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R2006-0173

IDA/R2006-0176

August 31, 2006

Closing Date: Thursday, September 7, 2006

FROM: Vice President and Corporate Secretary

Proposed Establishment of a Trust Fund for Lebanon

Proposed Transfer of IBRD Surplus to the Trust Fund for Lebanon

1. Attached is a memorandum from the President entitled "Proposed Establishment of a Trust Fund for Lebanon - Proposed Transfer of IBRD Surplus to the Trust Fund for Lebanon", dated August 31, 2006. This document is being **distributed in less than the required lead time** in order to maintain the closing date of September 7, 2006.
2. In the absence of objection to be communicated to the Vice President and Corporate Secretary by the close of business on **September 7, 2006**, the recommendation contained in paragraph 22 will be deemed approved and so recorded in the minutes of a subsequent meeting of the Executive Directors.
3. Questions on this document may be addressed to Mr. Kostner (ext. 35886).

Distribution:

Executive Directors and Alternates
President
Bank Group Senior Management
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

Office of the President

August 30, 2006

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Proposed Establishment of a Trust Fund for Lebanon

Proposed Transfer of IBRD Surplus to the Trust Fund for Lebanon

Introduction

1. I submit for your approval a proposal to establish a Trust Fund for Lebanon to finance an emergency recovery program for Lebanon. I also submit for your approval a proposal to transfer US\$50 million from IBRD surplus to the Trust Fund for Lebanon.

The War and its Aftermath

2. On August 14, 2006, a UN-brokered ceasefire brought an end to a short but intense war that had been waged in Lebanon for 33 days with devastating results. The Government of Lebanon (GOL) estimates that almost one million Lebanese (out of a estimated population of 3.5 million) fled their homes during the height of the war; about 250,000 are still internally displaced or refugees today. There is a lack of food, medicines and other non-food items to serve the displaced and returnee populations. The war-affected areas also experience a lack of safe drinking water and functioning health and sewage disposal systems.

3. A preliminary assessment by GOL indicates the partial or complete destruction of approximately 30,000 housing units, almost 110 bridges, close to 140 roads, around 350 schools and over 30 vital infrastructure facilities (airports, ports, sewage treatment plants, power plants, etc.). Health facilities also suffered extensive damage in the war-affected areas, as did over 700 industrial enterprises. Furthermore, the war caused a major oil spill off the coast of Jiyeh south of Beirut following the destruction of a power plant. The direct cost of the damages has been provisionally estimated by GOL at \$3.6 billion (equivalent to around 15 percent of 2005 GDP).

4. Due to the extensive destruction of physical capital and the disruption of trade and supply channels, Lebanon's economic activity is likely to contract significantly in 2006. After a fairly strong economic performance in the first semester, preliminary Bank analysis suggests that GDP for the entire year could recede by over 6 percent compared with 2005, with production in all sectors of the economy contracting significantly.

Expressed in dollar terms, the total output loss by end-2006 could reach an estimated US\$2.5 billion, with GDP per capita falling by over 7 percent. Preliminary government estimates indicate an increase in the unemployment rate from below 10 percent before the war to 25 percent after the cessation of hostilities.

5. The Bank expects the fiscal improvement which was witnessed during the first half of 2006 to be sharply reversed for the year as a whole due to the negative impact of the war on revenue collection as well as the pressing need for higher government spending. Even without accounting for additional expenditures for reconstruction, compensation or relief purposes, the fiscal deficit could reach 13 percent of GDP in 2006 and the primary surplus may drop to below 1 percent of GDP, a deterioration of about 50 percent over the 2005 outcomes in both cases.

6. The public debt dynamics are of equal concern. Under the aforementioned economic and fiscal estimates, the debt-to-GDP ratio could surpass 200 percent by the end of 2006 (against 173 percent in 2005). Considering unavoidable pressures on the expenditure side, already significant arrears, contingent liabilities, and a possible interest rate rise, the government's debt carrying capacity could become unsustainable. Donor financial assistance for reconstruction and recovery needs to avoid an aggravation of this very fragile situation.

7. The war has had a devastating impact, yet Lebanon has a democratically elected government with functioning institutions and established capacities. The government also has long-standing relations with the international community, including for development assistance. GOL is determined to lead the reconstruction and recovery effort and has the international community's support for so doing. As UN Security Council Resolution 1701 of August 12, 2006 is being implemented with the impending deployment of the United Nations Interim Force in Lebanon (UNIFIL II), it is hoped that stability will be restored, allowing the government and the international community to fully focus on the arduous task of economic and social rehabilitation and recovery.

