CHAPTER TWO

The Lebanese Economy prior to 1975
Impact of the War on the Lebanese Economy
Evolution of the Lebanese Economy in the 1990s
The Reconstruction and Development Plan

ECONOMIC DEVELOPMENT AND RECONSTRUCTION

A. The Lebanese Economy prior to 1975

Since its independence in 1943, Lebanon has adopted a liberal economic system that gave the private sector freedom of initiative in the economic field, including financial and monetary aspects, with no restrictions imposed on currency transfers and external trade. This openness gave Lebanon a comparative advantage in the region and enabled it to attract Arab and foreign capital and investment, helped to transform Beirut into an important regional trade and financial center, and enabled its banks to draw an important share of Arab deposits, especially from the oil revenues of Saudi Arabia and other Gulf states.

The basic contours and features of the economy were defined during the 1950s and 1960s with the rapid expansion of the services sector, especially commercial and banking services, which came to dominate the commodity - producing sectors (agriculture and industry) and to account for about two-thirds of the gross domestic product (GDP). Political developments in the Arab world, and the discovery of oil, were major factors behind the expansion of the banking sector in the 1950s and 1960s, when the number of banks operating in Lebanon rose from 23 banks in 1950 to 93 banks in 1966. These trends confirmed the service - orientation of the economy which assumed the role of an intermediary between the Arab countries and the advanced industrial countries. This special relation between Lebanon and its Arab milieu has been a major factor influencing the performance of the Lebanese economy. Between 1960 and 1973, real per capita gross national product (GNP) grew at an average annual rate of 5.6 percent.

However, the decade stretching from 1966 to 1975 witnessed some saturation in the services sector, and contraction in the banking sector, as a consequence of two important developments: a regional one, namely the Arab-Israeli war of 1967; and an internal development: the collapse of Intra Bank in 1966 which was followed by a drop in the number of operating banks from 93 to 74 banks in 1972. In contrast, the industrial sector experienced considerable expansion, with industrial investment rising at record annual rates averaging 21 percent between 1970 and 1974. Moreover, this industrial expansion was export - oriented, with Arab markets as its main destination. The share of manufactured products in total exports rose from 12.5 percent in 1960 to 30 percent in 1972. In contrast, the agricultural sector continued to fall behind; its share in GDP dropping from 19 percent in the 1950s, to

11.9 percent in 1964 and further to 9.3 percent in 1972, with this trend continuing up to the present. The middle class, which constituted a significant percentage of the population, and played an important role in the development and dynamism of the economy.

During this period, a number of features acted to influence the performance of the economy and its subsequent development, of which the following are worth noting:

- Limited state intervention in economic activity; the share of the public sector in GDP has been estimated at 12 percent; reaching its peak at 20 percent in the period 1958-1964.
- A high degree of monetary stability and the adoption of a floating exchange rate. The Lebanese pound maintained a stable and rising rate of exchange vis-à-vis foreign currencies during this period; the rate standing at about 2.3 Lebanese pounds for one United States dollar on the eve of the outbreak of war in 1975.
- Financial stability based on: satisfactory overall economic performance; low inflation rates; a stable exchange rate; absence of deficit in the budget; absence of public debt, both internal and external; and, a persistent surplus in the balance of payments reflecting, in particular, the inflow of Arab capital and remittances of Lebanese working abroad.
- In the external sector, the country consistently experienced a deficit in the balance of trade. However, the export/import coverage recorded some improvement during the early 1970s, reaching 66 percent in 1974, with industrial exports playing a major role in this development. This deficit, it may be noted, did not at the time exercise a direct negative impact on the economic and social situation in the country as the overall balance of payments was in surplus.

This positive assessment does not mean that the economy was free from structural weaknesses and distortions. Signs of strain were beginning to appear in the economy mainly as a result of saturation in the services sector, lack of discipline in economic activity and underdeveloped legislative and administrative structures governing the functioning of institutions and sectors. The collapse of Intra Bank and the ensuing crisis in the banking sector were the main symptoms of this crisis, which was also beginning to show in higher inflation rates averaging 5.8 percent per annum between 1970 and 1974. The economy was also particularly affected by the Arab-Israeli wars: the June 1967 war and the resulting general stagnation in the region and in Lebanon; and the war of October 1973 and the ensuing boom as a result of higher oil prices.

Economic experts point to the existence of a number of features and imbalances in the economy which, even if they did not have direct and visible negative economic effects, they could have laid the ground for the economic and social crises that emerged or were aggravated during the war and its aftermath. The most significant of these features and imbalances include:

- Substantial discrepancies in growth between the different regions of the country.
- Concentration of income distribution and existence of social discrepancies. 30 percent of the national income went to 4 percent the poorest 50 percent obtained only 18 percent of national income in the early of the Lebanese population, while sixties.
- Imbalance among the main economic sectors - services, industry and agriculture - in favor of services, which produced negative effects manifested especially in the deterioration of agriculture, the persistence of rural - urban

migration, and the swelling of Beirut and its poor suburbs in particular.

- Coexistence of two apparently contradictory tendencies within the internal structure of the economy. The first is the numerical dominance of small economic establishments having a traditional form (individual or family establishments, or companies of individuals). In 1971, 72.7 percent of all establishments employed less than 5 workers, compared with 24.6 percent which employed between 9 and 25 workers, and 2.7 percent with more than 25 workers. At the same time, the proportion of independent workers reached 24 percent of the total labor force in 1970. However, this phenomenon was accompanied by a high degree of economic concentration. Thus, the 2.7 percent of establishments that employed more than 25 workers in 1971 accounted for 45 percent of all workers in industrial establishments, 67.1 percent of industrial output, and 76 percent of the wage bill in that sector.
- An underdeveloped and politicized administration, and inadequate legislation to cope with the evolving economic and social situation.

