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Reconstruction and Development Issues in Lebanon

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Introduction: Lebanese economic thinking from Independence to the war

Lebanon has been considered before 1974 as the most advanced Arab economy on many different grounds. It was not only the most opened economy in the Region, functioning under a deregulated and decentralised system, but it also enjoyed the best basic infrastructures in terms of communications, telecommunications, tourist facilities, education and modern health system. In addition, Lebanon had at that time one of the highest Arab per capita income of approximately US $ 1250. Its currency was amongst the strongest currencies in the World; between 1964 and 1974 it appreciated from L.P. 3.2 to L.P. 2.5 to the US dollar. The State had no external debt and an insignificant amount of domestic debt. The Lebanese Central Bank, created in 1964, was enjoying a high degree of autonomy from the State authorities and did not engage in any type of credit administration and was not, as the case in many other developing countries, the equivalent of a Government agency refinancing a fragmented credit market or monetizing the Treasury deficit. Lebanon used to be called the "Switzerland" of the Arab World, hinting not only at its economic and financial performance, but also at the beauty of the country and the relatively well managed political system of distribution of power between the leadership of its different religious sects.

It is to be noted that since Independence in 1943, economic thinking in Lebanon was central to many political issues. Economic liberalism has been at the centre of political aspirations and almost a key element in the formation of the political consensus leading to independence. The various regulations and constraints imposed by France on the Lebanese economy had been deeply resented by the large and affluent families of traders or real estate owners. This is why a large consensus developed that Independence should lead to both political and economic liberalism. This consensus led in 1950 to the breaking of the custom union between Lebanon and Syria which economic policy was more inward looking and protectionist in favour of industry.

It is interesting to note that since the first days of Independence Lebanese economists would think the development of their country in terms of Reconstruction and State
Reform and that the issue of taxation and social justice was already in the mind of some of the most prominent economists or reformers.

Although forgotten during the fifties, the social justice issue and the overall human development approach were back in the sixties after the political disruption endured by the country in 1958. General Fouad Chehab who became President with both American and Egyptian support to put an end to sectarian violence, proved to be a devoted reformer. He called upon a French team of experts headed by the famous Abbé Louis Lebret, a man who had devoted his life to promoting socially sustainable and well balanced growth process. A new generation of young Lebanese economists acquired experience under the intellectual influence of Louis Lebret and Chehab reformist ideas. A considerable amount of data on all Lebanese regions was gathered showing the big discrepancies between Central Lebanon and Beirut and the rest of the country. Inside Beirut, the data showed the dangers of great economic and social imbalances between some prosperous parts of the capital and the growing shanty town areas.

During General Chehab presidency (1958-1964) the State was reformed and strengthened and the Central Bank of Lebanon was established. A Ministry of Planning was created together with a very strong Direction Centrale de la Statistique (DCS). DCS became quickly an effective organization producing fundamental economic data on solid basis (GDP, Balance of Payment, Industrial Census, Active Population census, etc...). Such data has been previously estimated by various non governmental sources as the Economic Department of American University of Beirut or some foreign embassies.

From 1964 to 1974 the economic growth of Lebanon was remarkable, except in year 1967 when Intra bank crisis of October 1966 and the Arab-Israeli war of June 1967 combined to produce a decline in GDP. The deterioration of the political climate of Lebanon was marked by the civil war of 1975-1990.

1 See in particular G. MENASSA, Plan de Reconstruction de l'Economie libanaise et Réforme de l'Etat, 634 pages, published by the Société Libanaise d'Economie Politique (S.L.E.P.), Beirut, 1946. Mr. Menassa was at the time President of S.L.E.P. and this major book was published with the collaboration of J. NAGGEAR, Vice-President, who became later in the sixties Minister of Planning. See also G. CORM, "Ruptures et continuités dans la pensée et les politiques de développement et de reconstruction au Liban depuis l'indépendance", in Proche-Orient études économiques, N° 43, November 1994, Université Saint Joseph, Beirut.

the country by the end of sixties did not affect economic growth. This deterioration is to be attributed to the first big Israeli attack on Lebanon in December 1968 and the increasing tensions between the Lebanese Army and the Palestinian Resistance Movements, in spite of the Cairo agreements between the PLO and the Lebanese Government signed in October 1969. The ever-growing inflow of money into Lebanon contributed to further strengthening of the Lebanese pound and to a rapid increase in banking assets.

The explosion of violence in April 1975 did not bring a stop to the growth of the banking sector. Despite full scale war between Lebanese and Palestinian factions and the heavy losses in properties and lives, the consumption levels remained high. A redistribution of economic activities from the commercial district of down-town Beirut to its Eastern and Southern peripheries or to provincial capitals like Saida, Tripoli and Zahlé, provoked a remarkable but uncontrolled real estate boom, fuelled by the very high earnings of the Lebanese who had massively migrated to the oil booming economies in the Arabian Peninsula or Iraq. When Israel invaded Lebanon in 1982, total assets of the banking sector had jumped from the equivalent of $ 5 billion in 1977 to $ 14.6 billion at the end 1982 in spite of seven years of violence and political destabilization3.

