanatory Note" published on the Ministry of Finance website www.finance.gov.lb.

| Debt (as of June 30, 2006) maturing in the years 2007-2010 (US\$ billion) | | | |
|--|----------------|----------------|--------------------------------|
| | <u>2007-08</u> | <u>2009-10</u> | <u>Total</u> <u>2007-10</u> |
| Foreign Currency Debt | 4.5 | 5.5 | 10.0 |
| Local Currency Debt | 11.4 | 3.4 | 14.8 |
| Total Public Debt excluding interest (Principal payments except for discounted t-bills) | 15.9 | 8.9 | 24.8 |

Indeed, 65% of the public debt outstanding prior to the July 2006 war matures during 2007-10, in addition to most of the new borrowing during and subsequent to the July 2006 Israeli war in the remainder of 2006. Close to US\$16 billion of the debt outstanding as of mid-2006 matures in 2007 and 2008 alone. As a consequence of the war, and with the prospect of larger financing needs of the government, spreads on Lebanese foreign currency debt have risen. This will further aggravate the future fiscal situation as a direct consequence of the war.

C. The Cost of the July Israeli War and International Support for Recovery & Reconstruction

22. The total **direct cost** to the Lebanese government of early recovery, reconstruction of public infrastructure, and housing compensations, that are to be covered by the Central Government budget is now estimated at about US\$1.75 billion. This excludes the private sector's and NGO's contribution to the reconstruction efforts, the compensation for destroyed private properties other than housing and the financing programs that aim for reviving private sector activity.

23. The international community reacted quickly and generously to support Lebanon. In addition to the deposits of US\$ 1 billion from Saudi Arabia and US\$500 million from Kuwait with BdL to help maintain confidence and monetary stability, the international community pledged generously to support reconstruction and relief efforts. On August 31, 2006, the Swedish government hosted a Conference for Lebanon's Early Recovery in Stockholm. At that Conference, Lebanon received indications of support amounting to about US\$900 million for humanitarian assistance needs and early recovery efforts. This financial support provided the conditions for the return of the quarter of the population that was displaced, and restoring minimum capacity in terms of infrastructure, access to basic social services and income generating activities, pending full reconstruction.

24. The pledges and commitments made prior to the Stockholm conference, especially by Arab countries, as well as those made on the occasion of the Stockholm Conference, including concessional loans for reconstruction, together with some reallocation of funds from existing project loans, are likely to cover the estimated total cost to the government of direct cost of early recovery and reconstruction, except for a remaining gap for the housing compensation component⁹.

25. For its part, the government established a number of mechanisms to ensure transparency and accountability with respect to the use of donor funds. These include a special account opened for each donor with the BdL specifying use of funds, and a UNDG Multi-Donor Trust Fund to be managed by UNDP to be used for those donors that have expressed a preference to channel their post-war assistance through UN channels, and allowing donors to sponsor a project directly (such as rebuilding

⁹ The magnitude of this gap will depend on final estimates for housing compensation payments and the utilization of grants provided by Gulf Countries, in particular Saudi Arabia (US\$570 million), Kuwait (US\$315 million), Qatar (US\$300 million), Oman (US\$50 million), Iraq (US\$35 million) and UAE (in an amount to be determined). This excludes grants provided in kind, relief aid and humanitarian assistance, grants provided to NGOs and the private sector, grants for technical assistance and security, and donors' administration costs.

bridges, schools, hospitals and villages). CDR will be responsible for funds allocated to reconstruction projects that it carries out, in compliance with donor requirements. In the case of housing, which is the largest component of the government's program, the government has opted for direct payments to home owners as they are best placed to procure construction and repair materials and services at the lowest possible cost, whereby checks are issued in favor of the beneficiaries as determined by the concerned government agencies and after a thorough audit conducted by an independent consulting engineering firm.

26. In order to improve aid coordination and harmonization, and the allocation of donor support to priority projects and programs, the government is putting in place a unified system of data collection and reporting. A Development Assistance Database is being established at the Prime Minister Office (PMO), with support from UNDP, while the Ministry of Finance (MoF) is establishing a transactional information system to monitor financial flows, with support from the World Bank. Both systems will be integrated and expanded to a unified system at MoF that will also cover external project loans and budget funds that finance the public investment program. MoF has established a donor coordination secretariat to support implementation and maintenance of the system.

27. In view of the substantial damage inflicted on the private sector (mainly agriculture and tourism), the government will provide some financial assistance as well as support through loan programs totaling up to US\$950 million, with a government subsidy on interest, and in some cases, guarantees. The government hopes to limit the cost of such subsidies with the help of lines of credits at concessional rates from international institutions such as the IFC, EIB, AFD, IDB, AFSED, OPIC and the OPEC Fund. These facilities are complemented by a number of temporary tax incentives to support business activity and promote investments as well as to help avoid large scale bankruptcies and business closures. In addition, the government will rely on commercial banks and existing micro-finance institutions for lending to the private sector. The BdL, together with Kafalat¹⁰, would be responsible for overall supervision of the programs.

28. The direct outlays for recovery and reconstruction, while significant (US\$1.75 billion, excluding the reconstruction cost that is directly borne by bilateral donors and private sector), pale in comparison with the indirect costs in terms of the impact on the economy and on public finances. Even with the implementation of the government's reform program, including privatization and strong fiscal adjustment, fiscal deficits would, without external support, far exceed the fiscal deficits that were envisaged in the pre-war reform scenario. Not only has the public debt to GDP ratio risen, but Lebanon now also faces higher fiscal deficits. The cumulative incremental fiscal deficit for the period 2006-10 is estimated at US\$5.9 billion, inclusive of the cost of recovery and reconstruction¹¹. The impact is mitigated somewhat by the pledged grants and loans for reconstruction, but incremental net financing needs of US\$4.5 billion remain for the period 2006-10.

III. THE GOVERNMENT'S REFORM PROGRAM

29. The pre-July war comprehensive economic reform program has been re-phased following the Israeli war. Apart from support to help Lebanon meet the direct cost of recovery and reconstruction, the need for external support to achieve a sustainable debt scenario has now risen further, and the near-term financing needs are substantial. The government remains committed to honor its debt obligations, as it has always done, even during the darkest days of war (in the midst of the war, in August 2006, the government paid the first principal installment due on a Paris II loan).

¹⁰ A company owned jointly by the National Institute for the Guarantee of Deposits (75%) and Lebanese commercial banks (25%), audited by independent external auditors. It provides for loan guarantees and interest subsidies (financed by Government) for commercial banks lending to SMEs.

¹¹ The difference between the cumulative fiscal deficits in the pre-war reform scenario (2006-10) and the cumulative deficits for 2006-10 in the post-war reform scenario (see below).

30. Even with a resumption of growth (reflecting the reconstruction impact and structural reform measures that the government will undertake), the post-war revenue base will be much smaller and the pre-war planned tax increases must now be delayed. Any early introduction of new tax measures would not yield prospecting results, and could well cause a slowdown in economic activity, leading to social and political unrest. On the expenditure side, following the Israeli war, it has become very difficult to reduce the ratio of current expenditures to GDP in the short term given the increase in security and social expenditures aimed at ensuring the delivery of basic public services in all regions and at compensating the war injured and families of deceased.

31. Similarly, unfavorable market conditions, and/or lower asset value, will delay the privatization plans (sale of assets) for some time, although the sale of the two mobile licenses should proceed shortly. Also, the preparatory process of restructuring and corporatization and establishing regulatory agencies and other sector institutions are moving forward.

32. On the other hand, social sector reforms and strengthening social safety nets become a critical element of a strategy aimed at ensuring the prevalence of the State over all the Lebanese territory, to the benefit of all denominational groups. A comprehensive approach to recovery and reconstruction is an equally important element of this strategy. Public sector reforms are key to improving the business climate, jumpstarting post-war recovery, and enhancing public sector performance to underpin the strategy of ensuring the State's presence and its efficient and transparent delivery of the recovery and reconstruction program.

33. In the absence of adjustment, and taking into account the impact of the July war, by 2010 the budget deficit would revert back to about 20% of GDP, debt service would absorb more than 85% of government revenues, and debt-to-GDP ratio would increase to about 215%. The financing needs of the government would lead to higher interest rates, weaken the banking system due to increased exposure to sovereign risk, and ultimately threaten the stability of the exchange rate and prices, affecting mostly the poor and the middle class (mainly wage earners) who cannot protect themselves against these risks.

34. Lebanon has fallen short of achieving its full potential because of political tensions, complicated macroeconomic situation, and structural rigidities. Given Lebanon's significant human resources, well-educated workforce, large Diaspora, well developed banking sector, and attractive climate and geography, Lebanon should be able to achieve better economic performance and a higher standard of living.