This development pattern had a direct impact on the internal fabric of the society. Growth based on commercial and banking activity and an open economic system, when national productive capacity is limited, is narrowly - based growth that deepens reliance on imports and encourages consumer life styles and behavior. Lebanese rural areas were the main victim of this pattern, which was also characterized by the uncontrolled and random expansion of the capital and other urban centers.

The above economic features and characteristics enabled Lebanon to enjoy a period of prosperity during the 1960s and the first half of the 1970s. At the same time, they rendered the country extremely vulnerable to external influences and contributed to generate, or accentuate, imbalances that were among the social causes of the Lebanese war.

B. Impact of the War on the Lebanese Economy

The outbreak of the war in 1975 interrupted the course of development. Its persistence and spread to various areas in the country played a major role in destabilizing the economy, which weakened confidence in the national currency and gave rise to rampant inflation. These negative effects were compounded by very serious events at the regional level.

During its long war, the country endured two major invasions by Israel: in 1978 and in 1982. The latter invasion extended into Beirut and led to the resumption of violence in the capital and Mount Lebanon area. The invasion also dealt a severe blow to the central government, which lost its ability to collect revenues, and created a *de facto* situation of geographical, political and economic division of the country.

Lebanon also suffered directly as a result of the Gulf war which broke out after Iraq invaded Kuwait in August 1990. This included the return of a large number of Lebanese that were working in Kuwait and Iraq; the loss of major export markets; and a drop in expatriate remittances and capital and investment inflows from the Gulf states that were a major source of the balance of payments surplus. These negative effects were compounded by the outbreak of another wave of domestic violence in 1989 and 1990 that took place against a political vacuum resulting from the inability to hold the presidential elections on the date stipulated in the Constitution (September 1988), and by the political divisions within the institutions of government, and outside it, that preceded the signing of theTaef Accord.

These developments help to show the extent of the pressure to which Lebanon has been exposed, and the resistance it put up before its resources and reserves, accumulated during years of prosperity, were exhausted.

The years of war inflicted heavy losses, at various human, social, and economic levels, in the immediate as well as in the medium and long term, some of which are irreplaceable. The following are the major losses incurred:

- The large number, estimated at 65,000, of citizens killed, in addition to thousands of cases of permanent disability.
- The large number of Lebanese who emigrated, which constitute a human drain affecting negatively the sustainable development potential. These included scientists and university graduates, skilled labor, young people and entire families which settled abroad.
- Deterioration in the standard of the labor force at all levels, causing Lebanon to fall behind in scientific development, technological innovation and progress in management techniques that were taking place at the global and regional levels.
- Material losses estimated at around US$ 25 billion.

The extent of the deterioration can be gleaned from the following indicators:

1. Decline of domestic output and cessation of growth

The massive destruction which the economy sustained during the war affected both the physical infrastructure and the public and private institutions. In effect, none of the economic sectors was spared the ravages of the war, in addition to suffering huge indirect losses.

The major productive sectors suffered most. Tourism ceased effectively; trade and transit activity through Lebanese ports and territory shrank considerably due to lack of security; industry incurred substantial damage as many industrial establishments were destroyed, and due to the forced displacement of workers and emigration of skilled labor; while agriculture was almost in ruins, especially in South Lebanon, because of the repeated Israeli invasions and attacks.

The outcome of these developments was to bring growth to a stand-still and, as a matter of fact, cause a deterioration of the entire production process. This was manifested, in particular, in the decline of aggregate and per capita GDP. The extent of the decline in GDP has been estimated at two thirds between 1975 and 1990, while per capita GDP dropped to about one thousand dollars only.

Over and above these direct losses, investors refrained from investing in Lebanon. This further weakened domestic productive capacity and prevented the country from taking advantage of the rapid technological progress taking place elsewhere.

2. Inflation

Inflation rates started to rise in the early 1970s, but they remained under control. Control over inflation, however, weakened during the war years, with sharp variations in the rate of inflation recorded depending on the phase of the war. In this respect, the phase that followed the invasion of Lebanon by Israel in 1982 was a decisive phase between the high inflation rates of the early years of the war and the hyper- inflation that characterized the second half of the 1980s (see table II-1). The Israeli invasion of Lebanon had profound political consequences reflected in the renewal of violence and the loss by the central government of its revenues and ability to collect them; it also had devastating economic consequences in terms of the destruction it inflicted on the infrastructure and economic establishments and vital facilities, the dislocation of the internal market and fall in Lebanese remittances from abroad. The annual rate of inflation exceeded 400 percent in the peak year of 1987, and very high rates of inflation continued through the early 1990s.

Table II-1: Average annual rates of inflation, 1970/1974 - 1985/1990
(period averages; percent)

Period	Average rate
1970-1974	5.8
1975-1979	19.1
1980-1984	24
1985-1990	138

Source: Consultation and Research Institute (Beirut).

3. Deterioration of the rate of exchange of the national currency

The Lebanese pound maintained a satisfactory and stable rate of exchange with respect to the United States dollar for many years, including the early years of the war that preceded the Israeli invasion of Lebanon in 1982. In 1974, the United States dollar was equivalent to LL 2.33. In June 1976, the rate of exchange of the pound recorded its lowest level in five years, LL 3.1 to one dollar, and then deteriorated to LL 4.7 to one dollar in 1982 (see Table II-2). As of 1985, the rate began a head-on plunge, to reach the average rate of LL 702 to the US dollars in 1990.

Table II-2: Evolution of the rate of exchange of the Lebanese pound, selected years
(LL per one dollar; yearly averages)

1974	1982	1985	1987	1988	1990
2.3	4.7	16.4	225	409	702

Source: Bank of Lebanon.