In 1977 a Conseil de la Reconstruction et du Développement (CDR) was created to rebuilt the basic infrastructures destroyed. The Ministry of Planning was consequently suppressed together with the DCS which data basis, archives and equipment had been annihilated by the war. The country will thus remain deprived of the capacity to produce any official statistics. The CDR was granted extensive administrative power over technical ministries and Government autonomous entities for public services (water, electricity, telephone). As hostilities resumed in Lebanon in 1978 and would remain permanent up to 1990, the CDR will not be able between 1978 and 1990 to implement its various reconstruction plans including those related to the reconstruction of the historical part of Beirut heavily damaged by the fighting that took place in 1975-764. The CDR will also abstain from formulating institutional and

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4 On the importance of CDR before 1992, see M.ISKANDAR & E. BAROUDI, op.cit.
policy framework to guide reconstruction, while this had been a preoccupation of
World Bank's three years program prepared for Lebanon in 1982/19835.

The last years of violence in Lebanon between 1983 and 1990 were extremely
disruptive as the Israeli army engineered more bloodshed between rival Lebanese
militias in the part of Lebanon under its occupation. Between 1984 and 1987 the
Lebanese pound endured a steep decline from L.P. 3.81 to L.P. 455 to the US dollar;
total deposits in the banking system declined from the equivalent of US $ 11.5 billion
in 1982 to $ 3.1 in 19876. The outcome of this loss of confidence in the traditionally
strong Lebanese currency was a dollarisation of the private sector activities and of the
largest part of domestic savings. Thus deposits in Lebanese Pound declined from 71%
of total deposits in 1982 to 7.7% in 1987, but were back to 20% in 1988 and 32.5% in
19897. In 1989-1990, the violence between the official Lebanese army under the
command of General Aoun and the so called Christian militia of the Lebanese Forces,
coupled with heavy exchange of fire with the Syrian army was the last episode of the
war in Lebanon but a very destructive one in terms of material losses. When General
Aoun was finally subdued in October 1990 (later exiled to Paris), the Taïeff
agreement of 1989 could begin to be implemented.

It is interesting for our analysis to note that the governments of so called National
Unity that came to power in Lebanon since the end of 1990 under a Saudi-Syrian
umbrella concretised an economic alliance between new wealthy Lebanese
contractors which fortune originated in the Gulf countries and the new wealthy
political establishment which fortune originated in the economic hegemony achieved
by Lebanese militia leaders between 1975 and 1990. This new group consisting of a
former militia leaders turned into business and community leaders allied to influential
wealthy contractors with strong business connections in the Gulf region, Europe and
the USA, will impose a new approach to reconstruction and reform in Lebanon8.

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5 See A. SBAITI, "Reflexions on Lebanon Reconstruction" in Peace for Lebanon? From war to
reconstruction, edited by D. COLLINGS and published in association with the Canadian Institute for
6 IFS, (op.cit.)
7 Figures from Bank of Lebanon Quarterly Bulletins for the period concerned.
8 On the new elite and its reconstruction ideology, see G. CORM, La reconstruction : idéologie et
paradoxes, in Les Cahiers de l'Orient, Quatrième trimestre, 1993, Paris; and on militia economic
hegemony, G. CORM, Militia hegemony and the reestablishment of the State, in Peace for Lebanon,
op.cit.
The new approach to reconstruction and reform in Lebanon

The approach taken by the new group of leaders promoted by the implementation of Taïeff agreement has totally changed the traditional focus of Lebanese economic thinking as briefly evoked in the previous historical part of this paper. The main features of this new approach could be characterised as follows:

a) In spite of 15 years of dramatic social distortions in Lebanon due to the war, the new team will not pursue in the reconstruction program the sustainable growth and regionally balanced development policies that had characterised pre-1977 planning efforts. As previously mentioned, the shift was already noticeable in the first CDR reconstruction program.

b) In addition, no special urgent attention will be given to the pollution issue, a major problem after 15 years of war during which tons of waste have been accumulated in Beirut and all around the country with no treatment whatsoever; it was also to be discovered that thousand of barrels of toxic wastes had been imported from Italy during the last years of the war. The amounts envisaged in the Reconstruction Plan are not of the magnitude required by the acute need of the country.

c) The State reform will be envisaged mainly in terms of privatization and discharging the State from a strong role in promoting and regulating reconstruction activities. Although the Lebanese State, contrary to the other Arab or Developing States, has traditionally been restricted to a very thin role in the economy, particularly in terms of economic regulation of the large and powerful Lebanese private sector, as well as in terms of securing a minimal redistribution of revenues to the lower strata of the population, the new approach will ignore these problems. On the other hand, no remedy has been developed or thought of to size down the number of unproductive and low paid civil servants and to reinvigorate civil service in terms of professional qualification and remuneration upgrade.

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9 See H. CHARIF, *Regional development and integration*, in Peace for Lebanon? From war to reconstruction, op.cit.
10 However one should take note of a World Bank loan of $ 25 millions for Public Administration Rehabilitation the content of which is not yet public; but which probably will consist of financing hardware equipment and some training needs attached to using such equipments.
The main advisors to the CDR, the sole State institution in charge of reconstruction policy, have been private consulting engineers firms (Bechtel and Dar Al Handassah) and not, as during Chehab period, an independent non profitable advisory institution with large experience in development issues.

These basic observations being made, the new Reconstruction approach had a very strong formal coherence and appeal that might explain the unqualified support generally received by the economic policies followed in Lebanon since the beginning of the Taieff agreement implementation. This approach could be summarized as follows:

1. It emphasises as the basic goal for reconstruction policies that of restoring Beirut commercial and financial importance in the new Middle-East economy characterized by attempts at solving the Arab-Israeli conflict and by structural adjustment and more opening of Arab economies, as well as attempt to create a middle-eastern trade zone including Israel and its Arab neighbours.

