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LEBANON: MOBILIZATION OF FINANCIAL RESOURCES FOR THE PUBLIC SECTOR AND RELATED POLICY ISSUES(1)

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The primary purpose of this paper is to outline a set of financial policy measures which can act as a guide to the national authorities(2) in their efforts to mobilize financial resources to bring into account the measures which they have already implemented in this regard. The focus of the analysis is mainly on the short-run period, i.e. the coming few years. While the emphasis of the paper is on mobilizing resources, the limits of this process as well as some of the constraints which will have to be placed on government-expenditure are also briefly touched upon. A full analysis of these latter issues is left for another paper.

Before we discuss resource mobilization and policy issues related to it a few preliminary observations may be in order. It should be stressed at the outset that policy coordination is a pre-requisite for any rational approach to developmental issues. While we shall not discuss here the various elements which must be considered in this regard, the following analysis is predicated on three assumptions:

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(1) This paper is part of the studies being conducted by the CDR to identify major economic and social issues pertaining to Lebanon's development and reconstruction. The background for these studies are the 20 agenda papers which were prepared by a number of specialists at the invitation of the CDR. The present paper is based on S. Makdisi's agenda paper "Policy Issues Facing the Lebanese Economy" (April 1978).

(2) The government and the C.D.R.

Firstly, the national authorities will be guided in their decisions by a coordinated policy framework. Thus when discussing the mobilization of financial resources, we take into account the interrelationship between monetary, fiscal and exchange rate policies as well as the interrelationships between internal and external borrowing; Secondly, the dominant feature of the Lebanese economic system will continue to be its market orientation though the Government sector will no doubt assume more important economic and developmental responsibilities than before; And thirdly, it follows, that financial policy measures, in contrast with direct participation of the Government, would constitute the primary route along which the Government will attempt to attain its envisaged national goals.

The paper is divided into five parts: the first outlines the measures which have already been taken or are planned by the authorities in their attempt to mobilize resources: the second and main part deals with the general issue of financial resource mobilization and related policy matters: the third briefly considers some of the constraints on public expenditure; the fourth lists the main conclusions and the fifth suggests areas where further analytic work needs to be carried out.

1. Measures adopted by the national authorities

With the cessation of the 1975-76 war, the national authorities' attention was focused on mobilizing resources for three related objectives: relief work, reconstruction of the damaged physical assets and development projects. It had been planned to secure foreign aid and loans, in particular Arab financial assistance, to help initiate the process of reconstruction of development. For this purpose, preliminary estimates were prepared concerning the magnitude of financial resources which would be required to finance a number of reconstruction and development projects.(1) For a number of these projects feasibility studies were completed and the authorities entered negotiations to secure the required financing, e.g. reorganization of the Beirut port, reconstruction of the damaged road network, the reconstruction of the center of Beirut, etc... The process of resource mobilization, the initiation of reconstruction work and the implementation of certain requisite policy measures have been delayed as a result of the delay in the hoped for political stability. Nontheless, concrete steps pertaining to external and

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(1) The distinction between reconstruction and development has in a number of instances proved to be tenuous. That is, the rebuilding of damaged assets was (and is) only part of certain envisaged projects.

internal resource mobilization have been taken.

At the domestic level, the authorities have already tapped part of the available bank funds by issuing short and medium-term treasury bills which were taken up by the commercial banks. As of August 10, 1978, the outstanding amount of short term bills (with maturities of one year or less) stood at LL 410 million. The outstanding amount of medium-term bills (with maturities of 2-3 years) stood at LL 171 million.(1) The proceeds from these bills have been used to finance current budgetary operations. Also the CDP is presently considering the issuing of medium-term bonds (7 years) to be held by the commercial banks. The exact amount and the terms of issue have not yet been determined.

At the external level, official efforts to secure long-term foreign financing has proceeded in three directions: the first is recourse to international and foreign organizations. Thus the IBRD has extended loans (inclusive of amounts agreed upon prior to 1975-76) totalling $50 million. The purpose of the loans is to finance the rebuilding of the Beirut port, the repair of the telex communication system and the restoration of the water supply system. The Kreditanstal Fur Wiederaufbau granted a loan of $9.8 million to finance the restoration of the water supply. The second is recourse to Arab regional organizations: the Arab Fund for Economic and Social Development extended loans totalling $39 million to finance the Beirut port and electricity projects. Loans totalling $17.4 million were also extended by the Abu Dhabi Fund for Arab Economic Development for the same projects mentioned above. The third course of action has been to the international capital markets. In early March 1978, the national authorities agreed with a consortium of foreign banks to a seven-year loan of $150 million to be used for financing reconstruction projects in the public sector. Thus the total of the recently contracted foreign loans amounted, as of August 10, 1978, to about $269 million (over LL 800 million at the current rate of exchange). The total amount of foreign loans outstanding stood at $294 million (LL 880 million at the current rate of exchange).(2) The national authorities are either negotiating or plan to negotiate longer-term loans to finance primarily infra-structure projects, which are estimated to cost over $2 billion.

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(1) These amounts exclude bills due prior to or as of mid-August, 1978 that could not be retired or renewed when they fell due because of the prevailing internal political situation. If renewed, the total outstanding amount of bills will stand, as of August 15, 1978, at over LL 1 billion (about $334 million at the current rate of exchange).

(2) See Lebanon, Information Memorandum, US $150 million, Medium Term Loan to CDR (March 1978).

With the above picture as a background, we proceed to discuss issues of resource mobilization facing Lebanon today. As the general principles involved are set out, reference will be made to the relevant steps already implemented, or are planned, by the national authorities.

II. Resource Mobilization: The Issues Involved

Financing for reconstruction and development initiatives undertaken by the Government must be drawn from some combination of the following sources:

(A) Funds mobilized by issuance of debt instruments to Lebanese financial institutions and other domestic purchases.

(B) Tax revenues and other fiscal receipts of the Government over and above its current operating budget requirements.

(C) Funds borrowed externally from various international sources -- or made available to the Government as foreign assistance grants.

We shall take up each of these sectors in three separate sections respectively. A fourth section (along with Appendix IV) briefly considers the role which exchange rate management may play in this context of resource mobilization.

A. Financial intermediaries

The potential role of Lebanese financial intermediaries in mobilizing resources for development is an important one. Two related indicators of the importance of financial intermediaries are (1) the ratio of total deposits to GNP and (2) the ratio of financial savings(1) to GNP. For end 1973 and 1974 (i.e. the period immediately prior to the Lebanese war of the two subsequent years), the ratio of deposits to GNP averaged 96 percent. With substantial growth in deposits up to 1978 accompanied by the decline in GNP, This ratio must have increased greatly. Similarly, the ratio of financial savings to GNP averaged 19 percent. Again, the ratio for subsequent years rose substantially: from end 1974 to end 1977, total deposits increased by LL 3429 million to LL 11609 million whereas GNP dropped. These ratios are among the highest in the world. They constitute a major indicator of the importance which financial

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(1) Defined here as the change in total deposits during a given period, a calendar year. Data concerning other financial intermediaries are not available.

intermediaries (and in the Lebanese context commercial banks in particular) assume in the national economy. However, the structure of the Lebanese financial system continues to lag behind especially as concerns the development of the capital market.

In focusing on financial intermediaries two sets of policies would seem to confront the national authorities: the first relates to mobilizing part of presently available resources to help cover public sector expenditure on reconstruction and development; the second is concerned with the development of the Lebanese capital market to help, among other things, raise the level of national savings (and not simply mobilize it) as well as increase its financialization. In what follows we shall concentrate on the first of these issues which themselves have implications to the development of the capital market. As suggested in the concluding section, the policy issues related to the development of the capital market is left for another paper.

