



The Lebanese Economy: Issues in its Post-War Development, 1992-2004

Ali A. Bolbol

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Abstract

The purpose of this paper is to draw a few lessons from the post-war experience of 1992-2004, in the hope that it can shed useful light on the future direction of economic policy. The paper outlines the travails of economic reconstruction, and discusses the drawbacks of high deficits, debt and overvalued exchange rates. This is followed by an analysis of the political economy analysis on the role of the government and financial sectors and some policy implications. The main thesis implied in the paper is that reform policies should focus more on the real sector of the economy, and should take advantage of the country's two fundamental assets, namely, its geography and its human capital.

الاقتصاد اللبناني: قضايا في التنمية خلال فترة ما بعد الحرب، 1992 - 2004

علي بلبول

ملخص

تهدف الورقة إلى استخلاص بعض الدروس من تجربة الاقتصاد اللبناني خلال فترة ما بعد الحرب الأهلية، 1992 - 2004. لإضفاء الضوء على توجهات السياسة الاقتصادية في المستقبل. تعرض الورقة المشاكل الاقتصادية التي واجهت عملية إعادة الإعمار، وتناقش سلبيات العجوزات المالية والدين المرتفع وسعر الصرف المغالى فيه التي عاشها الاقتصاد اللبناني خلال الفترة. تحلل الورقة أيضاً من مفهوم الاقتصاد السياسي دور الحكومة والقطاع المالي والمصرفي في الاقتصاد اللبناني، إضافة إلى تحليل بعض مضامين السياسة. والفكرة الرئيسية التي تتضمنها الورقة أن سياسات الإصلاح في المستقبل يجب أن تركز على القطاع الحقيقي وأن تستفيد من المزايا الأساسية التي يتمتع بها الاقتصاد، وهي موقعه الجغرافي المناسب ورأس المال البشري المتطور.

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Introduction

In its recent history, the Lebanese economy represents a case of missed opportunities. Its first opportunity for industrial take-off, centered around a budding silk industry in Mount Lebanon, was defeated in the 1880s by international economics through steep reductions in the price of silk (due to larger supplies from East Asia). What followed was a period of economic slowdown and intense emigration that saw more than 250,000 people leave the country in the period 1890-1914⁽¹⁾.

Not to be outlasted, a second opportunity later emerged. Mainly between 1926-1944, it was driven by infrastructure developments (by the French mandatory power), tariff protection, and expenditures by the Allied Forces. It also had a diversified structure with some political leeway as an industrial interest group. However, strong local politics overruled nascent economic possibilities implicit in this second opportunity, in that the political elite opted in 1948 to turn Lebanon instead into a center of commerce and finance⁽²⁾. Although this model did not fare badly – real GDP growth averaged 6.2% during 1948-1974 and even industry increased its share of GDP from 9% to 17% – economic prosperity was not deep and wide enough to ease social cleavages and override political tensions⁽³⁾. As a result, domestic (and regional) politics ditched economic potential, and a bloody civil war ensued.

When the civil war breathlessly finished, the country had lost by then, almost half of its national income. The imperatives of reconstruction and recovery gave economics a chance to tame politics; and the economic model that was put forth for that purpose was an improved version of the model that the country's short memory knew best: "Singapore of the Middle East"⁽⁴⁾. The aim was to refashion Lebanon as a center of finance in the Middle East – in as much as Singapore is that for South-East Asia. The comparison missed on two glaring dissimilarities: (a) Singapore emerged as an industrial and manufacturing base in the 1960s and 1970s before it graduated to become a mighty financial center, and (b) It also had strong national institutions and central government that glued society and its population together.

What the model also missed is that the country's civil war had its toll on this presumed comparative advantage, and any head-start or unique features that the economy had enjoyed in the pre-war period was dissipated. This was clearly reflected in the inability of the economy to sustain the recovery mid-way

through the post-war period, despite considerable infusion of public expenditures. Naturally, the combination of ensuing budget deficits and low growth led to high debt, the management of which still dominates the political economy of Lebanon to this day. Politics also poked its ugly head, clashing with economics and depriving the economy of needed reforms to deal with the debt crisis and with bringing back momentum to the recovery. Surely, a third opportunity was also missed.

After the events of 2005 (discussed in more details below), Lebanon has turned a new page on its politics, which should better accommodate sound economics and proper governance. The purpose of this paper is to elicit a few economic lessons from the post-war experience of 1992-2004, in the hope that it can shed useful light on the direction of economic policy in Lebanon's "Third Republic".

Economic Reconstruction and Recovery

After more than 16 years, the Lebanese Civil War ended in 1991 with all the characteristic stylized facts: destruction of much capital stock, disruption of the social and economic order, and substitution of financial and human capital away from the domestic economy⁽⁵⁾. Having been fought entirely on Lebanese territory, the war had also undermined the state and its capability. A weak state would naturally imply that the tasks of economic reconstruction must rely more on market mechanisms. But this is something that would not have been new to Lebanon since its economy had always been a model of *laissez faire* – however misguided – in the region and beyond⁽⁶⁾.

