The Lebanese Economy: Deficiencies and Remedies

by: Dr. Makram Sader[1]
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I- Introduction

1- The difficulty in addressing the socio-economic deficiencies in Lebanon comes from the large macro-economic imbalances involving the public finances and the external sector and the deep distortions in the labor, capital and money markets. It stems also from weak productive capacities at the levels of the work operating environment and the overall business climate, the availability of adequate inputs of production, and the internal structures of the private enterprises. The difficulty in tackling the socio economic problems lies also in the fact that these require contradictory policies in the early stages. For contraction in spending does not help much economic growth, while expansionary policies lead to the worsening of the financial and monetary situations. Of course, the crisis is not a fate and remedy options are available and open to discussion with the assistance of the international community, on condition that these should fall within a framework of comprehensive reform and adjustment policy and not to aim at gaining time only.

II - Profound imbalances and distortions

2- An objective diagnosis of the economic distress in Lebanon reveals serious imbalances at two levels. These are the deficit in public finances and the current account deficit with which are associated also price and market imbalances.

3- At the level of the deficit in public finances: Despite all efforts undertaken by previous and current governments and parliaments and all reform plans and pledges, and in spite of all the Arab and international support for Lebanon and the sheer size of all financial flows to the country, the fiscal deficit remained large and above 10% of GDP over the past 4 years. The large deficit is attributed to three sets of reasons:

- Firstly and most importantly the lack of flexibility and ability of primary expenditures to drop due to the bloated government social welfare function, support and transfers, including distended civil and military manpower on which was built the

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Republic of Taif established since 1989. And of course, some social categories and groups have benefited more than others of the welfare state depending on their proximity to the decision centers in the state authority. Therefore these current expenses, excluding interest payment and capital expenditures, remained at the level of 21% of GDP on average during the last few years.

• A second set of reasons is attributed to the weakness of government revenues from taxes, fees and other income, which amounted in the last few years to an average of 23% of GDP of which 15% the share of tax revenue. The weakness is due in one hand to the weak economic growth as demonstrated below, and in the second hand to the level and distribution of incomes in Lebanon, which is distorted and low. Per capita income is still at 7200 U.S. dollars at year-end 2008, despite retreating population growth and family size, as indicated by recent surveys, and, finally, to the weak government revenues which could be explained by the structure of the tax system, the reforming of which requires in addition to VAT, affecting consumption, a global income tax and a global well conceived real estate tax. In completing the tax system the state will recuperate its capacity to finance its expenditures and will gain more flexibility in investment promotion through tax exemptions and incentives.

• The third main cause, for the structural public deficit, lies in the debt service, which amounted to yearly average of 13% of GDP, more than 50% of the total public revenues, and 36% of the total public expenditures over the past 4 years. The escalating debt service due to the increased accumulation of large deficits and the swelling public debt constitutes the second largest public expenditure, and consequently the second main mechanism for the government to perform its role of income redistribution. And, of course, certain social categories and groups benefited from this role more than others depending on their shares in deposits and treasury bills, knowing at one side that the number of depositors in the banking sector is close to one and a half million with a great disparity in respect to the concentration of deposits, and, at the other side, that the central bank and the public institutions (CNSS, INGD,...) share stood during the same period, at around 25% of the total public debt to which we should add 14% (or 6.6 billions dollar) the international **bi** and **multi** lateral share. Thus, the redistribution effect concerns about 60% of the total gross public debt.

4- **At the level of the constituents of the external deficit and its financing sources:** the relatively large size of Lebanon foreign trade reflects the degree of openness of the country and, at the same time, the extent of exposure to the world markets. Total exports and imports of goods and services, return on investments and placements in addition to the current transfers in both directions, i.e., the total current account transactions between the Lebanese economy and the rest of the world reached, for example, on a yearly average in the past four years, 137% of GDP or 40 billion USD versus 29 billion USD for GDP. This situation characterizes typically a small economy extensively open to all kind of cross-border flows: Goods, Services, incomes, transfers, FDI, portfolio and other investments. Unfortunately and as far as we lack a strong national consensus and a strong central government system the regulation mechanism will remain external with either regional or international dominance.

