

INTERNATIONAL MONETARY FUND

MIDDLE EAST AND CENTRAL ASIA DEPARTMENT



SYRIAN ARAB REPUBLIC—2008 ARTICLE IV CONSULTATION

CONCLUDING STATEMENT

DAMASCUS

October 29, 2008

Syrian Arab Republic

2008 Article IV Consultation

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I. INTRODUCTION

1. **The mission is thankful for the Syrian authorities' excellent cooperation.** It benefited greatly from interactions with government officials and representatives of the public and private sectors.

II. RECENT ECONOMIC DEVELOPMENTS

2. **Syria's overall macroeconomic performance remained strong in 2007.** Non-oil GDP growth is estimated to have been about 6 percent. This is a moderate slowdown compared to 2006 due to unfavorable weather conditions affecting agriculture. Virtually all other non-oil sectors continued to grow strongly. However, overall growth registered about 4 percent due to declining oil production. Inflation was reported at just below 5 percent.

3. **While the overall fiscal deficit increased to about 3 percent of GDP in 2007 the non-oil deficit remained stable.** This reflected a drop in expenditures by about one percent of GDP, as both current and capital outlays declined. This was achieved despite the pressure on budgetary expenditure arising from the large number of Iraqi refugees. Oil revenue decreased by about 2 percent of GDP as the net external oil trade surplus virtually disappeared. Non-oil receipts, also declined, partly reflecting the reduction in customs tariffs.

4. **The external current account deficit widened to an estimated 3.3 percent of GDP in 2007 (from 2.8 percent in 2006).** The net oil surplus (after subtracting the share of foreign partners) was eliminated due to a decline in output and an increase in domestic consumption. However, non-oil exports, tourism, and transfers, were buoyant partly as a result of strong regional demand and the relaxation of foreign exchange controls. Net foreign assets of the Central Bank of Syria (CBS) and the Commercial Bank of Syria (CBoS) stood at about \$17 billion.

III. NEAR- AND MEDIUM-TERM OUTLOOK

5. **The near-term growth outlook is expected to be affected somewhat by the adverse global and regional developments currently underway.** The worsening of the international financial conditions appears to have not affected Syria's financial sector since CBS regulations strictly limits banks' foreign exposure and given their limited integration with the global system. However, Syria is likely to be affected by a regional slowdown resulting from global financial linkages with other countries in the region, notably with the Gulf. Non-oil growth is projected at about 6 percent in 2008. The decline in oil output is likely to continue. Inflation accelerated in 2008, driven mostly by higher food and fuel prices. However, it started to decelerate in the last quarter of 2008 with the decline in international food prices, and is expected to register on average about 15 percent for the year.

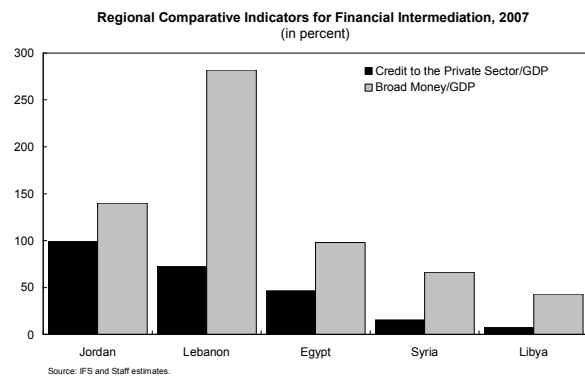
6. **The fiscal deficit is projected to remain at about 3 percent of GDP in 2008.** In nominal terms, the budget provides for a 10 percent expenditure growth over the 2007 outcome. It envisages a 4 percent increase in current expenditures and an 18 percent increase in capital outlays. In the absence of new fiscal measures, non-oil revenues and current

expenditures are projected to grow in line with GDP. Recent improvements in tax administration could, however, lead to a small improvement in the tax-to-GDP ratio.

