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Abstract

Since the onset of the Civil War in 1975 Lebanon has experienced burgeoning fiscal deficits and an unsustainable public debt overhang. Much of this arose from the loss of revenues during the period of the Civil War 1975-90 and attempts to maintain basic public expenditure, while from 1990-2006 it reflected post Taif rebuilding and reconstruction of key infrastructure with limited revenue capacity. Considerable progress from the 1990s has been achieved in rebuilding the shattered economy from both public and private international and domestic sources, but its legacy is a huge public debt and a servicing requirement that currently absorbs alone almost 30 per cent of total government revenue and is the highest in the world on a per capita basis. While the need to reduce this debt to a sustainable level would be daunting enough in itself, Lebanon's fiscal predicament was further compounded by the outbreak of war with Israel during July-August 2006. The consequence of this 34 day conflagration was the devastation of residential property, vital infrastructure, agricultural production, industrial production, exports, environmental damage, the collapse of tourism and a further erosion of the influence and power of the central government. Estimates of the direct and indirect costs for Lebanon of this relatively brief but devastating war conservatively vary from US$10-15 billion. The implications of such reconstruction and rebuilding costs for the budget and public debt are potentially calamitous for Lebanon. A key question is whether Lebanon can tackle this enormous task in insolation.

This paper explores the background to the fiscal crisis, identifies from available literature the extent, nature and cost of the war damage, analyses the options available to the authorities in rebuilding the economy and highlights key policy issues and measures that will be required if a sustainable economic recovery is to be achieved. Despite its demonstrated and remarkable resilience to past trauma the paper concludes that the fiscal crisis makes it impossible for Lebanon to tackle the reconstruction and rebuilding task on its own and particularly in the wake of the events of summer 2006. The country will require substantial and ongoing financial support from international lenders and donors. The success of these efforts in the case of Lebanon is of particular interest as it could well be a microcosm of possible future outcomes for the region more generally.

J.E.L Classification: E60, E61, E62, E65.

1. Introduction

Budget deficits, their funding and impact upon economic performance, have attracted considerable attention over the past few decades in both developed and developing economies (see, for example, Bailey, 1971; Allen, 1977; Sargent and Wallace, 1981; Aschauer, 1985; Barro, 1990; Miller and Russek, 1997; Cebula, 2003; Ramirez and Nazmi, 2003; Neaime, 2004; Saleh, 2003; and Saleh and Harvie, 2005 among others). In the case of Lebanon the budget deficit and its funding has attracted considerable attention from politicians, international organizations and domestic policy makers, stemming from its size and longevity (see, for example, Eken and Helbling, 1999; Makdissi, 1999; Darweesh, 1999; Al-Rifai, 1999; Korm, 1999; Wakim, 1999; Saidi, 2003, among others). Budget deficits first occurred in Lebanon during the period of the Civil War (1975-1990)[1], and were subsequently maintained during the post-war Taif reconstruction period (1990-present). As a per cent of GDP it increased from only around 3 per cent in 1975 to a peak of 33.8 per cent in 1990, one of the largest in the Middle East at this time, subsequently declining to under 10 per cent by 2003-05.

Consequently, Lebanese public debt increased precipitously after 1975, with gross public debt reaching 99.8 per cent of GDP by the end of 1990 of which 80.6 per cent was domestic. Post Taif reconstruction focused upon rebuilding the country, providing infrastructure and services, making Lebanon's services sector competitive with other countries such as Israel, creating a business friendly environment and reconstituting and reasserting state power. Subsequently, after 1993, there was a further acceleration in government capital and current expenditure that resulted, in tandem with a slow recovery of the government's revenue-generation capacity, in a perennial fiscal crisis. Between 1992 and the end of 2000, for example, the Lebanese government spent some US$5.7 billion on public infrastructure that included the electricity grid (US$1.371 billion), post and telecommunications (US$769.5 million), roads and public transport ((US$566.8 million), ports and airports (US$636.3 million), and the water sector (US$636.3 million). Budget deficits increased from 9.2 per cent of GDP in 1993 to 20.6 per cent in 1996 but declined to around 8.5 per cent in 2005. Spending initially increased GDP growth arising from the construction and real estate boom it triggered, but heavy reliance on funding through domestic and foreign borrowing contributed to a further rapid accumulation of public sector indebtedness and higher interest rates and its servicing represented a huge drain on public resources. This culminated in 2002 when the country faced a severe financial and economic crisis as national debt reached US$25 billion, equivalent to 150 per cent of GDP, and GDP growth stagnated. By April 2006 total public debt stood at US$38.8 billion (183 per cent of GDP) with debt servicing absorbing any additional revenue increases, and yields on government bonds remained high.

The recent deterioration in the economic situation was matched by political deterioration arising from the assassination of former Prime Minister Rafiq al-Hariri in

[1] Chami (1992, p.325) described the period 1975-1990 as one in which "the central government has become completely paralyzed and unable to collect tax revenue but continues to spend in order to maintain essential services, pay wages and salaries and subsidize some basic imported goods". This resulted in substantial budget deficits, financed primarily by the central bank and commercial banks, which contributed to a massive increase in money supply, high inflation rates and a severe depreciation of the Lebanese currency. Bolbol (1999b, p.442) also concurs that the budget deficits were "a symptom of a weak economy".