What should have been new and essential is a strong state, needed to develop proper governing institutions and secure political cohesion in a country that is liable to rampant corruption and to fractious confessionalism⁽⁷⁾. But that was not meant to be, for at least three reasons. Firstly, the Taif Accord that ended the war and ushered in the "Second Republic" stripped executive authority from the Maronite presidency. As a result, this left the elites of that community dissatisfied and in nascent, but bitter, struggle with those of the other two major communities (the Sunnis and the Shias) for the spoils of office⁽⁸⁾. Secondly, the Accord granted Syria a temporary stay in the country to secure the peace, but Syria understood this to mean an extended mandate over the country and the control of its internal affairs. Thirdly, external threat to security by Israel continued to be ever-present – although its intensity was curtailed after the liberation of the

South in 2000. In short, political rehabilitation was compromised by internal discord and external concerns. And this proved deleterious, since it is political rehabilitation that should have underpinned economic reconstruction and helped to transform it into meaningful recovery and sustained development.

But what was the program of economic reconstruction? The program with the most currency initially was Horizon 2000. It was a blue-print for infrastructure development lasting for 10 years (1993-2003) and costing \$12.9 billion (with \$7 billion projected to be financed externally, 17% from grants and 83% from borrowing)⁽⁹⁾. It aimed at laying the ground for the country to regain and advance its position as a bridge between Europe and Arabia, with renewed emphasis on the role of the service sector, namely tourism, finance, and information technology⁽¹⁰⁾. But it was also a plan that was devised by two construction companies, the local Dar-Al-Handasah and the International Bechtel, and not surprisingly short on the crucial matters of institutional development and national governance, considered to furnish the necessary, if not sufficient conditions for sustained growth⁽¹¹⁾. At any rate, Horizon 2000 was adopted by the post-war government headed by the late Prime Minister Harriri in 1992. However, soon, its priorities began to fade as deficits started to cripple government finances from 1997-1998 onwards⁽¹²⁾.

What derailed the financing of the program was a combination of factors. The Civil War did not bring any fiscal peace dividends. In fact, it added to the fiscal burden by the cost of rebuilding the army and the police. In addition, few of the promised grants came the country's way – no more than \$300 million. More importantly, the country elected initially not to resort to official concessional financing (bilateral and multilateral), partly because it did not want the reconstruction program to be hostage to foreign conditionality. As a result, deficits were financed by internal and external (private) borrowing at increasing rates, and with revenue not catching up, they ended saddling the economy with spiraling debt and its burdens. Even with the scaling down of the program, total public investments were close to \$9 billion by 2004⁽¹³⁾. But what is curious is that, given that the jewel of reconstruction – downtown Beirut – was financed through the private company Solidere, there was not much to show off in actual infrastructure developments for those sum of expenditures!

Perhaps more importantly, the program was characterized by a dearth of economic policy initiatives. The economic policy that really defined the post-war agenda was the use of the exchange rate as the nominal anchor for monetary policy, and the curtailment of deficit monetization. And here, the

exchange rate was deliberately (and rightly) undervalued at first so as to entice capital back into the country by the prospect of future appreciation. However, it has since appreciated to reach overvalued real levels⁽¹⁴⁾. Though this policy achieved monetary stability, there were other crucial policy choices that should have deserved greater attention by the government and aimed directly at the real sector and its operating environment – be it industrial, commercial, tax, public sector, or employment policies⁽¹⁵⁾. Of course, it is true that one can not ask too much from a beleaguered post-war government and clutter its policy agenda with increasing demands. But it is also true that the government dug itself in a deep hole by its deficit financing and exchange rate policies and in the process, was paralyzed to act on vital policy fronts. However, a belated recognition of this trap was acknowledged by the government, and in consequence it convened in 2002 the Paris II Conference to address the debt problem.

The Paris II Conference perhaps represents the second major economic program of the post-war period. It was largely a product of Harriri's efforts and reputation, and it gathered the Heads of State of Lebanon's friends from Europe and the Gulf. Its upshot was a pledge to provide \$4.4 billion in concessional funds (by the end of 2004, almost \$2.9 billion was provided), in addition to an agreement with the local commercial banks to forego interest on government debt equal to \$4 billion⁽¹⁶⁾. Paris II stipulated, however, that Lebanon should start to act seriously on economic reform. And primary among these reforms is privatization, especially Electricite du Liban (EDL) which has insatiably swallowed an average of \$400 million in annual subsidies⁽¹⁷⁾. Paris II succeeded in easing the financing costs of the government since interest rates on the debt fell by more than 4%. However, political bickering among the country's power brokers froze action on economic reforms and consequently, the benefits from Paris II could not be locked in to start the debt on a sustainable path. The only bright spot that marked any reform efforts was instating in 2002 a system of value-added taxation (VAT) that nudged up the tax revenues to GDP ratio by at least 3%.

But this could change. The death of Prime Minister Harriri in 2005 has led to a spring of changes in the country, most notably the withdrawal of the Syrian Armed Forces. As a result, Lebanon is now embarking on its "Third Republic", with presumably more independence in its decision making, so any new economic course should heed the obvious lessons from Paris II and before. These may be broadly encapsulated by the need to have a new political consensus that would underlie economic reforms and, more importantly, institutional reforms. Also, economic reforms should go beyond the mere objectives of debt reduction and

privatization – after all there are only two public utilities available for privatization, EDL and telecommunications⁽¹⁸⁾ – to encompass aspects that upgrade the quality of the investment and business environment in the country⁽¹⁹⁾.