5- A close look at the **structure of the current account** shows that the **trade deficit** (difference between the imports and exports of goods (FOB)) approximately average annually nine billion USD, to which is added the **income account deficit** of almost one billion USD to reach a total annual deficit in these two accounts of about ten billion USD. Conversely net services and current transfers accounts show a surplus of about 7.5 billion USD. The net outcome of transacting with abroad is a current account deficit exceeding annually 2.5 billion USD, or roughly on a yearly average 10% of GDP for the past four years.

6- In the past years, the pattern to finance this deficit, huge by international standards, has been through the movement of capital and especially through two main channels: **firstly**, foreign direct investments, especially in real estate (built and non-built property) and **secondly**, non-resident Lebanese and Arabs investment in the form of placements in the banking sector as deposits in the first place and treasury bonds in LBP and USD as a secondary option. Add to these, occasionally, special Arab deposits at the Central Bank as happened in 1995 and 2006. The proceeds of these financial inflows in the last four years reached nearly 5 billion USD annually, i.e., providing the funds to finance the current account deficit mentioned above of 2.5 billion USD and creating nearly an equivalent amount in the overall balance of payments and contributing to the accumulation of Net Foreign Assets (NFA) at the Lebanese commercial and Central banking system. NFA excluding gold at Lebanese banking system increased from U.S.$ 3.7 to 20 bn between December 1992 and 2008.

7- In spite of the positive trends in 2008, this integration model of Lebanon into the world economy has a limited sustainability in the long term for three reasons.

- The first reason lies in the weak coverage of imports by exports of goods (only 33% on average for the past four years). For the demand of imported goods is high and related to the fast rising of the public and private spending and the inability to be met by domestic supply. While exports are low and the share of imported inputs in the exported goods is high due to the weak domestic links among production activities and also because of the low competitiveness of the Lebanese goods, rooted in their higher cost, which is associated with the distorted price structure and labor markets.

- The un-sustainability of the model is ascribed secondly to its reliance on the export of young qualified Lebanese and the import of non-qualified labor. Given that the stock of human resources in Lebanon is limited (3.8 millions) and being drained at that pace this would accelerate the path to un-sustainability in addition to introducing deep distortions to the labor market and the overall national demographic critical balance.

• The third reason for describing this model of economic relations with the rest of the world as unsustainable is the permanent need for financing the current account deficit by attracting funds from non-residents in the form of real estate investments and bank deposits or loans to the public and private sectors. This leads subsequently and in the absence of economic growth at adequate rates to larger transfers to abroad in the form of interest and income as indicated by the permanent deficit in the income account, which adds annually to the trade deficit a 1 billion USD and more. Serving deposits, loans and investments have become an additional burden on the country's external payments. The same regional cyclical factors which facilitated during past and present periods the financing of the current deficit may themselves constitute in the future a determinant factor for capital outflow and/or less capital inflow.
The only way out of this complex situation is in initiating economic growth at high and sustainable rates. Where are we standing NOW?!...

III- Weak productive capacities for Economic Growth.

8- During the decade 1994-2005 growth rates in Lebanon were modest at 3.2% in comparison with emerging economies, especially those that experienced reconstruction where growth rates ranged between 8 and 10% or even exceeded this range. After 2006 war and the reconstruction activity 2007 & 2008 witnessed two consecutive rates at 7.5 & 8.5%.

9- **Modest growth rates cannot be explained by irregular factors that affect temporarily the level of demand up or down.** Following the assassination of PM Hariri, for example, the level of economic activity fell and the movement of tourists retreated, then activity returned later. Another example is high oil prices and fuel which impacted negatively the cost of production and the current payments, and positively the Lebanese exports to Arab markets, the remittances of the Lebanese expatriates to their families, and Arab investments in apartments and real estate in Lebanon. A third example is the July 2006 Israeli war, which precipitated an unusual size of grants and subsidies, in parallel to the large mass and the sharp drop in production and activity it caused, in addition to the package of loans pledged under Paris-3. These if used properly, can help to catch up on events and create a quantum leap in addressing macroeconomic imbalances in Lebanon.