Three related issues may be raised here: (1) to what extent is it feasible to channel resources to the public sector via the C.D.R.? (2) what are the respective roles of the commercial banks and other financial intermediaries? and (3) what debt instruments should be used in the process of mobilizing resources?

The commercial banking system is the primary custodian of available funds. The resources at the disposal of development and other longer-term credit institutions remain limited. The banking system is at present (and has generally been) highly liquid as indicated by (1) the relatively large amount of foreign assets which the commercial banks hold in Eurodollar and other short-term instruments, and (2) the level of cash reserves being maintained.(1) At the end of 1977, cash reserves and foreign assets comprised 66 percent of total deposits, compared with similar ratios in the pre-1975/76 years and somewhat higher ratios in those two years. As of end 1977, cash reserves alone amounted to about 16 percent of total deposits compared with 9 percent in 1973, 20 percent in 1974, 9 percent in 1975 and 12 percent in 1976.(2) It is known that the high state of liquidity of the system has continued to exist in the first of 1978 though more recent data are not yet available.

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(1) It should be borne in mind of course that the liquidity of the banking system is also affected by the policy of rediscounting or lending which the central bank chooses to follow.

(2) Required reserves first instituted in 1969 had been reduced to zero in 1976. And until 1973 the banking system had generally maintained excess reserves.

The above picture suggested to the authorities the possibility for diverting part of the banking resources toward the public sector. Recourse to bank borrowing should, however, be subject to at least four considerations: (1) the short-term nature of the available funds, (2) the present and future demand of the private sector for funds, (3) future changes in the liquidity position of the system and (4) the requirements of monetary policy as part of the Government's overall economic policy. In other words, when contemplating making use of available funds the constraints listed above should be accounted for by placing what may be considered as appropriate limits on the amounts to be borrowed and by designing the proper debt instrument for that purpose. Let us, as a matter of illustration, assume that the picture which prevailed at the end of 1977 continues to prevail at present. Taking into account the steps ahead implemented by the authorities, they may then envisage the following course of action: (1) The Central Bank would raise reserve requirements against all deposits to 10 percent. This would imply required reserves of LL 1161 million and excess reserves of LL 1898-1161 = LL 737 million. (2) The Central Bank would also stipulate that one half of the required reserves may be held (or perhaps may be required to be held) in short-term treasury bills (say a maximum of LL 600 million) which would carry a rate of return that is competitive with the rate of return on other short-term investments. As already mentioned in section I, the Government has already resorted to the issuance of short-term bills. If, at the time the reserve requirements are introduced, the outstanding amount of these bills is less than the stipulated total under the reserve requirements, then this would permit the Government to increase its indebtedness for budgetary purposes. And if the outstanding amount exceeds the stipulated total under the reserve requirements, then the Government is assured that a substantial part of its short-term indebtedness need not be repaid in the foreseeable future; in effect it would be transformed into a medium-term loan. This does assume, of course, that developing economic institutions would continue to permit the maintenance of treasury bills as part of the existing reserve requirements. (3) In deciding on its planned issue of 7-year bonds, the CDR may stipulate a ceiling of not far more than LL 500 million which would account for the larger part of the excess reserves; these bonds are expected to carry a fixed rate of interest; they should also be marketable and transferable, but not rediscountable with the Central Bank. Presumably the interest rate the bonds carry will be sufficiently attractive to induce the commercial banks and perhaps the public (through the banking system), to subscribe to them. Further, the issuance of medium-term treasury bills should be considered in conjunction with the floating of the CDR bonds. In competing for available funds, the two issues should be coordinated.

The above scheme or approach would appear to embody several important advantages: (1) it would continue to assure the Ministry of Finance and the public sector a pre-determined amount of the idle banking funds, (2) it safeguards the liquidity position of the banking system by maintaining at least 5 percent reserve requirements in cash and deposits with the Central Bank and would at the same time reactivate the potential use of these requirements as an instrument of monetary control; (3) it raises the earnings ratio of the commercial banks and (4) it constitutes one step towards the development of the capital market. In order to ensure that the public sector does not compete inappropriately with the private sector, upper ceilings on CDR borrowing may be envisaged, e.g. the ceiling of LL 500 million or less mentioned above. Moreover, upper ceiling may be placed on the proportion of individual bank portfolios which may be committed to CDR bonds. The future demand of the private sector may be satisfied by the funds which remain available and those which may accumulate in the banking system.(1) Obviously, this question cannot be considered in isolation of realistically projected monetary developments or of the type of monetary policy which would need to be followed during a given period of time. At this stage, however, we cannot go into the various scenarios of policy action which may be required under alternative hypotheses of emerging economic and monetary conditions. Future monetary developments may require a change in the stipulated reserve requirements. It remains to be emphasized, however, that under existing and envisaged conditions the commitment of LL 500 million or less of bank funds to medium-term investment does not seem to place an undue burden on the banking system. In fact, it would offer banks new investment opportunities while government spending will stimulate economic activity.

This brings us to the role which non-bank financial institutions can play in the short-un. We have one suggestion to make in this connection: it is proposed that the government and/or the CDR (and perhaps also the Bank) should consider utilizing some portion of the

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(1) To illustrate, assume: (1) the CDR places a ceiling of LL 500 million on its bond issue, (2) total deposits grow at an annual rate of 15 percent (which is less than the average rate of growth in 1971-1977 as well as in 1976-77 alone), (3) reserves grow at an annual rate of 20 percent (which is less than one half the growth rate in 1976-77) and (4) the 10 percent reserve requirement is maintained. At the end of 1978, total deposits will amount to LL 13,350 million and reserves to LL 2,277 million. Required reserves will be LL 1,335 million of which LL 667 million will be in the form of treasury bills assuming that either the commercial banks choose to hold these bills or are required to do so. Excess reserves will amount to LL 942 million of which a maximum of LL 500 million will be in CDR bonds. This leaves over LL 400 million in free reserves. If cash reserves are assumed to remain unchanged, this would leave excess reserves of LL 563 million of which a maximum of LL 500 will be in CDR bonds. But as mentioned in the text, if deemed appropriate, the stipulated maximum can be reduced or the reserve requirements can be changed.

funds mobilized from the commercial banking system by the means proposed above in capitalizing, jointly with private sector investors if possible, several specialized intermediate term credit institutions. For example, it might be desirable to add to the capitalization of the recently formed Housing Bank; or to create a similarly specialized intermediate-term credit institution designed to meet the needs of the agricultural sector.

Furthermore, in some instances, the CDR might want to consider issuance of requisite guarantees of external borrowing undertaken by such intermediate term credit institutions for working capital purposes -- as, for example, from the IFC division of the World Bank or from Arab sources.

B. Fiscal Policy

We are mainly concerned in this section with the revenue aspect of fiscal policy. Considerations of social equity, important as they are, will not be taken up here. It is assumed, however, that in the short-run and medium-run a more equitable income redistribution will result from the pattern of envisaged public expenditure. Indeed, the objective of maximizing tax revenue cannot but be subject to several constraints one of which is related to considerations of equity namely that the after-tax distribution after any tax reform or change should not be less equitable than the existing after-tax income distribution. This constraint is imposed by what modern societies would expect as a social objective. In present Lebanese circumstances, however, the fundamentally important constraint is the existing limitation on the availability of budget revenues over and above the current operating expenditures of the public sector. This latter consideration gains added significance when one considers that the tax base has been eroded as a result of the 1975-76 war. National income has dropped since 1974 while tax collections have lagged even further behind.

