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Economic Prospects for a Postwar Lebanon

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In the past sixteen years Lebanon has suffered a tragic history of intense internal warfare and large-scale economic destruction. An eventual Arab-Israeli peace agreement, or any such major political change in the Middle East, will affect the Lebanese economy mainly through its consequences on the country's political stability and on future prospects for reconstruction.

Lebanon has been chronically sensitive to its regional environment. The Palestinian and Syrian involvement in its internal conflicts, Israel's invasions in 1978 and 1982 and its continuing occupation in the South, the Iranian influence after the revolution, and Iraq's support for General Aoun's movement provide overwhelming evidence of this. The most recent example of such regional sensitivity was the repercussion of the Gulf war on Syria's role in Lebanon and on the improved prospects for state reconstruction.

It is thus clear that Lebanon's internal political situation can be strongly affected by an Arab-Israeli peace agreement. But the implications for Lebanon depend crucially on the nature of such an agreement. Experience has shown that such partial peace agreements as the Camp David accords or the 1983 Lebanese-Israeli treaty, which relegated the Palestinian question to a secondary position, accomplished little in terms of internal or regional stability. Real stability requires a comprehensive approach that directly addresses the central issue of the Arab-Israeli conflict, namely the occupation of and continuing settlement on Palestinian land. Only a just resolution of this question that gives Palestinians sovereignty over their homeland is likely to put the region on a new path of political stability and growth. It is the economic implications of this kind of scenario on Lebanon that we will be considering in this chapter.

The regional stability resulting from a resolution of the Arab-Israeli conflict would no doubt strengthen the political settlement in Lebanon and improve the prospects for economic reconstruction. Our working hypothesis is that Lebanon has reached a credible and durable internal political arrangement, and that reconstruction will take place in a stable and prospering regional economic environment.

Analyzing the economic implications of this scenario is a hazardous exercise. Not only has Lebanon gone through a sixteen-year transformation about which we have only fragmentary information, but to this we must add the uncertainties concerning future internal and regional arrangements and the impact of a peace agreement on both. This forces us to limit ourselves to a general, structural type of analysis.

Our starting point is a review of the Lebanese economy before the war, and the central regional intermediation role its predominant service sector used to perform. We next turn to the internal and external changes that have affected Lebanon since 1975. The simple view that the Lebanese economy will quickly recover its original shape once peace is achieved is undermined by the irreversible nature of many of these transformations. We argue that the new Lebanese economy is likely to be more of a peripheral one, and that its service sector will be less dominant, both domestically and regionally. The path of reconstruction itself will be a difficult one, and may be constrained by disorganized policy-making and by a shortage of capital and skills.[1]

The Prewar Economy

Prior to 1975 Lebanon was in many ways an economic success story. The country experienced a real growth rate averaging 6.9% yearly for the period 1960–74,[2] generally low inflation, continuous balance-of-payment surpluses averaging 5.8% of GDP for the period 1964–74, and a highly stable and convertible currency. It is estimated that in 1972 GDP was $2.1 billion for a population of 2.2 million. Table 6.1 gives a summary of main economic indicators for this period.[3]

Three major features characterized the function and structure of the economy: Lebanon's function as an economic intermediary between the industrialized West and its Middle Eastern neighbors; its laissez-faire system that allowed the unimpeded development of this role; and the predominance of the service sector that resulted from it.

Intermediation

Lebanese economic intermediation[4] can be traced back at least to the second half of the nineteenth century, when Levantine ports (Tripoli, Beirut, Sidon, etc.) served as the junction between European-dominated Mediterranean trade and Syrian-Lebanese interior trade.[5] It was the time when French and other European companies started constructing the modern harbor of Beirut, roads, and railroads linking it to Damascus and other Syrian cities. This infrastructure was later expanded, and financial institutions were developed to service trading and construction activities.

The local intermediating bourgeoisie that developed out of this history, including a majority of Christians with special ties to Europe,[6] had close business relationships with the West and had nurtured the linguistic, educational, and commercial skills that best served its position. A highly developed Western-style private education system produced graduates fluent in Western languages and in possession of a variety of professional skills that were scarce in the region. The best known institution of this kind is the American University of Beirut, the first university on the Western model in the region, which educated many Lebanese and Arab professionals and policymakers. Even though private education was not accessible to the many poor, and public education left little to be desired, Lebanon had the highest adult literacy rate of all Arab countries (73.5% in 1980).[7] In terms of foreign language skills, as many as 43% of residents aged ten to sixty in 1970 could speak French.[8]

The scope of Lebanese intermediation was greatly expanded with the growth of the Arab oil-producing economies starting in the 1950s. The country was well positioned to play a central role in servicing the professional, financial, and commercial needs of the modernizing Gulf states. Lebanese traders, engineers, technicians, physicians, lawyers, and teachers offered their services in that region, while many of its surpluses were channeled into Lebanon's banking, real estate, commercial, and tourism sectors.