35. The overriding objective of the reform program is to stimulate growth, create employment, reduce poverty, and maintain social and political stability. More specifically, the aim of the reform program is to raise the real growth rate to at least 4-5% over the next five years, improve social indicators, and reduce regional inequalities. Since the main source of economic vulnerability in Lebanon is related to the large public debt, placing this debt on a downward trajectory towards sustainability—while protecting the most vulnerable segments of the population—is a prerequisite for achieving the objectives of the program.

36. The reform program is an integrated package that will succeed only if its major components are implemented. In particular, external support is an integral part of the program and is crucial for the success of the reform efforts. It is articulated around six pillars including the financial support of the international community:

- Growth-enhancing reforms encompassing a large number of measures and laws that would increase productivity and reduce cost, which would enhance the competitiveness of the Lebanese economy;
- A social sector reform agenda to improve social indicators and strengthen (develop) social safety nets to protect the most vulnerable segments of the population;
- A strong phased fiscal adjustment that aims at increasing the primary surplus through streamlining expenditures—including by reducing waste (including legalized waste) and reforming state owned enterprises (SOEs) more specifically Electricité du Liban (EdL)— and raising revenues in ways that minimize the negative impact on the poor;
- A privatization program directed primarily at increasing investment, reducing the stock of public debt, and spurring economic growth;
- A prudent monetary and exchange rate policy aimed at maintaining price stability (and with it social stability), facilitating credit to the private sector, and maintaining a sound banking system;
- International financial assistance to help Lebanon finance the direct and indirect cost of the July war as well as to complement the domestic adjustment efforts, primarily by reducing interest payments on public debt and creating the kind of confidence that would encourage private sector investment and ease the pain of a domestic adjustment after the war.

A. Growth-Enhancing Structural Reforms

37. Enhancing growth is the corner stone of a successful reform program and a precondition for creating employment, improving living standards, and reducing the public debt burden. Economic growth is multifaceted, however, and there is no single measure or a set of measures that would boost growth overnight. While ensuring macroeconomic stability and accelerating public investment (discussed below) are all important for growth, other elements of the structural reform and growth-enhancing agenda encompass a large number of measures, such as governance (including aspects related to corruption), the business environment, trade liberalization, capital markets development, and debt management.

Governance

38. Good governance is a prerequisite for investment and growth. Acknowledging that governance should begin with the public service, the Office of the Minister of State for Administrative Reform (OMSAR) has prepared an administrative reform strategy that focuses on the core functions of a modern state. The strategy articulates several objectives that cut across all parts of government and aim at creating a transparent, accountable and effective public administration. These objectives aim to: (i) develop and establish modern management capacity in key administrations such as the central control and oversight agencies; (ii) reduce the size and cost of the public administration through streamlining its overall organizational structure and functions; (iii) modernize legislation especially that related to public procurement and accounting; and (iv) promote a citizen-oriented administration through simplification of procedures and advancing e-Government. Many of these measures have started a while ago and will continue over the medium term.

39. In view of its stated objective of greater accountability and better governance, the government approved and sent to parliament a draft law aimed at hiring an international and reputable firm(s) to audit public finances and public enterprises over the last fifteen years (1990-2005). It is expected that the selection of the firm(s) will take place after the adoption of this law by parliament and work will begin soon after. Since the risk of corruption is perceived to be prevalent mainly in large infrastructure projects and public procurement more generally, the government intends to expedite the completion of the new procurement law with the related decrees and implementation tools to be effectively deployed by mid-2007. This law will provide for a more efficient use of public funds while enhancing transparency in accordance with international business standards—the present procurement

law dates back to the early 1960s. On a parallel and related track, establishing a regulatory body for maintaining, monitoring and updating the public procurement system will also be on the agenda. In addition, the role of the Court of Accounts as an ex-post agency will be revived to ensure that all budgetary spending is in accordance with budgetary allocations. Fighting corruption also requires empowering state watchdog institutions to take punitive actions and enforcing conflict-of-interest regulations against senior public officials.

40. The government intends to address governance issues at the agency level in a pragmatic way. Given the difficulties in resolving these issues all at once, a few pilot agencies will be selected for close scrutiny. A successful reform in one public agency with early tangible results would strengthen the constituency for reform, and provide useful levers to sway public and official opinion. In this regard, the government has decided to start with two important ministries, the ministry of public works and the ministry of finance. Two internal control units will be established to monitor the operations of the various departments in the two ministries to ensure that they follow best practice in service delivery and to deal with corruption incidents. These units should be operational by end-2007. This pilot program could be extended to other public entities in 2008-10.

41. More generally, the government will continue to streamline and automate work procedures to reduce the citizen interface with public sector employees and reduce the risk of corruption. Several initiatives have already been taken in this regard at the level of the ministry of finance where information and procedures have been automated for some departments such as the cadastre, customs and taxation. The reform of budget preparation and implementation, and the elimination of all nuisance taxes will help fight corruption. These initiatives will be extended to other ministries and public agencies over the next few years.

42. The recent decision by the government to have transparent, merit-based, and proper procedures for public sector recruitment is a very important step in isolating recruitment from political and confessional considerations. While the equal confessional distribution of top public sector positions, as determined by the constitution, cannot be changed at this time, every effort will be made to hire the most qualified and to do away with the practice of assigning specific positions to specific confessions as long as the power sharing arrangement is respected. In this regard, the role of the Civil Service Board will be enhanced and proper and transparent assessment mechanisms will be put in place to improve selection.

Financial Sector Reform and Debt Management

43. The government plans to address the long-standing issue of underdeveloped capital markets as part of a broader strategy to modernize the non-bank financial sector and stimulate investment and growth. Apart from its growth-enhancing effects, capital markets development would help diversify risk and increase financial resilience in the face of shocks. The role of the stock market is also instrumental in the coming period as it will facilitate the corporatization and privatization drive, help attract long-term financing mainly from the region—especially at times of high oil prices—and provide the private sector with working capital. Similarly, the development of a secondary market for fixed-income instruments should contribute to financial deepening.

44. Several measures have already been taken to enhance the functioning of Beirut Stock Exchange (BSE), and in December 2005, parliament approved two laws on securitization of assets and on fund management, and is currently discussing the draft law on dematerialization of securities, the securities lending draft law, the insider trading draft law and the Capital Markets draft law (see Box below). The principal aim of the Capital Markets draft law is to provide the framework for the regulation and development of the capital markets in Lebanon, and hence build confidence in the quality of the market for both local and foreign investors. An important feature of the law is the

establishment of the Capital Markets Council, a new independent regulatory body responsible for overseeing regulating and developing Lebanon's capital markets. In addition, an advisory team set up by the ministry of finance has come up with several recommendations that will further develop the capital markets.

Box 1. Capital Markets Reform Measures

A. The following measures have already been taken:

- Allowed remote trading and listed government Eurobonds on Beirut Stock Exchange.
- Offered a tax incentive for companies listing on the BSE, by reducing the dividend tax from 10% to 5%
- Eliminated commissions paid on Eurobonds transactions listed on the BSE carried out on the official or secondary markets.
- Adopted the Asset Securitization Law and the Fund Management Law by parliament in Dec. 2005.

B. The following measures will be taken next year to further strengthen the capital markets:

- Pass the following draft laws: The dematerialization of securities law, the Securities Lending Law, the Insider Trading Law and the Capital Markets Law—all of them are currently under discussion at the Parliament.
- Set up the Capital Markets Commission, including a specialized financial court.
- Develop secondary market liquidity by introducing longer maturity benchmark instruments, and establishing primary dealers in LL issues.
- Establish a Delivery Versus Payment system for the LL, and increase trading hours and reduce settlement trade to T+2
- Develop an official stock market index
- Broaden investor base and attract institutional investors such as insurance companies and the National Deposit Insurance Company (NDIC)

45. In view of the high level of debt, improving debt management could have a positive fiscal impact. A draft law to establish a modernized debt management office at the ministry of finance has been reviewed by committees in the parliament. The debt office will assume the responsibility of the operational aspect of the debt in both local and foreign currency. In addition, the government is working towards developing a formal debt management strategy and improving cash management. In parallel, the government is also looking into the issue of strengthening domestic debt market and introducing primary dealers system that would enhance liquidity in the secondary market.

46. The draft law recommends the creation of "Higher Council for Debt Management" under the chairmanship of the minister of finance and comprising representatives of BdL and of various departments dealing with debt issues at the ministry of finance. In addition, the ministry of finance and the central bank are coordinating their efforts to improve cash management which would have a significant impact on debt management.