On the other hand, the potential for raising fiscal revenue exists. Lebanon has characteristically been an under-taxed country with government revenues constituting 14 percent and tax receipts 9 percent of GDP for 1973 against an average ratio of 15 percent for 47 developing countries in 1969-71.(1) Lebanese tax revenues have been and are strongly dependent upon indirect taxes which in 1973 comprised over one half of total tax receipts in comparison with about 15 percent accounted for by direct taxes. Further, government revenues including tax revenue appear to be somewhat income inelastic. During 1965-73, government revenues grew at an annual rate of 8.4 percent, direct taxes at 9.5 percent and indirect taxes at 7 percent compared to a rate of growth in GNP of 9 percent.

The availability of budget revenues may be increased by a three-fold effort directed at (a) improving tax collection, (b) raising certain tax rates and (c) instituting tax reform oriented toward a

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(1) See S. Makdisi, op.cit., p. 28.

C. External Borrowing

The basic factors determining the CDR's ability to mobilize external funding are the "absorptive capacity" and the "debt servicing capability" of the public sector of the Lebanon economy. Certain criteria governing the "structural balance" of the country's over-all external indebtedness also must be observed. More specifically, decisions concerning external borrowing should be made with reference to the following considerations:

1. Opportunities for productive utilization of loan funds derived from external sources warranting the interest and repayment obligations involved.

2. Consistency between external debt servicing obligations and the prospective availability of the "real" and financial resources for meeting these obligations without adverse consequences.

3. Maintenance of balance between various types and sources of external borrowing; and corresponding balance between utilization of financial resources available domestically and reliance on external borrowing.

The extent to which the private sector of the Lebanese economy draws on external sources for financing of investment projects -- and thereby incurs long-term capital servicing obligations -- is also an important consideration.

The conceptual parameters of absorptive capacity are described in Appendix I. These imply that external borrowing by the CDR must be coordinated with project identification and implementation, on the one hand, and with macro-economic analysis and policy on the other.

Given the potential for rebuilding and improving Lebanon's economic infrastructure and social services facilities, and also given the under-utilized productive potential of the economy, there is no difficulty in principle in demonstrating the country's capacity to absorb substantially enlarged external financing for public sector undertakings. Certain potential constraints on the ability to borrow abroad should be kept in mind, e.g. the limited availability, so far, of technical competence in the public sector to perform analytical functions required to formulate proposals for submission to potential sources of external financing, and the possibility of continued political uncertainties and associated paralysis of governmental processes which would limit the ability of the CDR to utilize effectively potentially available sources of external financing. While the latter constraint is political, the former can be circumvented by recourse to sources outside the public sector.(1)

The conceptual parameters of external debt servicing capability also are described in Appendix II. The principal considerations are as follows: the government's prospective ability to mobilize by means of taxation and domestic borrowing sufficient amounts of national savings to establish the necessary "real" basis for required transfers to foreign creditors; and, the extent to which the government will have access to sufficient amounts of foreign exchange to permit scheduled payments to these creditors. In other words, appraisal of Lebanon's external debt servicing capability involves comparison of the foreign exchange and national savings prospectively available to the government with projections of cumulative external indebtedness and related repayment schedules.

There already exists a relatively large accumulation of national savings in the form of gold and foreign asset reserves maintained by the Central Bank. To give one illustration, at the end of April 1978, official reserves amounted to $2125 million or 112 percent of the peak imports (c.i.f.) of 1974 (or about 135 percent of the estimated 1977 imports).(2) This extraordinarily large accumulation of official reserves constitutes an important element in Lebanon's external debt servicing capability: a large share of these reserves is potentially available for effecting required international transfers not otherwise supportable from current national savings and foreign exchange receipts available to the government.

The basic question to be addressed in this connection is the following: what constitutes a desirable and feasible growth plan for the government's external indebtedness, and what are the practical limits as quaged with reference to its prospective debt servicing capability? As already indicated, the answer to this question is dependent on the assumptions employed in projecting Lebanon's national income and balance of international payments accounts and the future ability of the government to mobilize the volume of national savings and of foreign exchange necessary to satisfy external debt servicing schedules. In other words, Lebanon's external debt servicing capability can only be estimated with reference to various assumptions and cannot be rigorously specified in quantitative terms. The best that can be done is to indicate plausible ranges on the basis of what in Lebanon's current circumstances must be highly speculative projections.

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(1) Even with the prevailing political uncertainty, some progress was made in arranging foreign financing.

(2) Legally, the Central Bank is required to maintain in foreign exchange a minimum of 50% of the currency in circulation or 30% of the currency in circulation plus sight deposits with the Central Bank. At the end of 1977, officially held foreign exchange amounted to 210 percent of the currency in circulation.

Results of efforts to determine several alternative ranges in statistical terms are contained in Appendix III. The main indications derived from this exercise can be summarized as follows:

1. If it is assumed pessimistically that the Lebanese economy continues to lag, so that by 1982 it is still operating below the levels attained in 1973 (the last year for which national accounting and balance of payments data estimates were systematically made), the presently scheduled external debt servicing obligations of the government will, by 1982, constitute a significantly larger drain on the governmental budget which will need to be supported by some combination of increased taxes or increased deficit financing in the domestic market. It appears unlikely, however, that significant amounts of official reserves would need to be drawn upon -- depending, of course, on the country's balance of international payments.

2. If the same pessimistic assumptions are made regarding economic recovery, and it is also assumed that as a result of substantial additional external borrowing in the meantime the government's external debt servicing obligations are increased by 1982 by as much as five times over currently scheduled levels, then not only would the budgetary problem be greatly intensified but also it would be necessary to draw on official reserves to meet a substantial portion of the required external payments.

3. If more optimistic assumptions are made regarding growth of the Lebanese economy during the coming five-year period, and regarding the country's balance of payments and the government's budgetary availabilities, then it appears that an increase of two to five times in the presently-scheduled external debt servicing obligations of the government could be accommodated with little or no recourse to the official reserve accumulation.(1)

It should be emphasized that the foregoing "indications" are simply a product of the assumptions made -- and are not intended to be taken as either predictions or policy guidelines. Furthermore,

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(1) Further discussion of relationships between the level of gold and foreign exchange reserves maintained by the Central Bank and the government's external borrowing operations and associated external debt servicing obligations is contained in Appendix IV.

it is important to recognize that domestic actions taken (or not taken) by the government will substantially influence its external debt servicing capacity. More particularly:

1. The future external debt servicing capability of the government will be closely related to actions taken to mobilize the domestic savings required as the real basis for external transfers -- which actions relate to taxation and internal debt management as discussed in previous sections of this paper.

2. The government's future external debt servicing capability also will be closely related to actions taken to establish its assured access to the foreign exchange required as the financial means for effecting transfers to external lenders -- which actions relate to foreign exchange management as discussed in a subsequent section of this paper.

A discussion of what constitutes a "balanced structure of foreign indebtedness" is contained in Appendix II. The implications of this discussion can be summarized as follows:

1. Careful attention should be paid to achievement of diversification of external sources of external borrowing and to consistency of over-all external debt servicing obligations with the likely time-phasing in the availability of resources for this purpose.

2. In negotiating loans from external sources every effort should be made, and presumably is being made, to obtain the most favorable terms including, when possible, combination arrangements involving loans at concessional terms or grant assistance.

3. In planning the extent to which the authorities should rely on external borrowing and thereby incur future external debt servicing obligations, careful attention should be given to corresponding claims on the economy's external capital servicing capacity relating to foreign investment on private account.