Laissez-Faire

Lebanon's economic vitality was greatly enhanced by the very liberal economic stance of its government, at a time when activist policies were followed by many of its neighbors. Business could be conducted under few restrictions, and whatever regulations existed were often ignored. The tax burden was low, labor organization was weak, capital could move freely, and bank supervision was limited and coupled with a Swiss-style bank secrecy law.[9] The economy was very open, with imports equivalent to 43% of GDP in 1972.

The size of the government was kept moderate. Its expenditures amounted to an average of 10.2% of GDP between 1964 and 1972 and were financed mainly through indirect taxes.[10] Public investment was geared toward the needs of the private business sector. Income redistribution and social welfare programs were limited. The latest study of income distribution, which unfortunately dates from 1959, found great disparities with 4% of the population earning 32% of total income.[11] This state of affairs may not have changed much by the early 1970s and, arguably, exacerbated the tensions that led to internal conflict.

While they lasted, Lebanon's relative stability and openness were an advantage at a time when political turmoil and increased state control were sweeping the region. The elimination of competition from the Haifa port in 1948 and the closing of the Suez Canal in 1967 strengthened Beirut in its function as the region's entrepôt. The creation of the state of Israel in 1948, the Egyptian and Iraqi revolutions of 1952 and 1958, a series of coups d'état in Syria, and the ensuing nationalizations and restrictions on capital movements allowed Lebanon to attract the financial and human capital as well as the commercial contacts of the Levant's trading class. A large number of Arab immigrants actively participated in the financing and development of the Lebanese economy.

A Service Economy

The orientation of the Lebanese economy led to the dominance of the service sector, which was performing most of the country's regional intermediation role. A look at table 6.2 reveals that services accounted for 56% of employment[12] and 73% of GDP in 1970, much higher than the 1965 average of 46% of GDP in middle-income economies.[13] The country's specialization in services allowed it to take advantage of its unique position in the region, but was achieved at the expense of development in the industrial and agricultural sectors. In 1970, value added per employee in manufacturing and agriculture was 69% and 41% of the same measure in the service sector.[14]

Table 6.2
Lebanon—GDP and employment by sector (1970) (in percent)

	Share of GDP	Share of employment
Agriculture	9.2	18.9
Manufacturing and mining	13.6	17.8
Construction	4.5	6.5
Services	72.7	56.3
Transportation and utilities	10.5	8.1
Trade	31.4	17
Financial services	3.4	3.4
Real estate	8.8	—
Other services	9.9	20.3
Public administration	8.7	7.5
Undetermined	—	0.4
Total	100	100

Sources: GDP Shares: Lebanon, Ministry of Planning (as quoted by Makdisi [1979], p. 141). Employment Shares: Lebanon, Ministry of Planning (1972).

The regional function of the Lebanese service sector is best seen from the balance-of-payments estimates in table 6.1. Although the country had a trade deficit that averaged 25.4% of GDP over the period 1964–72, its current account deficit averaged only 5.5%. The difference, equivalent to an average 19.9% of GDP, was mostly because of a surplus in the net provision of services to nonresidents (other factors accounted for only a quarter of this amount).[15] Foreign travelers, many of whom came not only as tourists but also as businesspeople, medical patients, or students, were an important source of income. Their number grew with the infrastructure that was developed to receive them, and reached an estimated 2.3 million in 1972 who spent the equivalent of 9.8% of GDP.[16] Another substantial source of income was transit trade, transport, and insurance. Lebanon functioned as a depot through which goods transited between the Mediterranean and the Arab hinterland, as well as an intermediary for the export of Saudi and Iraqi oil. This function was reinvigorated by the closure of the Suez Canal in 1967, after it appeared to be losing steam.[17]

Although its direct contribution to GDP may not have been large (it was estimated at 3.4% in 1970), the financial sector should be added to this list as the sector through which large flows of foreign capital were channeled into the country. Between 1964 and 1972, net capital inflows were equivalent to an average 11.2% of GDP and indirectly financed more than half of domestic investment.[18] Funds originated from the region's oil economies, from Lebanon's politically unstable neighbors, and from Lebanese emigrants and were placed both in Lebanon and in international capital markets. The financial sector that performed this function was the most developed in the region,[19] with bank deposits equal to 98% of GDP in 1972.[20]

Manufacturing and agriculture, on the other hand, were much less developed than services. Both sectors had evolved with little government intervention and were geared toward a regional market that absorbed 54% of Lebanese exports in 1974. The agricultural sector had experienced a significant transformation from silk-related and cereal production to fruit growing, almost entirely at the initiative of the private sector.[21] In 1971 three-fourths of the fruit produced was exported to the regional market.[22]

Manufacturing had also developed privately under the government's nonprotective low tariff policy. In stark contrast with the state-controlled heavy industries found in such countries as Algeria and Egypt, Lebanese industry was dominated by very small firms. The 1971 industrial census found that of the country's 11,000 industrial firms, 10,700 had fewer than twenty-five workers. They accounted for 55% of industrial employment and 40% of value added.[23] The sector specialized in low-skill light manufacturing, mostly in the areas of food processing, clothing, and construction materials.[24] There were many signs of accelerating manufacturing growth in the early 1970s and especially following the 1973–74 oil boom, as demand from the region's oil economies expanded. The share of industrial products in total exports grew from 73% in 1970 to 86% in 1974.[25] But this mini-boom was aborted at the outbreak of internal strife in 1975.