February 2005, which plunged the country into a further period of political and financial turbulence and resulted in further sectarian conflicts among various factions in the country. This adversely affected economic growth and contributed to significant deposit withdrawals and a sharp rise in dollarization, which put pressure on international reserves that resulted in their decline to around US$2 billion in the first quarter of 2005. By mid year the financial situation had stabilized and confidence was restored and, with a resumption of deposit inflows, liquidity conditions improved markedly. New Prime Minister Siniora announced in July 2005 that the government would pursue an ambitious economic reform and adjustment program, but this was ultimately delayed due to renewed political tension. The improved economic performance during this period did not last long due to inappropriate fiscal policies and the country's weak political and economic structure among other reasons. In particular, political conflict among different factions in the country, sectarian violence and a heavy reliance on financial aid from abroad (e.g. from Saudi Arabia, the GCC countries, USA, and the European Union) contributed to political uncertainty and economic fragility[2]. Arising from this GDP growth, after a decline in both public and private demand in the wake of the political crisis, slowed to only 1 per cent in 2005 after achieving 5 per cent growth in 2004. The strong growth in 2004 occurred due to a surge in tourism, export growth, which helped to reduce the current account deficit to 13 per cent of GDP, and construction activity. The budget deficit declined slightly in 2005, due to a decline in debt service payments on the public debt, a direct contribution of the Paris II conference, by 12.1 per cent. Overall net debt increased from 151.5 per cent of GDP at the end of 2004 to 158.8 per cent by end 2005, and gross debt increased further from 164.7 per cent of GDP at end 2004 to 175.1 per cent of GDP by end 2005. Tax revenues declined by 6 per cent overall in 2005 due to a drop in revenue from international trade taxes and to a lesser extent from lower domestic taxes on goods and services and fiscal stamp duties.

While severe the fiscal crisis was further compounded by the traumatic developments during 12 July- 14 August 2006, when Israeli bombing of key infrastructure and other facilities resulted in severe damage[3], a dysfunctional economy and further erosion of already weak central government authority. Once again the economy faced an enormous reconstruction challenge on a par with that after the 1975-90 Civil War. Damage to the economy was widespread across numerous sectors – in particular residential buildings and infrastructure (roads, ports, water and sewerage treatment, electrical plants, bridges, factories and farms). Total damage to residences was estimated at US$2 billion and transport sector damage at US$404 million. Oxfam estimated that up to 85 per cent of the country's 195,000 farmers had lost all or some of their crops valued at between US$135-185 million, and suffered a livestock loss of one million poultry, 25,000 goats and sheep, and 4,000 cattle. These losses have serious economic implications as 35 per cent of the Lebanese population either directly or indirectly rely for their livelihood on

[2] According to Dibeh (2005) "the political economy of policy making has a significant impact on the reconstruction process". Consequently, achieving political stability is the key to achieving economic stability.

[3] The Khiam Centre, funded by the Canadian Embassy, listed the following destruction on 22 July 2006: "28 vital points (airports, ports, water and sewerage treatment, electrical plants etc), 600 kilometres of roads, 23 fuel stations, 73 bridges, 72 overpasses, 6,800 private houses/apartments, 160 units in the commercial sector (factories, markets, farms etc.)". By the end of the hostilities on 15 August, the damage had increased substantially: government sources quoted 15,000 destroyed homes and 80 bridges hit (French newspaper report).

farming[4]. In the industrial sector ten large factories and more than 700 small and medium industrial units were completely or partially destroyed[5]. Damage to industrial factories was estimated at US$190 million with the loss of up to 10,000 jobs[6]. The closure of these factories resulted in a loss of export revenue and foreign markets, contributing to a loans crisis as many destroyed businesses were unable to meet their debt repayments. This was compounded by the fact that many businesses that had taken out loans had also lost their collateral, mainly their now destroyed property. Given that 30 per cent of Lebanese commercial banks' outstanding loans are to the private sector, this also had implications for the financial health of the banking sector. Tourism has also played an important role in the services sector. However, an oil spill from the destruction of five fuel storage tanks at the Jiyeh power plant affected 100 kilometres of coastline resulting in the country's worst environmental damage, and added an estimated US$50-100 million to the overall cost of reconstruction. This severely impacted upon the tourism sector, which had anticipated receiving 1.6 million visitors in 2006 (see Fattouh and Kolb, 2006).

State reconstruction officials argued that the direct damage arising from the 34 day war amounted to US$3.5 billion, including US$1.5 billion for bridges, roads and other infrastructure[7] and, of traditional importance to the economy, the electricity (US$208 million in damage), telecommunications and water sectors. This compared to a figure of US$2.5 billion by the Lebanese government on 16 August 2006 for total damage to the country's infrastructure. Even the latter figure represented a massive 10 per cent of the country's GDP for 2005 (US$21.2 billion). If indirect costs are also included, such as loss of tourism revenue, export revenue, government revenue, loss of FDI, the cost of stabilizing the currency and loss of GDP during 2006, total war damage could be as high as US$10 billion (see Table 2). The UN offered an even bleaker picture of the direct and indirect costs, suggesting a higher estimate of "at least US$15 billion, if not more"[8]. Jean Fabre, a spokesperson for the UN Development Program (UNDP), suggested that "The damage is such that the last 15 years of work to rebuild the country and revive its economy after the problems suffered by Lebanon (the 1975-1990 civil war) are now completely wiped out"[9].