The Bank's Response

8. The evacuation/relocation of staff based in the Beirut office was successfully completed on July 18, 2006. A mission returned to Beirut on August 27 to assess the security situation and initiate the return of staff, circumstances permitting. It is too early to assess the full impact of the war on the Bank's Country Assistance Strategy (CAS) (Report No. 34463-LB) which was discussed by the Executive Directors on December 15, 2005. Indications are that the overall orientation of the CAS remains largely relevant, yet that the unforeseen developments require a temporary re-positioning. Consequently, the Bank's short-term emergency response centers around three areas: the portfolio; support to the preparation of a national recovery strategy and program; and technical assistance.

9. The IBRD total exposure at the end of FY06 amounts to US\$459 million. As of July 31, 2006, the Bank's active portfolio consists of six projects¹ totaling US\$297 million, of which US\$107 million has been disbursed. Already during the hostilities, GOL and the Bank reviewed the ongoing operations and found them appropriate as they are mostly aimed at poor areas which happen to have been those most affected by the war. Approximately US\$40 million that had not yet been committed before the war have since been allocated to finance urgent rehabilitation activities. At the same time, the performance of the portfolio will require continued, close attention.

10. Upon request by GOL, the Bank will undertake a multi-sector mission during the month of September in coordination with donor/UN partners. The objectives are to validate the damage assessments carried out by the government and other agencies and to undertake an economic and social impact assessment. The impact assessment will place specific emphasis on key reform elements necessary for transitioning from a short-term reconstruction phase to a phase of sustainable growth in which the confidence of domestic and international capital markets in the country's economic prospects are restored. The mission will aim to develop a medium-term financing framework as the central constituent of this transition. The mission will also elaborate the modalities for efficient donor coordination, resource mobilization, and program implementation. The mission will, thus, assist GOL in preparing a comprehensive national recovery strategy and program for a donor conference in the fall in Beirut. Previously identified analytical and advisory activities will be folded into this new and urgent task.

11. GOL has sought the Bank's assistance for setting up a government-administered National Reconstruction Fund which would handle those contributions that donors choose to provide directly to it. Consequently, the Country Team is preparing a Post Conflict Fund grant proposal for US\$1 million to support the establishment and operation of this fund. It is expected that the fund would employ standardized and simplified procurement and financial management procedures for the transparent use of donor funds and the efficient implementation of activities financed by it.

12. The Bank's activities are folded into the wider response of the international community. UN agencies and several donors are actively engaged in addressing urgent humanitarian needs, among others, for water and sanitation, health and nutrition, and shelter. The Government of Sweden is hosting a conference on August 31 with the aim of mobilizing resources for the remaining humanitarian activities and launching early recovery activities. This conference is a forerunner to the Beirut conference which will focus on the medium-term and where the Bank is expected to play a prominent role. Bank staff are in regular contact with donor and UN partners to ensure the complementarity and coordination of our activities.

¹ These projects are: Education Development Project (LE-7010, US\$56.6 million, including US\$12.0 million that had been cancelled before the war and will shortly be uncanceled), First Municipal Infrastructure Project (LE-7026, US\$80.0 million), Community Development Project (LE-7064, US\$20.0 million), Ba'albeck Water and Wastewater Project (LE-7117, US\$43.5 million), Urban Transport Development Project (LE-7123, US\$65.0 million), Cultural Heritage and Urban Development Project (LE-7166, US\$31.5 million).

The Case for a Transfer from IBRD Surplus

13. The CAS base case foresees a lending program of US\$100 million over four years. All indications are that, as a result of the war, Lebanon has fallen into the CAS low case. While the disbursement ratio for FY06 of 17 percent surpassed the portfolio trigger of 10 percent, the ratio of the fiscal primary surplus over total fiscal revenue may be significantly below the lower limit of 8 percent, perhaps lower than 4 percent. The low case pre-empts new IBRD lending.

14. Given the magnitude of the physical damages and the increasingly precarious fiscal situation and public debt dynamics that are expected to prevail over the next 1-2 years, financing emergency needs and reconstruction efforts from non-concessional sources is not appropriate at this time from either the country's or IBRD's perspective. The authorities have indicated to donors their need for grant support or highly concessional loans. In this regard, Lebanon cannot access IDA resources as its GNI per capita, at \$5,500 prior to the war, is far above the IDA threshold of \$1,025.

15. Because Lebanon is in the low case and thus ineligible for new IBRD lending and has pressing need for grant or highly concessional financing in the immediate aftermath of the conflict, Bank Management recommends that the Bank provide grant financing for economic and social recovery activities by transferring US\$50 million from IBRD surplus to a Trust Fund for Lebanon (TFL). Though marginal in comparison to needs, this amount, provided in grant form, is equivalent to half the amount of IBRD lending envisioned under the base case (over half the time) and, thus, represents a significant Bank contribution to post-war recovery in Lebanon.