4. Decisions regarding the extent to which the government should engage in deficit financing, and regarding the extent to which deficits should be financed domestically and externally, are fundamentally important to the future of the Lebanese economy -- and probably warrant more careful consideration than heretofore has been given, or than may be possible under present circumstances.

Most of the considerations identified above as pertinent to the formulation of official policies with respect to reliance on external borrowing for the financing of reconstruction and development initiatives are of a technical nature. The policies ultimately to be established, however, are governed by a combination of technical, strategic and political considerations. In the discussion of policy guidelines which follows, therefore, certain strategic objectives and political constraints are explicitly taken into account.

The primary strategic objectives pertaining to external borrowing would appear to be the following:

1. Establishment of Lebanon's credit worthiness with the most desirable, sympathetic and dependable sources of future external loans -- and of the contacts and procedures that will facilitate development of mutually satisfactory relationships with these sources.

2. Utilization of whatever leverage that the unfortunate events in Lebanon in recent years, and the country's present difficult circumstances, may permit regarding qualification for external loans on concessional terms from sources motivated by humanitarian or political considerations.

3. Assurance that the amounts and types of external borrowing as are arranged in the near term to provide necessary financing of priority reconstruction projects are not inconsistent with eligibility for the likely future credit requirements of the CDR for longer term development purposes.

The political considerations that appear likely to function as constraints on the authorities' reliance on external borrowing are more difficult (and perhaps more sensitive) to specify. On the one hand, there are those domestic political issues relating to the purposes for which external indebtedness is to be incurred and, on the other hand, there are those foreign policy issues relating to the interferences and dependencies that are inherent in government-to-government debtor-creditor relationships. And in between these political issues that arise in connection with decisions regarding alternative sources and uses of externally borrowed funds are the political issues relating to the ways and means by which the CDR should initiate reconstruction and development projects relative to the scope to be afforded private sector initiatives, the extent to which CDR initiatives should be financed with resources potentially available domestically vis-a-vis reliance on external borrowing, etc. Finally, there are the political issues pertaining to the locus of decision-making authority regarding foreign borrowing and regarding the locus of managerial responsibility for utilization and servicing of external credit. We cannot offer here judgements of a political nature regarding these matters in the present context -- beyond those implied in the policy guidelines proposed in the following paragraphs.

The policy guidelines enumerated immediately below pertain to the current and likely near-term circumstances in Lebanon. These are followed by several proposals of a longer-term nature. The proposals are stated in as few propositions and in an succinct terms as possible consistent with clarity and the need for a comprehensive, coordinated policy framework. It should be understood that the purpose in presenting these proposals in this form is to facilitate discussion and decision-making -- and that the expectation is that modifications will be deemed to be desirable on strategic or political (and perhaps even technical) grounds.

The policy guidelines which appear relevant to the near future may be enumerated as follows:

1. As already undertaken by the national authorities (see above section I.), external borrowing by them in the near term should be limited to mobilization of financial resources essential for the implementation of economic infrastructure projects and social services programs that can become serviceable in the relatively near future and that have high priority as leading instruments of the reconstruction process.

2. Possibilities for mobilizing financing required for reconstruction program initiatives from domestic sources should be thoroughly explored before decisions are taken to borrow funds externally, and demonstration that adequate financing from domestic sources is unavailable should be required before approval of external borrowing is granted.(1)

3. In negotiations with prospective sources of external financing, clearly the objective would be to minimize the interest cost, to establish amortization schedules consistent with the prospective external debt servicing capacity of the Lebanese economy and the government, and to pursue clearly-defined objectives regarding source diversification, repayment flexibility, etc.

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(1) It is of course obvious that for all projects and programs to be undertaken with external financing it should be demonstrable that the economic return or net social benefit which can reasonably be anticipated warrant the cost of externally borrowed funds.

4. Administrative procedures and controls should be established to assure that policy guidelines are adhered to in the name of the national authorities, that orderly records are maintained, that the fulfilment of obligations to external creditors is not interrupted.

The following statements appear to be necessary additions to the foregoing in order to establish a coordinated and comprehensive policy framework governing external borrowing by the national authorities over the longer term.

1. External borrowing by the CDR should be programmed in accordance with national development plans and priorities and, particularly, with regard to improvements in domestic resource mobilization for public sector purposes that will reduce and eventually eliminate the need for further growth in external indebtedness.

2. Clearly-defined limits on the growth and ultimate size of external indebtedness should be established with reference not only to the development plans and institutional improvements referred to in the preceding item but also with respect to the absorptive capacity, debt-servicing capability and structural balance criteria referred to earlier. Specifically, with regard to the debt-servicing capability criterion, it is suggested that limits over the coming five-year period (i.e., during 1978-82) should be established with reference to projections of Lebanon's national income and balance of payments accounts, and of the government's budgets and official reserves -- as and when the necessary data and bases for their projection can be established.

3. In planning for the longer term development of the Lebanese economy a time frame should be established for gradual growth and subsequent gradual decline of the government's external indebtedness. It is tentatively suggested that during the coming five-year period growth within specified limits be programmed on the basis of various alternative assumptions; that during the succeeding five-year period the objective should be to maintain a more or less constant level of external indebtedness; and, that thereafter, the government's external indebtedness should be gradually extinguished -- perhaps in advance of required repayment schedules.

D. Exchange Rate Management

On the assumption that a policy of independent float will be maintained by Lebanon, two policy issues appear to face the national authorities: (1) what intervention policy, if any, should be maintained? and (2) what policy should be followed concerning the officially held international reserves which as of end April 1978 amounted to $2125 million?

As to the first issue whatever intervention policy is decided upon it should be predicated on the principle that it would not counter the basic underlying long-term trends. In practice, in the seventies and until the present time there occurred a strong tendency for the Lebanese pound to appreciate. The Central Bank, in its attempt to stem this appreciation accumulated in the process substantial foreign exchange reserves. At the end of April 1978 they amounted to about 153 percent of the 1977 imports (f.o.b.) and to 96 percent of the peak imports of 1974.(1) Should market forces continue to cause an appreciation of the pound, then intervention is going to lead to further accumulation of reserves. The economic impact of this appreciation would have to be dealt with by involving other policy instruments.(2) On the other hand, if the tendency is for the pound to appreciate, then Bank intervention will need to be designed with the understanding that long-term basic trends will not be countered.

Given the high level of reserves presently being maintained, one issue to resolve is whether an upper limit should be placed on further accumulation or indeed whether the existing level may be reduced a little by placing a relatively small part of these reserves at the disposal of the public sector. Or, given the "credit worthiness" and confidence which these reserves maintain, should their existence be simply used to enhance the bargaining power of the authorities in securing loans abroad? Either case has its own merits. Appendix IV attempts to clarify some of the issues involved.

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(1) According to the Money and Credit Law, the Central Bank should maintain foreign exchange equivalent to a minimum of 50 percent of currency in circulation or 30 percent of currency in circulation plus sight deposits. As of end 1977, the Bank's holdings of foreign exchange amounted to about 220 percent of the currency in circulation.

(2) See Makdisi, op.cit., p. 20.