Given the outline of the post-war story discussed above, what do the numbers say about the country's economic performance during that period? Table 1 shows that reconstruction created an initial spurt of growth, averaging 5.3% between 1992–1998. However, this did not manage to translate it to robust recovery as growth afterwards averaged 2% only, with a noticeable increase in 2003-2004. The drag on the economy's resources caused by the high budget deficits, especially between 1994-2002 as may be seen in Table 2, plus the overvalued exchange and interest rates, were no doubt contributing factors in the slowdown.

However, on the positive side, anchoring monetary stability to the exchange rate subdued inflation and brought it down to low single digits. Overall, growth rates in the post-war period averaged less than those of the 1948–1974 period, i.e. 3.8% against 6.2%. This is possibly due to a lower long-run desired capital stock in the post-war period because of higher country risk relative to that of the pre-war situation⁽²⁰⁾. Although it took the post-war economy only up to 1998 to recoup its 1974 real per-capita income at close to \$1300, this level nevertheless stagnated between 1999–2002 and so did Lebanon's Human Development Index⁽²¹⁾. Not surprisingly, unemployment increased by 1%, if not more⁽²²⁾. If deficits and debt were a big part of the explanation behind the post-war performance, then how did they exactly behave?

Table 1. Macroeconomic and Social Indicator (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP Growth	4.5	7.0	8.0	6.5	4.0	4.0	3.0	1.0	-0.5	2.0	2.0	3.0	5.0
Inflation	99.8	24.7	8.2	10.3	8.9	7.7	4.5	0.2	-0.4	-0.4	1.8	1.3	3.0
Exchange Rate (LL per\$)	1713.0	1741.0	1679.0	1621.0	1571.1	1540.0	1516.0	1508.0	1508.0	1508.0	1508.0	1508.0	1508.0
GDP(\$Million)	5544.7	7536.2	9165.0	11122.2	12996.2	14862.0	16166.9	16490.9	16494.2	16708.5	17377.1	18124.0	19754.0
GDP(LL Billion)	9498.0	13124.0	15388.0	18028.0	20417.0	22880.0	24509.0	24865.0	24865.0	25188.0	26196.0	27322.0	29780.0
GFP per capita (\$)	1772.0	2312.0	2710.0	3178.0	3640.0	4082.0	4370.0	4386.0	4380.0	4408.0	4552.0	4715.0	5104.0
Yield on 2-year	26.00	23.99	15.84	23.39	20.54	16.73	16.66	14.64	14.64	14.64	9.41	7.99	7.89
Treasury Bills													
				1990			1995			2000			2003
Human Development Index				0.673			0.732			0.752			0.758
				1990–1996			1995		1996–2001				
Average Unemployment				8.40						8.40			

Source : IMF, World Economic Outlook (Various Issues); Central Bank of Lebanon, Annual Report (Various Issues); AMF, Arab Unified Economic Report (Various Issues); ESCWA, Survey of Economic and Social Developments in the ESCWA Region (2005); UNDP, Human Development Report (Various Issues).

Table 2. Budget Deficit Types, Current Account Deficit, and Investment (% of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Conventional Deficit	14.76	8.84	19.26	15.64	18.08	20.23	14.15	14.39	21.35	16.78	16.39	14.41	10.17
Primary Deficit	9.93	2.87	9.35	5.32	5.08	5.49	0.47	-0.18	4.49	-0.34	-1.26	-3.40	-3.30
Operational Deficit	-33.19	-1.94	16.16	10.30	12.97	14.63	10.51	14.22	21.77	17.21	13.50	12.20	5.50
Current Account Deficit	49.80	49.00	44.30	42.90	35.30	38.90	37.10	29.70	27.80	32.20	25.10	24.40	27.90
Private Investment	27.56	26.11	19.84	19.66	20.63	20.50	24.77	24.69	25.48	24.48	26.77	25.82	26.90
Government Investment	1.54	2.99	9.26	9.44	8.47	8.60	4.33	4.41	3.62	4.62	2.33	2.58	2.59

Source : AMF, Arab Unified Economic Report (Various Issues); and authors' calculations.

Deficits and Public Debt

Budget deficits represent net borrowing requirements by the government, and as ratio of GDP, their behavior is depicted in Table 2. Deficit ratios were mostly on an upward trend up to 2000 when they exceeded 20%, but since then, have fallen to reach about 10% in 2004 – a behavior negatively correlated with GDP growth as noted earlier. There are two adjustments to conventional deficits reported in Table 2⁽²³⁾. The first adjustment is the primary deficit, which is equal to conventional deficits minus interest payments on the debt, and thus, represents a better indicator of discretionary fiscal policy. As a result, fiscal policy was relatively expansionary till 2000, when the primary balance remained in deficit and the expenditure (to GDP) ratio reached more than 40%. However, from 2001 onwards, the primary balance turned into a surplus buoyed by lower expenditure ratios and higher tax revenues driven by the VAT (which now contributes close to 25% of revenues)⁽²⁴⁾. What is interesting is the negative correlation between the resulting fiscal stance and GDP growth rates. This may be readily explained, however, by the fact that deficits crowded out public investments and coincided with higher interest rates till 2001-02, but later lower interest rates not only eased public finances, but also caused a pick up in private investments.