4. Budget deficit and public debt

The impact of the war on public finances and on the country's financial conditions in general was very profound. The erosion of government authority gradually paralyzed the administration and rendered it incapable of collecting and administering public revenues. From a budget surplus of 4.2 percent in 1974, the situation turned around into a deficit of 21.8 percent of total expenditures in 1975. The deficit kept on rising to reach more than 50 percent in 1981 and to peak at more than 90 percent in 1988 and 1989 (see Table II-3).

However, in view of the lack of reliable statistics and the limited coverage of collection of public revenues, it is difficult to draw firm conclusions on the tax burden during that period, which in its totality (including parallel taxes) may have been heavier than in the period preceding the war. Deficits were also caused by the fact that wages and salaries continued to be paid to employees of a largely non-functioning administration. Whereas the ratio of public expenditures to GDP did not exceed 12 percent, on average, in the early years of the war, the ratio is estimated to have climbed to 50 percent in 1991.

To finance increasing budget deficits, the Government resorted to issuing treasury bills bearing high interest rates, and to borrowing from commercial banks and the Bank of Lebanon. This led to a chain reaction: the resulting sharp expansion in the money supply causing in turn higher inflation rates and a sharp deterioration of the exchange rate of the Lebanese pound. The Bank of Lebanon found itself obliged to intervene in the exchange market, selling dollars to reduce the pressure on the Lebanese pound. However, it lost a considerable portion of its hard currency reserves without succeeding in stabilizing the rate of exchange, and repeatedly had to abandon its attempts. Thus, the Lebanese economy entered a vicious circle with the deficit in the general budget being financed by inflationary means, causing the national currency to weaken, the spread of the dollarization phenomenon on a large scale and capital flight.

Table II-3: The budget deficit in selected years
(As percent of total expenditures)

1974	1975	1981	1982	1987	1988	1989
+4.2	-21.8	-53.2	-64.4	-86	-92.2	-91.1

Source: Bank of Lebanon (various annual reports); and Issa, Najib, Economic Reform and Reconstruction in Lebanon, Economic and Social Commission for Western Asia (ESCWA), Amman, 1993 (in Arabic).

A distinctive feature of Lebanon's economic performance during the war years was the growth of the internal debt. The loss of state revenues, and the increase in defense spending, are considered as the two main factors explaining this phenomenon. The ratio of the internal debt to GDP rose from 4.2 percent in 1974 to 111 percent in 1982. In absolute terms, the debt rose from LL 14 billion at the end of 1982 to LL 194 billion at the end of 1987, and further to LL 1,590 billion at the end of 1990. Over 90 percent of this debt was in the form of treasury bills denominated in Lebanese pounds, the bulk of which was subscribed to by the commercial banks, bearing real yearly interest rates ranging between 25 percent and 35 percent between 1987 and 1992.

5. Trade deficit and balance of payments

Lebanon is essentially an importing country with a free trading system. The deficit on the balance of trade (see Table II-4), a permanent feature of the Lebanese economy since independence, has been usually met by the surplus on the services and capital accounts in the balance of payments.

The war, however, reduced the country's ability to produce and export. It also made it difficult to transact trade through Lebanon at a time Arab markets - Lebanon's main export outlets and trading partners - were shifting to other alternatives:

producing domestically or importing from other sources without the intermediation of Lebanon.

Table II-4: Lebanon's trade balance, selected years

Year	Trade Deficit (US$ million)	Export / Import Ratio (Percent)
1974	]	66
1980	-2,814	27
1985	-1,372	30
1990	-1,802	22

Source: Bank of Lebanon, Annual Report (1991, 1992 and 1993).

Moreover, capital inflows and remittances of Lebanese working abroad shrank as a result of the Gulf war; in addition, Lebanon lost some of the war-related sources of financing, especially after the Palestine Liberation Organization (PLO) was forced to leave Beirut in the summer of 1982.

During the second phase of the war (after 1982), the balance of trade and the balance of payments as a whole came under increased pressure. The coverage of imports by exports fell from 66 percent in 1974 to 22 percent in 1990, while the balance of payments recorded a deficit starting in 1983 and continuing until 1991. As a result of these developments, the Lebanese economy lost the element of balance in its external trade and financial operations.

6. Summary of economic conditions on the eve of theTaef Accord

On the eve of the end of the war, and in the light of the negative economic developments experienced, the Lebanese economy manifested the following features:

- A sharp and persistent decline in revenues,
- Per capita GDP was equivalent in 1990 to about one-third of its level in 1975; and the pattern of income distribution had worsened and the size of the middle class had shrank considerably.
- A rise in the burden and cost of financing the internal public debt by means of treasury bills bearing high interest rates,
- Continued decline in investment expenditures and a sharp rise in current expenditures, and
- Low investment levels, both public and private, had caused the physical capital and productive base to erode, and with it the ability of the economy to compete.

C. Evolution of the Lebanese Economy in the 1990s

1. Global economic developments

The war virtually isolated the Lebanese economy from the influences of the important developments that were taking place in the world economy, which contributed directly to shape economic relations in the 1990s, and with which Lebanon must now deal that the war is over. The main developments in this respect were:

- The substantial growth in developing countries' indebtedness, especially the non-oil exporting developing countries, and the resulting debt crisis in the early 1980s; and, developing countries turning into net capital exporters to the industrialized countries between 1985 and 1992.
- The decline in raw materials prices, and the rise in prices of manufactures produced with the help of advanced technologies.
- The oil-exporting countries emerging as a source of substantial financial surpluses at a time when the industrialized countries were suffering from recession and a liquidity crisis; the latter managing to attract the surplus to finance their own development and international borrowing.
- The shift in the advanced industrial economies away from Keynesian policies, and from the notion of the welfare state, to new and more liberal policies predicated on the notion of a reduced economic and social role of the state, and freeing of market mechanisms from restrictions that limit their efficiency at the national and global levels.
- The continuing process of freeing international trade and unifying tariffs at low levels, and pressure on prices of raw materials, including the price of oil, which have created conditions of trade that were not generally favorable to the interests of weaker parties, especially the developing countries.
- The shift in the focus of foreign investment in developing countries from lending to direct investment. This shift coincided with the emergence of structural adjustment programmes that aimed to create an economic, legislative and institutional environment conducive to such investments and to guarantee their safety and yields. These programmes also aimed to ensure the generation of financial surpluses needed to deal with the aftermath of the debt crisis, or to prevent its reoccurrence. This explains the emphasis placed in these programmes on achieving balanced budgets; cutting down on economically non-productive spending; pressuring developing countries to free their trade and rates of exchange; abolishing protective measures; reducing the planning or direct economic role of the state; and, removing restrictions on private sector activity to enable foreign capital to cooperate freely with it, etc.
- The enormous progress that has occurred in the field of technology and communications, and the concomitant deepening of the trend towards globalization and greater economic interdependence.

Finally, it should be noted that these transformations - essentially of an economic nature - took place against a background of far-reaching political changes: the collapse of the dual world system and the exposure of the crisis in prevailing development models, especially those adopted by developing countries and east European countries.

These developments in the global context - which do not exhaust the list of transformations that have been taking place in the world economy over the last two decades - bear directly on the process of economic recovery in Lebanon. This process can not be carried out effectively without taking into consideration the new global realities and conditions, and the mechanisms that govern their functioning.

Lebanon, which is trying to regain a role for itself - be it an old role or a new one - in the region and/or in the world - needs to create a domestic environment favorable to development, including the ability to attract national capital, whether from inside the country or from abroad, and foreign capital and investment. This implies finding solutions to the economic and financial issues it is faced with, and conforming to current standards and notions regarding the safety of investment.

There is no doubt that the task confronting Lebanon in this respect is a difficult one. Also, the recovery is taking place at a juncture when the forced interruption, by the war, caused Lebanon to loose part of its intermediation role with the Arab countries, as these countries established direct links with the advanced industrial countries; built their own industries which substituted for part of their imports from Lebanon; established their own financial and banking institutions; and developed their manpower capabilities. In addition, the oil surpluses, which supplied the Lebanese banking system with deposits dried up considerably due to the fall in oil prices and the financial obligations associated with the two Gulf wars.

In this sense, the approach to be pursued by Lebanon in its efforts to rebuild the economy can not have as its point of departure the conditions that prevailed up to the mid-1970s, assuming it to be a continuation of the normal course of development had it not been for the interruption caused by the war. To the contrary, the recovery effort should be viewed as a process that draws on elements of strength in the economy and society, and accordingly defines new roles and objectives that are in harmony with the new regional and global realities.

2. Onset of economic recovery (1991-1992)

In October 1989, agreement was reached on a national reconciliation pact that became known as the Taef Accord. This event formed the point of departure on the road to civil peace. However, tangible results had to wait until after military operations ceased in mid-October 1990, as the signing of the Accord was preceded and followed by an unprecedented wave of violence.

As of 1991, the Lebanese economy started to recover, with GDP growing by 38 percent compared with 1990. This large jump could be interpreted, to a considerable extent, as a compensation for the huge drop in GDP in the preceding two years. Inflation also began to recede in 1991, imparting some stability to the rate of exchange of the Lebanese pound. The balance of payments recorded a surplus exceeding one billion dollars in 1991.

This improvement experienced a setback in 1992. As a result of the wage correction at the end of 1991 which led to a sharp expansion in domestic liquidity, inflationary pressures re-emerged and pressure on the Lebanese pound mounted. This led to the collapse of the rate of exchange of the national currency, which fell to a record low of LL 2,830 to the dollar at the beginning of September 1992, after the Central Bank had intervened in the currency market without success. The setback in the economic situation affected the rate of growth of GDP which fell to 4.5 percent. It is to be noted that growing political and social tensions were a contributing factor to the temporary deterioration experienced in 1992.

It is noted that during the years of transition (1991-1992), the public finance situation improved considerably. As the Government re-asserted its authority, including in the fiscal field, government receipts increased to an average of 12 percent of GDP in 1991-1992 compared to half that level in 1988-1989. Together with improved revenue collection, expenditure restraints (even in 1992, the increase in budget expenditures was less than the rate of inflation) resulted in a sharp reduction of the overall deficit which stood at just over 50 percent of expenditures in 1992.

Parliamentary elections which took place at the end of summer 1992, and the formation of the Government by Prime Minister Rafic Hariri, ushered in a new phase of political and economic stability, which paved the way for launching the process of reconstruction and economic revival.

3. Government economic policy since mid-1992

The new government faced the task of restoring economic stability and confidence, and of extricating the economy from the vicious circle of inflationary financing and instability of the rate of exchange of the Lebanese pound. The government considered the attainment of **economic stability** as the corner stone of its efforts to reactivate the economic cycle; and to establish an environment conducive to sustainable economic growth and capable of creating new employment opportunities and real growth in incomes and, thus, to improve living conditions.

The government drew up a policy for the medium - term which aimed at achieving economic stability by controlling the budget deficit and reducing it gradually. The government considered the control of the budget deficit as the pre-condition for subsequent action to activate the economy and secure funds to finance development and reconstruction in the form of assistance and soft and ordinary loans, and to replace these sources after some time by financing from future surpluses. The means adopted by the government to achieve its objectives in the medium - term are based on the following principles:

First: Increasing revenues by improving levying and collection practices and procedures, and gradually adjusting rates of indirect taxes to reflect the rise in prices and the deterioration in value of the national currency during the events. This is in addition to the gradual adjustment of some tariffs and charges, especially those on electricity, water and telephone services, which would contribute to reduce the burden on the budget by eliminating government support of these services.