Internal and External Changes since 1975

Although the prewar period provides us with the only well-documented, firm basis we have to predict the future of a peacetime Lebanese economy, it can be quite misleading if we ignore the many structural and irreversible changes that have affected Lebanon since the start of the internal conflict in 1975. The sixteen years of war resulted in large-scale economic destruction and decay, and the disruption of Lebanon's regional intermediation role. The private sector responded through a contraction and reorientation of most of its activities, as well as a massive emigration of large segments of the domestic economy. Lebanon's regional economic environment has also been transformed. As it enters its reconstruction phase, Lebanon will find that its services are much less unique and needed than they used to be, and that its neighbors have developed substitutes for them. However, this loss of competitive advantage may be offset by the sheer increase in size of the Gulf economies since the oil boom of the 1970s.

Ravages of War

If Lebanese macroeconomic data were unreliable before the war, they became often simply unavailable thereafter. Table 6.3 gives a number of the more reliable statistics for this period.[26] An indication of the general collapse in standards of living that resulted from the war can be found in the evolution of the official minimum wage. In terms of 1990 U.S. dollars, the minimum monthly wage fell from $279 in 1975 to $65 in 1990, thus losing three-quarters of its dollar purchasing power. No statistics on other wages are available, but a 1989 study concluded that deterioration in other wages was even greater, as wage dispersion narrowed.[27]

One can distinguish two main phases in the evolution of the wartime economy, separated by the 1982 Israeli invasion (Hamdan 1989, Nasr 1990). The first phase was one of apparent prosperity despite the war. In addition to the considerable economic reserves—both public and private—that were accumulated before 1975, the country benefited from the oil boom that expanded demand for its output and emigrant workers. It also received large transfers of political money that financed different factions, including the large Palestinian economy.[28] All of these factors were reversed in the second phase, which saw no less than an economic collapse. Israeli-inflicted destruction was followed by a failed attempt at state reconstruction and a breakdown of expectations concerning a near resolution of the conflict. Economic reserves were by then thoroughly depleted or destroyed, oil-led growth in the region had subsided, and the flow of political money had become much more timid. It is in this phase that our minimum wage index experienced its major fall, having lost only 5% of its purchasing power as measured in 1990 U.S. dollars in the 1975–82 period.

The cumulative effect on infrastructure of sixteen years of destruction and decay is tragic. Most adversely affected were housing, industrial plants, transportation, telecommunication, water supply, and irrigation facilities.[29] It is estimated that the Israeli invasion alone caused $2 billion of damage in physical property.[30] The country's educational institutions and its ability to maintain its human capital also deteriorated seriously.[31]

The Wartime Economy

The destruction of economic infrastructure was accompanied by a disruption of Lebanon's regional economic function. The economy's response to this disruption exhibited two principal characteristics. First, domestic economic activity showed a remarkable adaptability to the new circumstances. Second, large segments of the domestic economy relocated abroad.

The adaptability of the domestic private sector took a multiplicity of forms.[32] Most of the traditionally dominant service sector activities—transit trade, financial services, transportation, tourism—either experienced severe contraction or had to reorient their activity in new directions. The financial sector can be taken as an example.[33] In the first seven years of the war, this sector did not seem to be adversely affected and sustained its previous growth rate. But, in fact, its main domain of activity had been redirected from channeling investment funds to channeling political money and remittances. After 1982, the considerable reduction in these flows and other financial strains caused a gradual contraction in most banks and resulted in a financial crisis.[34]

The industrial and agricultural sectors, less directly tied to regional intermediation, were able to absorb the shock in a first phase and return, before the 1982 invasion, to estimated output levels often comparable to what they were before the war.[35] However, both sectors had to yield in a second phase to the accumulating burden of destruction, lack of investment, shortage of skills, and to the uncertainty and costs of channeling goods in a politically fragmented space. Nevertheless, the resilience exhibited by manufacturing against many odds, its adaptation to capital shortage by relying even further on small-scale labor-intensive enterprise,[36] its taking advan-

Table 6.3
Lebanon—Macroeconomic data (1975–90)
(millions of U.S. dollars unless otherwise indicated/1)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Fiscal variables																
Budget deficit/2	96	169	185	211	306	522	548	1346	1756	1435	1267	762	336	626	933	—
Interest payment on public debt	20	8	15	24	34	60	114	240	365	371	356	280	71	193	305	—
Total public debt	—	—	—	—	322	1125	2069	4326	4570	3980	3420	1398	922	1484	2465	—
External	—	—	—	—	93	491	580	643	610	448	416	458	496	500	520	—
Internal/3	—	—	—	—	229	634	1489	3683	3960	3532	3004	940	426	984	1945	—
From bdl	—	—	—	—	—	—	428	460	967	1422	885	423	288	211	439	—
Non-bdl/4	—	—	—	—	—	—	1060	3223	2994	2109	2119	518	137	773	1506	—
Monetary variables																
M2 growth rt. (%)	11.5	4.7	28.6	19.4	27.3	31.5	40.3	20.3	27.0	23.7	56.1	172.0	354.2	47.8	13.4	55.1
Net foreign assets	2125	3576	2617	2797	3189	3661	4231	4530	3781	2238	2619	2494	2635	3276	3012	—
With bdl/s	1199	2990	1547	1810	1509	1565	1492	2591	2083	670	1073	487	368	978	928	—
With comm. banks	926	586	1071	987	1679	2096	2739	1940	1698	1568	1546	2008	2267	2299	2083	—