The second adjustment relates to operational deficits, which subtracts from conventional deficits the inflation component implicit in nominal interest rates. If actual inflation exceeds nominal interest rates (negative real interest rates), then operational deficits are smaller than primary deficits and the real value of the debt is reduced, as had been the case in Lebanon in 1992-1993 only. However, since then, it appears that actual inflation has become increasingly aligned with expected inflation, and as a result, surprise inflation has a chance of creating a wedge between the two and rendering a reduction in the real value of the debt

quite possible. This is of course something that does not recommend itself for economic stability's sake. Nevertheless, it is noteworthy that operational deficits have remained very close to conventional deficits with inflationary expectations not registering a significant component in nominal interest rates.

Given the state of escalating deficits throughout most of the post-war period, could benign monetization have been possible to slow down the rise in deficit ratios? The answer to this question depends on the fact that the amount of seigniorage revenue that the government can obtain from non-inflationary monetization, is determined by: the demand for monetary base, the rate of real GDP growth, and the income elasticity of real money demand. Assuming that the income elasticity of real money demand is unity, and keeping in mind that in 1992 the ratio of base money to GDP was 0.16 and the rate of GDP growth 4.5%, then the government could have generated 0.72 of GDP in seigniorage without igniting inflation or flight from the currency. In fact, during most of the 1992–1999 period as Table 3 shows, desired monetization was above actual monetization and the government lost an opportunity – however modest – to control the rise in deficits. But when the government started to monetize heavily especially in 2000–2001, it was too late by then because the economy had run out of steam, and the resulting decline in real money demand meant that the high actual monetization ratios translated to loss of international reserves.

Table 3. Desired vs. Actual Monetization and International Reserves Offsets

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Money Base / GDP	0.160	0.164	0.248	0.256	0.274	0.367	0.324	0.336	0.359	0.486	0.515	1.095	1.037
Real GDP Growth (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	5.00
Desired Monetization (% of GDP)	0.72	1.15	1.98	1.67	1.10	1.47	0.97	0.34	-0.18	0.97	1.03	3.28	5.18
Actual Monetization (% of GDP)	-0.17	1.46	-2.57	0.14	0.03	1.27	-0.99	0.14	7.69	18.96	-11.48*	30.14	5.30
International Reserves (\$ Million)	1496	2260	3884	4533	5932	5976	6556	7776	5944	5014	7244	12519	11735
International Reserves Offsets (% of GDP)	4.0	10.1	17.7	5.8	10.8	0.3	3.6	7.4	-11.1	-5.6	12.8	29.1	-3.1

* This is due to the write-off of around \$ 2 billion of treasury bills held by the Central Bank, nominally financed though the revaluation of government gold reserves at the bank.

Source : AMF, Money and Credit in the Arab Countries (Various Issues); and author's calculations.

Rising deficits would naturally lead to increasing debt which, if not checked, could render debt dynamics inherently unstable. This may be seen by analyzing the debt dynamics equation, which may be derived as follows. The excess of expenditures over tax revenues has to be financed from either borrowing

or money creation:

$$dB + dM = G - T + iB \quad (1)$$

where B is net debt, G is government expenditures net of interest payments iB, T is tax revenue, and M is money stock. Since $d(B/Y)/(B/Y) = dB/B - dY/Y$, where Y is nominal GDP, Equation 1 becomes:

$$d(B/Y) = P/Y + (i-dY/Y) B/Y - dM/Y \quad (2)$$

where $G - T$ is the primary deficit P. Since $i = r + \pi$ and $dY/Y = g + \pi$, where π and g are inflation and real GDP growth rates respectively, Equation 2 will be expressed as:

$$d(B/Y) = P/Y + (r-g) B/Y - dM/Y \quad (3)$$

Equation 3 traces the time path of the debt ratio B/Y, and the sufficient condition for its stability is $g > r^{(25)}$. In other words, the debt ratio will grow indefinitely as long as primary deficits are not covered by seigniorage and interest paid on the debt is larger than the growth rate of GDP. Alternatively, the debt ratio will converge to a steady-state level if interest is smaller than the growth rate. It will do so sooner and at a lower level if higher growth generates enough tax revenues to quickly erase the primary deficit.

Table 4 shows that the debt ratio kept increasing between 1993-2003, driven by primary deficits and, more importantly, violation of the stability condition. Only in 2004 did the ratio fall, when lower interest rates due to Paris II helped satisfy the stability condition. Hence, debt sustainability means that Lebanon could not pursue indefinitely its set of budgetary policies. Both tax policies – the VAT and financing schemes – had to be altered to bring the debt ratio on a more sustainable path.

Table 4. Ratio of Debt to GDP and Debt Dynamics (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Domestic Debt	51.4	44.4	60.7	66.5	84.4	86.5	88.5	102.1	109.2	112.0	96.6	98.2	88.5
Foreign Debt	5.4	4.3	8.4	11.2	14.7	16.3	25.7	33.5	42.1	57.6	84.0	85.6	93.1
Total Debt	56.8	48.7	69.2	77.7	99.0	102.7	114.2	135.6	151.4	169.6	180.5	183.8	181.6
P/Y	9.93	2.87	9.35	5.32	5.08	5.49	0.47	-0.18	4.49	-0.34	-1.26	-3.40	-3.30
(r-g)*(B/Y)	-92.71	-9.76	3.73	0.48	4.91	5.10	6.94	13.42	18.10	14.92	11.91	10.85	-1.08
$\Delta M/Y$	-0.17	1.46	-2.57	0.14	0.03	1.27	-0.99	0.14	7.69	18.96	-11.48*	30.14	5.3

* This is due to the write-off of around \$ 2 billion of treasury bills held by the Central Bank, nominally financed though the revaluation of government gold reserves at the bank.