III. Limitations on National and Public Expenditure: the Element of Stabilization

Mobilization of resources represents one side of the national equation. Expenditure represents the other side. To avoid serious economic instability, ex ante equilibrium must be maintained between resources and uses. Further, public expenditure forms part of total expenditure and to that extent it competes with the private sector for available resources. Thus, in setting their national targets the authorities may have to establish an upper limit for overall national expenditure as well as for the portion which is to be accounted for by public expenditure. These two issues are expected to be particularly relevant to the Lebanese economy. Inflationary pressures which intensified during the war of 1975-76 have continued to prevail though their intensity appears to have decreased.(1) It has been indicated that private enterprises are expected to continue to play the dominant role in the Lebanese economy. The public sector should therefore endeavour not to compete inappropriately with the private sector for available resources of finance even though a large part of public expenditure will eventually return to the private sector. As already pointed out in section II A, the future needs of an expanding private sector for sources of finance must be allowed for. This may entail strict controls on the resources of the public sector to the banking system. Further, in the past administrative bottlenecks have caused substantial delays in executing public projects with the result that available funds were not utilized. The immobilization of available resources by the public sector must be avoided. Or alternatively, when programming for public expenditure the limitations on public sector's ability to spend must be accounted for so as to ensure that available resources are not underutilized or misallocated.

The limits on overall expenditure as well as the subceiling on public sector expenditure cannot be determined apriori. Such limits can only be established in the light of the projected growth in savings over the coming few years and the degree of inflation which is to be tolerated, among other things.(2) The aims of development must be reconciled with requirements of the desired relative price stability. And in an open economy such as Lebanon's balance of payments developments exert an important influence one domestic activity and in turn they have to be accounted for when pursuing the objectives of stabilization. While we cannot go here into the

(1) However no official estimates are yet available.

(2) To the extent inflation is not externally induced and therefore largely outside the control of government.

details of any stabilization program, it should be mentioned that in the Lebanese context two monetary tools can be effectively utilized for the purpose of achieving monetary goals. The first relates to reserve requirements which if properly used can have an important impact on bank lending and domestic expansion. The second tool concerns credit ceilings which may be established on the domestic assets of the banking system. When using this tool, it should be ascertained that no loopholes exist, e.g. financing domestic expenditure through external borrowing. Further care must be taken to insure that the small banks are not unduly burdened.

Of course under existing conditions the concern of the Government is to stimulate rather than restrain domestic expenditure and monetary controls for the purpose of stabilization may not be the relevant economic issue. Nevertheless, they must be considered as potential weapons whose activation may become necessary once the process of reconstruction and development begins on a substantial scale with active public sector particularly.(1) To use them properly, the authorities should have some notion as to the limits on expenditure which ought to be envisaged. This is part of the exercise underlying the drawing up of a policy framework which could guide official policy actions.

IV. Conclusions

Because of data limitations and the prevailing uncertainties regarding future economic developments we are unable at this stage to estimate the global amount of resources potentially available for financing the national reconstruction and development program over the next few years. We believe, however, that the amount is very substantial and that there are no insuperable barriers of an economic or administrative nature preventing the requisite mobilization initiatives by the government with the CDR functioning as the guiding institutional force.

Furthermore, we believe that by proceeding urgently to take the policy decisions required for effective resource mobilization, and by establishing the priorities and procedures for utilizing these resources efficiently in the implementation of infrastructure projects and social services programs, a vitally important stimulus can be given to the economy the benefits from which will prove to

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(1) Let us also keep in mind the inflationary impact of external borrowing.

more than justify the additional tax burdens and substantially enlarged public sector indebtedness required. We are confident that the substantial enlargement of its financial resource availabilities that the government could achieve in the near term by acting on our recommendations would not be prejudicial to rejuvenation of private sector activities whose dynamism and profitability has traditionally characterized the Lebanese economy. On the contrary, positive government action as initiator will serve to stimulate a posititive response from the presently cautious private sector. Furthermore, if stimulation by the public sector is carried out properly, such a response need not be inhibited by lack of adequate funding resulting from the actions we propose the government should take in the near term to mobilize the potentially available financial resources it requires to launch and sustain a forceful reconstruction and development program.

Our recommendations can be summarized as follows:

1. That a 10 percent reserve requirement against all deposits be instituted, with the specification that 5 percent of the required reserves be held in the form of short-term treasury bills (about LL 580 million on the basis of the data for end 1977 and the end of the first quater of 1978). However, whether the treasury bills should be required to be held or left at the discretion of the commercial banks needs to be further examined particularly in the light of the overall present and prospective budgetary situation.

2. The CDR plans to issue 7-year state-guaranteed bonds. The upper ceiling that should be established on this issue would depend upon the prevailing expected monetary situation. On the basis of the situation which prevailed in early 1978, an upper limit of LL 500 million would appear plausible. But any decision to float CDR bonds should be made in conjunction with any planned issues of medium-term treasury bonds. Further, should a less relaxed monetary situation be expected to develop in the coming months, then a lower ceiling might be envisaged. Alternatively, a lowering of the suggested reserve requirements may also be considered. The bond issue should be marketable and transferable but not rediscountable with the Central Bank. The fixed interest it carries should be sufficiently competitive.

3. That a major effort be made to improve tax collection. This is essential for securing larger amounts of budget revenues in the short-run and renders tax reform in the longer run more effective.

4. That a special development surtax be levied pending introduction of more thorough-going tax reform oriented toward broadening of the tax base. The surtax can only be specified after a thorough evaluation of all the economic issues involved, and it could become an element in the envisaged long-term tax reform.

5. That Lebanon should utilize its strong international credit standing as aggressively as necessary to implement vital economic infrastructure projects and social services programs of demonstrable priority and feasibility as leading instruments of the reconstruction and development process; but that external borrowing at commercial terms should not be relied on in lieu of efforts to mobilize potentially available domestic resources, on the one hand, or of corresponding efforts to arrange for external grant funding or loans on concessional terms.

6. That while we are reasonably confident that Lebanon could qualify for (and would be able to service without unduly burdening its economy) a level of external debt servicing obligations of from two to five times that presently scheduled for 1982, before external obligations of such magnitudes are incurred not only should the points referred to in the preceeding item be carefully taken into account but also that consideration should be given to utilization of official foreign exchange reserves over and above some comfortable minimum level as an alternative to additional external borrowing.

V. Suggestions for Further Work

We recognize that the results of our efforts as reported in this paper provide an insufficient basis for systematic programming of financial resource mobilization. A good deal of additional work needs to be done to develop a clearer picture of availabilities from the several potential sources, including a clearer picture of the governing limits over time. We believe that work along these lines warrants high priority within the CDR.

While further work is required along each of the three lines we have pursued separately (namely, taxasation, deficit financing in the domestic market, and external borrowing), efforts should also be directed toward development of an integrated analytical framework or model that would incorporate all the parameters and interrelationships of the Lebanese financial system in such a way as to facilitate analysis of the likely consequences of various hypothetical assumptions or actual developments. Such a model would be of little value, however, unless the data base for the Lebanese financial system and the economy generally is greatly improved both in terms of reliability and timeliness. In fact, without substantial improvement in required statistics, economic and financial analysis of all sorts will continue to be seriously inhibited.

Our major, general suggestion, therefore, is that efforts be initiated immediately to re-institute collection, processing and reporting of data on the Lebanese economy and financial system in accordance with the concepts and systems employed before the war. We believe it would be appropriate to call on the IMF and/or the World Bank for necessary technical assistance in this connection.

There are several specific research projects that we suggest the CDR should initiate -- whether with inhouse staff or by commissioning outside consultants. These are as follows:

1. Statistical analysis of the prospective needs of the government for budgetary support in the form of deficit financing arranged in the domestic market and of the prospective capacity of the banking system for meeting these needs.

2. Assessment of possibilities for stimulating further development of the Lebanese financial system with emphasis on establishment of institutions and instruments appropriate for providing intermediate and long-term credits to particular sectors of the economy.