Availability of IBRD Surplus

16. In order to respond to unforeseen events given the increased incidence of natural disasters and geopolitical tensions, the Executive Directors agreed on August 7, 2006, to propose to the Governors an increase in the allocation to IBRD surplus of an additional US\$100 million from FY06 net income. The financing for the proposed TFL out of IBRD surplus would meet the purpose of responding rapidly to post-conflict emergency needs in the absence of a country's access to other available Bank resources. The transfer from IBRD surplus to the TFL would be subject to the Governors' approval of the increase in IBRD surplus at the 2006 Annual Meetings.

The Trust Fund for Lebanon

17. The rehabilitation of damaged infrastructure, support to war-affected, marginalized groups, and jump-starting economic activities have been identified as priority areas of distinct Bank comparative advantage. Given the extent of the damages, the tight fiscal constraints and the considerable demands on the government's implementation capacities, it is essential to include the private sector and civil society in the reconstruction and recovery process. The Bank will, therefore, work closely with IFC and MIGA to leverage donor funds with private capital. The establishment of a Trust

Fund for Lebanon, administered by IDA, would enable the Bank to finance an emergency recovery program comprising these areas on a grant basis.

18. Prior to the outbreak of the war, two infrastructure projects (developing water systems in the Beka'a valley and in the area of southern Beirut) were already under preparation. The heavy damage afflicted to public infrastructure in these regions renders the two projects even more critical. The CAS envisages an expansion of the Municipal Infrastructure Project, the best performing project in the portfolio, as well as a social protection project that would take into account lessons learned through the ongoing Community Development Project. Considering the severe impact of the war on municipalities and communities, a continuation of the Bank's engagement in these two areas is highly desirable. IFC is developing a risk-sharing facility with Lebanese commercial banks focusing on housing mortgages, and funding small and medium enterprises. This facility would be blended with commercial funding to reduce the cost of capital to affordable levels.

19. The size of the TFL would not permit a considerable impact on the beneficiary population with Bank assistance alone. Consequently, the Country Team would prepare only those new projects that can leverage significant additional donor resources through project co-financing or parallel financing, or through the government's National Reconstruction Fund.

20. The preparation of TFL-funded projects would be carried out on an accelerated basis using the procedures outlined in OP 8.50 in order to provide near-term recovery assistance. Streamlined procurement and disbursement procedures, consistent with Bank guidelines and used in other post-conflict situations, would be employed. Given the government's severely strained fiscal position, the Bank would finance 100 percent of eligible expenditures under TFL-funded projects². To ensure appropriate accountability and transparency in the use of funds, projects will be designed consistent with Bank financial management requirements, and accounts will be audited according to Bank guidelines.

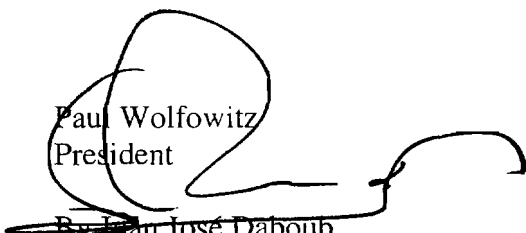
21. In the interest of commencing project implementation as quickly as possible, it is proposed that procedures similar to those followed in the case of Learning and Innovation Loans be adopted, allowing for approval of projects by the Regional Vice-President with project documents and grant agreements being made available to the Executive Directors for informational purposes. The operation of the TFL would be reviewed on a periodic basis.

Recommendation

22. In view of the foregoing, I recommend that the Executive Directors approve:

² Following a request by the Ministry of Finance dated August 25, 2006, the Bank agreed to increase to 100 percent the current financing percentage of disbursements of current projects, financed by the Bank under the existing loan agreements, for the next 12 months.

- (a) the resolution set forth in Attachment A, providing for the establishment of a trust fund administered by IDA in accordance with the procedures set out above, to finance on a grant basis a program of emergency assistance for economic and social recovery in Lebanon,
- (b) the draft Report of the Executive Directors set forth in Attachment B recommending that the Board of Governors authorize the transfer of US\$50 million from IBRD surplus to such trust fund in the form of the resolution set forth in Annex A to Attachment B, and
- (c) the delegation to the Regional Vice-President to approve projects following procedures similar to those adopted in the case of Learning and Innovation Loans.



Paul Wolfowitz
President

~~By Jean José Daboub~~
Managing Director

ATTACHMENT A

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INTERNATIONAL BANK FOR RECONSTRUCTION
AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

(DRAFT)

RESOLUTION No. ____

RESOLUTION No. IDA ____

TRUST FUND FOR LEBANON

WHEREAS:

(A) It is desirable to promote the purposes of the Bank and the Association by establishing a Trust Fund for Lebanon (TFL), administered by the Association, in order to finance an emergency recovery program for Lebanon;

(B) The Executive Directors of the Bank are proposing to the Board of Governors of the Bank to adopt a resolution authorizing the transfer from IBRD surplus, by way of a grant, to the TFL of US\$50 million;

(C) The Association is prepared to establish the TFL, to be trustee thereof and administer it on the terms and conditions set forth in this Resolution;

NOW THEREFORE it is hereby resolved that, subject to the adoption by the Board of Governors of the Bank of the proposed resolution referred to in paragraph B of the Preamble:

1. The TFL is hereby established, constituted of the funds which shall from time to time be contributed in accordance with the provisions of this Resolution, and any other assets and receipts of the TFL. The holding currency of the TFL shall be US dollars.