Source : AMF, Arab Unified Economic Report (Various Issues) ; and author's calculations .

The increase in total debt masked a differentiation in the trends of its

components. The domestic debt ratio peaked in 2001 at 112% to fall afterwards to 89% in 2004, whereas the foreign debt ratio rose consistently to reach 93%. The simple reason for the switch in debt composition is clear from Table 5, i.e. lower interest rates on foreign debt. The government tried as part of its better debt management to issue T-bills with longer-term maturities (one- to three-year issues), so as to avoid the risk of debt rollover. However, this has proven not to be cheap – costing 100 basis points for each additional year⁽²⁶⁾.

Even interest on foreign debt began exhibiting a larger risk premium, since between 1997 and 2002 interest rates on Eurobonds increased from 6.2% to 9.3%. And it is this of course that was behind the Paris II Conference, in the aim of increasing the share of official sources in foreign debt (currently at 11% only) and, as a result, reducing the cost of servicing it. However, foreign debt is a double-edged sword, requiring in counterpart the availability of foreign exchange and claiming a part of the latter for its servicing needs. Although Lebanon stands a remote chance of experiencing an episode of illiquidity with a foreign reserves to short-term debt ratio of more than 200%, one can not rule out, however, an episode of insolvency (in the medium term), given the high ratios of debt to GDP and debt to exports that are in excess of 90% and 1000% respectively ⁽²⁷⁾.

Table 5. Budget Deficit, Debt and Interest Payments (LL Billion)

	Budget Deficit	Debt			Interest Payments			Interest Rates (%)		
		Domestic	Foreign	Total	On Domestic Debt	On Foreign Debt	On Total Debt	On Domestic Debt	On Foreign Debt	On Total Debt
1992	1402	4882	515	5396	394	65	459	10.4	20.9	11.2
1993	1161	5823	569	6391	754	30	784	15.4	5.8	14.5
1994	2964	9348	1297	10644	1472	53	1525	25.3	9.3	23.9
1995	2820	11997	2014	14011	1745	117	1862	18.7	9.0	17.5
1996	3692	17229	2994	20223	2508	185	2693	20.9	9.2	19.2
1997	4629	19787	3721	23508	3222	186	3408	18.7	6.2	16.9
1998	3467	21686	6306	27991	3051	301	3352	15.4	8.1	14.3
1999	3579	25383	8332	33715	3214	410	3624	14.8	6.5	12.9
2000	5311	27161	10476	37637	3572	625	4197	14.1	7.5	12.4
2001	4229	28214	14509	42723	3470	842	4312	12.8	8.0	11.5
2002	4293	25294	21992	47286	3278	1345	4622	11.6	9.3	10.8
2003	3938	26834	23396	50230	3108	1767	4874	12.3	8.0	10.3
2004	3260	26373	27710	54083	2246	1776	4022	8.5	6.4	7.4

And no doubt, political instability and tight monetary conditions in

international financial markets could only aggravate both problems – illiquidity and insolvency – especially now that the benefits from Paris II seem to be exhausted. The effects of these problems could potentially be huge, reverberating throughout the domestic banking system and creating havoc in the economy, since commercial banks hold more than 50% of the outstanding foreign debt.

What emerges from the above analysis are three facts. Firstly, budget deficits crowded out mostly public investments, but the high interest rates that the economy witnessed slowed down private investments as well. Benign monetization could have retarded the rise in budget deficits initially, but conservative central banking practice precluded that. Secondly, not resorting to more official, concessional financing early on – for reasons that presumably have to do with an inflated image and reputation of Lebanon – contributed to a viscous cycle of higher interest payments, rising deficits, and unsustainable debt. Finally, excess liquidity in commercial banks coupled with attractive yields on Lebanese Eurobonds have “localized” most of the foreign debt. Any possible default on the debt will have, as a result, a more damaging effect on the economy than if the debt had been owned by outside investors. Overall, the casualty of these developments has been economic growth, since economic management in Lebanon has turned into debt management, in course and in objective.

Interest and Exchange Rates

It is evident that high interest payments were feeding the deficit and the rising debt, reaching close to 49% of expenditures in 2001 before dropping to 38% in 2004. It is inevitable, though, that debt ratios rise after wars. But is this also true of interest rates? Interest rates (on two-year T-bills) averaged 14.9% during the 1994-04 period of high deficit ratios, whereas inflation and GDP growth (as a proxy for real interest) rates averaged 4.1% and 3.8% respectively. As a result, it is difficult to justify the domestic currency risk premium of more than 6% that was priced into domestic interest rates, for two reasons. Firstly, the Central Bank’s hard commitment to fixed exchange rates, with a decent chest of international reserves at its disposal to support it, helped prevent possible devaluations and any consequent loss in the real value of domestic debt. Secondly, the much lower interest paid on foreign debt, since the average difference between real interest rates on domestic and foreign debt exceeded 7%⁽²⁸⁾. As important, it is also argued that the high interest rates on domestic debt instruments – which act as a benchmark for other rates – were a product of imperfect competitive bidding in the auctioning of T-bills that kept interest rates artificially high⁽²⁹⁾. At any rate,

not allowing interest rates to be fully determined by market forces has magnified unnecessarily the debt problem and put a brake on domestic investments.