Other costs include the permanent loss of human capital through death and migration (some 500,000 skilled Lebanese fled during the war), the permanent loss of both foreign and domestic investment (capital flight during the war amounted to around US$2.5 billion) that could result in: lower future growth; rising poverty; increased unemployment costs; loss of export revenue; loss of tax revenue; undermine the

[4] Some 12 per cent of the total workforce is directly employed in agriculture, and it contributes approximately 11.7 per cent of the country's GDP.
[5] Industry in Lebanon is mostly limited to small businesses concerned with reassembling and packaging imported parts. In 2004 it employed 26 per cent of the Lebanese working population and contributed 21 per cent of GDP.
[6] Some 99.3 per cent of damaged factories were uninsured against war damage and 70 per cent indebted to a bank or financial institution (Bank Audi, 2006, p.3).
[7] Lebanon has traditionally been reliant on transit and seaborne trade, consequently the destruction of bridges, roads, ports and airports constitute a major problem to the economy. The destruction of bridges, roads and trucks also affected transit trade to the Gulf both directly, by limiting national exports, and indirectly as freight forwarders were not able to ship goods to Persian Gulf countries via Beirut.
[8] As reported in Spero News (2006).
[9] Ibid.

stability of the currency; reduce foreign exchange reserves; and undermine the stability of the government,

The impact of these developments on the budget deficit, and its financing, had now become of critical significance to the country. Increased government spending to deal with immediate emergency needs were estimated at around US$13.3 million while the loss of direct and indirect government revenues was estimated at around US$66.3 million. These developments further exerted intense pressure on the government's already precarious budget deficit[10]. In addition, the government's privatization reforms had to be put on hold due to a loss of investor confidence in the economy, and a likely decline in revenues generated from the sale of damaged assets. Consequently, in the immediate term at least, privatization does not present a viable option as a source of government revenue.

Perhaps even more precarious is the situation facing an already weak central government. The fragile foundation upon which it has been based during much of the Taif reconstruction era had become eroded even further making it even less well equipped to tackle, alone, the enormous economic rebuilding challenges. The legacy of an already weak budgetary position and high indebtedness before the war in July-August 2006, as well as increased political and economic risk, has compounded and intensified this problem. This restricts the government's access to further domestic and, in particular, foreign borrowing, with existing debt servicing absorbing most of any additional revenue sources. Consequently, gaining access to international donor funding has become pivotal, requiring a concerted and coordinated effort by the Lebanese government and the international community - international investors, governments and international development and donor agencies.

In this context the paper proceeds as follows. Section 2 examines the evolution of budget deficits and public debt in Lebanon since 1970. Section 3 elaborates in more detail potential policy responses to the fiscal crisis and pertinent lessons for the current post 2006 situation. Finally, section 4 provides a brief summary of the key findings from the paper.

2. Budget Deficits, Public Debt and GDP performance in Lebanon

Pre August 2006

Prior to 1975 the Lebanese government's fiscal budget was always balanced and it had never resorted to borrowing. Borrowing and budget deficits are, therefore, a relatively recent phenomena for the country. From Table 1 it can be observed that budget deficits occurred primarily after 1974. These deficits were sizeable and persistent throughout 1975-2005. In particular, the period 1975-1990 was one of deepening economic crisis for the economy, as evidenced by a marked deceleration in economic growth and private investment activity. The budget deficit, as a percent of GDP, increased from only 2.9 per cent in 1975 to 33.8 per cent at its peak in 1990 (Table 1), becoming one of the largest amongst the Middle East countries. Increased government expenditure and declining government revenue were both responsible for this steep increase. Total

[10] The implications of this for the fiscal crisis are explored in the following section of the paper.

government expenditure as a percentage of GDP increased from 15.4 per cent in 1972 to 39.4 per cent in 1990. The dramatic increase was mainly made up of current expenditure, arising from the generous wages and salaries paid to government employees and interest payments on the public debt. On the other hand budgetary capital expenditure declined from 6 per cent of GDP in 1980 to 1.7 per cent in 1990, contributing to the overall deterioration in the public capital stock.

Table 1 Real GDP Growth and Key Fiscal Indicators in Lebanon: 1970-2005 (in % of GDP)

Years	Real GDP[1] growth rate(%)	Budget deficit	Domestic public debt	External Public debt	Gross public debt
1970	6.6	-0.5	2.6	4.3	6.8
1971	9.2	0.8	34.4	3.9	6.0
1972	12.4	0.7	2.6	2.9	5.5
1973	5.3	-0.5	3.3	1.9	5.3
1974	3.1	0.6	3.9	1.4	5.3
1975	-16.1	-2.9	2.0	1.5	3.5
1976	-57.6	-11.9	19.8	2.8	22.6
1977	67.7	-7.0	18.4	1.4	19.8
1978	-2.6	-9.7	21.7	1.6	23.3
1979	2.4	-8.9	23.8	2.8	26.6
1980	1.5	-9.8	32.1	5.1	37.1
1981	0.5	-11.8	41.8	6.8	48.5
1982	-36.8	-21.9	111.9	6.4	118.4
1983	22.7	-21.3	131.2	6.6	137.8
1984	44.5	-13.7	111.4	4.2	115.6
1985	24.3	-26.1	75.7	7.3	83.0
1986	-6.8	-26.1	75.7	7.3	83.0
1987	16.7	-16.7	26.1	16.8	42.9
1988	-28.2	-18.8	38.5	13.6	55.0
1989	-42.2	-34.5	72.8	19.0	91.8
1990	-13.4	-33.8	80.6	19.2	99.8
1991	38.3	-16.3	63.9	12.9	76.8
1992	4.5	-14.8	53.4	4.6	58.0
1993	7.0	-9.3	44.2	4.3	48.6
1994	8.0	-20.5	61.1	8.5	69.5
1995	6.5	-18.4	66.5	12.1	78.6
1996	4.1	-20.6	84.4	14.6	99.0
1997	3.9	-20.2	86.5	16.4	102.9
1998	3.0	-14.1	88.5	25.9	114.4
1999	0.6	-14.4	102.3	33.6	135.9
2000	0.0	-23.7	109.5	42.3	151.8
2001	2.0	-13.4	112.3	57.3	169.6
2002	2.0	-11.8	97.1	84.3	181.4
2003	3.0	-9.5	98.9	86.1	185.0
2004	5.0	-9.2	80.4	84.3	164.7
2005	1.0	-8.4	87.7	86.9	174.6

Note: [1] Data for the years 1970-1996 was obtained from Eken et al., 1995; and Eken and Helbling, 1999. For the years 1997 - onwards data was obtained from Bank Audi and the Ministry of Economy and Trade, Lebanon (2006).