10- **Modest growth rates cannot be explained also by the ballooning public debt.** For the financing of the state did not prevent the financing of the private sector as indicated by the rates of growth of credit to the private sector compared to the GDP growth, and the real interest rates compared to the actual growth rates, and the high level of liquidity in the banking sector in comparison with the lending to both the private and public sectors.

We don't believe – contrary to the IMF / WB literature always repeated,- that the Lebanese economy has a "crowding out" effect. In fact, the small size of the Lebanese economy, extensively open to regional and international markets, has been always able to attract large financial flows mainly from Arab Oil Exporting Countries with over liquid markets. Upon a recent study released by the International Finance Institute in Washington the GCC countries registered during the last five years a current account surplus of $ 542bn. Out of which 300 were placed in USA, 100 in Europe, 60 in Asian markets and 60 in MENA region mainly in Egypt, Turkey, Jordan, Morocco and Lebanon.

II- <u>**Modest growth rates in Lebanon during the last decade can be explained instead**</u>

- **firstly,** by the low rates of investment, which fell from 30% in the period 1993-1997 to about 20% in the period 2000-2005 to be stabilized at 24% for the years 2006 - 2008. And of course, this retreat was not compensated by an increase in the labor force, which has been drained by the immigration nor was compensated by an increase in the technical progress, i.e., the qualitative factor (Cultural / administrative / organizational ...). The best evidence of that is the drop of import of machinery and equipment at fixed prices by 7% annually since the year 1993. Also weak competition in the Lebanese market (Corruption, Clientelism,...)did not encourage the Lebanese business community to increase its productivity (see World Bank Bulletin-Beirut office-first quarter 2006).

- **Secondly,** the explanation of modest growth rates resides in the absence of appropriate non-bank financial intermediation structure (Stock market...) and the concentration of financial intermediation in commercial banks with short-term resources, the nascent investment banks still lacking substantial resources (4.2% of total banking system assets at the end of 2008) and appropriate funding capabilities in addition to being insufficiently equipped with human competences and required experience and expertise to contribute efficiently in project financing &/or corporate restructuring in both the Private and public sector. Similarly Capital market capitalization remains very low at 40% of GDP out of which 60% representing the capitalization of the 5 commercial banks listed on Beirut Stock Market by the end of April 2007. Capitalisation ti GDP ratio dropped to 28% at the end of 2008.By comparison, bank claims on private sector exceeded, 80% of the GDP or five times the market capitalization, excluding banks.

- **Thirdly,** one could also explain the modest growth rates by the inefficient business and investment climate, particularly in what is due to the cost and quality of public goods and services, which adds unjustified burdens and charges on the enterprise sector and on the labor market instead of being a supportive element and a cost mitigate.

• **Finally**, we can attribute modest economic growth rates in Lebanon during the past dozen years to the negative effects of the economic model that was in place and consisting of the use of cash flows and abundance of funds to finance consumption through public and private debt. Total demand was met partly by the import of goods and services at world prices, while the structure of domestic prices increased due to higher demand domestically-oriented (real estate, wages, ...). The investments concentrated gradually and increasingly in the activities producing non-tradable goods and services (construction, schools, universities, restaurants, hospitals ...) knowing that the productivity in these activities is low. Thus the profitability of enterprises was affected and these latter could not produce sufficient added value to cover their costs, i.e., wages, interest, taxes, and depreciation, and achieve acceptable profitability. Economists describe this phenomenon by the increase in real effective exchange rate (REER). The increase indicates lower competitiveness of the domestic economy vis-à-vis the rest of the world. The REER reached 170 in 2002 (100 in 1995). It dropped to 120 in 2008 explaining the relative increase in Lebanese exports.

12- Thus, we are faced with structural weaknesses in the growth potential of the economy over the medium and long term and with structural deep imbalances and serious impediments preventing adequate, regular and sustainable growth rates. These distortions in the price structure and in the allocation of resources (capital and human resources and techniques) need structural adjustment, and call for policy measures that involve the financial intermediation structure, the operating environment of enterprises and the investment climate, particularly in what is related to the State Owned Entities (SOE's). These would also call for reforms at the level of the private corporate sector itself.