But this is not the end of the story. Focusing on foreign debt, even a spread of 4-5% could be considered excessive, especially in the light of its contribution to GDP growth⁽³⁰⁾. To investigate this concern, there is the need to look at the economics of resource flows. For given domestic savings, these flows – net debt, FDI, equity, and other flows – cover excess investment and thereby close the resource gap. Accordingly, from the GDP identity, investment I is financed from domestic savings S_d and resource flows identical to the trade balance (deficit) TB in goods and services:

$$I = S_d + TB \quad (4)$$

Multiplying both sides of Equation 4 by dY/Y and rearranging the resulting terms, this leads to:

$$dY/Y = (S_d/Y + TB/Y) dY/I. \quad (5)$$

Equation 5 breaks down the growth in GDP into that financed by domestic and foreign sources, each multiplied by the marginal productivity of capital (MPK) dY/I . Table 6 shows that Lebanon depends exclusively on resource flows as contributors to its GDP growth. The onus then, is to increase in the long run the source of domestic savings and obviate the need to rely on what could be unreliable or hard-to-attain external sources⁽³¹⁾.

Table 6. Resource Gap, Investment and Domestic Savings (% of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Resource Gap	38.1	38.1	38.2	38.5	38.2	38.2	38.2	38.2	38.2	38.2	38.2	34.3	38.8
Investment	29.1	29.1	29.1	29.1	29.1	29.1	29.1	29.1	29.1	29.1	29.1	28.4	29.4
Domestic Savings	-9.0	-9.0	-9.1	-9.4	-9.1	-9.1	-9.1	-9.1	-9.1	-9.1	-9.1	-5.9	-9.4
Net Flow of Long-Term Debt	-0.6	0.1	4.2	7.2	5.9	6.4	9.6	7.7	8.7	15.4	26.1	3.4	6.60
Foreign Direct Investment	0.1	0.1	0.1	0.3	0.6	1.0	1.2	1.5	1.8	1.5	1.5	2.0	6.5
Portfolio Equity Flows	0.0	0.0	0.0	0.3	0.9	0.5	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Δ International Reserves*	-4.0	-10.1	-17.7	-5.8	-10.8	-0.3	-3.6	-7.4	11.1	5.6	-12.8	-29.1	3.9

* Negative changes in International Reserves are equivalent to accumulation of reserves, whereas positive changes are equivalent to depletion of reserves.

Source : AMF, Arab Unified Economic Report (Various Issues)

More importantly, does the increase in GDP due to debt flows outweigh the interest paid on its service such that the resulting net effect is an increase in

national income? Table 7 shows that the average contribution of foreign debt to GDP is smaller than the interest paid on it: 0.72% against 2.54%. Hence, Lebanon is not getting its “money’s worth” from foreign debt. This also means that foreign debt imposes a double burden – a general burden that relates to servicing ability, and a more taxing burden that arises from the fact that the “price” of this ability is larger than its “reward”. One possible explanation for this result is that, being mostly public, the foreign debt is used to finance budget expenditures that are mostly current and of limited growth mileage. Another explanation could be that which relates to the productivity of investment: even if a decent part of foreign debt is devoted to capital budgetary expenditures, the growth potential of these expenditures is not going to be all that high given an MPK of no more than 13%⁽³²⁾.

The question of interest rates, of course, ties closely to that of exchange rates. The system of pegged exchange rates to the \$US that the country has adopted since 1996-97 left very little maneuver to activate monetary policy. This is because of the infamous “impossible trinity”: with free capital mobility and fixed exchange rates, Central Bank monetary independence is sacrificed. In effect, interest rates in Lebanon are set at world levels plus a risk premium. However, these rates have shown to be overvalued and, in all likelihood, so have exchange rates⁽³³⁾. Although it is not easy to ascertain the equilibrium real exchange rate, a simple check for its overvaluation is whether external and/or internal balance is maintained. In this respect, and as seen in Tables 1 and 2, both unemployment and current account deficits have been hallmarks of the post-war period – a preliminary indication that exchange rates are indeed overvalued.

Table 7. Contribution to GDP Growth (%)

	GDP Growth	$\Delta Y / I$	Contribution to GDP of			Interest Rate on
			Resource Gap	Domestic Savings	Net Debt Flows	Foreign Debt as % of GDP
1992	4.50	0.15	5.70	-1.35	-0.09	0.45
1993	7.00	0.24	9.10	-2.10	0.02	0.31
1994	8.00	0.27	10.30	-2.40	1.13	0.28
1995	6.50	0.22	8.40	-2.00	1.58	0.49
1996	4.00	0.14	5.30	-1.30	0.82	1.15
1997	4.00	0.14	5.30	-1.30	0.90	1.35
1998	3.00	0.10	3.80	-0.90	0.96	1.63
1999	1.00	0.03	1.10	-0.30	0.23	2.19
2000	-0.50	-0.01	-0.38	0.09	-0.08	2.80
2001	2.00	0.06	2.30	-0.60	0.92	3.86
2002	2.00	0.06	2.30	-0.60	1.56	5.54
2003	3.00	0.10	3.40	-0.03	0.34	7.04
2004	5.00	0.17	6.60	-1.60	1.12	5.96
Average	3.81	0.13	4.86	-1.11	0.72	2.54

Source : AMF, Arab Unified Economic Report (Various Issues); and author’s calculations.