Source: Saleh and Harvie (2006); BDL (various years); Ministry of Finance (various years); Eken et al. (1995); Eken and Helbling (1999); Authors' calculations.

Government revenue, on the other hand, remained very low as a proportion of GDP during 1975-1990 (around 6 per cent), due to: the slowdown of economic activity; and the inability of the government to collect revenue due to the Civil War, as most of this was in the form of indirect taxes and customs and trade taxes which became difficult to collect with the loss of control over legal ports of entry and a consequent surge in illegal imports.

During 1970-1975 the average annual growth of nominal gross public debt registered only 3.5 per cent, and the nominal gross public debt averaged 5.4 per cent of GDP. In the pre-war period public debt was not, therefore, a major concern. Subsequent large budget deficits during 1975-1990 significantly changed this situation with gross public debt rising sharply and peaking in 1983 at 137.8 per cent of GDP (see Table 1).

Over the post-war Taif reconstruction period (1991-2005) infrastructure rebuilding, together with large and expanding current expenditure and slow recovery of the revenue-generation capacity, resulted in further fiscal imbalances and rising public debt. Budget deficits increased from 9.3 per cent of GDP in 1993 to 20.6 per cent in 1996 before declining to 8.4 per cent in 2005, while domestic public debt, in particular, as a percent of GDP increased from 44.2 per cent in 1993 to 86.5 per cent and to 87.7 per cent in 1997 and 2005 respectively. In nominal terms gross public debt increased from US$3.7 billion in 1993 to about US$32 billion in 2003. External public debt increased from US$0.3 billion to about US$15 billion in 2003 as a result of the Paris II conference in 2002, where the government met with international donors to seek bilateral assistance and lower interest rates by restructuring its higher interest rate bearing domestic debt obligations. An aggregate amount of US$4.4 billion was pledged in 15-year loans at reduced rates to support the government’s effort to reduce public debt (Central Bank of Lebanon (BDL), 2003). The majority of public debt is in the form of domestic public debt, although the gap with external public debt has closed noticeably since 2000 and particularly so since 2002. Money creation remained the primary method of budget financing with the issuance and sale of treasury bills mainly to commercial banks. Other subscribers, but with a much lower share, were other financial institutions, the general public, and public entities. It has been argued (see, for example, Chami, 1992; Makdissi, 1999; Bolbol, 1999a, b; among others) that the main effects of the large budget deficits, and the way in which they have been financed, have been through: an increase in the structural budget deficit; higher interest rates; increased money supply; rising inflation; a depreciation of the Lebanese pound; stagnation and a slowing of economic growth.

Post August 2006

The damage arising from the July-August 2006 war was widely spread across a number of economic sectors, but most acutely in residential housing and infrastructure. This has profound implications for government spending and the budget deficit. Table 2 summarizes the potential direct and indirect costs arising from the war that can be gleaned from the literature and government sources, as well as additional effects that are difficult to quantify. These estimates obviously contain a sizeable margin of error but the magnitudes are clearly substantial. The estimated direct costs are equivalent to 10.7 per cent of 2005 GDP, while estimated direct and indirect costs are equivalent to 46.4 per cent of 2005 GDP. This does not include other costs such as those arising from the permanent loss of human capital and investment, which are extremely difficult to quantify. If the UN figure mentioned previously of US$15 billion is closer to the mark this is equivalent to 70.7 per cent of 2005 GDP. These are staggeringly high and would appear to be insurmountable for the present government acting in isolation.

Table 2 Direct and indirect costs of the war on Lebanon as of end July 2006

Sector	**Estimated cost of destruction (US$ million)**
1. Direct costs	
Housing and trade	1,464
Transportation	404
Electricity	208
Industrial establishments	90
Water	74
Military installations	16
Petrol stations	10
Total direct costs	2,266
2. Indirect costs	
Loss of government revenue	66.3
Loss in FDI and portfolio investment	2,000
Tourism revenue	3,000
Stabilization of the currency	2,500
Total indirect cost	7,566.3
Total direct and indirect war costs	9,832,3
3. Other costs more difficult to quantify:	
Loss of human capital	No estimate at present.
Loss of permanent investment	No estimate at present.

Sources: (Al-Mustaqbal Tanshur Taqeer Markaz Al-Da'm Al-Iqtisadi", *Al-Mustaqbal*, 22 August 2006, Fattouh and Kolb (2006).

Status of international assistance

The fiscal crisis and past policy failures have resulted in the current weak central government of Prime Minister Siniora being heavily dependent upon the benevolence of international donors, and the wealth of prominent supporters, to enable it to conduct and implement the massive reconstruction task at hand. The government needs to convince donors that it has the ability to conduct this task, although its past performance is not encouraging. This situation has been further exacerbated by the current political turmoil and instability. The post Taif reconstruction effort contained both public and private sector components, although this became increasingly opaque at times due to the significant contribution of Rafiq al-Hariri. As the Prime Minister of the country from 1992 to 1998, and again from 2000 until his resignation on 20 October 2004, Hariri played a crucial role in regard to the public sector effort. He also spearheaded a comprehensive private sector reconstruction effort, arising from three dimensions: he possessed vast personal wealth[11] and was the initiator and major shareholder of Solidere[12]; he possessed considerable personal prestige particularly with Saudi investors; and he possessed considerable ability, in general, to attract international finance. In the foreseeable future, however, such public-private funding mechanisms that were important in the 1990s will not be available in the future without an expanded role for international donations.