3. Detailed investigation of the revenue losses incurred by by the treasury as a result of inadequate tax administration, and of possibilities for increasing tax revenues by means of more effective tax collection.

4. Exploration of desirable and feasible reforms of the existing tax regime with reference to prior studies of these matters and to the new circumstances confronting Lebanon as a result of the political and civil disturbances of the past few years.

5. Detailed analysis of the existing structure of import tariffs with particular emphasis on determination of the degree of effective protection afforded various industries and activities.

6. Development of a clearer picture in quantitative terms of Lebanon's external debt servicing capability under various plausible assumptions regarding near and intermediate term developments in the economy.

7. Development of a model of Lebanon's likely requirements for external borrowing under various assumptions regarding success in mobilizing domestic resources and regarding success in establishing eligibility for external grants and concessional loans.

8. Exploration of various innovative possibilities for utilizing Lebanon's external financing availabilities for stimulating the private sector on the one hand and for addressing pressing sectoral and regional development problems on the other.

APPENDIX I

Salient Tax Reforms based on the Maxwell-Taylor Reports:

1. A global tax on income assessed on a single base consist in the aggregate of an individual's income from various types, with higher personal and family exemptions than currently prevail. Basic taxes are applied on taxable income at flat differentiated rates which are lowest for wages and salaries (4%), higher for professional incomes (6%) and highest for commercial income including rental income (8%). Interest, key money gains, foreign dividends and capital gains are excluded as being the object of a separate taxation. A single progressive surtax is imposed on aggregated income of all types, with a surtax exemption (LL 10,000), and without allowance for family exemption.

2. A corporate tax imposed on the corporation net income, with an exemption (LL 10,000), 10% up to a given amount (LL 25,000) and 20% on the remainder. Distributed earnings are subject to a 20% withholding rate: the withholding is final for bearer shareholders, and is credited against the combined income tax of nominative shareholders.

   The effect of combining incomes is to raise the income tax base, as middle and higher incomes will move to higher tax brackets. The effect of the increase in rates in the above two taxes proposed in the Maxwell-Taylor report in 1969-70, was estimated to produce 15 to 25% additional revenue.

3. A special land tax consisting of:

   a- a land increment tax on realized capital gain from the sale of land suitable for building, the base of the tax being the difference between the net selling price, and the last purchase price plus 6% interest plus expenses. The income tax rate on commercial profit is applied on the average yearly increment. The result is multiplied by the number of years.

   b- a 50% tax on land improvement resulting from public works,* the improvement being defined as the difference between the assessed value of the land 1 to 3 years after completion of of the improvement, and 1.1 times its assessed value two years before the date of expropriation of land for the improvement.

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*To cover improvements such as irrigation, annual charges based upon benefits received can be imposed.

c- a 1% tax on building sites, imposed on the difference between their actual value less a LL 200,000 exemption per person, and 1.5 times their assessed value as non-building land.

4. More generally, capital gains taxes could be imposed on gains from the sale of land and buildings, whole firms, individual items of industrial or commercial capital, equity securities, art treasures and the like. These taxes will be highly revenue-productive in Lebanon where capital gain is an important form of income. Alternatively, if they discourage speculation, they will have a favorable effect on allocation of capital and on checking inflation.

5. Tariff duties could be re-organized to raise more revenue by (a) concentrating on the high revenue-yield items while placing items with low revenue yields into broad categories to which a uniform (5%) ad valorem tax is applied; (b) eliminating the use of differential rates for the same item, a high and a low one according to use, or at least raising the minimum rate to 5%· and (c) avoiding prohibitive import duties.

6. A value-added tax of the consumption type, where the base is the sales receipts of each firm, minus purchases including purchases of capital goods. This tax combines features of revenue productivity with incentive to efficiency and to investment.

7. In the short-run reconstruction period especially, some ear-marked taxes could be introduced, e.g. highway taxes based on vehicle-ton-miles with user tax revenues placed in a fund for public expenditure on highway construction and maintenance, thus ensuring a quid pro quo.

APPENDIX II

NOTE ON
FACTORS GOVERNING ELIGIBILITY FOR EXTERNAL FINANCING

The basic parameters or limits of a government's ability to mobilize external financing are "absorptive capacity" and the "debt servicing capability" of the public sector of its economy. Certain criteria governing the "structural balance" of the government's indebtedness, both externally and domestically, are also important considerations. The purpose of this note is to explain these concepts and to indicate how they govern appraisals of a country's "credit worthiness" as viewed by potential sources of external financing.

Absorptive Capacity

International lending agencies normally premise loans to national governments on project financing proposals that indicate adequate prospective economic yields or social cost/benefit relationships. Inability to formulate such proposals constitutes a basic constraint on the ability of many governments to qualify for external financing. A related aspect of absorptive capacity is capability within the public sector to implement projects proposed for external funding in ways that will permit achievement of the best-obtainable productivity or efficiency standards. For example, unavailability of necessary labor skills or managerial competences often limits absorptive capacity -- as do so-called supply "bottlenecks" for essential physical inputs.

Absorptive capacity also has a macro-economic dimension. When an economy is already experiencing inflationary pressures as a result of shortage of materials and manpower, initiation of additional projects in the public sector with external financing would normally be judged to be inadvisable on stabilization grounds.

Debt Servicing Capability

Even more important to many international lending agencies than indications of absorptive capacity as a criterion of eligibility for long-term credit is evidence regarding the capability of a government to meet the interest and repayment obligations specified in loan agreements. The principal parameter of this capability is the government's prospective claims to sufficient amounts of foreign exchange to permit scheduled payments to foreign creditors on a timely basis. A government obligated to make such payments also must be able to mobilize sufficient amounts of national savings to establish the "real" basis for the resource transfers affected by means of international financial flows. Appraisal of a government's external debt servicing capability, therefore, involves comparison of national savings and foreign exchange prospectively available to it with projections of cumulative external indebtedness and related repayment schedules.

As the foregoing statements imply, there are two other corollary determinants of a government's external debt servicing capacity -- namely, its ability to capture resources either by means of taxation or deficit financing in the domestic economy, and its ability to draw on past accumulations of national savings in the form of gold and foreign exchange. In other words, external debt servicing capacity is closely related to fiscal policy and foreign exchange management.

Balanced Indebtedness Structure

The question of what constitutes proper types and degrees of balance in a government's foreign indebtedness structure is more pertinent to decision-making on the part of the borrower than to appraisals made by potential lenders. It is generally advisable to draw on a variety of external sources both because international financial institutions tend to specialize in particular types of lending and because diversification of sources serves to broaden contacts and to establish credit worthiness for future utilization. Equally obvious is the desirability of developing a composite structure of external indebtedness that calls for a relatively even level of servicing payments consistent with the likely time-phasing of resource availabilities. Also, ample provision should be built into the over-all external debt structure for flexibility in the timing of both disbursements and repayments so that penalties can be avoided or minimized if unexpected problems develop. Finally, borrowing governments should, of course, attempt to negotiate the best attainable terms with lending agencies at every juncture -- an aspect of which in some instances could involve a mixture of loans at international commercial or market rates with loans for purposes of mutual interest to the borrowing government and a lending agency at concessional rates. This latter point can be extended in some instances to encompass possibilities for joint negotiation of external loan financing and grant assistance.

In addition to these commonplace observations, there are two somewhat more technical points to be made regarding what constitutes proper balance in a government's foreign indebtedness structure. The first of these is that what constitutes a manageable level of external debt servicing obligations of a government is a function of the prospective size and likely variation of external payment flows on private account. In other words, the capability of the national economy as a whole to support external capital servicing obligations, both public and private, needs to be taken into consideration when estimating a borrowing government's external debt servicing capability.