There are at least three potential drawbacks to overvalued exchange rates

for the Lebanese economy. Firstly, loss of competitiveness and export capability, as high real effective exchange rates during 1992-02 reduced the exports to GDP ratio from 10.5% to 5.3%, only to recover to 8% when real exchange rates fell in 2003-04, as may be seen from Table 8⁽³⁴⁾. Secondly, quasi-fiscal costs incurred in sterilization activities that aim at maintaining the exchange rate peg. These quasi-fiscal costs could be very important, especially in the context of foreign debt where the difference on what the Central Bank pays as interest on government bonds because of sterilization and what it earns on investing the reserves arising from foreign debt could exceed the interest savings reaped from resorting to foreign instead of domestic debt – on average equal to at least 3.5% in quasi-cost⁽³⁵⁾. Thirdly, reserve offsets caused by excessive monetization – at given income and prices, the excess money is exchanged for foreign currency at the fixed rate, such that the added government bonds on the asset side of the Central Bank's balance sheet are offset by reserves loss – as was intensely the case in 2000-2001 and 2004 (see Table 3). And as is commonly known, fixed exchange rates deny the economy the flexibility to adjust to external shocks – economic not politic – and to help in diversifying exports and their markets.

If more exchange rate flexibility is then desirable, what determines the magnitude of its adjustment?⁽³⁶⁾ To study the extent of flexibility, the question may be posed as one involving a trade-off. On one hand, a depreciation in the exchange rate increases the domestic currency value of foreign debt and reduces the government's ability to service it⁽³⁷⁾. On the other hand, the lack of needed depreciation denies the economy the capacity to attain external balance and contributes to further foreign debt.

Table 8. Real Effective Exchange Rates, Exports and Tariffs

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real Effective Exchange Rates	72.3	86.5	92.4	100.0	107.1	112.6	121.7	123.9	149.7	153.0	153.8	133.0	123.7
Real Exports (\$ Million)	619.1	663.8	653.7	716.1	1131.7	624.6	687.2	651.3	645.1	799.3	900.0	1254.5	1360.1
Exports (% of GDP)	10.45	8.43	6.98	6.43	8.87	4.36	4.47	4.21	4.24	5.26	5.13	7.96	8.09
Average Tariff (%) *	4.56	8.13	8.47	12.03	13.69	16.08	18.53	23.05	18.69	14.86	16.32	15.22	11.46

* Tariff revenue divided by value of goods imports.

Source : AMF, Arab Unified Economic Report (Various Issues); and author's calculations

To resolve this bind, a government loss function may be constructed to balance the government's choice between these two options and to minimize its losses. Let $f = F/Y$, where F is foreign debt; hence, $df/f = dF/F - dY/Y$. Since changes in foreign debt are equal to current account imbalances, then:

$$dF = -TB + i_f F \quad (6)$$

where i_f is interest rate on foreign debt. As a result:

$$df/f = -TB/F + i_f - dY/Y \quad (7)$$

Let e be the exchange rate, or the domestic currency price of one unit of foreign currency, and \dot{e} be its rate of change (positive \dot{e} signifies a depreciation in e). The effect of depreciation on the government's worsening ability to repay its foreign debt may be expressed by interpreting interest paid as: $i_f + \dot{e} - \pi$. This translates Equation 7 into:

$$df = (i_f + \dot{e} - \pi - TB/F - dY/Y)f \quad (8)$$

To indicate increasing marginal cost, the loss function L will be quadratic in df and the departure of \dot{e} from the desired change in the exchange rate \dot{e}^* that maintains external balance:

$$L = \alpha [(i_f + \dot{e} - \pi - TB/F - dY/Y)f]^2 + \beta [\dot{e}^* - \dot{e}]^2 \quad (9)$$

where α and β are positive, reflecting the cost coefficients or degree of risk aversion to foreign debt accumulation and external imbalance respectively. The optimum change in the exchange rate \dot{e}° that minimizes L is:

$$\dot{e}^\circ = \dot{e}^* - (i_f + \dot{e} - \pi - TB/F - dY/Y) f\alpha/\beta \quad (10)$$

Assuming a perfect pass-through effect such that $\pi = \dot{e}$, then Equation 10 becomes:

$$\dot{e}^\circ = \dot{e}^* - (i_f - TB/F - dY/Y) f\alpha/\beta \quad (11)$$

Equation 11 indicates that optimal changes in the exchange rate will be less than \dot{e}^* the higher the public aversion to foreign debt (α) and the interest (i_f) paid on the latter, in addition to larger trade deficits (negative TB) that require the contracting of more foreign debt. In this context, one primary reason why optimal exchange rate adjustments have been absent from economic decision making is the foreign currency exposure of commercial banks and their borrowers. Notwithstanding the validity of this concern, its probable damage to the balance sheets of banks is exaggerated⁽³⁸⁾. This is because, while the ratios of deposit and

private credit dollarizations are 70% and 83% respectively, the ratio of private credit to deposits is only 35%. In other words, the bulk of dollarized deposits is in foreign assets, reserves, and foreign currency sovereigns, and any ensuing currency and maturity mismatches are not substantial⁽³⁹⁾.