2. This basic goal is to be achieved through priority given in the reconstruction program to:

   a) the creation of the largest real estate company in the Arab World (SOLIDERE) entrusted with the reconstructing the historical and commercial down town area of Beirut and empowered by law:

      − to expropriate all property right holders numbering 120000 and compulsorily transform them into shareholders of the Company
      − to design the plan of the new town
      − to execute the rehabilitation of the infrastructure
      − to carry on real estate promotion and future maintenance activities
      − to reclaim several thousand square meters of land on the see.

The law (N° 117 of December 1991) excluded the Sate and Beirut municipality from any control on the operations of the Company.

With a capital of $ 1.6 billion, trading in the company's share would be the cornerstone of a capital market designed to play a regional role.
b) the implementation of a large program of transport and telecommunication infrastructure:

- an airport designed to accommodate 6 or 7 million passengers a year,
- a network of highway around Beirut and linking Beirut to Damascus and other regional capitals,
- an International Conference Centre with a luxury hotel of 1,000 rooms to be built on the public domain on the front of the sea in Ras Beirut area,
- a plan for a one million telephone line network and a complementary system of cellular telephone.

c) a sharp decrease in direct taxation to attract Arab and international capital in Lebanon and reactivate the role of Beirut as regional financial centre.

3. This approach has been concretised by two basic documents: the law on the creation of SOLIDERE adopted by Parliament in December 1991 and the Horizon 2000 Plan for infrastructures adopted by the Council of Minister and that the CDR is managing. The plan covers the period from 1992 to 2002 with a level of public investment expenditures of US $ 11.7 billion in constant dollars. This amount is divided between $ 10.5 billion of physical investment and US $ 1.2 billion of grants and credit support to the private sector. The initial three years portion of the Plan envisages an investment of US $ 3.9 billion to remove critical bottlenecks in electricity, water and telephone supply, roads and other basic infrastructure as the port of Beirut, the public schools and hospital rehabilitation.

SOLIDERE Law as well a Horizon 2000 have been the object of very hot debates inside Lebanon but that have received no attention on the regional or the international scene. The successful share issue of $ 600 million at the end of year

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1993 for SOLIDERE to raise liquid funds strengthened the image of a revival of Beirut as a financial centre and a new emerging market. No in-depth discussions of the constraints and shortcomings of the present economic policies in Lebanon, took place except inside Lebanon, although the main media vehicles would not report the technical criticism expressed about reconstruction policies.

Although the Mexican crisis in December 1994 has made international investors more cautious about so called emerging markets and in spite of a growing social crisis in Lebanon, the Lebanese authorities approach to reconstruction and reform have not been amended to take into consideration the numerous remarks and criticisms. The belief in the soundness of the basic assumptions dictating reconstruction issues is more solid than ever in the eyes of the new governing elite. Its feeling is that as the Peace process advances in the Region, Lebanon should accelerate the implementation of the ambitious US $ 11.7 billion of spending on rehabilitation of the main infrastructure of the country, so that Beirut could restore its pre-war position as the most attractive Arab Tourist and Financial Centre of the region. No consideration is given to the major changes that had taken place in the region during the last twenty years and to the urgent domestic social needs after 15 years of violence and destruction.

**Main issues in the present economic condition in Lebanon**

1. **The lack of basic economic data and in particular the exact level of GDP**

   A central problem in any debate about Lebanon economic policy is the lack of fundamental data based on effective census and sampling. Thus we do not know the exact level of GDP so as to be able to derive with a certain degree of precision the main ratios needed to analyse the coherence of the economic scenario behind the Reconstruction policy. No population census has been made and we do not know the number of buildings damaged and the number of new square meter of construction since 1975. As already mentioned, since 1975 the Directorate of Statistics has been cancelled and its data basis disbanded. It is only last year that the Council of Minister re-established the legal existence of the Directorate and appointed Dr. Kasparian who has been the pillar of the pre-1975 DCS, to head the reinstate Directorate with a reduced budget. Therefore there is yet no official figures for the main macro-economic aggregates contributing to the formation of GDP.
The only reliable figure available for the GDP of Lebanon dates back to a 1988 survey financed by UNDP on which the most reputable Lebanese economists have worked to arrive at a GDP figure for that year. The estimate reached US $ 3.3 billion or US $ 1160 on a per capita basis equivalent to that outstanding in year 1974 in current dollars\(^\text{12}\). For 1992 estimates of GDP ranges from $ 3.8 billion (Bankers Association, Annual Report 1991/1992) to US $ 6.5 billion (Banque Audi, Secretariat for Planning and Development), while a recent published IMF document on Lebanon (Occasional Paper 120, February 1995) States a figure of $ 5.1 billion jumping to $ 7.7 billion in 1993. This artificial jump is due to an increase of 21% in the CPI in L.P. and an estimated growth rate of 7% added to a 2% appreciation in the exchange rate (in spite of 21% rate of inflation).

On the other hand, the most recent economic scenario of the Government, as presented to Parliament together with the 1995 budget law based its GDP projection between 1995 and year 2007 on the basis of $ 8.5 billion for 1994 in terms of the price of the "basic year"\(^\text{13}\); but this year is not explicitly mentioned and one can suppose that it is year 1992 where the $ 11.7 billion Plan was announced. In current price, this would mean a GDP of more than $ 11 billion for year 1994.

With such confusion in GDP figures any economic policy could be justified or criticized, especially in relation to the most debated issue in Lebanon today which is the level of affordable indebtedness given the size of the economy and its very low productive basis, an issue that we will discuss later in this paper. In fact, the confusion about GDP figures stems from the phenomenon of the dollarisation economy which has not yet been properly analysed and which will be discussed in the next paragraph.