Table 6.3 (continued)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Trade																
Net exports	−775	−71	−734	−1026	−1727	−2359	−2895	−2666	−3027	−2476	−1654	−1582	−1340	−1732	−1734	−1886
Exports	1121	496	691	755	773	841	815	719	572	431	376	412	468	601	502	499
Imports	1896	567	1425	1780	2500	3200	3710	3385	3598	2907	2030	1994	1807	2333	2236	2385
Registered ind'l exports/6	—	—	—	—	—	529	526	405	286	140	136	126	187	271	175	—
Prices fx. rates & wages																
Inflation rate/7	9.9	28.9	19.3	10.2	23.8	23.7	16	13.8	7.2	14.8	64	105	403	155	70	142
Nominal fx. rate (LL/$) (LL/$; pd. averag	2.3	2.87	3.07	2.96	3.24	3.44	4.31	4.74	4.53	6.51	16.42	38.37	224.60	409.23	496.70	695.10
Real fx. rate/8	—	—	—	—	—	100	119	122	112	147	234	272	328	244	182	147
Min. month. wage/9	115	115	136	136	168	196	186	195	243	192	90	70	28	49	70	65

1/ End-of-year exchange rate used for stock variables and average exchange rate used for flow variables.
2/ Defined as the sum of the changes in net borrowing from Banque De Liban (BDL), T.Bills in circulation, and external debt.
3/ Defined as sum of cumulative loans loans from BDL, and outstanding amount of T.Bills.
4/ The sum of outstanding treasury bills (excluding those held by BDL) and commercial banks' lending to public institutions.
5/ Excludes holding of 9.2 millions ounces of gold.
6/ Industrial exports that were registered with the Ministry of Petroleum and Industry.
7/ Figure for 1990 is the change in price index from October 1989 to October 1990.
8/ Defined as nominal $ exchange rate multiplied by U.S. price index divided by Lebanese price index.
9/ For 1986–1989, values are the averages of the two minimum wages that were legislated in the year.
10/ Figure for May 1991.

Sources: Except for what follows all data derived from Banque De Liban "Annual Report" (various issues). Net Exports, exports, imports, nominal exchange rate, U. index: "International Financial Statistics," International Monetary Fund; Registered Industrial Exports: Ministry of Petroleum and Industry (as quoted by and BDL Yearbook (1989): Minimum wages: Institute of Industrial Studies, "Developments of Minimum Wages and Cost of Living Adjustments" (in Arabic).

tage of falling real wages to increase output vigorously between 1984 and 1988,[37] are encouraging signs for the future of this sector.

In the absence of central political authority, one unfortunate way in which economic activity was reoriented is the various forms of illegal activity that formed the parallel economy—smuggling, extortion, drug cultivation and trade, arms and ammunition trade, etc.[38] There is a danger that vested interest in such activities is such that they may persist beyond any political settlement unless the government has the will, power, and dedication to eradicate them.

Emigration

The second way in which the Lebanese economy adapted to the war situation is through a massive emigration of large segments of the domestic economy, both in the form of worker emigration and of the relocation abroad of service sector concerns. Though no exact figures exist, Labaki (1989, 1990) estimates that net emigration reached a total of 740,000 between 1975 and 1988, followed by another 240,000 who fled the escalation of hostilities in 1989.[39] The scale of this phenomenon is astounding for a country of about 3 million inhabitants. Early emigration was biased toward active participants in the labor force, who represented 50% of emigrants to Arab countries in 1975.[40] This share was reduced to 25%–30% by 1985, as emigrant workers settled and were followed by their families. Another characteristic of emigration is its bias toward skilled workers. Eighty percent of emigrant workers to Arab oil-producing countries in the 1975–82 period had technical qualifications of some kind. Thus emigration has been a major drain on the country's skilled labor resources and seems to be increasingly permanent. It has, however, provided a large flow of remittances that have helped cover the country's trade deficit.

The emigration of workers was accompanied by an emigration of businesses. Before the war a large number of multinational companies active in the Middle East had their headquarters in Beirut.[41] Moreover, Lebanese businesses were increasing their scope of operations to the Arab world. The war severed the first type of presence and expedited the second, as most internationally active firms relocated abroad. Labaki (1990) illustrates this phenomenon with a 1979 list of sixteen Lebanese insurance companies that were operating in the Gulf region as well as in Cyprus, Greece, and Jordan.

Regional Transformation

In addition to the changes that have affected its domestic economy, Lebanon has seen its regional environment undergo dramatic transformations. As it enters its reconstruction phase, the country will find that its traditional intermediation role is less essential than it used to be, and that the services it can offer are less unique. To its advantage, however, it will find a much larger regional market.