Improving the business environment

47. The government is committed to undertake a whole range of reforms with respect to business laws and regulations, some of which have been under consideration. The key objective of these legal and regulatory reforms is to improve competitiveness and reduce the cost of doing business in Lebanon. A number of these laws fulfill the government's commitments as part of its membership in the World Trade Organization, which is expected by the end of 2007. Other initiatives are part of the Action Plan that the government has agreed on with the EU as part of the European Neighborhood Policy. In addition, the government's support and reform programs will have a special focus on SMEs, given their potential for contributing to employment creation.

48. Various business surveys point to the high cost of doing business in Lebanon compared to regional and international standards. This cost is normally based on criteria such as (i) minimum capital requirement and cost of registration; (ii) the time it takes to get a license, start a business or close a business; (iii) the flexibility of the labor market and the ease of entry and exit of workers; (iv) the complexity of the tax system; and (v) the enforcement of contracts. The government plans to address these issues by designing a well-sequenced action plan for the next five years (Box 2).

49. Several other measures are under consideration to ameliorate the business climate. They include (i) ratifying a modern competition law and removing state protection including exclusive agency rights, which would reduce monopoly power and prices by 2007; (ii) adopting an e-commerce law and establishing business development centers (incubators) to incubate new companies; and (iii) ratifying the insurance draft law to regulate the sector, galvanize the stock market and attract new investors.

Box 2: Improving the Business Environment

The government intends to improve the business environment and reduce the cost of doing business in Lebanon through:

- Lowering the minimum capital requirements and the cost of registration by mid-2007.
- Reducing the time it takes to obtain a business license, and the cost of opening and closing a business, which is high in Lebanon by regional standards by end-2008.
- Improving access to credit. The system of subsidized interest for productive investment, a scheme which is supposed to be managed by the central bank, should be reviewed with a view to improve its efficiency.
- Strengthening the role of Kafalat (which provides loan guarantees for worthy investment) and promoting the creation of venture capital funds should also facilitate financing. Reforms in the fiscal and capital market areas will reduce the need for government to borrow from banks, and create a variety of financial products that should facilitate access to credit.
- Simplifying further the tax procedures and reducing the number of separate taxes and fees. While Lebanon ranks well in this category relative to the region, the ongoing tax reform efforts including the tax procedures code and the elimination of the nuisance taxes will help (2007).
- Expediting the clearance of imports, including by increasing automation at the port, and lowering the related cost. A one-stop-shop at the Port of Beirut will provide better services to trade and export.
- Modernizing the existing labor laws and reforming the end of service indemnity system as part of the pension reform (outlined below).
- Strengthening and shortening the enforcement of legal contracts by increasing the number of judges and court offices and the number of court rooms, improving court staff training, and opening small claim courts with no right for appeal (2008-10).

50. To encourage the recovery of the private sector in the aftermath of the Israeli war, the government is undertaking a series of specific measures and incentives at the tax, regulatory, financing, and promotional levels. The government has laid out a comprehensive plan for recovery of the private sector that is based on three main pillars: (a) a basket of tax incentives developed by the ministry of finance to support private sector enterprises and reduce the burden of the war; (b) programs that allow easy and low cost access to financing on flexible terms/long maturities, as well as allowing for restructuring of outstanding loans in addition to special direct arrangements between banks and indebted clients; and (c) measures aimed at promoting Lebanese exports and promoting Lebanon as a regional business center.

51. Improving competitiveness of the Lebanese economy more generally is critical for promoting exports, creating employment, and enhancing growth. The cost of production in Lebanon is relatively high, affecting the ability of Lebanese products to penetrate regional and international markets. In addition to the need to eliminate barriers in the face of increasing openness and liberalization, there is a need to reduce the cost of production resulting mainly from unreliable supply of electricity, the high

cost of telecommunication, as well as cobweb administrative procedures that put an undue pressure on costs and affect competitiveness (all of which are integral part of the reform program). To monitor competitiveness indicators on a continuous basis, the government will establish a Competitiveness Council. This council would be composed of major public/private institutions to report on, and deal with, business activities bottlenecks and act as "bureaucratic Inertia Buster".

B. Social Sector Reforms

52. The economic reform program would be incomplete if not accompanied by a comprehensive social reform program. As a result, the government has developed a social action plan as an integral part of its fiscal and economic reform program. Social sector reform is beneficial for promoting sustainable and equitable development and combating poverty, and hence achieving the government's commitment to the "Millennium Development Goals". Such reform is crucial for long-term sustainable economic growth. The main objectives of the social action plan are to: (i) alleviate poverty and improve the quality of education and health indicators; (ii) improve the efficiency of public social spending and keep it at an appropriate and sustainable level; and (iii) reduce regional disparities in development indicators through a proper distribution of investment and other resources and encourage investment and other job-creating activities in the more deprived areas.

53. Social indicators are not commensurate with the level of spending, which is comparable to that in developed countries. In 2004, social spending (public and private) amounted to 21% of GDP (excluding pension). In 2005, public spending on social services accounted for approximately 42% of primary expenditures, 27% of total expenditure and 8% of GDP. Despite this relatively high social spending (on health and education), indicators remain unsatisfactory. In the education sector, the drop out and repetition rates are relatively high, hovering around 22% and 23%, respectively. In the health sector, infant and maternal mortality were 18.6 per thousand and 88 per one hundred thousand (Papfam, 2004), respectively.

54. The incidence of poverty in Lebanon might appear limited and controllable, since although 25% of the population lives in relative hardship, only 4% live in extreme hardship (Living Conditions Index, 2004). However, there are large regional disparities in poverty incidence and intensity in the country. Available statistics show that peripheral regions suffer from high rates of extreme poverty (reaching 11% in North and South Lebanon, compared to 1% in Beirut and some regions of Mount Lebanon). Data also reveal that densely populated urban areas, such as the Northern and Southern Suburbs of Beirut, Tripoli, Saida and Baalbeck, have the largest concentrations of the poor.

55. Living conditions improved considerably between 1995 and 2004 (Comparative Living Conditions Index), with a decrease in the percentage of the deprived population from 34% in 1995 to 24.5% in 2004. This progress is attributable to improvements in the social.

56. The government is committed to improving both the efficiency and the targeting of its social sector expenditures and had already started to address this issue in a comprehensive manner prior to the July 2006 war. Steps were initiated to reinforce the role of the Ministry of Social Affairs (MoSA) in social policy making and development. The war has slightly delayed the implementation of the reform agenda and has significantly exacerbated income-poverty, increased social needs, and expanded the incidence of poverty and vulnerability to other groups. Besides the loss of life and human capital (injuries, disabilities, adverse schooling effects and emigration), increased unemployment has contributed to an increase in poverty and vulnerability. Although the Israeli war has affected all regions and all population groups, the poor and vulnerable remain more susceptible and less capable of coping with the adverse impact of the war.

57. In areas directly affected by the hostilities, recovery efforts will improve the capacity to cope with the losses in the short term but remain insufficient to create sustainable growth; whereas in other historically poor areas that were not directly affected by the war (such as Akkar), the situation may worsen as a result of chronic poverty, increasing marginalization, and decreased access to employment if not covered by the social program. Other regions that were neither directly affected by the hostilities nor included high poverty rates, such as Greater Beirut (excluding the Southern Suburbs) and Mount Lebanon, where 57% of the labor force and 54% of enterprises are concentrated, will be also affected from the structural impact of the war due to loss of jobs and investments. Even within each region, the adverse direct and indirect effects of the war may be unevenly distributed.

Main elements of the social plan

58. Prior to the July 2006 war, the government had started the implementation of a social action plan aimed at strengthening existing programs and developing new programs to address the above-mentioned social indicators. Immediately after the end of the hostilities, the international community has provided support and direct assistance to help deal with the aftermath of the war and the government intends to provide fiscally-neutral incremental financing to improve social conditions through well-targeted interventions to address the needs of the most vulnerable groups.

59. The government has established an inter-ministerial committee to coordinate the efforts of various ministries and prepare a comprehensive medium-term social development strategy. Such a strategy is a first step towards improving the efficiency of social spending and reducing waste, which are caused by the lack of coordination between concerned ministries. In addition, each of the concerned social ministries will develop its own sectoral strategy.

Box 3: Some Elements of the Medium-Term Social Strategy

- Reactivating the inter-ministerial committee for social policy that comprises the Ministries of Health, Education, Social Affairs, Labor, Economy, and Finance. The role of this Committee is to set overall sector strategies and priorities, and monitor and evaluate the implementation of social strategies. The Committee will be supported by a technical secretariat.
- Reducing overlapping in the provision of social services across ministries, as well as unifying social funds under one transparent and efficient administration. This measure could be implemented in 2007.
- Processing and analyzing the results of the 2004 multi-purpose household survey, and designing targeting mechanisms that would help improve the coverage, integration and impact of the existing, but fragmented social safety net.
- Completing a poverty assessment of the country, and introducing appropriate social safety net measures accordingly.
- Expanding basic health services coverage and improving efficiency and quality; reducing infant and maternal mortality including by enhancing preventive health care and increasing the vaccination rate for poor children in selected areas.