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12 See UNDP/Leb/89/001 for the result of the survey. However other sources for same year indicate a GDP of $ 2.6 billion. The confusion about GDP series since 1974 could be seen by looking at table 74, page 193 in B. LABAKI, Bilan des Guerres du Liban, L'Harmattan, Paris, 1993, and Table 1 of the Statistical Annex of Le livre blanc de l'économie libanaise, published in Beirut in 1993 by RDCL (Rassemblement des dirigeants et chefs d'entreprises libanais), as well as Table XII.1 for the period 1970-1980, p. 361 in M. SKANDAR and E. BAROUDI, The Lebanese economy in 1982-83, Middle East Economic Consultants, Beirut, 1984.

Our own estimate of the GDP for 1994 based on discussion with several Lebanese economists envisages a level of $6.8 billion in 1994, taking into consideration the following assumptions:

- a GDP level in 1988 of $3.7 billion, increasing UNDP estimates by 16% to correct potential under valuation of the GDP at that time,
- an average rate of domestic inflation in dollar term of 10% per annum from 1988 to 1994,
- an annual percentage of real decrease or increase in GDP as per official figures and IMF figures to be found in the IMF document already mentioned.

2. The dollarisation of the economy and the linkage between inflation rate and exchange rate

To our knowledge, no objective discussion has taken place on the harm done to the economy by allowing its dollarisation to the point were:

- a basic component of M1 is US dollar bank notes not included in the official figures of currency in circulation
- only the Public Sector continues to conduct its transactions in domestic currency, including the issuance of T bills, while private sector activities are mainly conducted in dollars including credit facilities extended by banks (90% of total lending)
- the largest part of domestic savings (70%) is still kept in US dollar in spite of the stability of the exchange rate in the last two and a half year.

Given the intricacies of the issues involved, we will only briefly question the economic "wisdom" that has developed in Lebanon concerning the dollarisation of the economy considered as a positive factor not impeding economic growth.

a) since the steep decline of the Lebanese pound in 1985/87 the Authorities have taken no measure whatsoever to preserve the value of financial assets or liabilities denominated in Lebanese pounds, as other countries did in Latin America or as in the case of Israel. This total "laissez faire" policy has allowed debtors in LP to avoid reimbursement and savers in L.P. and salary earners in L.P. to be ruined by the crumbling of the L.P.
b) the exchange rate fall has been highly manipulated during 1983/1987 period when the L.P. felled from its average level of 4.73 to the US dollar in 1983 to its average level of L.P. 225 in 1987 with a peak at L.P. 498 in November of this year; the same happened during 1992 when the L.P. felled to its lowest level of 2560 to the US dollar in spite of the restoration of political stability in the country. It should be noted here that up to September 1988 the L.P. remained on average well below the level of 400 to the US dollar and that at the time of the Taïeff agreement in the last quarter of 1989 it fluctuated between 450 and 500 to the US dollar.

c) the restoration of political stability and security at the end of 1990 led the Central Bank to a policy of administered exchange rate preventing a sharp appreciation of the L.P. vis à vis the US dollar that should have taken place, if spontaneous market forces have been left free; later, in 1992 when speculation against the Pound began, the Central Bank tried in vain to control the market and administer the exchange rate to avoid a decline in the L.P. rate. Since October 1992, the same policy of administered rate has been implemented preventing a substantial appreciation of the L.P. rate vis à vis the US dollar against positive market forces then, in the last months, preventing a depreciation in the front of a change in mood in the market.

d) Inflation measurement in Lebanon should take into account the dollarisation of Private sector activities and savings since 1986/87. Price increases in domestic currency might not have the same impact on revenues and consumption in a dollarized economy than in an economy based on the domestic currency as the main storage of value. This might explain why there is no consistent relation between inflation and variation of exchange rate as shown by the following figures. If this is the case, then exchange rate variation reflect either speculation or artificial exchange rate administration by the BOL when speculators are dormant. The following figures show the difficulty of reconciling inflation rates with exchange rates annual changes:
<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation rate in L.P.</th>
<th>Exchange rate (end of period)</th>
<th>Exchange rate (yearly average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>72.2 %</td>
<td>+ 5 %</td>
<td>- 81 %</td>
</tr>
<tr>
<td>1990</td>
<td>68.8 %</td>
<td>- 67 %</td>
<td>- 41 %</td>
</tr>
<tr>
<td>1991</td>
<td>51.5 %</td>
<td>- 4.4 %</td>
<td>- 32 %</td>
</tr>
<tr>
<td>1992</td>
<td>120 %</td>
<td>- 109 %</td>
<td>- 85 %</td>
</tr>
<tr>
<td>1993</td>
<td>29.1 %</td>
<td>+ 7.24 %</td>
<td>+ 2 %</td>
</tr>
<tr>
<td>1994</td>
<td>8 %</td>
<td>+ 3.88 %</td>
<td>+ 1%</td>
</tr>
</tbody>
</table>

**e)** Due to the fact that there is a very high rate of dependence on imported input in the formation of local value added and due to the fact that the Lebanese economy is an open economy with no domestic bottlenecks, my own belief is that a strong causal relationship exists between the depreciation of the exchange rate and the domestic inflation rate and not the opposite. This relation is best shown by comparing the inflation column with the average annual exchange rate fluctuation, while there is no consistent relation between inflation and end of rate period, except for years 1990 and 1992.\(^{14}\)

**f)** In addition, in the last ten years there has been a permanent net surplus in the balance of payment except for year 1992 (- $ 54 million), ranging from a minimum of $ 32 million in 1987 to more than $ 1.1 billion in each of the years 1993 and 1994, in addition to $ 1 billion in 1991; such figures confirm our analysis of the succession of phases of speculation against the L.P. and administration of the exchange rate that governs the foreign exchange market in Lebanon with no relation whatsoever to economic fundamentals.