Lebanon has to a large extent been replaced in the services it used to provide to the region's economies. The Gulf economies have developed their own banking, insurance, transportation, medical, and educational facilities. International concerns, once based in Beirut, have consolidated their presence in other countries—the Gulf states, Bahrain, Cyprus, et cetera. The Gulf countries' capital surpluses, for example, are now to a large extent managed directly by the West's capital markets, with no need for Lebanese institutions. To take another example, Lebanon is no longer important for the transit trade between the Mediterranean and the Arab hinterland. Besides the reopening of the Suez Canal, many of the region's economies have developed and modernized their own harbor facilities to fill their needs or compete in transit trade (Saudi Arabia's Jiddah and Dammam, Syria's Latakia and Tartous, Jordan's Aqaba, etc.).[42]

Neither can Lebanon be expected to resume its original role as an enclave of free enterprise and stability in the region. Given the country's legacy of political instability, as well as the *infitah* movement toward liberalization in a number of the region's economies, Lebanon cannot be expected to regain its unique edge in attracting foreign investments.

However, we must keep in mind that most of Lebanon's prewar economic successes were achieved before the fourfold oil price increase of 1973–74. One particularly relevant measure of the oil economies' tremendous growth in the 1970s is Saudi Arabia's trade deficit in nonfactor services, which grew from $90 million in 1970 to $24,283 million in 1980.[43] Lebanon may not need to recover its previously dominant role in exporting services or attracting capital to prosper in this environment. The question is to what extent this larger market will compensate for its loss of competitive and historical advantage.

Table 6.4
Lebanon—Central Government Revenues, 1970–72 (in percent)

	1970	1971	1972
Total tax revenue/GDP	10.4	11.2	11.2
Share of tax revenue			
Indirect taxes	57	61	65
Customs duties	15	14	18
Fees and dues	14	15	15
Direct taxes	29	24	20
Income taxes	15	14	18
Total	100	100	100

Source: Lebanon, Ministry of Finance (as quoted in Makdisi [1979], table 2, p. 140).

Economic Prospects for a Postwar Lebanon

From the history of Lebanon's economy we can now turn to its economic reconstruction prospects under a peace scenario. We identify two critical factors for the pace of reconstruction. The first is the government, and its ability to manage the difficult fiscal situation it will be facing. The second is the willingness of capital and skills to return to Lebanon. Where reconstruction will be taking the Lebanese economy is difficult to ascertain, but it is unlikely that Lebanon's service sector will recover its previously central position in the region. This may lead to greater domestic sectoral balance, with a more important role for the light manufacturing sector.

Government Finances

Legacies
To understand the future fiscal and monetary policy challenges the Lebanese government will face, we must start with a quick overview of the history of public finance in Lebanon.[44] We have seen that, consistent with its economic liberalism, prewar Lebanon had a moderately sized government. As indicated in table 6.4, the central government relied mostly on indirect taxes, fees, and dues, which provided 80% of total tax revenue in 1972. The contribution of direct taxes was limited, accounting for only 20% in the same year. Although Lebanon had a full legal income taxation system, in practice

tax collection was lax, and tax evasion was widespread and difficult to track because of bank secrecy.[45] Nevertheless the government managed to maintain moderate budget deficits in the 1957–67 period, followed by surpluses until 1974.[46] In 1975 public debt was very small, and the Bank of Lebanon had accumulated $1.2 billion in foreign currency and 9.2 million ounces of gold.

This state of financial soundness started deteriorating following the outbreak of hostilities in 1975, as tax revenue suffered and an increasing gap appeared in the government's finances. But the real difficulties came after the 1982 Israeli invasion. As the Gemayel government was using up foreign currency reserves to reequip the national army, its attempt at state reconstruction was collapsing with the gradual encroaching of militias into state territory. In subsequent years the government had to bear the burden of paying its unproductive employees, providing unpaid-for electricity and telephone service, and subsidizing fuel, bread, and credit for various sectors of the economy, while its capacity to raise revenue was breaking down. Militia-controlled harbors, smuggling, and the mere incapacity to tax stripped the state of its major sources of revenue.[47] Estimated tax revenue decreased from 39% of expenditures in 1980 to 9% in 1986 and 2% in 1989.

The resulting budget deficits were such that between 1982 and 1984 public debt increased from $3.6 to $5.3 billion, and the Central Bank's sale of foreign exchange reserves to the treasury reduced their amount from $2.6 to $0.7 billion. In 1985 the Bank of Lebanon, under a new leadership, tried to reaccumulate reserves and started heavily monetizing the deficit. Inflation accelerated and reached an estimated 1987 peak of 403%, while real public debt decreased to $1.4 billion. High inflation was accompanied by a collapse in the nominal exchange rate, which overshot and led to a temporary real depreciation, and dollarization of the economy.[48] Although debt inflation and the suspension of fuel subsidies gave some relief, the gap in the government's finances could not be closed. In dollar terms public debt increased to $2.5 billion in 1989, and inflation seemed to be accelerating again, reaching an estimated October-to-October rate of 142% in 1990.