7. **The authorities launched a program to phase out petroleum subsidies in May 2008.** Gasoline and diesel prices were increased by 33 and 240 percent, respectively. To mitigate the impact of the diesel price increase, the authorities issued coupons that would allow the bearer to purchase diesel at 9 SYP/liter. These coupons were available to all Syrian families and covered about 4.4 million tons, roughly the amount of local production of diesel. However, the cost of explicit oil subsidy increased due to the sharp rise in international prices during the first eight months of 2008.

8. **The external current account deficit is projected to widen to about 4 percent of GDP in 2008.** Import growth will decelerate somewhat, but will remain buoyant due to strong domestic demand. The growth of non-oil exports and tourism receipts may also slow down moderately as a result of the weakening of the regional outlook. The oil balance is envisaged to deteriorate further on account of declining output and expanding domestic consumption.

9. **Broad money is projected to grow by about 20 percent.** Growth of credit to public enterprise is projected to remain high (37 percent). Credit to the private sector is expected to accelerate somewhat to about 25 percent. The level of financial intermediation remains low, including by regional standards.



10. **The medium-term outlook is expected to improve as the global and regional slowdown comes to an end and the world economy begins to recover.** However, this positive assessment would be contingent on perseverance in advancing fiscal and structural reforms. If the pace of ongoing fiscal adjustment continues, it should offset the decline in oil revenue. Thus, the fiscal deficit could remain at about 3 percent and public debt below 35 percent of GDP. The current account deficit is expected to remain at around 4 percent of GDP. Non-oil growth would likely pick-up to about 6.5 percent while inflation would decelerate to mid-single digits. However, this outlook would be subject to considerable downside risk should Syria's fiscal and structural reforms efforts weaken or if the regional slowdown were to deepen or remain prolonged.

IV. POLICY DISCUSSIONS

11. Against this background, the policy discussions focused on three main areas: (i) fiscal policies and reforms needed to compensate for the decline in oil revenue; (ii) monetary and exchange rate policy; and (iii) structural reforms aimed at enhancing medium-term growth, with emphasis on the financial sector.

A. Fiscal Policy and Reforms

12. **In view of the decline in oil revenue over the medium term, the mission encourages the authorities to reduce the non-oil fiscal deficit by about 1 percent of GDP in 2009.** This can be mostly achieved by a combination of continued expenditure restraint, reducing oil subsidies, and strengthening tax administration.

13. **The mission encourages the authorities to take further measures to reduce the petroleum subsidies.** In this connection, the decision to raise fuel oil prices by 33 percent effective December 1, 2008 is welcomed. In order to maintain the progress made in reducing the non-oil fiscal deficit, it would also be important to limit other current expenditures to the budget allocations.

14. **The authorities' intention to rationalize capital outlays is encouraging.** Priority should be given to completing projects under construction. Strengthening procurement procedures and evaluation of the viability of investment proposals will also help maximize the return on investment. Consistent with the Tenth 5-Year Plan, and to ensure an adequate level of infrastructure investments, it would be important to continue to encourage private sector participation including through private-public partnership agreements with adequate safeguards.

15. **There is an urgent need to further enhance public expenditure management.** Priority should be given to improve monitoring of expenditures at the regional level. Establishing a single treasury account would help achieve this objective as well as improve expenditure control. There appears to be a large amount of extra-budgetary and quasi-fiscal operations that are conducted by public enterprises and financed by the banking system. It would be crucial to limit the expansion of credit to the public sector. These operations should be brought on budget, and the consolidated budget deficit should be primarily financed by treasury bills, the interest on which should be market-determined.

16. **Good progress is being made in preparatory work for the VAT.** The mission encourages the authorities to adhere to the new target date of 2010. Furthermore, it would be

important to implement integrated information technology systems and enact a tax procedure code. In addition, the authorities are encouraged to ensure that the Large Taxpayer Offices (LTO) and the five envisaged Medium Taxpayer Offices (MTO) report directly to the integrated Tax Commission. Adopt a single rate with few exemptions would also be in line with best practices.