**g)** Where should the Lebanese pound stands today in relation to the US dollar is a question open to debate. One could argue that it is grossly overvalued and maintained artificially high since 1992 by the overgenerous interest rates granted on T bills (an issue we will discuss in the next pages) that have attracted Lebanese and Arab savings abroad. But the opposite argument could

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also be well developed. After all, the exchange rate was standing around 450-500 in 1989 and around 500-700 in 1990 while unending violence and political hysteria were still paralysing the economy. Why then should the exchange rate be standing to-day at 1625 for one US dollar when the country is no more enduring violence (except in the border area with Israel) and is enjoying a strong economic and political leadership devoted to reconstruction, in addition to a continuous large inflow of Lebanese capital allowing to cover the huge deficit of the current account balance? Could the budget deficit alone explain the demise of the L.P.? These are questions to be seriously debated for the future of Lebanon.

3. The deficit of the State

This is another issue clouding the prospects of a solid economic recovery and which is not being properly addressed. It is to be noted that the economic scenario of the Authorities, referred to previously, envisages that the public deficit estimated at $ 2.4 billion approximately in 1995 (including reconstruction expenditures) will steeply decline between 1995 and year 2003 to reach a surplus position in year 2005 in constant dollar. The scenario envisages a turnaround in the ordinary budget deficit (excluding reconstruction expenditures) in year 2000 with surplus increasing from $ 160 million that year to $ 600 million in year 2002 (with a surplus in total budget operations, including development expenditures, taking place in year 2004 as already mentioned)\(^\text{15}\).

In fact one of the central issues in the debate about the Reconstruction Plan is the financing constraint\(^\text{16}\). The CDR in its various Progress Reports sounds confident about the availability of various types of financing, including BOT schemes (already implemented for the cellular telephone system). Up to now approximately $ 2 billion of foreign financing has been contracted ($ 1.6 billion in loans and $ 400 million in grants). In addition, the economic scenario of the Authorities envisages development expenditures of more than $ 10.7 billion (in constant

\(^{15}\) It is to be noted that a previous scenario elaborated by the CDR and handled to the Parliament in the spring of 1992 was envisaging a surplus in the ordinary budget operations beginning 1996 and that would finance up to 60% of the reconstruction program.

\(^{16}\) In a recent article, Professor Elias Gannagé, a highly respected and well known Lebanese economist expresses its doubt about the realistiveness of the Reconstruction Plan not only in terms of funding, but also in terms of the very high annual rate of investment implied by the Plan (38% on average for the first five years). Professor Ghannagé in this stimulating study compares IRFED mission Plan of 1964 to Hariri Plan of 1992. See "Du Plan "Lebret" au Plan "2000" : étude comparative", in Proche-Orient études économiques, op.cit.
dollars) between 1995 and year 2005 almost totally financed by domestic and foreign borrowing.

It is to be noted however that the budget deficit (including development expenditures) has jumped from L.P. 1260 billion in 1992 to L.P. 2800 billion in 1994 representing more than 55% of total expenditures\textsuperscript{17}. In consequence, the amount of T bills has jumped from L.P. 2 333 at the end of 1991 to L.P. 9 339 by September 1994 or more than US $ 5.6 billion against the equivalent amount of US $ 2.6 billion at the end of 1991\textsuperscript{18}. The increase in L.P. is thus 4 times, while expressed in US $ it is 2.15. However the percentage of implementation in the Reconstruction Plan which first urgent recovery program began in 1992, varied in May 1994 only between a minimum ratio of 0.6% (health and social affairs) of contracts awarded by CDR and a maximum ratio of award of 37% for solid waste disposal, the average percentage being in the range of 8% to 12%\textsuperscript{19}. At the same time, it is to be noted that the ordinary budget deficit (i.e. without Reconstruction expenditures) has jumped from L.P. 452 billion in 1992 to L.P. 1450 in 1994\textsuperscript{20}.

To tackle this dramatic situation no overall plan has been adopted. The financing of the budget deficit has been obtained at very high cost from domestic resources as the average yield offered to subscribers of T bills has been around 20% in 1993 (16% above the US dollar interest rate for three months deposits, while the currency was stable and appreciated by 7.24% during that year and around 19% in 1994 while the currency appreciation continued at the rate of 3.88%).

Curiously, the Authorities borrowed at such high rates in 1993 and 1994 more than the Treasury needs as shown by the sharp increase in Public Sector Deposits with the Central Bank from L.P. 927 billion at the end of 1992 (US $ 500 million) to 2749 billion (US $ 1.65 billion) by September 1994\textsuperscript{21}. It is not clear if this policy originated in the desire to attract more inflow of capital from abroad and strengthen BOL foreign currency reserves or to constitute liquid reserves for the State and the CDR to spend on reconstruction programs to meet expected shortcomings in foreign funding.

\textsuperscript{17} See Ministry of Finance document to Parliament on 1955 budget, \textit{op.cit};

\textsuperscript{18} Bank of Lebanon Quarterly Bulletins.