Some confusion exists over the amount pledged for Lebanon's reconstruction and how much is needed. Security and humanitarian assistance is often included with reconstruction pledges, adding confusion about the totals. Among the major reconstruction, and economic recovery, contributions that can be identified are the following. First, at an Arab League meeting on 20 August 2006, Saudi Arabia (US$500 million) and Kuwait (US$300 million) pledged a combined total of US$800 million in reconstruction assistance. Second, a UN sponsored early recovery donor conference in Stockholm on 31 August 2006 raised US$940 million in pledges with some of this for expanded humanitarian aid[13]. Qatar alone pledged US$300 million specifically for reconstruction assistance. The Lebanese government insisted at the conference, however, that it maintain control over any financial aid provided. Third, Saudi Arabia and Kuwait provided US$1.5 billion to support Lebanon's reserves in a bid to stabilize the country's currency. This money, however, could not be spent and, therefore, could not be counted as reconstruction assistance. Fourth, private donors, including investment funds such as that developed by the Association of Islamic Banks[14], have also contributed funds. Such commercial funds, however, are most likely to be invested in income generating business, and were unlikely to contribute to the financing of core reconstruction costs. Fifth, the US President, a week after the ceasefire, announced an aid package of US$230 million but without detailing disbursement modalities. Sixth, Hizbullah has demonstrated the potential to play a leading role in the reconstruction of the economy, with financial backing by Iran. Finally, it can be expected that additional funds from the Gulf countries will also be forthcoming. It should also be mentioned that other factors are making an ongoing contribution to the reconstruction efforts. Specifically, the Paris I and II[15] donor conferences contributed to a reduction of debt servicing costs and to keeping the public debt at less than it otherwise would have been.

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[11] In the 1970s Hariri established his own construction company, CICONEST, which was a major beneficiary of the oil price boom at this time and the construction boom which it triggered in the Middle East. He accumulated vast amounts of wealth in a short period of time and emerged as a powerful construction tycoon.

[12] Solidere is a private joint-stock company worth about US$2 billion that almost single handedly, due to being awarded a government monopoly, transformed and revived the central business district of Beirut following the Civil War.

[13] The amount was nearly double the US$500 million that organizers of the donors' conference had requested to assist Lebanon to recover. Adding previous pledges and commitments for longer-term reconstruction projects, organizers said a total of US$1.2 billion had been promised to help Lebanon back on its feet. Other major pledges included US$175 million from the United States and US$54 million from the European Union. The U.S. figure was part of the US$230 million already offered by U.S. President George W. Bush. For more details on the key outcome of the conference see Lebanon under Siege (2006).

[14] Wealthy Lebanese and Arab businessmen also offered to rebuild designated bridges and other specific infrastructure projects.

[15] At Paris II former Prime Minister Rafik al-Hariri was able to secure US$4.4 billion in soft loans from donor states to help reduce Lebanon's debt servicing, but only US$2.5 billion of the pledged money came to Lebanon. This allowed the government to reduce the budget deficit and cut interest rates. Eight donor countries participated in Paris II, namely Malaysia (US$300 million), Sultanate of Oman (US$50

While these pledges of assistance were welcome it was clear that the government required access to considerably more resources. In this regard the Paris III meeting of international donors held in January 2007, representing a continuation of both the Paris II and Stockholm meetings, was crucial, particularly at a time when Lebanon's public debt reached US$41 billion equivalent to more than 180 percent of Gross Domestic Product. The conference resulted in the securing of some US$7.62 billion[16] worth of grants and conventional bank loans (see Credit Libanais, 2007) to assist with the repayment of debt and to recover from the war[17]. The amount pledged exceeded by over 80 per cent the US$4.2 billion offered at the Paris II donors' conference in 2002. The United States did not contribute to Paris II because it wanted Lebanon to commit to a program of reform linked to disbursements[18]. This time, however, the release of funds arising from Paris III depends upon two factors: efforts by the Lebanese government in achieving economic reforms; and the attainment of economic and political stability in the country[19]. While there is no doubt that these pledges will assist the Lebanese government in reducing the public debt, what is ultimately needed is real economic reform, sustainable economic growth, peace and long term political stability.

3. Policy imperatives for sustained economic reconstruction and recovery

Policy priorities

In the wake of the summer 2006 war the country faced a number of urgent economic imperatives that require an effective policy response. These imperatives and policy responses formed the core of the government's economic recovery program presented at the Paris III donor conference. These key imperatives relate specifically to: infrastructure reconstruction; tackling the fiscal crisis and large public debt overhang; attending to environmental damage and encouraging the recovery of tourism; and strengthening the role of the private sector.

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million), United Arab Emirates (US$300 million), Kuwait (US$200 million), France (US$540 million), Kingdom of Saudi Arabia (US$700 million) and Qatar (US$200 million).

[16] Of which US$1 billion was required, specifically, to support the budget.

[17] The major pledges included: Saudi Arabia (US$1 billion for development projects and a further US$100 million in budget support); United States (US$770 million of which US$250 million in cash transfer tied to economic reforms; US$220 million to fund Lebanese military equipment and training, US$184 million to support the international peacekeeping mission, US$60 million to train and equip security forces, US$50 million to fund reconstruction projects and US$5.5 million for de-mining); Arab Monetary Fund (US$700 million over five years); World Bank (US$700 million in additional funding to support implementation of the government's program); France (US$649.4 million loan on favourable terms); European Union (400 million euros of additional aid in the form of grants and loans); European Investment Bank (960 million euros divided into 400 million euros for priority investments, particularly in the electricity sector, and 560 million for the private sector); United Arab Emirates (US$300 million); Arab Investment Bank (US$250 million); Islamic Development Bank (US$250 million); and the UK (US$48 million to the UN agency dealing with refugees in Lebanon and US$115 million over the next four years for reconstruction projects with no conditions) amongst others smaller pledges.

[18] Similar to that traditionally adopted by the IMF.