Second: Rationalizing and programming of spending so that the rate of increase in current expenditures remains below that of economic growth in the years ahead, i.e., reducing the ratio of current expenditures to GDP.

Steps were initiated in the direction of reforming the tax system, as one of the main pillars of financial reform. The new tax policy aims to achieve the following objectives: lowering the direct tax burden on citizens and improving living conditions; encouraging the inflow of capital and investment to help stimulate economic activity, expand output and create new job opportunities to help cut-down unemployment,; and, reducing tax evasion and improving levying and collection. In addition, the government took steps to modernize legislation and to launch the process of rehabilitation and reconstruction of the physical and institutional infrastructure.

4. Indicators of economic performance in the 1990s

After two years of transition, the Lebanese economy was showing at the beginning of 1993 clear indications of improved economic and financial performance. By the end of 1994, the government had succeeded to restore confidence in the national economy, to considerably improve standards of economic and financial management, and to get the process of rehabilitation and reconstruction going. The economic performance of 1995 continued to be strong, even though there were indications of a slowdown towards the end of the year as a result of domestic and regional developments. The nature and extent of the improvements are reflected by the indicators given in Table II-5 below.

The Government has made important macro-economic gains during the first half of the 1990s. Initial economic recovery has been remarkable. Yet, much remains to be done to achieve a sustainable fiscal performance and thus to fully secure the key goal of economic stabilization. Main areas in which progress was achieved as a result of the policies pursued by the government may be summarized as follows:

- Growth of GDP has been remarkable as an increase of 75 percent was registered since 1990. The growth performance averaged 7.1 percent over the 1993-1995 period. The recovery brought per capita income from less than US$ 1,000 in 1990 to an estimated US$ 2,600 in 1995; per capita income was only at about 50 percent of the 1974 level).
- There has been a considerable appreciation of the currency and inflation has come down from a level of about 120 percent in 1992 to 11 percent in 1995, and a single-digit level in 1996.
- Foreign exchange reserves have been replenished with reserves held at the Central Bank rising to about US$ 8 billion at the end of 1995, including about US$ 3.6 billion in gold.
- There has been a strong sustained growth of the assets of commercial banks which stood at LL 29,055 billion at the end of 1995. Reflecting growing confidence, there has also been a gradual reduction of the extent of dollarization of deposits, but borrowing remains mainly dollar-based. Foreign exchange deposits as a percentage of total deposits of commercial banks dropped to 56 percent at the end of December 1996.
- The balance of payments began to record surpluses again, as of 1991, as a result of large capital inflows generated by a re-emerging confidence in the country and high return on financial investments, mainly treasury bills.

Table II-5: Selected economic indicators, 1991-1995

Indicator	1991	1992	1993	1994	1995
Real growth in GDP (percent)	38.3	4.5	7.0	8.0	6.5
GDP at market prices (US$ million)	4,451	5,545	7,535	9,110	11,120
Rise in consumer prices (percent)	51	120	29	8	11
Population (million)	2.61	2.70	2.81	2.94	3.09
Assets of commercial banks (LL billion)	6,798	14,634	18,809	24,285	29,055
Rate of dollarization (percent)	70.1	67.5	69.3	59.1	62.3
Exports (f.o.b., US$ million)	490	601	686	737	982
Imports (f.o.b., US$ million)	2,180	3,786	4,907	5,541	6,721
Balance-of-payments (US$ million)	1,074	54	1,169	1,131	256
Foreign exchange reserves, excl.gold (US$ million)	1,237	1,448	2,220	3,840	4,487

Three-month TBs (nominal rate)	14.50	12.59	16.51	13.05	15.40
Government revenues (LL billion)	522	1,138	1,855	2,241	3,033
Government expenditures (LL billion)	1,196	2,219	3,017	5,204	5,856
Public external debt (US$ million)	332	273	327	772	1313
Total internal debt (LL billion)	2,639	5,070	5,823	9,321	11,998
Net total debt (LL billion)	...	4,383	4,993	7,953	11,391
Rate of exchange (LL/US$,annual average)	928	1,713	1,741	1,680	1,621

Source: Ministry of Finance, Bank of Lebanon, estimates of IMF and World Bank.

Success achieved in consolidating the rate of exchange of the Lebanese pound, and in bringing inflation under control, has been associated with stagnation in some sectors, as growth has generally concentrated in the financial and real estate sectors, and in activities related to the rehabilitation of the infrastructure. High interest rates (treasury bills in particular), the level of compulsory legal reserves required from commercial banks, and the structure of the banking system, its deposits and lending operations, have resulted in a shortage in liquidity and the rise in rental profit margins carrying a low risk, compared with the productive sectors, causing the share of rent in GDP to rise. Also, success at the macro-economic level has been at a high social cost.

In contrast, Lebanese exports continued to grow at rates lower than imports causing the trade deficit to widen further. As a result, the export/import coverage was gradually reduced from 16 percent in 1991 to 10 percent in 1995. At the same time, the internal and external public debt continued to grow rapidly. However, the expansion of imports and growth of indebtedness cannot be regarded as being entirely negative, since a considerable part of imports, as well as the rise in external indebtedness, can be explained by the need to provide for and finance reconstruction, equipment and supplies necessary for recovery and development.

The government has given high priority in its financial policy to rectify the growing deficit in the general budget, considering this a pre-condition and key to achieving financial stability and launching the process of development. The government succeeded in reducing the 1993 budget deficit to 38.5 percent of total expenditures, from about 56 percent and 48.7 percent in 1991 and 1992, respectively. This improvement was influenced by several factors including improved collection, by 85 percent, as well as higher revenues from customs and real estate taxes. These favorable developments, however, were offset by the rising cost of servicing the internal debt which increased by two-thirds to reach more than one-fourth of total expenditures and two-thirds of the aggregate deficit. This deficit was entirely financed from internal sources, namely subscriptions by commercial banks in treasury bills. The Bank of Lebanon resorted to this procedure to contain the possible expansionary effects of foreign capital inflows on the money supply and, hence, on inflation.