\textsuperscript{19} CDR, Progress Report, January 1995

\textsuperscript{20} 1995 Budget Presentation Document.

\textsuperscript{21} Bank of Lebanon Quarterly Bulletins.
In any case the cost of this policy has been very high as the burden of servicing the domestic debt constitutes now by far the largest item in budget expenditures reaching L.P. 1 600 billion approximately in 1994 or the equivalent of $1 billion on total Budget expenditures of L.P. 4 100 billion (US $2.5 billion), to which one should add approximately more than L.P. 1 300 of additional unbudgeted expenditures disbursed through Treasury advances.

Another puzzling factor in the fiscal policy being followed by the Authorities is the drastic cut in direct taxation to attract foreign investment and to incite the private sector into effectively paying a reduced amount of income tax (10% flat on all types of activities) and 5% on share dividends. It should be noted in this respect that the share of direct taxation in the total receipts of the State was already low when Lebanon was enjoying a booming economy from 1960 to 1974 standing at around 22% of total State receipts with the income tax representing about 10% only of such receipts. The total tax burden related to GDP was standing at 12% in 1972, a very low rate indeed.

Today, as we do not know exactly what is the level of GDP it is difficult to estimate the tax burden compared to GDP. There is also no detailed figures about the collection of various taxes. According to the last report of Bank of Lebanon for the year 1990-1992 (P.62), direct taxes (including registration taxes) amounted to 17.8% of total State receipts in 1992 (L.P. 183 billion on a total tax receipts of L.P. 1 031 billion) before implementation of the tax reform bringing income tax to the flat rate of 10% beginning in 1994. Unfortunately no such figures are available for 1993 and 1994.

Total tax receipts however according to the 1995 Budget presentation to Parliament was standing at

- L.P. 982 billion in 1992 (a totally different figures of that of the BOL Report),
- L.P. 1855 billion in 1993 (when the rate of inflation has been 29%)
- L.P. 2200 billion approximately (L.P. 1880 billion up to end October) in 1994 in which the rate of inflation was estimated at 8%.

If GDP in L.P. as estimated by the IMF was standing at L.P. 13 122 billion in 1993 the tax burden this year was 14.1% only. In 1995, assuming an increase in current GDP of 14% (9% inflation and 6% growth) the ratio of tax to GDP increases slightly to 14.7% as compared to 12% in 1992.
As the level of domestic State indebtedness is already very high, the real issue here is to know whether the financing of the Reconstruction Plan could take place without a significant increase in taxation, and namely in direct taxation given the already high rate of indirect taxation. It is to be noted here that the Lebanese commercial banking sector is already financing 75% of the T bills issued, with an additional 6% financed by BOL (September 94). While Lebanon banking sector has traditionally financed exclusively the private sector, we are now in a situation where the ratio of lending to the State increased from 31% of total domestic lending in 1990 to 46% in September 1994. T bills subscriptions by the Lebanese banks represents now 87% of their resources in L.P. a very high ratio given the volatility of L.P. deposits in the banking system in case of any new wave of speculation against the domestic currency. It is to be noted also that the average maturity of deposits ranges between 30 to 40 days, while the average maturity of T bills issued has been lengthened in the last two years to reach 316 days at the end of 1994.

4. The real estate boom and its links to saving behaviour

From 1977 to 1983, as already mentioned, an important part of Lebanese savings went to the real estate sector. The market declined dramatically between 1984 and 1990, but has revived since then and is now on a booming trend again in spite of inflated prices and although it is estimated that approximately 30% of new buildings constructed since 1977 are empty. As is well known, renting has disappeared due to the successive laws blocking rents in favour of tenants. In spite of new laws allowing for a gradual increase in old blocked rents, real estate owners continue to prefer selling apartments or offices to renting them. Given the very high level of savings in the richest strata of the population which have enough wealth to self-finance new constructions, there is no effective market to regulate real estate prices. As is many Arab countries, real estate promotion is considered the best local investment, safeguarding the value of money invested in the middle term and granting economic prestige to building owners. Rather than selling at lower profit level than envisaged, self-financed owners prefer to keep empty buildings waiting for the market to reach the desired level and reap the full amount

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22 Lebanese Banks Associations, Monthly Bulletin N° 1/95, January 95, Table 10, page 51.
23 Real estate experts estimate that 42000 appartments in Beirut are empty (see Commerce du Levant, November 1994, Beirut, p. 48).
24 Credit to construction in the banking sector is no more than 9% of total credits granted to private sector (BDL Quaterly Bulletin N° 62, 3rd Quarter 1994, p. 10-11).
of profit they have initially envisaged which rate is usually in the range of 30% to 50% in constant terms of initial investment. In addition, construction of luxury apartments is a predominant feature of the real estate sector in Lebanon in spite of the huge needs for low cost housing.

Given the present boom in construction activities there is some anxiety at what will happen when new buildings will begin to be constructed in the large downtown area in the hands of SOLIDERE, as well as what will happen to all the new buildings constructed during the years of war in Beirut Suburbs where most companies have relocated after the destruction of the centre of Beirut.

To my knowledge there has never been any in depth study of the functioning of the real estate market in Lebanon and its adequacy to the needs of the country. In this context it is difficult to envisage any efficient mobilization of savings as long as the real estate market will continue to be inelastic and to freeze a large part of savings in the luxury segment of the market. The larger issue here is that of helping the economy with the development of an effective financial market.