Finally, there is the difficult question of what constitutes proper balance between external and domestic deficit financing by a government -- or, put more generally, the question of what criteria should govern governmental decisions regarding utilization of additional foreign credits vis-a-vis greater reliance on financial resources potentially available domestically by means of taxation and issuance of securities to financial institutions and other purchasers. This question, in turn, related to the amounts of local currency counterpart funds necessary to permit effective absorption of external borrowing and to provide the budgetary means for servicing external indebtedness. The essential point, however, is that reliance on external borrowing by governments, while perhaps politically or administratively expedient, is often times a poor substitute for needed domestic monetary and fiscal policy reforms.

APPENDIX III

NOTE ON
INDICATORS OF LEBANON'S EXTERNAL DEBT SERVICING CAPABILITY

The analytical exercise contained in this note is intended to suggest plausible ranges of Lebanon's external debt servicing capability on the basis of various simplifying assumptions and crude statistical projections.

The following two alternative growth paths for Lebanon's external debt servicing obligations are initially assumed for the period 1978-1982:

1. The growth path that was already scheduled as a result of the existing and then-being-negotiated external borrowing as of 31/12/77.

2. A growth path that would require external debt servicing payments by 1982 five times larger than those scheduled as of 31/12/77.

The second set of assumptions necessary for this exercise relate to performance of the Lebanese economy during the period 1973-1978 and 1978-1982. The two alternative assumptions in this regard are:

1. That the national income accounts and international payments accounts for 1973 (the last year for which systematic estimates are available) and 1978 are roughly the same in nominal terms, and that the figures and relationships will be about the same in 1982. (In other words, under this pessimistic assumption there would be declines in the real values of all figures at the rate of inflation over the period).

2. That the national income accounts and international payments accounts for 1973 and 1978 are roughly the same in nominal terms, but that between 1978 and 1982 the figures increase at a rate of 10% per annum with relationships between various figures remaining proportionately the same.

The questions to be explored hypothetically are as follows:

1. Assuming that the growth path in external debt servicing obligations scheduled as of 31/12/77 remains unchanged

through 1982, and assuming that the economy continues to decline in accordance with the first assumption stated in the previous paragraph, what percentage of gross **domestic savings and of balance of payments receipts on current account will the government require to meet its** external debt servicing obligations in 1978 and 1982?

2. Assuming that external debt servicing obligations increase five times between 31/12/77 and 1982 and that the economy declines as posited above, what will the percentage be in 1982?

3. Assuming that there is a fivefold increase in debt servicing obligations by 1982, and also 10% per annum growth in national income and international payments figures, what will the percentages be in 1982?

If the 1973 figures are taken to be reasonably representative of conditions prevailing in 1978, then the volume of gross domestic savings accounted for by the government in 1978 would be LL 190 million-- or approximately U.S. $63.3 million. Since U.S. $5.8 million is reportedly payable by the government as foreign debt service in 1978. Slightly less than 10% of that portion of national savings available to the government is required to meet its external debt servicing obligations. If there is no further foreign borrowing between 1978 and 1982 so that the growth in servicing obligations by 1982 is limited to that already scheduled (i.e., would amount to U.S.$46.3 million), and if the nominal amount of gross national savings available to the government in 1982 remains at the same level assumed for 1978 (i.e., at U.S. $63.3 million), almost 75% of that portion of national savings available to the government will be required to service its external indebtedness.

Now suppose that the government's external debt servicing obligations increase by five times between 1978 and 1982, all other assumptions stated in the previous paragraph remaining unchanged. In that case the payments required of the government to service its external indebtedness would amount to U.S. $ 231.5 million -- slightly over 3.5 times the portion of domestic savings available to the government under the assumed conditions. Even if the amount of savings captured by the government increased by 10% per year from the LL 190 million level assumed for 1958, its external debt servicing payments would still be about 2.5 times the amount of savings captured in 1982.

This situation would not mean that the government would necessarily experience any difficulty in meeting its external debt servicing obligations ince it presumably could draw on past accumulated national savings held by the central bank as official reserves. If the level of such official reserves is assumed to be the same in 1982 as that reported as of 30/9/77 -- i.e. approximately U.S. $1,715.6 million equivalent of which more than half was in excess of that legally required as "cover" for the Central Bank's currency and deposit liabilities -- somewhat less than 15% of these reserves would be required to meet all of the government's external debt servicing obligations in 1982 even if these obligations had increased by five times the level presently scheduled for that year.

The problem can be put in somewhat different terms. Suppose the objective was for the government to be able to meet external debt servicing obligations in 1982 of five times the amount scheduled for that year as of 31/12/78 (i.e. U.S. $231.5 million) without drawing on the official reserves held by the Central Bank and without exceeding 10% of that portion of national savings available to the government What total amount of national savings would the government need to be able to capture? The answer is, of course, U.S.$231.5 million equivalent, or approximately LL 6,945.0 million. This figure is in excess of 35 times the nominal figure assumed above in the most pessimistic projection of the national accounts, and about 25 times the corresponding figure based on assumption of 10% per annum growth between 1978 and 1982. These calculations illustrate the magnitude of the budgetary problem the government confronts if its external debt servicing obligations are to increase substantially and if it is not to draw on official reserves to meet these obligations.

Turning now from the preceeding focus on public sector savings and related budgetary aspects of Lebanon's external debt servicing capability to a focus on the balance of international payments aspects, corresponding assumptions can be made regarding the relationship between the figures reported for 1973 and the situation that prevails in 1978 and might prevail in 1982. Assume, for example, that the reported 1973 deficit on current account of LL 317.0 million (approximately U.S. $105.4 million) is repeated in 1978, so that the U.S. $5.8 million external debt servicing obligations of the Lebanese government in 1978 must be derived from the over-all surplus of LL 217.0 million (approximately U.S. $72.3 million) resulting from capital inflows (and "errors and omissions") reported at LL 534.0 million. If by 1982 the same balance of payments figures prevail, the presently scheduled increase in the government's external debt servicing obligations to U.S. $46.3 million would amount to slightly more than 20% of the over-all surplus. And if by 1982 the government's external debt servicing obligations had increased by five times the presently scheduled level, the full amount of the assumed over-all surplus would be required to satisfy the government's external creditors.

The foregoing figures would, of course, be modified somewhat if growth in the balance of payments figures were assumed, but the main implication would not be much affected -- namely that the burden on the country's balance of international payments resulting from a fivefold increase in the government's external debt servicing obligations above presently scheduled levels would be excessive and would need to be relieved to some extent by drawing on past accumulations of official foreign reserves.

In conclusion, it is evident, therefore, that the fundamental and ultimate determinant of Lebanon's external debt servicing capability for the foreseeable future (however dimly it might be perceived) is the extent to which it is deemed to be desirable and feasible to draw on the official reserves for debt servicing purposes. Lebanon is in an enviable position in that, differently from most developing countries and countries that have undergone adversities of the sort Lebanon has recently experienced, it has the option to draw on such extraordinarily large reserves. But this cannot be done without limit, and should not be done without a clear plan for establishing the government's capability for servicing whatever level of external debt servicing obligations it incurs from currently generated savings and foreign exchange receipts.