B. Monetary and Exchange Rate Policy

17. **The mission welcomes CBS' commitment to maintaining a prudent monetary policy stance.** In this connection, public banks should be instructed to strictly limit directed lending. This should help reduce money growth and contain inflationary pressures. At the same time, it is important to develop indirect monetary policy instruments. Should the plans to launch treasury bills falter, the CBS would be encouraged to issue its own certificate of deposits. Consideration should also be given to establishing standing facilities at the CBS.

18. **The mission urges the authorities to work toward the goal of granting the CBS full independence to formulate and implement monetary policy.** Furthermore, CBS needs to gain full control over foreign exchange reserves. The ongoing transfer of the official foreign exchange reserves held by the CBoS to the CBS is encouraging.

19. **The mission welcomes the significant progress toward exchange rate unification was made on January 1, 2007** with the abolition of the official "budget" rate. The authorities switched the reference currency from the U.S. dollar to the SDR in August 2007. Since then, the pound has appreciated against the dollar by about 10 percent. In real effective terms, the pound appreciated somewhat more by end-June 2008. Preliminary econometric estimates, which are not reliable because of data and methodological shortcomings, suggest

that the real exchange rate of the pound may be moderately overvalued relative to its medium term equilibrium level. The mission recommends maintaining the current level of the nominal exchange rate in the present context, as this appears to be in line with market forces and consistent with the CBS' policy of containing inflation.

20. **For the medium term, the mission encourages the authorities to prepare the ground for allowing a gradual move toward greater exchange rate flexibility.** Increased flexibility would help maintain external stability over the medium term, given the prospective depletion of oil reserves. It would also facilitate a gradual increase in monetary policy independence.

21. **Private banks appear to be well capitalized.** The overall capital adequacy ratio for private banks was at 13 percent at mid-2008. This is above the minimum requirement of the CBS and the Basel Committee (12 percent and 8 percent, respectively). These ratios have not been calculated for public banks; these banks have been granting loans to some loss-making public enterprises. Credit to public enterprises, which is mostly provided by public banks, grew by nearly 40 percent in 2007 and by more than 60 percent in the first half of 2008. Such rapid credit growth could have adverse consequences for the banks and create large quasi-fiscal liabilities.

22. **The mission encourages the authorities to continue to follow up on the recommendations of the Financial Sector Assessment Program.** The CBS has started to address the deficiencies identified in the assessment of the Basle Core Principles of Effective Banking Supervision, including by efforts to improve the supervision of state banks, and it has prepared for the issuance of treasury bills. It would be important for the CBS to

accelerate its reforms, including by further enhancing its supervisory capacity. In addition, priority should be given to restructuring state banks and to ensuring that they operate on a commercial basis. Any necessary subsidies to strategic sectors or vulnerable groups should be provided directly from the budget in a targeted and transparent fashion, rather than through public banks. Compliance with prudential regulations by public banks needs to be enforced. Subjecting public banks to less stringent supervision than private sector banks could encourage risky lending practices. All banks should be subject to annual audits by independent firms and produce reliable financial soundness indicators.

C. Structural Reforms and Other Issues

23. **The continuation of the current strong economic growth is contingent on advancing the authorities' wide-ranging structural reform agenda** to increase private investment. The mission welcomes the steady progress in opening up different sectors, including telecommunication. Progress has also been made in reducing import tariffs and shortening the import negative list. It would be crucial to sustain the reform momentum in these areas.

24. **Staff encourages the authorities to accept the obligations of Article VIII of the IMF's Articles of Agreement.** The authorities should remove any remaining foreign exchange restrictions and multiple currency practices. Making further progress in liberalizing the foreign exchange market, and refraining from introducing regulations to tighten control would help strengthen confidence and eliminate the parallel market.

25. **The mission welcomes the ongoing efforts made to enhance the framework for anti-money laundering and combating the financing of terrorism.** It encourages the

authorities to continue working with the regional groups and international institutions in advancing the framework.