5. The domestic financial market and the status of the currency

We will here identify the main issues related to the aspiration of the governing elite to make of Beirut one of the important Arab Financial markets in the region. In this respect it is important to note that the main prerequisite for becoming a regional market is first to be an effective domestic market supplying the needs of the economy through properly structured financial instruments. As it is known, if pre-war Beirut was no doubt the commercial banking centre of the Middle East, it was never able to develop a domestic capital market. Its stock exchange remained constrained by the small number of companies which share were registered and by the small number of transactions taking place as most companies were owned by a few families unwilling to raise additional equity capital through the SE.

On the other hand the Intra Bank attempt to become an active local and international "banque d'affaires" buying large stakes in important domestic and international companies were obstructed by the stringent banking regulations implemented in 1964. The Central Bank and the Council of Minister, after some hesitations, did let this giant bank collapse in 1966 which affected very negatively the economic growth rate in 1967 as already mentioned previously. The law on
medium and long term credit banks adopted by Parliament in 1967 to regulate investment banking in Lebanon remained almost unused. Except for three international bond issues that took place in 1974 in Lebanese Pounds, Lebanon would not develop any efficient capital market before the war.

To-day the ambitious plans to turn Beirut in a full fledged financial centre has still a long way to go. The only actively traded share is that of SOLIDERE, the mammoth real estate company which price jumped to $170 a few months after its issue at a price of $100 and which is now down at the more realistic level of $120-130. But it is interesting to note that Byblos Bank owned by one Lebanese family is proceeding with an equity capital increase through the services of a newly established finance company; Ciment Libanais has also proceeded with an offering of $100 million in bonds and equity. A $400 million Eurobond issue for the State was also issued in spring 1994 for three years at 10 1/8%, a high cost indeed.

There is no doubt that there is a great potential for the development of the capital market in Lebanon, but there are many preliminary steps to be taken before such a market could develop on solid ground. The modernization of laws and regulations to provide for a mutual fund industry and for the securitization of banking and real estate assets is amongst the clearest prerequisites needed, together with a special effort to train judges in modern financial issues and improve their salary structure. Without the proper set of modern laws and a well trained judicial system no sound and long term capital market development could take place.

Another obstacle to the development of domestic capital market is the low level of income tax which makes difficult for the State to offer efficient packages of tax incentives, as has been done elsewhere, so as to direct savings into the capital market and out of short term banking deposits and direct real estate investment. To this purpose, commercial banks which enjoy a highly effective branch network in the country should be encouraged through adequate Central bank regulations to participate in the development of capital markets and be permitted to gradually transform in global banking institutions. This will require a complete redrafting of the present banking law (the Code de la Monnaie et du Crédit) along more efficient lines to promote investment banking activities in the country.

Lastly, the status of the Lebanese Pound should be clarified. The present policy of the Authorities is still unclear as to its main target : is the dollar going to continue
to be encouraged as the main currency outside the payment of State expenditures or receipts and subscriptions to T bills? The denomination of SOLIDERE share in US dollar and the fact that the BOL is operating a very effective system to compensate checks in US dollar and other foreign currencies and that it is attracting US dollar deposits from Lebanese banks at a premium over LIBOR: all these moves could be interpreted as a support to the dollarisation of the economy, the use of L.P. remaining restricted to State domestic payments and deficit financing at very high cost.

Such an ambiguity in official policies will be detrimental in the long run to establishing the domestic capital market on solid ground. Rather than keeping obscure the fate of the Lebanese Pound, the Authorities should look either at developing a more coherent policy to re-establish the Pound on a sound basis, implying that the State deficit should be drastically reduced. Failing that a transparent mechanical link between the US dollar and the Pound should be adopted encouraging savings to remain in L.P.

In any case, Lebanon could hardly become a regional financial market centre without tackling the issue of the status of its domestic currency and without having first developed its domestic capital market.

6. The social issues in Lebanon to-day

Already before the war there was a sharp contrast between an affluent and prosperous Lebanon and misery belts around Beirut and unemployment and deprivation in the peripheral areas in Eastern, Northern and Southern Lebanon.

Migration to the Gulf countries and Africa has contributed in Lebanon as in other parts of the Arab World to dramatic social changes. New wealth has been diffused. However, in the case of Lebanon fifteen years of war and the crumbling of the Lebanese Pound have also conducted to social and economic dislocation that could be summarized as follows:
1. Between 600,000 and 800,000 people have been displaced by force inside their own country and only a very small percentage of this population has returned to its original location\textsuperscript{25}.

2. The war has created approximately 50,000 to 60,000 handicapped people

3. Salaries are ranging between the equivalent of $150 and $600 per month with an average salary closes to $250-$300. Given the high cost of living in Lebanon such level of remuneration is totally inadequate and worker productivity is now very low. The public health and education systems have almost disappeared during the war and private schools and hospitals are extremely expensive and can not be afforded by ordinary people. In addition, the social security system is limited to regular wage earners.

4. Consequently, income inequality in Lebanon is higher than before the war and the middle class who has been the backbone of the country is under difficult conditions and is looking for migration out of the country to OECD areas. Those Lebanese having no access to domestic or external foreign currency resources and being paid in Lebanese Pound are those who suffer most in a dollarized economy.

5. There is no collective transport services in Lebanon and the increase in number of old imported used cars has created a terrible bottleneck in the transport system, adding to the overwhelming pollution problem.

6. Influx of unskilled migrant workers from East Asia and Syria is keeping a downward pressure on the scale of salaries, while many Lebanese remain unemployed or partially employed. Although no unemployment in figure is available, there is no doubt that the poverty line includes an important segment of the Lebanese population\textsuperscript{26}.