60. In order to enhance the efficiency of public social spending, the government will also improve targeting mechanisms and eligibility criteria. In the same vein, the results of the Multi-Purpose Survey will be used for evidence-based policy making and programming. Within the broader context of a statistical data improvement, the implementation of the Statistical Master Plan (SMP) will be accelerated. The SMP would set out a medium-term action plan for producing and disseminating data, building statistical capacity and reforming concerned institutions.

61. In education, many schools, especially in peripheral areas, lacked adequate equipment, with coverage and quality problems. In addition, during the July 2006 war, more than 15% of public schools sustained serious damage and large numbers of teachers and students were displaced. The recovery of the sector is well underway and most of the capital costs needed for rehabilitation were pledged by donors. Concurrently, the government will accelerate the implementation of comprehensive sector reform program that will contribute to efficiency gains and improved equity. Also, gradual measures to rationalize sector expenditure will be implemented following the completion of school mapping and a teacher rationalization study. These reforms will be underpinned by strategic planning and decision support tools to be developed in the course of 2007 which will help achieve the said objectives. This includes strengthening of education policy making and planning capability at the Ministry of Education, the installation of a sector management information system to monitor key sector outcomes, and the development of evaluation tools for the instructor's development program. Within the sector, addressing the issue of the high level of dropouts in certain regions, which was further exacerbated by the war, will be a sector policy priority.

62. In the health sector, apart from physical damage (16 hospitals and 65 outpatient facilities were damaged), the war has considerably increased sector expenditures. Government subsidies to health insurance funds and reimbursements to private hospitals will increase on account of treatment of the injured and disabled. This underscores the urgency of implementing key sector reforms. The government will take a number of measures aimed at enhancing its capacity to improve the overall public health system and narrow the equity gap in terms of sector outcomes. These include: (i) reforming health insurance to ensure greater efficiency and improved access (e.g. harmonizing or integrating public health insurance funds, and strengthening management and contracting capacity of public funds); (ii) developing targeting methods to better evaluate the coverage provided by the Ministry of Health; (iii) upgrading and institutionalization of the national hospital accreditation program and its expansion to primary health care; (iv) introducing performance-based contracting for targeted primary health care services, particularly in poorer areas; and (v) enacting "Carte Sanitaire" legislation to better monitor and regulate health care investments.

Specific social interventions

63. The government intends to reduce poverty by improving a number of existing programs and introducing new programs within the framework of the Ministry of Social Affairs. The most important programs are cash transfers to poor senior citizens, female-headed poor households, and disabled poor. Beneficiaries of these programs will be identified based on transparent eligibility criteria established according to poverty targeting maps.

64. The government will also work on reducing regional disparities through promoting local development as an efficient tool for balanced regional development and poverty reduction. This includes increasing capacities of the Social Development Centers of MoSA and creating coordination and synergy among key local development actors (e.g. MoSA, Economic and Social Fund for Development, Community Development Programme, UNDP, international donors and organizations, and active NGOs).

65. The government will develop programs to improve education indicators, particularly to reduce student drop-out and repetition rates in public schools in poor regions. These programs aim at reducing the burden of the education cost on the poor households in targeted areas through subsidies to school related expenses (books, stationery, transportation and school feeding), on condition that these students remain in school until the end of the compulsory educational stage (age 14). The Ministry of Education will also establish remediation centers to help poor students and provide technical training in various specialized disciplines. Poor households will be also exempted, either partially or fully, of public school registration fees.

66. The government is also committed to improving health indicators. The Ministry of Public Health will introduce a number of health programs, such as increasing the number of vouchers provided to poor pregnant women for clinic visits before and after giving birth. In addition, needy patients will be totally exempted from hospitalization fees and a voucher system will be established for poor patients with chronic diseases. The ministry of public health will also cooperate with the ministry of education to enhance the school health program, by raising the number of MD visits to schools and expanding the program to basic education.

C. Pension Reform

67. The reform of the pension system in Lebanon is a priority because of its social, economic, and fiscal impact. The social aspect of pension reform relates to equity considerations and to the need to protect the poor or those who do not have the means to save sufficiently for retirement. The fiscal cost of the pension schemes in Lebanon is very high by regional and international standards and is likely to increase sharply over the medium and long term if not addressed soon. The private sector end-of-service indemnity scheme does not provide adequate income protection during old age yet imposes a heavy burden on employers and does not facilitate switching between jobs. As a result, it reduces the incentive for hiring and introduces more rigidity in the labor market with negative impact on employment and growth.

68. The two public sector defined benefit schemes, the civil and military systems, impose a heavy burden on the budget (2.5% of GDP in 2004) with an implicit debt of close to 60% of GDP (defined as the present value of the pension promises for current retirees and current contributors). The private sector system, which is managed by the National Social Security Fund (NSSF) while financially viable for another 15 years or so, could have major contingent liabilities on the budget.

69. With technical assistance from the World Bank, the government will overhaul the pension system and to this end it is preparing a draft law to be submitted to parliament. The objective of the reform is to integrate the three systems into one modern fully-funded defined contribution (FF-DC) scheme by 2008 while preserving their acquired rights under the present system. However in the case of the civil service and the military, the government will face transition costs over the short term. These costs will be estimated and appropriate financing mechanisms devised. Over the medium and long term, however, the reform is expected to bring considerable savings to the government and future generations. The main features of the pension reform are:

- The undertaken reforms will ensure the continuation of all allowances and indemnities to existing members.
- The closing down of the systems for civil servants and the military to new entrants with new civil servants and military personnel joining the new FF-DC system. Current contributors can choose to move to the new system on a voluntary basis.
- The pension scheme for members of parliament will be revised to make it consistent with the rest of the public sector.
- The new pension will extend the coverage to self-employed and casual workers with limited saving capacity.

D. Fiscal Adjustment and Structural Reform

70. Fiscal adjustment is essential to put debt on a downward trend. The government will undertake strong and sustained fiscal adjustment efforts beginning in 2007 (implementation of some reform measures is expected during 2007) to gradually improve the primary balance, from a deficit of nearly 1% of GDP in 2006 to a surplus of 8% of GDP in 2010 so as to reverse the debt dynamics and place the debt-to-GDP ratio on a downward path. Fiscal adjustment has to be shared equitably to be sustained and every effort will be made to minimize the impact of fiscal adjustment on the poorer segment of the population. It will require both strong expenditure and revenue measures and an improvement in the budget preparation.

Expenditure Measures

71. The government has generally followed a tight expenditure policy in recent years and will continue to rationalize current spending. Current expenditures, excluding interest payments, at 17.8% of GDP (in 2005) are not high by international standards and thus there is not much room for cutting them further beyond the pressing need to reduce waste and increase effectiveness and productivity of spending. The government fully recognizes that improving public management is crucial to enhance efficiency of and reduce waste in public expenditures. Addressing these issues upfront is important to improve the business environment and foster growth. The key areas for expenditure reform include rationalizing non-interest expenditures, containing the wage bill, and reforming public sector enterprises, especially EdL¹².

Primary expenditures

72. The government intends to rationalize current expenditures through various measures and reforms including (i) reviewing the salary and benefit structure in some public entities in particular, and the salaries of current and previous members of parliament as well as ministers, in addition to allocations to the Presidency of the Republic and the Presidency of the Council of Ministers; (ii) reducing to a minimum official travel expenses and revisiting travel allocations; (iii) saving on transportation allowances through extending the working hours in the public sector from the 32 hours a week to at least 36 hours by mid-2007; (iv) reducing waste related to gasoline consumption and communication costs in the public sector; and (v) closing the Fund for the Displaced and the Council of the South—which are expected to fulfill their intended mission by 2008. While the financial impact of these measures could be limited to about 0.2% of GDP, their impact on the overall efficiency of government operations should not be underestimated.

73. The government will contain the wage bill in the medium term through limited hiring and productivity increase and through automation and promotion of e- government, allowing the size of the public sector to shrink by attrition. However, with respect to military and security staff, there will be an increase in the short run to meet security needs and to honor Lebanon's obligations in the context of the UN resolution 1701. Over the next five years, 20 % of public sector employees would retire (and 45% in the next 10 years) providing a good opportunity to rejuvenate the public sector while at the same time reducing its size and enhancing its efficiency without having to force any employee out. Replacing only partially those who are retiring in the next five years would lead to important savings. It is expected that the wage bill to GDP would be reduced by 2.0% by 2011.