[19] The government's program presented at Paris III consisted of three components: structural reforms to stimulate growth; fiscal adjustments to raise revenue and promote the efficient use of public resources; and the implementation of social safety nets and special programs targeted to the poorest and most vulnerable, to ensure that they do not suffer unfairly and that they share in the benefits of reform.

Infrastructure
Reconstructing the country's infrastructure[20] will be crucial to rebuild the economy, unify the country, meet social needs, stimulate private activity and regenerate exports. In comparison to the post Taif public and private sector reconstruction efforts under Prime Minister Hariri the current reconstruction efforts need to be: truly nationwide in scope rather than focused primarily upon Beirut; more transparent; and insulated from political interference. For example, more focus should be given to the poorer parts of the country where increased income from infrastructure expenditure has the potential to exert a higher multiplier effect arising from an associated expansion in consumption expenditure[21]. As mentioned previously Saudi Arabia, Kuwait and Qatar have already pledged between them US$1.1 billion for reconstruction, but more will clearly be required. The first step, however, will be to work out the modalities for project development and disbursement, and the Lebanese government has proposed that countries adopt specific projects – such as for specific roads and bridges. Many basic decisions relating to the reconstruction and rebuilding of the economy, however, remain at an early stage with many crucial decisions still to be made.

Fiscal crisis and public debt overhang

The Lebanese authorities, as a matter of urgency, also need to tackle the ongoing and intensified fiscal crisis and large public debt overhang. First, and of immediate concern, is the need for US$1 billion in budget support for the current financial year to compensate for revenue losses. The war caused a direct loss of about US$650 million in revenues that could not be collected. It also caused the economy to contract from a projected 6 per cent growth rate by mid 2006 to –2 to -3 per cent growth for the year (Bank Audi, 2006), causing another US$350 million in revenue losses[22]. The budget will go from a projected primary surplus (before debt service) to a primary deficit. The government's only alternative to finance this deficit is to print money but this would have a deleterious effect on inflation and adverse impact on the health of the Central Bank's balance sheet. On the other hand, taking on more debt to finance the deficit would further exacerbate the country's existing public debt which is already the highest per capita in the world. Second, is the need to refinance the existing public debt of US$36 billion[23]. Private Lebanese banks hold US$20 billion of this debt and they have already indicated that they will refinance it. A key issue will be their willingness to allow a grace period at a minimal interest rate. The remaining US$16 billion will require assistance from international official and private creditors and the working out of a debt relief scheme, although this will be complicated. The third issue relates to the electricity sector. Subsidies to the sector cost the government about US$1 billion annually, equivalent to around 20 per cent of its revenues and around 5.3 per cent of GDP (Anonymous, 2007)[24]. Between electricity subsidies and debt service the Lebanese government spends half its annual revenues, crowding out other investment in

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[20] Top priorities are electricity plants and grid, water supply and sewerage, roads and bridges, with preliminary estimates suggesting required expenditure in the order of US$3.5 billion. Also required will be the reconstruction of airports, ports, telecommunications, and residential property.
[21] The gap between rich and poor widened in the 1990s resulting in grassroots dissatisfaction over the skewed distribution of the reconstruction benefits, leading the government to shift its focus from rebuilding infrastructure to improving living conditions.
[22] Other estimates of GDP growth for 2006 suggest 0 per cent according to the Central Bank of Lebanon, -5 per cent by the International Monetary Fund and –8 per cent by the Economist Intelligence Unit.
[23] Finance Minister Jihad Azour expected public debt to reach US$41 billion by the end of 2006.
[24] It has also been suggested that at least 500 institutions are not paying their electricity bills.

infrastructure or expenditure in the social sectors. Ending the electricity subsidies will produce an economic shock and hardship among the poor that will require in its place a targeted subsidy program. This is the type of initiative where donor grant funding for feasibility studies and technical assistance could generate a considerable and beneficial multiplier effect.

Tackling the fiscal imbalance will require fundamental improvements on both the revenue and expenditure sides. On the revenue side an increased VAT rate, introduction of a more efficient and progressive income tax system, and the return to a tax on petrol equivalent to its 2003 level need to be considered. The government recently announced that it was planning to increase the current rate of VAT from 10 per cent to 12 per cent in 2008, and then to 15 per cent in 2010. By the end of 2010 the government is expecting VAT revenues to be worth around 2 per cent of GDP. The proposed increase in the VAT rate is, however, still quite low in comparison with many other developed and developing countries. Tax reform is one of the most important and effective policies to tackle the deficit and debt problem in Lebanon. For example, property tax in Lebanon accounts for only 3 per cent of GDP in comparison with 4.5 per cent in OECD countries (Anonymous, 2007). Hence, tax reform in this area has the potential to significantly improve government revenue. Another potential source of expanded tax revenue is tax on interest income. The government is planning to increase the rate of such tax from 5 per cent to 7 per cent by 2008, and is expected to generate revenues equivalent to around 5 per cent of GDP. This again has the potential to enhance government revenue and reduce the public deficit, but the government needs to be aware of its potentially adverse effect on attracting overseas investment. Tax measures of this sort are more likely to be objectives over the medium to long term, particularly given the precarious state of the economy over the short term.

Speeding up the process of privatization of certain public sectors – especially telecommunications and electricity[25] is, therefore, the only realistic option for the government to tackle the budget deficit in the short term. A key issue here is whether to use the funds generated from privatization to reduce the public debt or to finance investment expenditure. The total returns from privatization are anticipated to generate a reduction in debt equivalent to 15 per cent of GDP (Anonymous, 2007). Hence, privatization is a step in the right direction to reduce the public debt and deficit but has to be supported by many other economic and tax reforms policies. The war of 2006 will, however, stall the privatization process due to: the damage to many public sector assets; the reduced revenue that would be generated from the sale of these assets at this time; a general loss of confidence, and higher perceived risk, in the economy by domestic and foreign investors.