In 1994, the actual deficit reached 57 percent of total expenditures, thereby exceeding the planned deficit (45 percent). This resulted from expenditures increasing much faster than revenues, delays in putting into effect the law regulating the settlement of building infractions, and in implementing the new tax reforms. Efforts were initiated to restructure expenditures; in this connection, it is noted that capital expenditures increased to 19.4 percent and 18.6 percent of total outlays in 1994 and 1995, respectively, compared to 14 percent of total outlays in 1993. It is noted here that investments of the Council for Development and Reconstruction, financed through foreign loans, increased rapidly from LL 52 billion in 1993 to LL 175 billion in 1994 and LL 486 billion in 1995.

The 1995 and 1996 budgets introduced a measure of austerity and planned deficits were below 40 percent of expenditures. As a result, it is noted that planned capital expenditures in the 1996 budget dropped to 13.5 percent. The actual performance of 1995 showed an improvement but fell short of the target (49.6 percent). In 1996, unexpected developments at the national and regional levels, in particular the Israeli attacks of April 1996 created claims which were not provided for, causing the actual deficit to exceed by a considerable margin the planned deficit.

As a result of the above developments, the public debt has grown at a fast pace during the first half of the 1990s. The following observations explaining the nature of this growth should be noted.

First: The growth of the public debt in the 1990s, especially after 1992, has been associated with the expanding needs to finance the process of economic recovery and reconstruction, whereas in earlier years it was mostly of an inflationary nature and not linked to the financing of economic growth and productive activities.

Second: The budget deficit/GDP ratio showed an uneven performance, moving from 8.9 percent in 1993 to 19.4 percent in 1994, and 15.7 percent in 1995. The volume of the public debt and GDP moved together. The net public debt to GDP ratio increased from 38 percent in 1993 to 63 percent in 1995.

Third: Government efforts to modify the composition of the public debt, and reduce the share of the internal debt in the total (it is important to note that about 80 percent of the stock of debt was short-term, high interest domestic debt), through a number of measures that included lowering interest rates on treasury bills from around 35 percent in 1992 to around 15 percent at the end of 1995. This measure was accompanied by a reduction in the mandatory subscription of commercial banks in treasury bills, from 60 percent to 40 percent of the value of their deposits in Lebanese pounds at the end of August 1994.

Fourth: Notwithstanding the expansion of the external debt and the rise of its share in total public debt, it has remained within manageable limits as it did not exceed 12 percent of GDP at the end of 1995 (about US$ 1.3 billion), and its share in total debt was only 15 percent. This means that Lebanon still has a considerable margin to borrow externally to finance development, especially that the foreign exchange reserves held by the Bank of Lebanon are about three times the size of the external debt (six times if gold is included), which provides a guarantee for the Lebanese economy and for actual and potential lenders.

It should also be pointed out that the cost of servicing the public debt represented an increasing share of the general budget, rising from 23 percent in 1992 to 32 percent in 1995, and an estimated 37 percent in 1996. In the present context, the correction of this distortion is linked to restoring financial balance, by expanding revenues and reducing expenditures; as well as by accelerating growth, expanding the capacity of the economy to export, cutting imports, and selling off assets.

5. Concluding observation

Successive Lebanese governments since 1992 have adopted, more or less, the same economic policies which focus on promoting confidence in the economy, and attempting to achieve the dual objective of economic stabilization - especially cutting the budget deficit and absorbing the internal debt - and rebuilding and rehabilitating the physical, social and institutional infrastructures.

In this sense, Lebanon did not have to depart from the liberal economic tradition and principles which prevailed before the war and which it managed to preserve despite enormous pressures during the last two decades. It had to draw on the elements of strength in the economy and develop them further, to modernize institutions and legislation, and to improve economic and development management. The main elements of strength include:

- An open economic system,
- An economic tradition and environment favorable to private investment,
- Availability of skilled manpower resources and entrepreneurs,
- Leading role assumed by the private sector in commodity and services - producing sectors.

D. The Reconstruction and Development Plan

It is fitting, before reviewing the situation with respect to main components and themes of sustainable human development in Lebanon in the next chapter of the Report, to introduce the country's strategy and programme for national recovery.

1. Background

Efforts of development planning date back to 1958 when the first five-year development plan was formulated, but which was not implemented due to the political crisis and outbreak of violence in the same year. The country's first real experience with development planning goes back to 1962 when, following the completion of a major and comprehensive study on Lebanon, a five-year plan was formulated. However, the implementation of the plan was postponed on the grounds that the concerned administration needed streamlining. A third plan covering six years was formulated in 1972 and also was suspended in the mid-1970s due to political turmoil at the regional level and the outbreak of violence in the country.

With the end of military operations towards the end of 1990, the government faced the task of rebuilding the country's physical, social and institutional infrastructure and preparing the economy to confront the challenges facing it, having been cut off from the stream of regional and global events and developments for more than fifteen years. In dealing with the effects of the war and the demands of recovery and reconstruction, the government faced two options.

The first option would embrace a radical policy of austerity, with its attendant sharp increases in taxes and duties, and cutbacks in expenditures. Such a policy mix has negative implications on the social situation that may be difficult to tolerate. The second option would rely on accelerating growth in the medium and long term with the help of a development and investment programme financed by internal and external borrowing, which would activate the economy and increase state revenues through economic growth. The government opted for the second course and proposed an ambitious public investment programme.