IV-Reform initiatives, policies and strategies to address the socio-economic crisis

13- As we noted at the beginning of the paper, efficient remedies are regrettably becoming very difficult. What is needed is to put back the economy on the path of growth and at the same time address the public finances, all without exposing the delicate social condition to further exposure. The situation is that growth requires more spending, whereas dealing with the fiscal deficit and huge debt demands contractionary policies and putting an end to all the channels of social distribution and transfers. Examples of these latter are getting electricity without paying the price of the service, the social security bill, hospitalization at the expense of the Ministry of Health, paying the wages of all the security forces and related cooperatives, paying the wages of public school teachers without a sufficient numbers of students ...). These are often perceived as sunk cost, while in fact are unproductive expenditures and enlarged subsidies on which was built the Republic of Taif, at a time when other oil producing economies with a small population could not do so. Whilst addressing the public finances necessitates more taxes, resuming growth entails easing the burden of taxation and fees incurred by enterprises, enabling these latter to increase profits and consequently their investments. Whereas growth and fiscal adjustment require interest rates as low as possible, the maintenance of relatively high interest is considered necessarily to attract capital from abroad in order to finance the deficit in the external sector, which is associated with patterns of consumption and savings in the country and measures the Savings-Investment gap.

14- In fact, very few countries were able to emerge from structural crises with such complexity. This required the presence of a strong and reliable power structure and a business community which puts the public interest above all else, with big sacrifices over a long time, not less than 10 to 12 years, from the various constituents of the society, i.e., dwellings, corporate sector and the government. It needed also adjustment programs, supported by the international community with significant potentials and credibility (International Monetary Fund, World Bank, European Union, ...) and well conceived and fairly implemented policies allowing the process of resources reallocation towards productive sectors and activities capable of producing tradable and competitive goods and services to succeed.

The useful policies to deal with such a crisis can focus, for example, on the following five ways or directions.

15- **Private sector corporate restructuring**: Corporate Restructuring has taken place, for example, over the past fifteen years in the States of Eastern and Central Europe that joined the European Union. Turkey currently lives this dynamic. The restructuring means re-capitalizing institutions using well known techniques (Debt/Equity Swap ...) among investment banks, in conjunction with the injection of long-term funds at sufficient amounts and reasonable interest rates. It also means the reorganization of enterprises and their management, and to open these institutions to new techniques and strategic partners, in addition to introducing transparency in the operation and accounting systems, and finally to be listed on the stock Exchange.
This approach needs the investment banking expertise, in cooperation with international financial institutions. It also needs mechanisms to **refinance investment banks** involved in the financial restructuring. Would it be possible to allocate part of the pledged aid funds and grants related to Paris III to corporate restructuring in order for the corporate sector to have sound finances and create new job opportunities and renew production capacity? If yes, priority should be given to enterprises, activities and sectors the most capable of producing tradable goods and services, thus reducing the size of the external deficit.

16 -**Restructuring of State Owned Entities (SOE'S):** This should apply to public sector entities producing of marketable goods and services; exactly as to private sector enterprises. Electricité du Liban remains the best example of this public entities sector. What is needed is full restructuring in terms of production, distribution and collection, within the

framework of an overall policy for the entire energy sector in Lebanon, due to its positive or negative implications for the economy as a whole and for the operating cost of the private sector. Restructuring involves firstly, capitalization and long-term financing, and secondly, bringing in a strategic partner, and thirdly, modernize operation systems, internal organization, and technical and administrative aspects, etc. ... and fourthly, work on the listing on the Stock Exchange. Then partial or integral privatization, based on fair pricing and good transparency could take place only as part of restructuring process not to provide just cash money to reduce the debt stock!..

17- **Rationalization of the cost of public services**: Most importantly education, health and transportation ... in order to put an end for the current situation where the cost is paid twice: One on the economy through the budget and treasury with low or almost non-existent efficiency, and another one on the private sector through the cost of securing these services directly. What is needed is to agree on an acceptable quality of these services, the regularity in providing these services, and a balanced cost distribution on beneficiaries consisting of the corporate sector, households and the public sector. These services must be the mainstay for private institutions and a wage cost reducing factor, including the cost of social security, rather than be a cost burden on these institutions and their productivity.