On the expenditure side emphasis needs to be placed on reducing non-productive and poorly targeted outlays, and tackling the cost of debt servicing . In terms of the former, priority needs to be given to reducing electricity subsidies. This will have an adverse

[25] In 2002 the government emphasized privatization, initially in the telecom sector and electricity, with continued planning for sales of the state airline, Beirut port, and water utilities in line with Paris II. In reality, only the telecommunications sector has generated profits and was potentially attractive to investors. The government pledged to apply the proceeds of sales to reduce public debt and the budget deficit. In addition, it projected that privatization would bring new savings as government payrolls are reduced, interest rates decline, and private sector growth and foreign investment are stimulated. However, progress on privatization has been much slower than anticipated.

impact on the poor and will require the development of appropriate and targeted hardship alleviating measures.

A recent study by Saleh and Harvie (2006)[26] concluded that a re-structuring of government spending from current to capital (infrastructure) expenditure can produce a number of potential advantages for the economy. First, an expansion in capital expenditure produces a larger favourable impact on private sector investment (through a crowding in effect), which the country desperately requires after the recent war destruction, enhancing the productive capacity of the economy. Expansionary capital expenditure is also found to enhance international competitiveness and improve the trade and current account performance (due to a larger depreciation in the real exchange rate) as well as resulting in an accumulation of foreign asset stocks (reducing external debt). An expansion in government consumption expenditure, on the other hand, produces unfavourable external developments with the trade and current account balances both deteriorating in line with a decline in foreign asset stocks (equivalent to an increase in external debt). This finding suggests that improved productivity of government spending can best be achieved by restructuring it from current to targeted capital expenditure.

Saleh and Harvie (2006) also find that government capital and current spending produce similar outcomes in terms of the interest rate and inflation, and are best funded, where possible, through bond financing rather than through monetary accommodation as this is non inflationary and results in considerably less interest rate volatility. They also conclude that a gradual fiscal expansion is preferable to that of a rapid expansion as it results in considerably less volatility in terms of major macro outcomes.

In addition to the need for government to enhance its revenue capacity and spending productivity, other measures will also be required by the government in its economic recovery program. This includes reducing red tape and corruption in the public sector. According to Transparency International Lebanon ranked 78 out of 133 countries in 2003 (see Thomas, 2003). It ranked below most Arab countries, and had equal ranking with Palestine. Other Arab and Middle East countries which performed better than Lebanon included Oman and Bahrain ranked 26, UAE and Tunisia ranked at 37 and 39 respectively. Iran ranked 78, Yemen ranked 88, and Libya ranked 118. Israel ranked 20 and was the only country in the region to achieve such a ranking. These results are very alarming for Lebanon, indicating that the issue of corruption, and the need to improve governance, is now one of the key problems facing the government as it attempts to improve the country's economic performance. In addition, the Lebanese government needs to push ahead with its economic recovery program, including: reactivating the liberalization and privatization of the telecom sector; lowering the high costs of business entry and exit; and strengthening contract enforcement. These represent reinvigorating the structural reform agenda agreed at the Paris II donor conference, but which the government has been very slow in acting upon due primarily to inauspicious economic and political circumstances.

Environmental damage and tourism

One of the major sectors affected by the war has been tourism. The sector plays a crucial role in the economy due to its strong linkages with other service sectors such as

[26] Based upon a dynamic macroeconomic model for Lebanon.

transportation, construction, real estate, banking and financial services and retail. Tourism directly contributes between 10 to 12 per cent of GDP (World Tourism Organization, 2006), and employs around 300,000 people with one third of these working in catering businesses[27]. The Ministry of Tourism predicted 1.6 million visitors in 2006 that would generate some US$2 billion in revenue, and reflected the major advance in economic and political stability achieved by the country before the outbreak of war in mid 2006. This prediction was on track during the first half of the year with record tourist numbers, registering a 49.3 per cent increase over the 2005 figure. However the war precipitated: a dramatic decline in tourist numbers by 58.6 per cent in the third quarter of the year; the cancellation of festivals and concerts; and the closing down of restaurants, hotels, nightclubs and beach resorts. This resulted in an overall decline of 8.6 per cent in tourist numbers for the first nine months of the year.

Early recovery efforts at the end of the war in mid August 2006 focused upon cleaning up an oil spill off Lebanon's coast and clearing unexploded bombs. This reflected the need to re-generate this sector and of its overall considerable importance for the country in terms of employment, GDP, and foreign exchange earnings. However, the country will not be successful in attracting back tourists, investment and returnees without achieving sustainable peace amongst its various secular factions and with its regional neighbours.

Promoting the private sector

The sustained recovery of the Lebanese economy will require strengthening of the private sector. This sector has the potential to generate jobs, growth, exports and to integrate the country’s poorest communities with the rest of the country. Economic recovery after the Civil War (1975-90) was strongly facilitated by private activities in the agriculture sector, construction sector and banking system as well as by resilient private sector small and medium sized manufacturers mainly concerned with reassembling and packaging imported parts. The main sources of foreign exchange are generated by the private sector in the form of family remittances, banking services, manufactured and farm exports, supplemented by assistance in the from of international aid.

Lebanon has a competitive and free market regime and a strong domestic laissez faire commercial tradition. The economy is service-oriented; the main growth sectors include banking and tourism. There are no restrictions on foreign exchange or capital movement, and bank secrecy is strictly enforced. Lebanon has recently adopted a law to combat money laundering, and there are practically no restrictions on foreign investment. Lebanon also benefits from its large, cohesive, and entrepreneurial diaspora, and the many Lebanese who live and work abroad generate considerable remittances for the country. The country is also in the process of finalizing its membership of the WTO which it hopes to have completed by the end of 2007. Hence the government is trying to further liberalize the economy and to ease trade restrictions.