2. Elaboration of the development plan

The Government revived the Council for Development and Reconstruction in 1990 and entrusted it with the task of preparing a national reconstruction strategy and implementing a recovery programme. A phased recovery approach was adopted, involving first the restoration and rebuilding of the capacity of existing physical infrastructure and facilities to enable the private sector to lead economic recovery. Subsequently, capacity would be expanded through construction of new facilities while economic and social distortions induced by the war would be progressively addressed. In the final stage, the economy would be developed and modernized largely through the utilization of domestic potential.

Successive Lebanese governments had prepared a large number of studies covering development projects in the different regions; in particular projects that were prepared in connection with the afore-mentioned plans. These projects were drawn upon in the formulation of the current plan, after having been updated and their relevance, feasibility and cost re-assessed. New projects were added based on damage surveys and assessment of needs carried out by the Council for Development and Reconstruction.

The National Emergency Rehabilitation Programme (NERP), involving US$ 2.3 billion public investment over the 1993-1995 period, was proposed and adopted in 1992. It was designed as a multi-sectoral operation focused on emergency repairs and rehabilitation of physical and social infrastructure. The programme was subsequently expanded and merged into a ten-year plan, known as *Horizon 2000 for Development and Reconstruction,* announced by the Government in October 1994. Since the completion of the initial version (US$ 18.5 billion financing requirements in the 1993-2002 period), there have been several revisions to take into account the evolving national and regional situation and developments in critical factors affecting the course of recovery. It is noted that the Council for Development and Reconstruction has adopted a dynamic approach to planning and programming, adjusting the macro-economic model from time to time to take account of important changes in an evolving national and regional context.

It should be pointed out that the plan was mainly prepared by the Council for Reconstruction and Development in consultation with line ministries and public agencies, with the assistance of private sector consultants and consultations with the World Bank. The plan in its integral form was reviewed by the Government and transmitted for approval by Parliament, which opted not to approve the programme as such, but rather to review and approve it on sector and project basis through adopting decree-law programmes.

3. Objectives of the reconstruction and development programme

Recovery and development efforts aim to position Lebanon as a competitive force in the regional and international economy, capable of confronting the challenges of the twenty-first century. *Horizon 2000 for Reconstruction and Development* was formulated deliberately with ambitious objectives and targets, aiming for Lebanon "to regain its position among the world's upper-income nations in the first years of the twenty-first century" through first completing the process of the reconstruction of the country and subsequently engaging into self-sustained development. The plan hinges on three axes: comprehensive re-establishment of adequate basic infrastructure, including social infrastructure as a basis to stimulate the development of the productive sectors; balanced regional distribution of public investment; and, promotion of private sector development through increased savings. The present version of the plan accords increased priority to the social sectors and human resources development.

The plan aims to achieve a doubling of the standard of living as measured by per capita income during the 1995-2007 period. Moreover, the proposed development programme would also raise the standard of living in the broader sense by improving general living conditions, especially in the fields of education and health services, the environment, etc. This would be achieved by stimulating economic growth which is projected to average 9 percent between 1995 and 1998, 8 percent during the 1999-2002 period, 7 percent between 2003 and 2005, and 6 percent for the last two years, 2006 and 2007. The achievement of these targets depends on sustained economic stabilization which is a key goal and at the basis of the recovery.

The projections of the economic model underpinning the recovery plan show a gradual reduction in the budget deficit in terms of its ratio to GDP, and the transformation of the deficit into a small surplus beginning with the year 1999, to rise gradually thereafter.

4. Summary content of Horizon 2000 for Reconstruction and Development

Table II-6: Sectoral distribution of expenditures in Horizon 2000, 1995-2007
(Percent of total)

Sector	Share
Physical infrastructure (electricity, communications, roads and highways)	37
Social infrastructure (education, youth and sports, vocational and technical training; higher education; health; social affairs; housing; the displaced)	25
Socio-economic services (water, effluents, solid wastes, environment, public transport and railways)	22
Productive sectors (agriculture and irrigation, industry and petroleum, airport, ports, free zones, tourism, private sector services)	8
Government apparatus (government buildings, security forces, information and public administration)	8

Source: Baroudi, Nouhad, Council for Reconstruction and Development, Horizon 2000: A Synopsis, Beirut, September 1995.

The sectoral distribution (Table II-6, above) and geographical distribution (Table II-7, below) of planned public expenditures reflect the government's intention to give the private sector the leading role in the process of economic revival and growth, and to spread projects to ensure balanced development throughout the country.

The sectoral distribution of expenditures reflects the importance of, and priority accorded by the Government to, the provision of basic physical infrastructure which is essential for normal life and activities to resume. The provision of social infrastructure and socio-economic services, which absorbs almost half of planned expenditures, is of particular importance from the perspective of development that is both human and sustainable. Support to the productive sectors will be provided essentially in making available supporting infrastructure and facilities as well as credit programmes. Limited financial resources are also planned for rehabilitation and reform of the public administration.

Table II-7: Regional distribution of planned expenditures in Horizon 2000, 1995-2007
(Percent of total)

Mohafaza /region	Share
Beirut	14
Beirut Suburbs	20
Mount Lebanon (excluding Beirut suburbs)	15
North Lebanon	18
Nabatyeh	8
South Lebanon	11
Bekaa	14

Source: Council for Reconstruction and Development, Horizon 2000 for Reconstruction and Development, Executive Summary, Beirut, 1993.

With respect to the geographical allocation of expenditures, 38 percent of these are for projects of a nation-wide character, 59 percent for projects of a regional nature, and 3 percent for studies and administrative matters. The urgency of the needs and the size of the population were also taken into consideration in the allocation of projects among the various regions, in order to reduce disparities in the availability and quality of infrastructure, and to incorporate more closely the regions in the national economic cycle.