The estimates of Lebanon's external debt servicing capability suggested in the foregoing paragraphs are, obviously, premised on highly arbitrary assumptions. The "indications" derived from this crude statistical exercise are not intended to be taken as either predictions or policy guidelines, but rather are intended to illustrate the sorts of considerations on which financial programming in this area should be based. A more thorough-going analysis of the country's external debt servicing capability would involve systematic up-dating and projection of the country's national income and balance of payments accounts, and realistic estimation of likely availabilities from future government budgets for external debt servicing purposes. The indicators or ratios it would be desirable, ideally, to derive from these procedures are the following:

1. Proportion of projected gross domestic savings required for servicing both public external indebtedness and externally-provided capital on private account.

2. Proportion of projected balance of payments receipts on current account required for servicing both public external indebtedness and externally-provided capital on private account.

3. Proportion of projected budgetary receipts required for servicing both external and domestic public indebtedness.

4. Proportion of projected external debt servicing obligations likely to be met (or potentially capable of being met) from past accumulations of official foreign exchange revenues.

In addition to these standard indicators of external debt servicing capability some evidence of a country's ability to withstand temporary balance of payments adversities without imperiling its ability to honor external obligations is given by the ratio of projected expenditures for imports of goods and services to projected official foreign exchange revenues. Also, more detailed analysis of the prospective variability in major components of a country's expenditures for imports and receipts from exports is sometimes undertaken in an effort to compile additional evidence regarding risks to its external debt servicing capability associated with unusual degrees of dependence on particular imports or exports.

Given the availability and quality limitations on Lebanon's national and international accounting data, the recent disruptions in historical trends indicated by these data for the pre-events period, and the prevailing uncertainties regarding likely future economic and financial developments, it is extraordinarily difficult to estimate the various ratios described above for Lebanon. Furthermore, there is no good basis for estimating likely future levels of external borrowing and debt servicing obligations. But even if the various standard indicators of Lebanon's external debt servicing capability could be determined with some degree of accuracy, there would still remain the problem of interpreting their significance or reliability as measures of Lebanon's external debt servicing capability. The usual method for interpretation is by way of reference to international standards as established by similarly-situated groups of countries. Reliable interpretation of Lebanon's circumstances on this comparative basis would be difficult, however, both because the structure of the Lebanese economy is virtually unique and because there are so many imponderables in the contemporary and prospective circumstances of the country. To illustrate the point, consider whether the indicators of Lebanon's external debt servicing capability are better compared to those of neighboring countries such as Turkey, Jordan and Egypt, or to certain other middle-income level countries such as Greece, Italy and Mexico, or to essentially trading and service oriented countries such as Singapore and Hong Kong.

APPENDIX IV

NOTE ON
RELATIONSHIPS BETWEEN BANK OF LEBANON GOLD AND
FOREIGN EXCHANGE RESERVES AND GOVERNMENT OF
LEBANON EXTERNAL BORROWING

As already indicated in section II C, Lebanon has accumulated a large amount of gold and foreign exchange reserves amounting at the end of April 1978 to U.S. $2,125 million (LL 6375 million or 112 percent of the 1974 peak imports). And to the extent that the valuation placed on the gold component of these reserves is below the world market price, their true value is correspondingly greater than what is officially indicated.

Some observers regard this level as being considerably higher than what would necessarily be required for economic and psychological reasons particularly that Lebanon maintains a policy of independent float (an independent flexible exchange rate policy). Others tend to believe that such a high level, even if it is considered extraordinarily high, can only generate internal and external confidence in the Lebanese economy.

There are, it would seem, important political, psychological and/or "confidence" factors that make it difficult under the prevailing circumstances for the government to contemplate drawing on the gold and foreign exchange reserves as an alternative to borrowing externally. And presumably there also are corresponding considerations, both strategic and economic, that govern the amounts and types of external borrowing by the government -- both that recently arranged and that being planned for the months and years ahead. It is not the purpose of this note to speculate about these matters. Instead, in the following paragraphs an attempt is made to explore the strictly economic consequences of increasing the government's external indebtedness while the Bank's foreign assets are extraordinarily large and progressively increasing.

The first point to consider is the cost to the Lebanese economy that results from this procedure. If it is assumed that the Bank's foreign assets are invested in the international market and are managed in such a way as to earn the maximum return consistent with the required degree of safety; and, if it is assumed that the government's external borrowing is likewise arranged in accordance with the best possible terms available in the international market; then, the costs to the Lebanese economy from being involved simultaneously as borrower (through the government) and lender (through the Bank) in the international market can be specified as follows:

They are the sum of the "transactions expenses" incurred by the Bank and the government in their respective international lending and borrowing operations and the interest differential between what the government could borrow at from the Bank (leaving it no worse off in the yield obtainable on its foreign assets) and what the government must pay for external sources of borrowed funds. Without examining the relevant quantitative evidence it seems reasonableto assume that this cost, while probably significant in percentage terms, has not yet been of major consequence absolutely because the volume of external borrowing by the government has so far been relatively small. As the government's external borrowing increases, however, the cost of borrowing and lending simultaneously could become a matter of some importance.

The second point to consider is the extent to which the financial cost identified a ove may be offset by benefits derived from the present practice. Leaving aside those benefits associated with avoidance of any potential conflict of will between the government and the Bank (which, quite conceivably could be very substantial, if not absolutely prohibitive, in political terms), the strictly economic benefit would appear to be limited to whatever advantage is derived from the lower interest cost and the increased availability of borrowed funds to the government in the international market attributable to the large and independently controlled gold and foreign exchange reserves of the Bank. Presumably the "credit worthiness" of the government as viewed by potential external loan sources is substantially improved by the Bank's reserve position -- and perhaps also by the foreign asset management practices followed by the Bank. (e.g. willingness on the part of international banks that act as agents for Bank reserve investments to participate in loans to the government might be greater than otherwise; and these banks likewise might be more inclined to provide various services to the government in making arrangements for external borrowing). It seems reasonable to assume that positive benefits of these sorts are not inconsiderable -- and that so far they have adquately offset the costs identified above.

The next question to consider is whether, in the future, the cost-benefit relationship described above might be appreciably improved by modification of the size or composition of the Bank's foreign exchange reserves, or by modification in management practices followed by the Bank with respect to these reserves -- including, of course, the possibility of the Bank standing ready to lend directly, within prescribed limits, some of its reserves to the government. Suppose, for example, the Bank were to agree to stand ready to lend directly to the government at the interest rate otherwise obtainable by it in the international market a certain portion of its foreign exchange reserves, say 7 percent of the amount outstanding at the end of April 1978.[1] This would leave the level of official reserves above its level at the end of 1977, while providing the government with a loan of U.S. \$150 million or about LL 450 million at the current rate of exchange. Such a loan could conceivably have been considered as an alternative Eurodollar loan of the same amount that was recently arranged by the CDR with a syndicate of international commercial banks -- the basic terms of which provided for a floating interest rate of LIBOR + 1½%, 7-year repayment term, and various "commitment" and "participation" fees.

Under such an arrangement it could very well be that significant cost savings might have been realizable without a fully offsetting reduction in benefits. This possibility is premised on several assumptions which may or may not be realistic -- including, particularly, a relatively low political cost in arranging direct borrowing by the government from the Bank. In any case, this line of thinking suggests that it might be desirable to explore the possibility of establishing an arrangement between the government and the Bank that would permit, within prescribed limits, direct access by the government to some portion of Bank foreign exchange reserves while permitting it to continue to maintain a high level of reserves. In addition to visibly affording the government a lower cost alternative to foreign borrowing in some instances, such an arrangement might also serve to increase the government's negotiating strength with potential external lenders by making clear the existence of a credible alternative to their offered terms.

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[1] Latest available data.