26. **Staff urges the authorities to improve data quality and provision to facilitate surveillance and inform economic policy.** Data quality and provision are significantly below what has been achieved by countries that are at a similar stage of development.

Table 1. Syrian Arab Republic: Selected Economic Indicators, 2004–08

	2004	2005	2006	Prel. 2007	Proj. 2008
(Change in percent, unless otherwise indicated)					
National income and prices					
Real GDP	6.7	4.5	5.1	4.2	5.2
Oil	-6.1	-8.6	-7.1	-5.0	-0.1
Non-oil	10.1	7.5	6.9	5.9	6.0
Nominal GDP (LS billions)	1,263	1,491	1,709	2,025	2,433
Of which: Non-oil	986	1,134	1,305	1,558	1,886
Nominal GDP (\$ billions)	25.0	28.6	33.5	40.5	43.4
Crude oil production ('000 barrels/day)	462	431	400	380	380
GDP deflator	10.9	12.9	9.1	13.7	14.2
Oil export price (\$ per barrel)	33.4	48.3	57.9	63.0	87.5
CPI period average	4.4	7.2	10.4	4.7	14.5
Total population (millions)	18.8	19.3	20.4	20.8	21.3
Of which: Iraqi Immigrants (millions)	0.8	0.9	1.5	1.5	1.5
(In percent of GDP, unless otherwise indicated)					
Government finances					
Revenue	27.2	24.0	25.5	22.3	22.4
Oil-related revenue	11.2	7.1	7.3	4.9	5.2
Non-oil revenue	16.1	16.9	18.2	17.3	17.2
Expenditure	31.4	28.5	26.6	25.7	25.5
Current expenditure	19.0	18.1	16.3	16.1	16.0
Development expenditure	12.4	10.4	10.3	9.6	9.5
Overall balance	-4.2	-4.5	-1.2	-3.4	-3.1
Non-oil budget balance	-15.4	-11.6	-8.5	-8.4	-8.3
(Changes in percent of initial stock of money)					
Broad money					
	11.1	11.5	9.4	9.8	19.0
Net foreign assets	5.4	0.7	-2.3	-2.0	4.0
Net domestic assets	5.8	10.8	11.7	11.9	15.0
Credit to government	2.8	6.1	0.3	-3.1	-0.7
Credit to public enterprises	0.5	1.7	3.4	7.6	9.2
Credit to private sector	4.3	6.9	3.5	4.3	5.7
Credit to private sector (change in percent)	35.0	45.9	17.9	20.2	24.5
Credit to private sector (in percent of GDP)	11.7	14.5	14.9	15.1	15.6
(In billions of U.S. dollars, unless otherwise indicated)					
Balance of payments					
Current account balance	-0.4	-0.6	-1.0	-1.3	-1.8
(in percent of GDP)	-1.5	-2.3	-2.8	-3.3	-4.0
Overall oil balance 1/	1.3	0.6	0.1	-0.9	-1.4
(in percent of GDP)	5.2	2.0	0.4	-2.1	-3.0
Non-oil exports of goods and services	6.4	7.7	9.1	11.2	13.4
(change in percent)	99.2	20.4	18.6	23.5	19.1
Non-oil imports of goods and services	-9.3	-10.4	-12.1	-14.0	-15.8
(change in percent)	20.8	12.5	16.1	15.4	12.9
Overall balance	0.2	0.0	-0.8	0.7	0.1
Official net foreign assets	17.6	17.6	16.8	17.5	17.6
(in months of imports of GNFS)	18.2	13.7	11.3	9.4	7.6
Weighted average nominal exchange rate LS/\$ 2/	50.5	52.2	51.0	50.0	45.7
Real effective exchange rate (in percent, + appreciation)	0.0	1.7	10.7	4.7	...

Sources: Syrian authorities; and Fund staff estimates and projections.

1/ Oil trade balance less profit of foreign oil companies.

2/ Trade-weighted average of official and parallel market rates before 2007. For 2008 data are for July.