74. In this context, overstaffing in various ministries and in some public entities that are no longer operational will be examined closely. Overstaffing exists mainly in the ministry of education since public education in Lebanon has one of the lowest teacher-to-student ratios in the world (one teacher

¹² Transfers to EdL will gradually decrease from a level of 3.5% of GDP in 2006 to 0.3% of GDP in 2011, based on the Power Reform Program and World Bank October 2006 oil price forecasts.

per 9 students). It is worth noting, though that some schools suffer from severe shortages while others have an abundance of teachers, reflecting a mal-distribution of schools among regions. Excess employees in the public sector in general will be identified (2006-2008) through a civil servant census, and will be put under the Civil Service Board with possible reallocation to other ministries after undergoing proper training to improve their capabilities.

75. As regards public investment (capital expenditures), other than recovery and reconstruction outlays, Government plans to maintain the same level of capital expenditures to GDP, while increasing the share of foreign financed investments. In parallel, cost recovery will improve, as a result of restructuring and privatization in a number of sectors. For example, government subsidies to EdL are expected to drop as a result of the power sector reform plan

76. The level of the July war-related capital expenditures needs to be increased to account for the reconstruction process. In tandem, the efficiency of capital expenditures needs to be improved, to support the government's objectives of growth, enhance social conditions, and minimize regional disparities.

Public Investment Program

77. The government intends to have an adequate level of capital expenditures to maintain existing infrastructures and prevent its rapid deterioration and to invest in much needed new investment projects. The government aims to keep capital expenditures, excluding war-related spending, in the medium term at about 2.7% of GDP. However, the share of foreign-financed investments should be increased to an average of 45% during the period 2009-2011 (from the current 38 percent share). In addition, as part of the government's overall strategy, the private sector will play a greater role in infrastructure investments and in the provision of public services through various arrangements and in partnership with the public sector. Whereas the public investment program during the 1990s focused heavily on rebuilding the country's physical infrastructure, in particular transport, power and telecommunications, the future program, excluding the reconstruction program resulting from the July/August 2006 war, will put greater emphasis on providing basic public services.

78. The total loans that are likely to be used over the next three years are estimated at about US\$880 million out of US\$2.12 billion representing the total amount of undisbursed concessional loans. These loans stand for an average of 80% of the cost of the projects to which they are allocated, whereas the remaining part is to be financed by the treasury. The available loans will be allocated to several projects related to public services and infrastructure, as well as to socio-economic and productive sector projects covering all Lebanese regions. These projects are at different stages of implementation: some are being implemented but not yet completed, while others are still at the beginning of the implementation process.

79. A host of factors have played a role in the low level of utilization of foreign loans in recent years. Implementation difficulties and fiscal constraints were exacerbated by the unsettled political environment. Expropriation delays and shortages of local counterpart funds slowed down project implementation. Moreover, delays in parliamentary ratification of signed loans contributed to delays in project start-ups. As the generic and systemic problems are now being addressed, the rate of project implementation will improve from recent levels. In particular, the government will also ensure that within the overall fiscal constraints there will be timely and adequate availability of local budget funds to projects that are underway so that their benefits can be reaped as soon as possible.

80. Implementation has also suffered from delays due to the low capacity in line ministries, and the resulting overload on CDR. However, to restructure CDR's capacity to undertake reconstruction and development capital investments, the government has embarked on a series of measures that will address CDR's effectiveness. These include strengthening the capacity of CDR's procurement, financial management and legal functions, and streamlining related internal processes from bid and terms of reference preparation to contract management and disbursement.

81. The need for public investment in physical infrastructure will decline after completion of the reconstruction, and with the privatization envisaged in the government's reform program. The government will seek a greater private sector role in sectors such as telecommunications, power, roads and urban development in the context of public-private partnerships. Within the overall financial constraints of the macroeconomic program, the focus of the public investment program will increasingly be on sectors where remaining needs are significant, such as water and wastewater, the environment and rural development.

82. The government is currently reviewing the entire program of ongoing projects and programs, with a view to deciding whether, given the reconstruction needs, implementation constraints and current priorities, the scope of ongoing projects and programs should be reduced, projects that have barely started should be continued, and certain loan agreements which have been signed should be either cancelled or renegotiated. The government will consult with lenders and donors on the steps to be taken as a result of this review and, in case of cancellations, lenders and donors will be asked to consider reallocating funds within the same sector for activities that have a higher priority (including to cover recovery and reconstruction expenditures that have no alternative funding), or provide new financing for high priority new projects within the medium term capital expenditures program.

83. The scope for initiating new projects with budget funds will be limited, given the fiscal and debt constraints. New, generally small, investments that ensure that benefits from past investments are fully realized will have a high priority. For most new projects, the government will seek foreign project loans or, wherever feasible, partnerships with the private sector. The selection of new projects and programs will take into account the need for an equitable regional balance, as well as the need to fulfill basic needs and reduce poverty. In this regard, the government will place top priority to selecting those projects that generate economic activity and new jobs in the outlying regions. Upon completion of this review, the government will, by the end of the first quarter of 2007, adopt a detailed public investment program for the medium term that is consistent with the overall macroeconomic targets and current priorities.

Other fiscal structural measures

84. In order to enhance the transparency and efficiency of public spending, the government intends to implement a number of measures to improve expenditure management. These measures should be implemented by 2008 and include (i) expanding the coverage of the budget to include the foreign-financed public investment executed by CDR (ii) preparing a medium-term expenditure framework and adopting top-down approach in budget preparation; (iii) eliminating the budget carry-overs on current expenditures and containing treasury advances; and (iv) implementing the Treasury Single Account to improve cash management. The ultimate objective of this reform would be to develop a modern Budget System Law (BSL), which will be the anchor for all the reform measures.

85. The government will look into the possibility of adopting a fiscal accountability law that would set targets for some important macroeconomic variables, particularly the level of budget deficit or public debt. Constraining the ability of the government to borrow, for example, would force it to undertake the necessary reform measures instead of resorting to more indebtedness. Such a law would oblige future governments and parliaments to adhere to the set targets and ensure fiscal discipline in the future.

Reform of the Power Sector

86. The reform of the power sector is the most important expenditure measure. Also, electricity being a major input element to the local economy, improving service quality would contribute to economic growth in Lebanon. Lowering the budgetary support to EdL would pave the way for achieving fiscal sustainability, stimulating economic activity, and reducing the need to raise the tax burden in the future.

87. EdL has been beset by major governance problems, resulting in significant technical and non-technical losses (estimated at 15% and 20%, respectively) and about 6% loss on collection—a total loss of more than 40% of the power generated. With fuel prices high, and in the absence of alternative fuel sources or bold measures this year, budgetary support to EdL reached about US\$1 billion in 2006, or about 20% of fiscal revenues and 3.5% of GDP, a real hemorrhage for public finances. Overall, total outlays towards the power sector including the service of the debt incurred amount to more than a quarter of the total public debt. Reducing losses and strengthening sector capacity to encourage private sector involvement will be achieved through a set of short and medium-term actions. The government recognizes that there are no quick fixes for EdL, but savings of about 3% of GDP could be realized over the next five years based on various measures (Box 4) while awaiting EdL privatization (See below).

Box 4: Reform of the Power Sector

Reforming EdL requires a number of measures at different levels:

Under enabling initiatives, the government will:

- Appoint qualified advisors to the Ministry of Energy and Water, EdL and HCP
- Complete the auditing of EdL financial statements for 2001 through 2006
- Appoint a new Board of Directors for EdL
- Establish the Electricity Regulatory Authority and design its bylaws
- Introduce potentially necessary amendments to Electricity Law 462
- Corporatize EdL
- Design establishment decree and new bylaws for EdL
- Unbundle generation, transmission and distribution functions of EdL
- Complete the establishment of a National Control Center to audit volumes and performance (*contract already signed*).

Under short term restructuring initiatives, the government will:

- Modify restrictive oil specifications based on 2003 study
- Negotiate additional bilateral contracts for fuel oil and gas oil to reduce high premiums (*Ongoing*)
- License private companies to install and operate remote meters
- Reduce illegal network connections and enforce bill collection through support from security forces and the justice department (*Ongoing*)
- Secure the supply of liquefied natural gas to the Zahrani plant

Under medium term restructuring initiatives, the government will:

- Secure the supply of natural gas to the Deir Ammar plant
- Build a gas pipeline between the Zahrani and Baddawi plants
- Complete the expansion and rehabilitation of the 220 KV transmission network
- Complete the infrastructure needed for the Ksara Station (including 400 KV network) to allow Lebanon's integration into the regional electrical network known as the "Seventh Joint"
- Decide on the viability of the Zouk and Jiyeh plants
- Privatize EdL

Other potential improvements would cover:

- Rehabilitate existing power plants, particularly Zouk and Jiyeh
- Install additional capacity in Deir Ammar and Zahrani (with private sector participation)
- Sign contracts with private sector companies to produce electricity (outside main urban centers) and sell to EDL (inside main urban centers)
- Increase hydro-electrical production capacity by issuing BOT contracts
- Provide the necessary investments to improve transmission
- Provide the necessary investments to improve distribution
- Secure more financing to invest in additional 2300 MW to be ready by 2015 to meet the increasing demand for energy (add 1000 MW to replace retired existing capacity and 1300 new additional capacity)

88. To ensure the success of the power reform program, consultants will be engaged in early 2007 with international donor support to: (i) assist the Ministry of Energy and Water (MEW) in designing, implementing and monitoring and evaluating policy reforms of the power sector; (ii) assist EdL in its day to day operation of the entity with a focus on technical and financial aspects; and (iii) assist HCP in the restructuring and privatization of EdL.