18 -**Gradual fiscal adjustment**: So that the role of public finances would be to raise the productivity of the economy through moderate primary surpluses, based on limiting unyielding subsidies and transfers channels while securing and protecting as much as possible most exposed social groups, and maintaining or even strengthening capital spending. The gradual fiscal adjustment should also be based on increasing taxes within a clear policy that avoids taxes and fees which can be passed by economic agents to the structure of prices, including wages, or in a way that increases the burden of the corporate sector. What is needed is a tax policy mix favorable to the profitability of enterprises with investment incentives, particularly in the tradable goods and services, as well as favorable to the purchasing power of wages earners. It is about time in Lebanon, to use the tax policy to support the business community and the productive forces, with clear restraints, to pump profits and wages back in the economic cycle, thus contributing to maintaining aggregate demand at a level favorable to the required growth rates.

19 -**The social policy:** The social policy required at this stage must be based on three pillars:

- **first**, social safety nets for the most exposed category or group of the Lebanese society so as not to strain under the burden of the fiscal adjustment or the burden of radical economic reforms required to help private and public enterprises. For adjustment and economic reform programs with their restrictive policies, austerity measures, and cuts and amendments in the allocation of resources will require sacrifices for long years and at the expense of the living standards of many social groups that benefited basically from the existing system at an earlier time.

• **The second** pillar is that the cost of social services should be assumed jointly by the Lebanese community, and thus should not rest completely on the corporate sector or revenues associated with work and production.

• **The third** and most important, is the ***establishment and development of adequate retirement schemes*** coping in one hand with the reality of the Lebanese economy comprising **a large non-residents income earners, and a large resident non-wage income earners**. These systems should be favorable, in another hand, to the goal of mobilizing Lebanese savings to form a stable long-term savings fund, paving the way for the financing of the corporate sector through non-bank markets and financial instruments. For the absence of long-term savings is associated regrettably with a lack of long-term financing mechanisms and products. Elaborating a modern and sophisticated law for retirement and social protection systems and funds must be the basis of any future social vision. It is a vital and important issue for which economic and trade unions bodies in Lebanon should strive for. The absence of such systems and legislations is a major scandal not to say a national disaster! ... Not only for the domestic labor force but also for non-resident Lebanese labor force working mainly in GCC countries where they don't have access neither for acquiring hosting countries nationalities nor for any kind of retirement schemes where they work and live today or where they will retire i.e. in Lebanon tomorrow!.. Their saving power has been dramatically reduced during the last 5 to 7 years because of the fierce competition on the GCC countries of the Indo-Pakistanese cheap and qualified labor force; and, because of the rising cost of living.

V- Conclusion

20- In light of this hard fact and the complex and interrelated problems and issues, we should all realize especially economic and business organizations and trade unions that there are no magic solutions, especially quick fixes. The important thing is to have at the government level a right vision for the depth of the crisis and associated risks, and to elaborate policies and decisions that address the roots of this crisis and not those that aggravate it. It is time to migrate from transfers, subsidies and rent incomes to real productive economics.

21- In sum, the productivity of enterprises, regardless of sectors and activities, is the core and the focal point to put back the Lebanese economy on the path of growth. All policies and efforts should move in this direction. This is to the common interest of economic organizations, including the trade unions. Their point of views or position vis-à-vis of the Euro-Mediterranean Agreement, of the Great Arab Free Trade Area (GAFTA), the Syro-Lebanese Treaty and vis-à-vis the new European "politique de voisinage" should be determined by the contribution of such treaties and agreements to restaurate the productive capacities of the Lebanese economy and society, to restructure our private and public corporate sector, and to open new markets to our tradable goods and services.

22- It's also within this rational that we should look to Paris III conference.i.e. It will make available for us a kind of supplementary (a supporting) of saving enabling us to come through the long and difficult transitional period without being obliged to sacrifice neither the economic growth nor the social equity while addressing the macroeconomic imbalance. It is not too late to put Paris III into contribution

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