5. Financial requirements of the plan

Financing public investment over the thirteen years of the plan is estimated to require US$ 17.8 billion at 1995 prices, or about US$ 22.2 billion at current prices. An additional US$ 8.8 billion are added to cover the budget deficit during the first four years of the plan (the plan expects that the budget will be in balance as of 1999) and to service the public debt. This raises the total financial requirements of the plan to US$ 31 billion at current prices. The plan scenario expects these financial requirements to be met from external and internal sources, as shown in table II-8 below.

Table II-8: Sources of financing the development programme, 1995-2007
(Billions US$, percent)

Source	1995 - 2000		2001 - 2007		1995 - 2007	

	US$ billion	Percent	US$ billion	Percent	US$ billion	Percent
Foreign grants	0.3	2	-	-	0.3	1
Foreign loans	8.2	61	3.0	17	11.2	36
Internal loans	4.7	35	2.5	14	7.2	23
Budget surplus	0.2	2	12.1	69	12.3	40
Total	13.4	100	17.6	100	31.0	100

Source: Baroudi, Nouhad, Council for Reconstruction and Development, Horizon 2000: A Synopsis, Beirut, September 1995.

The plan considers that public outlays of US$ 18 billion are necessary to stimulate private sector involvement and, accordingly, expects it to invest around US$ 42 billion over the duration of the programme. According to the plan, this is consistent with earlier patterns, where available information indicates that in the periods preceding the war (1964-1974) and following it (1991-1994), private sector investment was four to five times that by the public sector.

This programme is predicated on maintaining a fine balance between the different variables underlying the economic model used. Hence, the success of the programme becomes closely linked to the ability of the government to adhere strictly to its policy of financial stabilization. This, in turn, means proceeding with tax reforms, and the reform of the administration and institutions, so as to be able to service and repay the external and internal debt, and to ensure that projects are executed according to specifications and on schedule.

It is to be noted that the implementation of the reconstruction programme has proceeded in a truly remarkable manner. It has developed from comparatively modest beginnings to a programme of truly international level and standard. As of October 1996, US$ 3 billion worth of foreign funding had been secured for ongoing and future projects, while US$ 3 billion worth of work had been contracted, and a considerable pipeline of projects was in preparation. The programme focus gradually changes as progress is made in implementation, and it is a matter of pride for the country that the process of reconstruction and development, managed and coordinated through the Council for Development and Reconstruction, enjoys the confidence of main bilateral and multinational funding agencies.

6. Issues of debate concerning the national development option

An operation of the magnitude and importance of the ongoing reconstruction and development programme inevitably gives rise to different views and interpretations and provokes wide discussion. The following are among issues that have been raised in connection with the development strategy, policies and programmes pursued by the government; and, may be read in conjunction with issues related to the application of the concept and approach of sustainable human development in the Lebanese context discussed above.

- The plan represents basically a public investment programme conceived within a macro-economic framework; it does not include specific sectoral objectives and targets, supported by coherent programmes. How can the plan be improved to include integrated programme frameworks by sector or theme, which would also cover the requirements for institution-building, including legal and regulatory systems, and administrative reform, being basic determinants of growth.

- The experience of the last few years has demonstrated that there are many factors - political and social, of influence on economic domestic or regional origin - that can have a strong performance. To achieve the national course of goals set by the plan and to stay the development as projected by the economic model is at issue.
- The ability of the Lebanese economy to absorb productively the planned volume of public investment (US$ 18 billion) and more than twice that amount in terms of private investment over a period of thirteen years. This relates to capacity development in both the public administration and the private sector - in different fields and at different levels.
- The scope and content of the national plan are very ambitious. A number of construction projects may exceed the country's needs in the medium term, putting additional strain on the economy. These must be viewed within a strategic option of meeting regional and global challenges versus satisfying in priority domestic basic aspirations and developing domestic capabilities and potential.
- The respective priority of, and relationship between, the economic and social aspects of the national development option has been at issue. The retained option emphasizes economic growth which would create conditions that over time would lead to solving social problems. The opposite view, while recognizing the vital importance of economic growth to the development process, stresses the need to adopt in this connection broad sectoral and social policies to resolve pressing social problems, which the government does not deny. Policies and measures to maintain financial stability and to increase government revenues are translated into interventions and measures with immediate effect, whereas policies in the social realm are still at an embryonic stage with effects to come much later. The most pressing issues in this latter respect relate to wage policy and price stability; social insurance policy and safety nets; policies related to public services; labor policy; housing policy; etc.
- The retained option emphasizes in priority public infrastructure reconstruction along with the strengthening and modernization of the overall framework for private sector development. At the sectoral level, priority is given to the financial and banking sectors. The policies applied do not provide enough encouragement to the productive sectors as observed, for example, in the lack of adequate facilities to promote small or medium enterprises, or to ease the conditions they face in obtaining information and credit. Furthermore, and despite the allocation of projects to the regions, the centralized nature of the development plan may not provide sufficient benefits to rural areas, which would further inhibit the achievement of the potential of the productive sectors.
- The ability of the Government to implement the development plan keeping the public debt and its servicing under control, so as to prevent the country from falling into the debt trap as happened with other developing countries. The public debt can only grow at rates that the country is able to sustain in the long run. Adequacy of means available to service the debt must be carefully monitored; in the recent past, interest on the debt has been growing at rates faster than the growth of treasury revenues.

Lebanon has made over the past few years considerable macro-economic gains, which must be preserved and further expanded. Looking ahead, much more remains to be done, particularly with respect to the fiscal deficit and debt, and it must be constantly borne in mind that necessary action will have to be undertaken with limited resources.

Chapter three of this report reviews and assesses the sector situation, highlighted by main indicators of development. This should contribute to a better assessment of the national development option and of the extent to which it is in harmony with the concept and approach of sustainable human development.