[27] Lebanon’s service sector has traditionally been based upon tourism and banking, and the sector itself is the most important pillar of the economy. Nearly 65 per cent of the workforce is employed in the sector and it contributes 67.3 per cent to GDP.

Perhaps this will enhance further Lebanon's trade with its neighbouring countries, and especially within the Middle East and with European countries. Lebanon is also trying to enhance further its capital and stock markets.

After the Civil War the private sector was seen as the engine for economic revival and sustainable growth. A similar role will be required in the wake of the summer 2006 war. In this regard a number of policy initiatives will be required. First, the role and contribution of the banking sector will be crucial. The banking sector achieved a healthy performance over the first nine months of 2006 despite the summer war, and its adverse repercussions for overall economic activity and implications for its business clientele base as mentioned previously. Assets, deposits, loans and especially shareholders' equity all reported strong growth in the first nine months of the year. Bank profitability also increased and appeared to be unaffected by the adverse economic developments as both interest and non interest income increased. Banks' assets grew by 4.5 per cent over the first nine months of 2006 primarily driven by customer deposits. Total loans increased by 7.1 per cent over the year to September 2006, and capital adequacy strengthened throughout 2006. Hence the financial sector remains strong in Lebanon but there are major problems in the real sector.

Consequently, an important contribution to recovery of economic growth and employment generation, particularly in the private sector, needs to be made by the commercial banking sector. Lebanon's strong commercial banks have experience in administering micro and small business finance, and they have considerable liquidity. However, the current lending risk is high, and, consequently, interest rates and lending terms are prohibitive for many of Lebanon's small businesses. To get the business sector moving it is essential that Lebanon's small and medium sized enterprises have access to funding. Consequently, the government has an important role to play as a conduit between liquidity constrained small businesses and the liquidity abundant banking sector. Government agencies and the commercial banking system need to work in close collaboration to devise innovative and effective means of meeting the funding and rebuilding requirements of small businesses. The government could provide partial or full loan guarantees and financial assistance to reduce lending risk and lower borrowing rates, provide a repayment grace period and extend the lending term. While financial assistance, including subsidies, would need to be eventually phased out, they would open the credit market to a wide range of small entrepreneurs whose businesses have been destroyed or disrupted by the war. In addition to increasing the availability of financing for micro and small businesses, there is also a need to expand large scale private sector financing that would facilitate investment in new business opportunities and support restructuring and modernization of medium and large scale enterprises.

Apart from finance another key obstacle for small and medium enterprises in Lebanon is the very high cost of production (especially for electricity, transport, telecommunications and that arising from red tape and corruption etc.). The government must tackle these issues as a matter of urgency. The government needs, as mentioned previously, to reduce red tape and corruption, reactivate the liberalization and privatization of the telecommunications[28] and other sector sectors as quickly as feasible, lower the costs of business entry and exit, and strengthen contract enforcement. Hence there is a need to reinvigorate the Paris II structural reform agenda, and this has now

[28] This remains the most attractive and profitable sector for private investors.

been given momentum by outcomes from the Paris III donor conference. While privatization of sectors such as telecommunications, electricity, the state airline, Beirut port, and water utilities have been on the agenda since 2002, little progress has been made. The events of summer 2006, however, have made the privatization task extremely difficult at present, and progress is likely to be further slowed due to war damage that will considerably reduce the revenue generated from their sale and the reluctance of international investors to invest at this point in time. A successful re-invigoration of the private sector has the potential to make an important contribution to reducing the debt overhang. According to a recent government report in Lebanon a 1 per cent increase in GDP will lead to a reduction in debt, as a percentage of GDP, by 5.1 per cent. Hence, the government in Lebanon should focus more on maintaining sustainable economic growth in Lebanon by all means as this is an important step in tackling the public sector deficit problem.

Measures also need to be implemented to encourage the return of some if not all of the US$2.5 billion in foreign and domestic investment that fled the country during the war, and of some of the 500,000 skilled Lebanese who fled during the war. Such financial and human capital could play a key role in revitalizing the private sector. They can facilitate Lebanon regaining its place as a hub for business and financial services in the Gulf; and restore its engineering and construction companies to the role as major builders in the Gulf countries.

4. Summary and Conclusions

Devastated by Israel’s bombs, threatened by the increasing economic and political influence of Syria and Iran, divided from within, facing substantial fiscal and current account deficits and the need to rebuild its fragmented economy, Lebanon faces many difficult tasks ahead. The process of economic recovery will not be easy and will be heavily dependent upon the benevolence of international donors. Despite this, history has demonstrated that the country has remarkable resilience. However, recovery such as that experienced in the post Taif reconstruction period will be more difficult in the wake of the war of summer 2006. The government is much weaker and subject to considerable secular divisions, access to funds from public and private sources for reconstruction will be much more difficult, there will be much greater dependence on the benevolence of international donors, and there has been considerable capital flight and migration of skilled labour that could be permanent. Nevertheless, as one of the Middle East’s few functioning democracies, its pivotal role in trade and finance in the region and its important role for the attainment of lasting peace in the region suggests that, while small economically, the success of the country’s reconstruction efforts this time around are of much wider regional significance.

Key to the country’s future growth and development will be the need to reconstruct the country’s war damaged infrastructure, tackle the unsustainable fiscal deficits and debt overhang, reinvigorate its private sector focusing upon tourism and enhancing the recovery of small and medium sized enterprises by tapping into the strength of its banking sector. However, there are clear limits to what the country can do in isolation. Its future now depends very heavily on international lenders and donors, and in this regard the outcomes from the Paris III conference will be pivotal. What happens in the future for Lebanon could be a microcosm of what will happen, more generally, in the Middle East region.

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