89. As part of the program aimed at reducing non-technical distribution losses, the government is preparing tenders for the provision, installation and management of 1.2 million remote-controlled power meters which will help identify theft and non-payment. In addition, ongoing transmission investments, including a national control center will contribute to technical loss reduction. With respect to generation, an operation and maintenance contract is in place for the two main power plants. In order to increase generation efficiency and reduce costs, Government aims to substitute fuel with gas by: (i) providing Liquefied Natural Gas (LNG) to the Zahrani plant; (ii) providing natural gas through a regional pipeline to the Baddawi plant; and (iii) constructing a gas pipeline between the two power plants. With regards to the expansion of future generation, the government intends to rely on the private sector under Independent Power Producer arrangements.

Revenue Measures

90. In view of the sizeable adjustment needed and the relatively limited scope for further cut in primary public spending, the above expenditure measures will not be sufficient to raise the primary surplus to a level that is commensurate with the objective of reducing the ratio of debt-to-GDP over the medium term. Hence, serious revenue-enhancing measures would need to accompany or even precede some expenditure cuts, given the difficulty in rationalizing public expenditures in the short term.

91. Much has been done in the past few years to improve the tax structure and collection, as shown in the sharp increase in the tax revenue. A number of other structural measures aimed at modernizing the revenue administration towards a function based structure with strong headquarters, fully automated business processes, risk-based compliance programs, and skilled and professional staff, include (i) integrating within the newly created large taxpayer office (LTO) the collection function and introducing further automation including electronic filing (2007); the coverage of the LTO is further expected to be extended to include the VAT, built property tax and some indirect

taxes; (ii) staffing fully the newly established tax roll department, modernizing and updating the business activity code, and ensuring accurate recording of taxpayers (2007); (iii) finalizing the registration of private and public sector employees in the withheld tax on salaries and wages database, and extending the reformed operations to the regional offices; and (iv) unifying tax procedures under a unique "Tax Procedure Code" which is presently under final revision and discussion in parliament, an important step for the introduction of the Global Income Tax (GIT) in 2008.

92. Any change in tax policy in the context of the present reform program should be guided by the need to minimize distortions and enhance equity and fairness in the distribution of the tax burden, taking into account the broad objectives of this program. In this spirit, the government plans to implement a number of revenue-enhancing measures that would attempt to shift the tax burden to those that are in the high-income brackets.

93. The tax on interest income will be raised from 5% to 7% beginning in 2008. The fact that interest received constitutes an important share of taxable income of those in high income brackets reinforces the argument for this taxation. This tax increase could generate about 0.5% of GDP in revenue, assuming a 10% rate of growth of deposits over the medium term (a realistic estimate judging by recent trends), a 72% dollarization rate, and relatively stable interest rates over the medium term.

94. The introduction of the value added tax (VAT) in early 2002 was a major success, generating 5.1% of GDP in revenue in 2005. The Lebanese VAT law exempts basic food staples and social items such as education and health services, medicine, books, and public transport, which make the bulk of low-income household consumption of goods and services (it is estimated that about 60% of their consumption is exempt from the VAT). In this regard, the VAT could be seen as a progressive tax on income spent due to the fact that the goods and services exempted from the VAT represent a relatively smaller portion of spending by high-income households.

95. In this light, the government plans to raise the VAT rate from 10% to 12% in 2008 and from 12% to 15% in 2010. Over the medium term, a 15% VAT will generate additional revenue of at least 2% of GDP. All this will bring the total contribution of the VAT to the budget to about 7.5% of GDP by 2010. For improved collection, the government further seeks to adopt monthly VAT filing for large corporations as of 2007.

96. The contribution of the gasoline excise tax to the budget declined from LL 800 billion in 2003 to about LL 360 billion in 2005 and has almost become nil for the period May-August of 2006 (total collection of car gasoline excises for 2006 is not projected to exceed LL 250 billion) due to the capping of the retail price at the May 2004 level, which has created additional economic distortions and eroded the gasoline excise revenue base. This decision was introduced temporarily on the assumption that oil prices would go back down in the near future. The excise tax will be adjusted gradually beginning in 2007 until it reaches its pre-cap rate by 2011. At the same time, the cap will be lifted to allow a full pass-through of international prices to domestic retail prices.

97. As part of the overall tax reform, the government will replace the scheduler income tax by a global income tax (GIT) by 2008 without any changes in the tax rates. This will aggregate the taxpayer's sources of income, introducing more equality in tax burden. This measure will not impose any new burden on low-income people but will introduce a fairer distribution of the tax burden. Together with the improvement in the overall tax administration and compliance, the reduction in administrative complexities, and the unification of exemptions, the GIT is expected to improve tax revenue. It is estimated that the introduction of the GIT will generate about 1% of GDP of additional revenue over three years, 2008-10. The government intends to strengthen the administration of the

property tax and broaden its base. The yield of the property tax in Lebanon, at 0.3% of GDP, is low compared to developed countries (1.45% of GDP for OECD).

98. The property tax administration has started the process of updating and building a comprehensive database on built properties to be achieved through a synchronization of information systems between property tax database and Cadastre as a first step, and municipalities at a second stage.

99. In this context, there is a pressing need to settle the long-standing issue of seashore violations through the adoption of the appropriate draft law, which was recently approved by the cabinet. It is expected that at least LL 135 billion will be collected in the form of penalties in 2007. In addition, the government will begin to collect rent on these "leased" properties beginning in 2007 estimated at LL 45 billion a year. In deciding on how much rent to charge, the government will take into account the fact that these properties are not subject to property tax and hence they should yield high rent generating additional revenues for the budget.

100. The government seeks to strengthen its collection of revenues from the various public properties particularly from Casino du Liban through the agreed upon arrangement with its management. This arrangement stipulated that the government that will start collecting 40% of total net revenues from gambling for the next 10 years instead of 30% which was collected during the last 10 years. This ratio will be further raised to 50% before the agreement is terminated and the Casino operation is fully returned to government.

E. Privatization Program

101. The achievement of government's key objective of a sustainable growth with equity is critically dependent on reducing the level of public debt, so as to bring about lower interest rates to encourage private investment, and to accommodate adequate levels of social expenditures and public investments as a result of an easing of the debt service burden.

102. The privatization component of the government's reform program is key to both the objective of promoting growth and that of reducing debt and the fiscal deficit. It would also contribute to the deepening and expansion of Lebanon's capital markets. The privatization program is expected to improve the reliability and quality of the provision of public services, reduce operating costs through increased efficiency of operations, expand the range of services offered to customers, reduce the cost of services to business, introduce competition and hence improve the competitiveness of the economy.

103. The legal framework for privatization had already been established in late 2000 with the adoption of a framework privatization law (Law 228) that formed the basis for developing sector-specific laws to underpin privatization operations in various sectors. The Higher Council for Privatization (HCP) was established in the Office of the Prime Minister in 2001 and two sectoral laws were enacted in 2002 to form and privatize a fixed line telecommunications company and to corporatize, unbundle and privatize the power sector. Apart from transport, these two sectors represent by far the largest components of public infrastructure in terms of assets. Both laws provide for the establishment of regulatory bodies for the respective sectors. As mentioned above, privatization did not go ahead during 2003-05 because of political constraints.

104. Preparation for privatization and liberalization in telecommunications has been resumed after the war. The key components of the telecom privatization plan are: (i) the establishment of a regulatory authority and appointment of its board by the first quarter of 2007; (ii) the enactment of a law authorizing the sale of the mobile sector's assets and relevant operating licenses by the first quarter of 2007; (iii) the sale of a majority stake in, or 100 percent of the mobile sector companies by

the second quarter of 2007; and (iv) the formation of Liban Telecom (as envisaged in Law 431 of 2002), through the incorporation of the fixed line operator Ogero (a Government-owned entity) and two departments of the Ministry of Telecommunications, by mid-2007 and its privatization in 2008. The HCP is finalizing contracts with reputable international firms to assist with the privatization of the mobile sector and has retained another one to help corporatize Liban Telecom.