ATTACHMENT A

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2. The Association shall hold and administer such funds and receipts in trust (in such capacity, the Trustee) for the benefit of the member countries of the Association by providing financial assistance to Lebanon consistent with the Association's purposes; the Trustee shall manage and use them only for the purposes of, and in accordance with, the applicable provisions of the Articles of Agreement of the Association and the provisions of this Resolution, keeping them separate and apart from all other accounts and assets of the Association. The Trustee shall exercise the same care in the discharge of its functions under this Resolution as it exercises with respect to its own affairs and shall have no further liability in respect thereof. The privileges and immunities accorded to the Trustee shall apply to the property, assets, archives, income, operations and transactions of the TFL.
3. All amounts credited to the TFL from the grant of the Bank shall be used by the Trustee exclusively for the purpose of financing productive expenditures for emergency recovery projects in Lebanon on grant terms.
4. Pending the disbursement of financing from the TFL, the Trustee shall invest funds held in the TFL in accordance with the Association's policies and procedures for the investment of trust funds administered by the Association. The income from such investments shall be credited to the TFL.
5. The Association shall enter into agreements with the appropriate public or private entities or international organizations, to be identified as the recipients of grants, pursuant to such terms and conditions as provided in this Resolution.
6. The Trustee shall establish and maintain appropriate records and accounts to identify the resources of the TFL, the commitments and the reimbursements of expenditures financed out of the TFL, and the receipts and disbursements of funds in the TFL.
7. (a) The Trustee shall, as soon as practicable after the end of each fiscal year of the Association, furnish to the Executive Directors of the Association: (i) a report on projects financed from the TFL; and (ii) a management assertion together with an attestation from the Trustee's external auditors concerning the adequacy of internal control over cash-based financial reporting for trust funds as a whole. The costs of such attestations shall be borne by the Trustee.

ATTACHMENT A

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(b) If all funds in the TFL have not been fully committed within two years from the effective date of this resolution, no new commitments of remaining funds shall be entered into after that date. All disbursements against commitments shall be completed within four years of the effective date of this resolution. Any remaining assets of the TFL shall, unless the Trustee decides otherwise by decision of its Executive Directors, be transferred to the Bank.

(c) After all commitments from the TFL shall have been fully disbursed, the Trustee shall as soon as practicable furnish to the Bank a report on the operations financed from the TFL.

8. The Trustee is authorized to enter into agreements on such terms as shall be determined by the Trustee, with members of the Bank and other donors in order to co-finance assistance activities on a parallel basis with the TFL.

9. The functions of the Association as Trustee of the TFL shall terminate as indicated in paragraph 7 b., except for action necessary for winding up the activities of the TFL, in an expeditious and orderly manner, unless an extension of the termination date is decided by the Executive Directors of the Association.

ATTACHMENT B

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

(DRAFT)

REPORT OF THE EXECUTIVE DIRECTORS

Transfer from IBRD Surplus to Fund

Trust Fund for Lebanon

1. In view of the need for exceptional assistance to Lebanon following the war of July/August 2006, and in order to promote the purposes of the International Bank for Reconstruction and Development (the Bank) and the International Development Association (the Association) in these circumstances, the Executive Directors consider that a program of emergency assistance for economic and social recovery in Lebanon should be undertaken forthwith as an initiative for the benefit of the members of the Bank and of the Association. The Executive Directors recommend that the Board of Governors authorize the transfer from IBRD surplus of the amount of US\$50 million to the Trust Fund for Lebanon.
2. Accordingly, the Executive Directors recommend that the Board of Governors adopt the draft Resolution attached hereto.

ATTACHMENT B

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ANNEX A

**INTERNATIONAL BANK FOR RECONSTRUCTION
AND DEVELOPMENT**

**DRAFT RESOLUTION FOR SUBMISSION
TO THE BOARD OF GOVERNORS**

RESOLUTION No. ____

RESOLVED:

1. That the Bank transfer from IBRD surplus, by way of grant, US\$50,000,000 as of the effective date of this resolution to the Trust Fund for Lebanon, to be administered by the Association, such transfer to be drawn down by the Association immediately upon the establishment of the trust fund, and used in accordance with the resolution establishing the trust fund.
2. The amount of such grant may at any time be converted in whole or in part into other currencies as may be needed for the purpose of the trust fund.