The Future

Even with the return to full central government authority and capacity to tax, the fiscal situation will be very difficult in the future. In addition to its ordinary expenditures, the government will have to finance a large public reconstruction program. Moreover, given the polarization in the distribution of income that resulted from the war, the government will face political pressures for social welfare programs, especially in the area of housing for the *muhajjarin* (displaced populations). The official Council for Development and Reconstruction estimates that the government will need to spend \$4.5 billion over the next five years, including \$3 billion over the next three years, for the emergency rehabilitation of basic services and for priority programs.[49]

The government would be lucky if it could manage to balance even its *current* budget. Considering that the budget deficit was \$918 million in 1989, current spending will be *at least* \$1 billion per year. Iskandar (1991) estimates that indirect taxes, fees, and dues can cover less than half this amount. If they account for the same share of total revenue as in the prewar days, direct taxes may not add more than \$100 million. A sound reinvestment of the Central Bank's 9.2 million ounces of gold reserves—which the government may be reluctant to do—could probably return an additional \$300–\$400 million per year and close the gap. Even under this very optimistic scenario, we are left with the much-needed public investment program.

How will the government finance its deficits? In a December 1991 Paris conference, Lebanon received a commitment for \$700 million in aid for the next three years from various industrialized and oil-exporting countries.[50] As far as debt finance is concerned, the government's indebtedness in 1989 was already \$2.5 billion, although external debt was only \$520 million. Thus Lebanon is likely to receive foreign loans from the World Bank and other parties, but the amount is uncertain. In any case, a substantial part of the budget deficit will have to be financed internally. Finally, the government is well advised not to return to inflationary finance to close its budget gap, and perhaps slow down the reconstruction program if needed. The exchange rate appreciation accompanying the resurgence of capital inflows provides an opportunity to stop runaway inflation. Returning to inflationary finance would be putting the cart before the horse. An unstable currency may undermine the capital inflows that help finance the very reconstruction program (private and public) the government seeks to accelerate.

In practice there is a real danger that a weak Lebanese government may find its borrowing capacity insufficient to finance the expenditures it is under pressure to make, and may automatically monetize its deficits. This is a classic recipe for runaway inflation. Conditioning international lending on fiscal discipline will help reduce this risk. In any case a fiscal reform is urgently needed. Its object should be to improve the government's capacity to raise revenue in the least distorting way possible. It should improve the way taxes are collected, while avoiding the high tax rates that would jeopardize the return of capital and skills. A well-executed reform would help reduce current deficits, improve the confidence of lenders, and provide future revenue to service the government's accumulating debt.

Capital Inflows and Return Migration

With the destruction that has afflicted the economy's infrastructure in the past sixteen years and the emigration that has drained Lebanon's human resources, the pace of economic reconstruction will depend mostly on the resurgence of capital inflows and return migration. These are likely to place a limiting constraint on growth.

Lebanon's total reconstruction needs for capital are very large.[51] An interesting example of the scale of needed resources is the Downtown Beirut Reconstruction Project, a plan to reconstruct from scratch an area of 1.4 million square meters. The project would be owned jointly by the government, holders of land titles, tenants, and investors who would put perhaps $1 billion.[52] With the current levels of income the contribution of domestic saving to reconstruction can only be minor, and the economy will have to rely on capital inflows from abroad. This may lead to an appreciation of the real exchange rate, which would hurt the export sector.

Private investment funds may come to a large extent from Lebanese fortunes abroad. An encouraging indication is the $610 million combined balance-of-payments surplus of the Central Bank and commercial banks in the first six months of 1991, a time when the political situation was improving but still uncertain.[53] Arab capital other than Lebanese may constitute another important source of funds. Naturally, Lebanon cannot recover the lion's share it used to receive of Arab foreign investments, estimated at 58% of the cumulative $1.2 billion Arab capital invested abroad between 1945 and 1968.[54] But the drastic reduction in this share may be offset by the large increase in Arab assets abroad, and the apparent willingness to invest them in developing countries (Sherbiny 1986 estimates that $53 billion of the cumulative $474 billion OPEC surpluses in 1984 were invested in developing countries).[55]

Whatever its source, investment will depend on perceptions of the country's political stability, as well as on the productive prospects of the economy. This is where a peaceful settlement of the Middle East conflict would be most beneficial. It may both reduce the country's political risks and guarantee a favorable regional market in which its economy can prosper. The government's ability to finance its share of reconstruction also will depend on such factors. This is not only true of private lending, but also to a large extent of grants and loans from international agencies. In the past the Lebanese government has been repeatedly denied promised funds because of the unsettled political situation.

In addition to capital, returning skilled labor will also be necessary for reconstruction. Before the war Lebanon distinguished itself with skills that were scarce in the region. The fact that Lebanese emigration was biased toward skilled workers, and that the region's other economies have been improving the quality of their work force, will considerably reduce Lebanon's advantage. It is difficult to predict the magnitude of return migration. A good portion of the large emigration fleeing the hostilities of 1989–90 was probably temporary. But the estimated 750,000 emigrants who left before then may not return so easily. To the previously mentioned signs of permanent settling, we may add the fact that an estimated one-third of this emigration took place more than ten years ago (Labaki 1990). Lebanese businesses operating in the Gulf will also find it disadvantageous to relocate away from their customers. But even if it does not return, this emigrant worker and business community will nevertheless benefit the country through its wide international commercial network, as well as through its remittances.