105. The privatization of the mobile sector companies will be undertaken in a transparent manner through a public offering that ensures the widest possible stockholder base. Other than reducing the total debt stock, this operation will play a major role in developing the Beirut Stock Exchange, fueling growth and job creation, and providing mobile telephony services more efficiently.

106. The scope for immediate privatization of the power sector is more limited given the state that EdL is currently in. However, urgent action is needed to reverse the grave fiscal impact of EdL on the budget. Energy generation is far below installed capacity and system losses (technical and non-technical losses and non-collection of bills) are high. EdL's losses are large even though tariffs are not low by regional standards, and rising fuel prices have compounded the problem. Government is covering EdL's operating losses as well as capital expenditures and debt service, representing outlays of a total of 3.5% of GDP in 2006. In the meantime, sector investment requirements for the five years are estimated to be in the order of US\$1.5 billion. Given the heavy debt burden facing the economy and the increased demand for power consumption, it is imperative for the private and not the public sector to provide the needed investments and services in the future.

107. As in the case of telecommunications, legislation adopted in 2002 (Law 462) provides the legal framework for privatization of the sector. The law envisages the creation of a regulatory authority, and the separation of generation, transmission and distribution activities, in anticipation of the creation of one or more public corporations responsible for generation and distribution. Transmission would remain a public function.

108. Privatization of the sector remains the government's objective for the medium term, but in the short run, the focus will be on strengthening sector capacity and reducing losses, with involvement of the private sector where feasible.

109. With respect to other infrastructure, government will prepare legislation in the course of 2007 to support privatization in the water and wastewater sectors, through concessions. In the case of ports and the Beirut Airport, government intends to proceed with privatization through concessions as well.

110. As for sectors other than public infrastructure, the national airline, Middle East Airlines (MEA), was restructured in 2001. The restructuring, which involved major layoffs, has contributed to MEA achieving an operating profit in 2005, despite the rise in fuel prices. For 2006, losses are envisaged as a result of the war. Nevertheless, when market conditions are deemed to be adequate, BdL plans to divest its shares in MEA, as well as its shares in the INTRA Investment Company (financial institution), which is a major shareholder in the Casino de Liban. Finally, the Government-owned refineries, which have not been operative since the 1975-90 war, would be offered for sale to private investors interested in establishing refinery and/or oil storage capacity or in any form of cooperation with the private sector.

111. In terms of early impact on public debt (in 2007 and 2008), only the planned privatization in the telecommunications sector should represent fairly significant amounts. By law, proceeds from all privatization efforts are to be applied to public debt reduction.

F. Monetary and Exchange Rate Policies

112. Maintaining macroeconomic stability through a proper monetary and exchange rate policy is a prerequisite for stimulating private sector investment and growth and for maintaining social stability. In the past few years, the central bank (BdL) has played a much greater role than a typical central bank would under normal circumstances. But circumstances were not normal by any means. The difficult political and security situation which manifested itself mainly in higher dollarization and in pressures in the foreign exchange market required the central bank to resort to various (and sometimes untypical) financial and long-term monetary instruments to maintain such stability and avoid a financial crisis. This was very much in evidence following the assassination of Prime Minister Hariri and during the July/August war. The BdL issued dollar denominated CDs to banks and lengthened the maturity of deposits, to help stabilize a difficult situation.

113. With the onset of economic reforms and the expected support of the international community, the central bank will focus its attention on its main mandate of maintaining price stability using only short-term monetary instruments. At the same time, BdL's policy independence will be strengthened mainly through improving the fiscal situation and not resorting to any direct borrowing from the central bank. In an environment of renewed confidence and good coordination with fiscal policy, there is a scope for reducing interest rate spreads. This could be accomplished without necessarily creating much pressure on reserves given the stability of the deposit base, which has proved to be less sensitive to changes in foreign interest rates. In the absence of fiscal tightening and reform, however, the ability of the central bank to influence interest rates is limited given that capital is fully mobile and the exchange rate is fixed.

114. A potential reduction in interest rates—starting with a reduction in the margin on dollar deposits—should boost the demand for credit by the private sector and channel excess liquidity toward productive uses and help the development of capital markets (see above). As the level of international reserves is approaching an adequate level, the need for the central bank to absorb liquidity will diminish and so will the cost of sterilization.

115. As part of its efforts to focus on its main mandate and to rid its balance sheet from assets that do not typically belong to a central bank (but are there because of special past circumstances), the BdL plans to sell part of its shares in the Middle East Airlines (MEA), and Intra Investment Corporation which includes Casino du Liban by mid-2007, market conditions permitting. In tandem, BdL will put forward a liquidity management strategy to ensure the smooth running of markets given any debt swaps and reductions that may take subsequent to the International Conference in January.

116. The policy of stable exchange rate has served Lebanon well and is critical to maintaining price stability and confidence. While competitiveness is not a concern at this time, structural reforms of the kind included in the economic reform program will enhance competitiveness. Furthermore, to broaden the range of its policy instruments, the central bank will develop the necessary tools to deal with a more flexible exchange rate regime in the future, should the need arise and provided that price stability is not jeopardized.

G. Banking Sector's Contribution to the Domestic Effort

117. Commercial banks in Lebanon remain profitable and well capitalized by international standards. Asset quality remains good, with less than 10% ratio of problem loans to total loans. The risk associated with the large exposure to the government is mitigated by the abundant liquidity in the banking system compared to international standards. But this risk is expected to fall due to the ongoing reform efforts and the expected international financial assistance that would reduce the need for government borrowing. The BdL will gradually push banks to become intermediaries in government papers (instead of being the principal holders of these papers), thus reducing their

exposure to sovereign risk and allowing them to finance private sector activities which would enhance growth and job creation.

118. As for the financial contribution of commercial banks to the adjustment efforts, it will be up to the banking sector to determine the size and modalities of their contribution as was the case at the time of the Paris II meeting. Any voluntary contribution from banks will complement and facilitate the government's reform efforts.

IV. MEDIUM-TERM MACROECONOMIC FRAMEWORK

A. Macroeconomic scenario with domestic adjustment

119. The implementation of the government's reform program as outlined above, with early recovery and reconstruction and without further external support, assumes that growth would resume fairly quickly (from the low 2006 base) as of 2007. Real GDP growth is conservatively estimated to stay in the 4-5% range over the medium term. These are modest targets given the potential for higher growth rates. However, erring on the side of caution is intended to come up with a set of measures that would safeguard fiscal sustainability in the face of adverse external or internal shocks.

120. The financial impact of the July-August war in terms of additional financing needs for the period 2006-10 is estimated at US\$4.5 billion. This amount represents additional financing requirements over and above what was expected in the pre-war medium term scenario, in the absence of any external support. This represents the cumulative additional fiscal deficits during 2006-10, less grants and financial contribution from the international community for recovery and reconstruction.

| Box 5. Impact of War--Incremental Financing Needs 2006-10 | | | | |
|--|---------|---------|---------|---|
| US\$ million | Total | | | Notes |
| | 2006-08 | 2009-10 | 2006-10 | |
| Revenues ^{1/} | -1,735 | -612 | -2,347 | Delayed adjustment and lower GDP |
| Non-Interest Current Expenditures | 1,296 | 16 | 1,312 | Delayed adjustment and security/social expenditures |
| Current Primary Balance ^{1/} | -3,032 | -627 | -3,659 | |
| Capital Expenditures ^{2/} | 1,711 | -82 | 1,629 | Recovery and reconstruction, less private sector |
| Primary Balance ^{1/} | -4,743 | -545 | -5,288 | |
| Interest | 307 | 411 | 718 | Higher debt |
| Additional Fiscal Deficit | 5,050 | 956 | 6,006 | This amount is the total of overall fiscal deficits for 2006-10 (cumulative) in the post-war scenario LESS the same in the pre-war scenario |
| Grants/Loans Recovery and Reconstruction | 1,452 | 0 | 1,452 | |
| Incremental Financing Needs | 3,598 | 956 | 4,554 | |

^{1/} Excluding Grants
^{2/} Including Housing

121. Domestic adjustment efforts, in the absence of external support beyond the initial support that has already been pledged for recovery and reconstruction, will lead to significant improvements in macroeconomic balances over the next five years. Under reasonable assumptions on growth, inflation, and interest rates and all things being equal, the primary budget position is expected to increase from

a -0.7% of GDP deficit in 2006 to about 8.9% of GDP surplus in 2011, a total adjustment of about 10 % of GDP. The overall deficit would decline to 2.1% of GDP with interest payments absorbing slightly less than half of revenues (11% of GDP). As a result of these macroeconomic and structural adjustments, the debt-to-GDP ratio would decline from about 180 % in 2006 to about 145% in 2011.