\textsuperscript{26} Estimated at 30% of total population by K. HAMDANE well known specialist of social issues in Lebanon, in Le malaise social : Quelle guarant?, Commerce du Levant, 18 janvier 1995.
The present reconstruction policies do not address directly these social issues, nor does it recognise the link existing between these social bottlenecks, distortions and imbalances and the general low level of productivity of the economy and the built-in high costs of production in the country hindering the competitiveness of the economy. The exclusive emphasis of the Reconstruction Plan on physical infrastructures is designed in the Government approach to allow Lebanon to reconquest a "place in the sun" in the new Middle East economy that it believes is in the shape. In the eyes of the new governing elite, only through such a reconquered position, will Lebanon come back to growth on solid ground, thus allowing to alleviate progressively the difficult social conditions of a large part of the population. For this elite, only through private sector expansion and services could social problem be progressively resorbed, as current wisdom goes nowadays. The State has no role to play and should remain a marginal institution in the process of economic development. Its high level of indebtedness denominated for its larger part in the unstable domestic currency do not seem, in the eyes of the Government, to constitute a big obstacle to the establishment of a sound financial market as long as domestic economic growth rates are high.

**Conclusion** : Towards a re-forcusing of Reconstruction priorities and a fiscal stabilization plan

In the absence of reliable economic data in Lebanon it is difficult to present a full in-depth appraisal of the Reconstruction policy presently implemented in Lebanon and its chances of success. For such a small and open economy as Lebanon an important additional factor of uncertainty is the future political and economic evolution of the regional environment. If the anticipated economic benefits of the shaky peace taking place between Israel and its Arab neighbours do not materialize in the near future, than Lebanon present reconstruction policies might become an unbearable obstacle to sound, sustainable and well balanced economic growth in the country. Domestic, social and political tensions, already high but contained by the Syrian presence, could become more explosive. However, even if the regional environment develops positively, one should be aware that the country badly needs a serious and coherent policy of institutional building and improved mechanism for economic and political governance, as well as a bold policy for manpower rehabilitation, and job creation. The low level of productivity of the Lebanese economy and the high costs affecting
the productive sector and mainly the services will not be cured through exclusive priority given to the building of major infrastructures.

A downsizing of the huge infrastructural scheme is urgently required in Lebanon both to contain the Treasury deficit and to allow for more spending on crucial social and educational issues, in addition to clearing up pollution which has become a very serious problem in Lebanon. In any case, it seems unrealistic to believe that State investment program, as it is, could be adequately financed without a serious review of the tax policy. Such a review should lead to an increase in the tax burden during a few years through raising of income tax and improving the present unfair balance between Direct and Indirect Taxation. Without such a review, the Treasury deficit will continue to increase endangering more and more the financial stability of the country and the precarious status of its currency. The increase in the already heavy domestic indebtedness will crowd out the financing needs of the private sector.

It is our very rough estimate that the overall tax burden should be raised to at least 30% of GDP (at the present level of $7 billion) in order to put a break on the alarming rate of increase of the domestic debt. It should be reminded here that total State spending has increased from $1.31 billion in 1992 (on the basis of the average annual exchange rate) to $1.7 billion in 1993 to $2.63 billion in 1994, while receipts has been stable at around $1 billion in 1993 and 1994. This amount barely cover the domestic debt service burden in relation to outstanding amount of T bills issued ($5 450 million) at an average interest rate of 18.77% according to various maturities. All these data clearly shows that the present fiscal policies should be redressed without delay to emerge out of the spiralling budget deficit and fiscal imbalances, causing domestic inflation, an increase in social discontent, and a threat to the stability of the financial system and the development of an efficient capital market.

To this effect an efficient Reconstruction Plan should:

1. reduce its over ambitious infrastructure schemes or at least phased it more adequately over the years to be harmonized with realistically available resources,

2. devote more programs to:

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27 Figures from 1995 Budget presentation to Parliament already mentioned. However one should not that the figures stated are attributed to the Central Bank of Lebanon, as if the Ministry of Finance has no figures available.
a) fight pollution  
b) develop a strong public transportation system for low income earners  
c) develop the public health and education system for low and middle income earner  
d) provide for more manpower rehabilitation and training  
e) provide assistance and support to agricultural and industrial sector, namely in marketing, R&D, and export promotion

3. adopt a fiscal stabilisation plan to substantially reduce the increase in domestic indebtedness and its huge cost on interest payments, which will help strengthening the L.P. exchange rate and entering a phase of de-dollarizing the economy,

4. adopt a policy of free fluctuation on the foreign exchange market leaving the L.P. to find its adequate level within an improved macro-economic framework, a stabilisation plan and a properly refocused Reconstruction Plan.

But however realistic and urgent are these objectives the most preoccupying feature of present Lebanon is the absence of a real dialogue between the new wealthy governing elite and all those who are trying to introduce some flexibility and more economic and financial in-depth approach in the reconstruction policy. By making an intensive use of its financial influence to prevent any serious debate about the difficult issues of reconstruction in Lebanon, the new governing elite is contributing to more demise of democracy in Lebanon and to an impoverishment of economic and social thinking. These were among the strongest comparative advantages Lebanon used to enjoy in the region before the war.

I am not sure that the reconstruction of Lebanon, but also the general improvement of social and economic conditions in the Arab region to secure peace and stability, can effectively take place without these essential ingredients: democracy, positive debate, governance, transparency, social and economic thinking without simplified ideological recipes.