Return of the Service Economy?

The Lebanese economy must be reconstructed from scratch. The question is whether it will return to the same service-led regional intermediation function it used to perform, or whether it will grow in new directions. Our guess is that, although they will remain the main sector in the economy, Lebanese services are likely to be less dominant both domestically and regionally. On the other hand, the light manufacturing sector should account for an increased share of GDP.

In terms of comparative advantage, one has to conclude that human capital intensive exports, in particular services, will still play a major role in the economy. The country is so small that it must remain very open. Except for its adequate agricultural potential, it has a very limited physical resource base to rely on. Its physical capital stock has been destroyed, and its human resources, however much eroded, will remain its primary asset.

But, as has been emphasized in recent trade theory,[56] history can play as determinant a role as comparative advantage. When the existing infrastructure, institutions, networks, and qualified work force are important for the decision to locate new service activities in a country, then a successful history can have a snowballing effect. This phenomenon worked to Lebanon's advantage in the past, but it may now work to its disadvantage. The disruption of Lebanon's service exports for sixteen years, the fact that they have been supplanted by others, the emigration of skills, the destruction of infrastructure will likely prevent the country from recovering its central position in the Middle East. Even if its service sector prospers again, it will remain a peripheral one.

One should not be overly pessimistic, however. The scale of the regional economy compared to what it was before 1973 is such that, for all we know, a small peripheral Lebanese economy may do as well in the future as it did before the war as the regional economic hub. Lebanon still benefits from some advantages. It has a broad international business network provided by its emigrant labor force and businesses. Its currently very weak financial sector will probably be reviewed in the process of financing reconstruction, and it may be able to take advantage of bank secrecy to expand its operations further. The tourism sector, which will take long before it can rebuild its image and infrastructure, will meanwhile benefit from the large emigrant Lebanese community.

Nevertheless Lebanon's loss of comparative and historical advantage in the export of services is likely to lead to greater sectoral balance. It does not take much insight to predict that the construction sector and its related industries will thrive. More interestingly, there are good reasons to believe that light manufacturing will account for a bigger share of GDP than before the war. In the early 1970s, a structural tilt in the domestic economy toward more manufacturing in response to regional growth was already apparent, as the provision of services was shifting closer to the customer. Writing right before the war, Dubar and Nasr (1976, p. 77) could predict "a substantial increase in the share of industry in GDP, that would exceed twenty percent in 1980." During the war, manufacturing showed remarkable resilience despite severe handicaps. It shifted toward smaller labor-intensive units to substitute for disappearing capital and take advantage of reduced real wages. An important development during this period was the flow of refugees and rural migrants, who formed a large urban pool of cheap labor, particularly in the southern suburbs of the capital, of which industry now can take advantage. However, manufacturers will have to face the problems associated with a poor public infrastructure, the scarcity of capital and skills, and the higher real exchange rate that may accompany capital inflows.

These problems will also affect agriculture, which will have to compete with other sectors for capital. But if capital is available, Lebanese agriculture could take advantage of an important irrigation potential (estimated at 215,000 hectares of irrigated land, compared to 86,000 hectares currently irrigated)[57] and adopt advanced intensive agricultural techniques to meet the growing needs of the regional market. However, as is typical of the development process, one would still expect to see the share of agriculture in domestic employment and output decline over time.

Conclusion

This chapter examined the possible economic effects on Lebanon of Arab-Israeli peace. Because of Lebanon's sixteen years of internal strife, the most important contribution of a peace scenario would be on the settlement of the Lebanese political crisis and the prospects for economic reconstruction. Although Arab-Israeli peace may not be a necessary condition for such a settlement, it would probably reinforce it.

The country is very fragile economically and will have to walk a tightrope in the transition toward recovery. Although a vigorous reconstruction phase is not impossible, its pace may be constrained by disorganized policy-making and a slow return of capital and skills. At the end, even if this trial is passed, the permanent changes of the past sixteen years may lead to a very different Lebanese economy from what it was before the war. It may be more of a peripheral economy in the region, and its service sector may be less dominant.

Notes

1. We are grateful to Stanley Fischer and Elias Tuma for helpful comments. This paper was written while Amer Bisat was at Columbia University. The views expressed here are those of the authors; they do not represent the views of the International Monetary Fund, its staff, or its executive board.

2. Estimate based on Mallat (1988), table 7, p. 38.

3. Most of the available data on the Lebanese economy are highly unreliable and should be interpreted with care.

4. For a further analysis of Lebanon's regional intermediation role, see Nasr (1978).

5. For an analysis of the economy of Mount Lebanon and Syria between 1880 and 1914, see Owen (1981), chap. 10.

6. For an account of the economic role of minorities in the Middle East during this period, see Issawi (1982), pp. 89–92.