| Box 6. Macroeconomic Scenario with domestic adjustment w/o foreign assistance | | | | | | |
|--|-------|-------|------|------|------|------|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| <u>Share of GDP (%)</u> | | | | | | |
| Revenues | 20.8 | 22.1 | 23.4 | 22.9 | 24.4 | 24.5 |
| Grants (recovery and reconstruction) ^{1/} | 2.4 | 3.7 | 0.1 | 0.0 | 0.0 | 0.0 |
| Total Expenditure | 36.9 | 39.3 | 32.7 | 28.7 | 27.8 | 26.7 |
| Current expenditure | 32.3 | 32.3 | 28.6 | 26.1 | 25.1 | 23.9 |
| Non-interest | 19.2 | 19.2 | 16.5 | 14.2 | 13.5 | 12.9 |
| Interest | 13.1 | 13.2 | 12.1 | 11.9 | 11.6 | 11.0 |
| Capital expenditure | 4.6 | 6.9 | 4.1 | 2.6 | 2.7 | 2.7 |
| o/w Reconstruction | 2.2 | 3.7 | 1.0 | 0.0 | 0.0 | 0.0 |
| Primary Balance before grants | -3.0 | -4.1 | 2.8 | 6.0 | 8.2 | 8.9 |
| Primary Balance after grants | -0.7 | -0.3 | 2.8 | 6.0 | 8.2 | 8.9 |
| Interest | 13.1 | 13.2 | 12.1 | 11.9 | 11.6 | 11.0 |
| Overall Deficit (before recovery/reconstruction grants) | -16.1 | -17.2 | -9.3 | -5.9 | -3.3 | -2.1 |
| Overall Deficit (after recovery/reconstruction grants) | -13.7 | -13.5 | -9.2 | -5.9 | -3.3 | -2.1 |
| Gross Debt (US\$ billion) | 40.3 | 40.5 | 41.3 | 43.0 | 43.9 | 44.7 |
| Gross Public Debt to GDP ratio (%) | 180 | 170 | 161 | 157 | 151 | 145 |
| Real GDP growth | -5.0 | 4.0 | 5.0 | 4.5 | 4.0 | 4.0 |
| Inflation rate | 7.5 | 2.2 | 2.7 | 2.0 | 2.5 | 2.0 |
| GDP (US\$ billion) | 22.4 | 23.8 | 25.7 | 27.4 | 29.2 | 31.0 |

^{1/} Excludes grants provided directly to beneficiaries, private sector and NGO and Technical Assistance

B. Macroeconomic Scenario with External Support

122. Reducing the debt-to-GDP ratio to 145% is a major accomplishment but a debt ratio of such magnitude remains too high by any standard and cannot be sustained over the long term, leaving Lebanon vulnerable to systemic failure. While there is no universal agreement on what constitutes a sustainable debt position, from a practical point of view, it is the level at which the government can satisfy its budget constraint without having to resort to drastic measures or experience difficulties in servicing debt in the future, given reasonable expectations about future fiscal effort.

123. From the operational point of view, public debt in Lebanon is deemed sustainable if the debt-to-GDP ratio declines noticeably over time. Assuming an average real growth of 4%, a real interest rate of 6% and a reduction in the debt to-GDP ratio by about 15% on account of privatization proceeds, Lebanon has then to maintain a primary surplus of 3.5-4.0% of GDP to keep the debt-to-GDP ratio constant over time. But given the high level of debt and the susceptibility of this debt to exogenous shocks, the objective is to reduce the debt ratio over time by achieving higher primary

surplus and/or by external financial support. While the adjustment in the primary surplus planned for 2006-2011 is substantial (10% of GDP), over the next 15 years Lebanon cannot realistically sustain an average primary surplus of more than 3.5-4% of GDP (or about 2-2.5% over the period 2010-20) since compressing expenditures and raising additional revenues would become extremely difficult to maintain in view of the country's needs, allowing only a slight decline in the debt ratio.

124. In view of the high level of debt and the ensuing vulnerability with its social and political repercussions, international support would be crucial for Lebanon to secure a continuous and perceptible reduction in the debt-to-GDP ratio over the long run. Significant external support in the form of grants and highly concessional loans would substitute part of the new market borrowing with a significant impact on debt dynamics especially if this support is frontloaded. While grants would have the greatest impact on the debt stock, highly concessional loans would affect the debt ratio through a reduction in debt service. At the Paris II meeting, the international community extended long-term concessional loans at an interest rate that was about half the rate at which Lebanon could borrow at that time. To receive the same degree of concessionality granted under Paris II, under the present circumstance, Lebanon hopes to receive large grants in substantial amounts and in addition to concessional loans at an interest rate in the range of 3-4% (close to donors' cost of fund) and a maturity period of at least 15 years with a grace period of 5 years.

125. Without international support, the debt-to-GDP ratio will likely revert back to an unsustainable path especially in the face of any exogenous shock unless further fiscal adjustments are taken. However, further cuts in spending or more increases in taxes would not be possible without stifling economic activity or provoking social and political unrest, which would negate fully the benefits of reform.

126. More importantly, international financial support will help create the right environment for reform and contribute significantly to increasing growth and reducing interest rates, which in turn will have a greater impact on debt. For every one percent increase in the growth rate, the debt-to-GDP ratio would decline by about 1.5% a year. Similarly, a reduction in the real interest rate by one percentage point would have a similar impact on the debt ratio. A combination of both would likely reduce the debt ratio considerably to sustainable levels over the next 10-15 years.

127. The government plans to place all financial contributions in a special account at the central bank earmarked exclusively for debt service and principal repayments. Any future primary fiscal surpluses would also accrue to this account. This account will also be used for privatization proceeds for the exclusive purpose of debt reduction.

C. Implementation of the reform program

128. Given the breadth of the reform program and the need for timely implementation over the next five years, a committee representing the ministry of finance, the ministry of economy, and the central bank will be established to ensure proper monitoring of various measures of the program. This committee will prepare a detailed timetable for implementation and work closely with other ministries such as social affairs, health, education and labor to ensure that all actions on the social front are being implemented on a timely basis. The committee will report directly to the prime minister, who will follow up with ministries and agencies not abiding by the agreed timeline under the program while keeping the Council of Ministers fully informed of any developments.

129. The committee will publish a semi-annual report on the status of implementation of the program. In case of delays, the report will explain the reasons and set a new timeframe for implementation. If there are fundamental reasons for a shift in the strategy, then the government will consult with parliament and Lebanon's partners, including international financial institutions and key donors, before a new strategy is adopted.

V. CONCLUSION

130. In this paper, the government of Lebanon presents a comprehensive economic reform program that aims at boosting economic growth, creating employment, maintaining social and political stability, and moving the country to a prosperous era following 30 years of civil strife, Israeli occupation, and unsettled political situation. One first step in tackling the formidable challenges that lie ahead is to address upfront the main source of vulnerability represented by large fiscal deficits and high levels of debt and debt service. If these risks are not addressed, they would lead to unsustainable debt situation and give rise to social and political tensions.

131. This reform program attempts to address the repercussions of thirty years of destruction and suffering and comes in the aftermath of a major devastation caused by the July-August Israeli war. This war increased the burden of public debt and required even more drastic fiscal adjustments than envisaged before the war. Without significant external support, Lebanon would again enter into a vicious cycle of rising debt, high interest rates, depressed private investment and growth that remains well below its potential. Such trend, if not reversed, could easily lead to economic, social and political instability.

132. Assuming no adverse developments occur and provided the government delivers on all its reform measures, the domestic effort will lead to significant reductions in the budget deficits and improvement in the primary surplus amounting to about 10% of GDP; nevertheless, these efforts alone will not be sufficient to reverse the debt dynamics. All things being equal, the debt-to-GDP ratio will remain at best at about 145% of GDP and the debt service will still eat up about 50% of total revenue—a very high level of debt by international standards that could not be sustained in the long term. Generating larger primary surpluses over the long term would not be possible without upsetting the delicate social and political balance in the country.

133. Hence to reduce the debt-to-GDP ratio over time, support the efforts of the Lebanese government, and improve the chances of success of the economic reform program, Lebanon will need the support of the international community. Lebanon hopes to receive financial assistance mainly in grants and highly concessional loans to bring down the debt-to-GDP ratio to a sustainable level, placing Lebanon on a promising and sustainable path out of the debt overhang.

134. Lebanon once again is at a crossroad. It is facing the task of recovery and reconstruction, but this time against a background of public debt that stands at close to twice the level of GDP, and in the aftermath of a massive war that has derailed a promising path. The government is committed to implement its pre-war reform program, although with some re-phasing to take account of the impact of the war. But what the government can do will fall far short of what is needed, and it therefore looks to the international community to provide generous financial support and invest in Lebanon's future.