7. Richards and Waterbury (1990), table 5.5, p. 113.

8. Ministry of Planning (1972), p. 98.

9. Between independence and 1964, central banking responsibilities were given to the private *Banque de Syrie et du Liban*, and prudential regulations and supervision were virtually nonexistent. The Bank Secrecy Law was promulgated in 1956. The Lebanese Central Bank (Bank of Lebanon) began operations in 1964, but commercial banking was left practically unregulated until the failure of Intra Bank in 1966, and the establishment of the Banking Control Commission in 1967 (see Makdisi [1979], pp. 48–53).

10. Public finance during this period is discussed in more detail later in this chapter.

11. Study done by the IRFED Mission and quoted by Aly and Abdun-Nur (1975), pp. 160–63.

12. Employment shares may be somewhat distorted by the fact that they do not account for the employment of Palestinians who reside in refugee camps (Ministry of Planning [1972], p. 6).

13. World Bank (1990), pp. 182–83.

14. See Aly and Abdun-Nur (1975), p. 162. For reference, the corresponding ratios for the United States were 79% and 104% in 1970.

15. See Mallat (1988), table 22b, pp. 75–76.

16. See Mallat (1988), table 21, p. 70; Badre (1972), pp. 170–73.

17. See Mallat (1988), table 20, p. 68.

18. Gross private domestic investment accounted for an average 20.6% of GDP during this period.

19. As an indicator, Lebanon had 70.6 bank branches per million inhabitants in 1970s, compared to 45.6 in Turkey, 40.2 in Iran, 24.6 in Jordan, and 6.1 in Syria (Makdisi [1979], p. 176). For a description of the Lebanese financial sector during this period, see Makdisi (1979), pp. 39–48.

20. Mallat (1988), p. 218.

21. See Dubar and Nasr (1976), pp. 93–97.

22. Ibid., p. 94.

23. Ibid., tables II.7–II.8, pp. 77–78.

24. Ibid., p. 80.

25. Maroun (1984), table 3, p. 31.

26. Because of the unreliability of inflation figures in this period, we had to translate data into U.S. dollars to get some notion of their variation in "real" terms.

27. See Hamdan (1989), p. 27.

28. See Khalidi (1984).

29. See Council for Development and Reconstruction (1983).

30. Ibid., p. I.5.

31. See Al-Amine (1989).

32. See Hamdan (1989).

33. For a detailed survey of financial sector developments during the war, see Chaib (1985) and Bisat (1990).

34. In 1990 alone the Central Bank had to inject $127 million into fifteen banks on the verge of failing, and force another five banks to resort to its funds and raise their capital to acceptable levels.

35. Nawam (1988) estimates the value of industrial exports at $726 million in 1974 and $1,317 million in 1981, which amounts to roughly equal values in real terms. Similarly, fruit exports were estimated at 338,000 tons in 1974 and 333,000 in 1980 (Maroun [1984], table 5, p. 33).

36. The share of small industrial firms with five to nine workers increased from 20% of industrial employment in 1971 to 36% in 1985 (Hamdan [1989], p. 35).

37. Nawam (1988) estimates industrial exports to have increased from $320 to $728 million (first nine months) over this period.

38. See Zagorin (1982) and Nasr (1990).

39. This last figure is for the first eight months of the year.

40. All statistics in this paragraph are from Labaki (1990).

41. Of the 772 service sector corporations operating in Beirut in 1970, 248 were subsidiaries of foreign corporations and 152 were mixed-capital corporations (Dubar and Nasr [1976], p. 68).

42. See Maroun (1984), chap. 6.

43. See Katouzian (1989), p. 55.

44. For a discussion of Lebanese public finance before 1975 see Makdisi (1979), pp. 35–38, and Mallat (1988), pp. 261–81 and 351–86.

45. Torbey (1987) gives a detailed discussion of Lebanon's income tax system.

46. See Mallat (1988), table 5, pp. 272–73.

47. Abu Sakr (1988) gives a detailed discussion of state finances during this period.

48. For a further analysis of this episode, see Saba (1987) and Saidi (1989).

49. The funds are to be allocated as follows: 58% for infrastructure; 27% for social services (including 21% for housing); 13% for the productive sector; and 2% for management and technical assistance (*al-Nahar* 13 December 1991, p. 1).

50. *Al-Nahar*, 14 Dec. 1991, p. 1.

51. According to a recent U.N. report presented to the Council for Development and Reconstruction, Lebanon requires $18 billion as a prerequisite for a return to "the normal cycle of growth," including $5 billion for public infrastructure (*Al-Hayat*, 27 August 1991, p. 9). Although this number appears excessively large, it reflects the country's extreme needs for capital.

52. *Al-Hayat*, 3 Oct. 1991, p. 9.

53. *Al-Hayat*, 17 Aug. 1991.

54. Study by the Lebanese Ministry of Planning, quoted in Maroun (1984), p. 9. The original Lebanese pound figures (L£ 2.2 billion of the cumulative L£ 3.8 billion Arab foreign investments went to Lebanon) were converted at an average exchange rate of 3.2 L£/$ for this period.

55. See Sherbiny (1986), table 1, p. 7.

56. See, e.g., Helpman and Krugman (1985), and Krugman (1991a, 1991b).

57. See Baalbaki and Mahfouz (1985), pp. 25–26.

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