The discussion so far, has established two essential observations. Firstly, interest rates were higher than warranted by market essentials, and setting them at reasonable rates could have eased the country's escalating debt through lower interest payments and higher growth. Resorting to foreign debt did slow down the rise in debt ratios, but that proved to be doubly burdensome. Secondly, exchange rates were kept at what appears as overvalued levels, and their downward adjustment could have benefited the economy by more than any presumed harm to the balance sheets of the banking system and its ripple down effects.

Conclusion: Political Economy and Policy Implications

It is congenial to close the paper with a discussion on some aspects of political economy that have helped engender the post-war economic performance. Any discussion of the political economy of Lebanon has to wrestle with issues of governance and the institutional capability of the state. Lebanon is a difficult country to govern, and badly governed countries rarely produce sound economies. Its segmented politics, largely a product of its confessional system, ultimately breeds corruption and government failure. The extent of government failure and corruption caused by confessionalism can not be underestimated⁽⁴⁰⁾.

Corruption administered in small doses in a confessional system could, of course, be acceptable, since it could play a functional role in redistributing resources to those groups failed or not favored by the market (or history). Thus, in the process a semblance of needed social balance is created. However, Lebanese corruption does not come in small doses and is not economically costless, especially in the post-war period.

There are two main reasons for this rampant corruption. Firstly, the rivalry and lack of sufficient trust among confessional groups make it difficult to establish independent oversight authorities that could hold confessional elites accountable for their actions. The result is that elites find little inhibition and have no qualms at appropriating part of public resources to their private purse. Not surprisingly, this turns contagious because it trickles down to corruption at the lower echelons of public officialdom. And it also proves costly. For instance,

it is estimated that the cost of corruption in disbursing non-recurrent expenditures during 1992-2002 was close to \$7 billion⁽⁴¹⁾. Secondly, the patronage system that confessionalism entails and which aims at cementing allegiance ties between elites and their followers. This has spawned sizeable crony employments in an overstuffed public payroll of about 220,000 (more than 20,000 employed in the post-war period alone) at a cost of more than 10% of GDP⁽⁴²⁾.

Although imperfect and perhaps an unfair analogy, what is seen then, is a government sector that somehow resembles its EDL: living beyond its means, mired in inefficiencies, and lacking in proper governance.

Failure, however, is not confined to the government sector only. It has spilled over to economic sectors as well, perhaps most crucially, the banking sector. It is not inaccurate to argue that the post-war economy decided to “lead by finance”, banking on its reputable commercial banks to deliver recovery and more. However, commercial banks have contributed mildly to the country’s development, but have lived opulently off its hardships. Historically, banks financed one third of investment only, which is too low for a bank-based financial system⁽⁴³⁾. In 1987, they started the monetary crisis by speculating heavily against the Lebanese pound.

Zeroing in on the post-war period, the situation remains the same. The share of banks’ credit in investment dropped to 15% by 2004, exchanged for the comfort of investments in lucrative government bonds. Given the case of overvalued interest rates discussed earlier, these investments netted banks more than \$9 billion in excess interest payments. Incidentally, if added to the aforementioned \$7 billion in corruption cost, this becomes almost identical to the country’s current foreign debt and makes the latter a possible case of odious debt⁽⁴⁴⁾. What is ironic is that banks are not particularly profitable, while their return on equity is an average 10%, their return on assets is less than 1% – at 0.65% only. It is unfortunate, then, that the rentierism involved in finance capital, diverted banks away from their true and needed mission, i.e., to complement internal finance in funding worthwhile investments.

The above has highlighted the dilemma of balancing political constraints and government failure with economic and social objectives. But if these constraints can somehow be minimized or side-stepped, then consensual economic reforms on selected yet essential policies can benefit from two general recommendations that are implied by the paper – governance and institutional

reforms – bearing in mind the necessity of parallel, though difficult.

Firstly, in the short term, strategies to reduce the public debt should rely on concessional, official sources for its foreign borrowings. It should set interest rates at lower, market-determined levels for its domestic borrowings. The resulting slide in debt ratios should release more bank deposits to be borrowed by the private sector, and should involve finding the right incentives and commitments by commercial banks to lend to this sector. And in due time, more flexibility in exchange rates will be desired, especially when foreign debt becomes reasonably reduced.

Secondly, in the medium term, the prime focus of economic policy should be on the real sector – not the financial sector. There are too many more sophisticated centers emerging in the region. This should translate to reducing the cost of doing and attracting business in the economy, and to assisting business in increasing its productivity. In this respect, and although not discussed in the paper, the economy can fall back onto its proximate fundamentals; i.e., it can try to “forget its history” and “rediscover its geography” – at the center of trade routes between Asia, Europe, and North Africa – and to rely on the literacy and acumen of its people.

- (1) See Owens (1981).
- (2) See Gaspard (2004).
- (3) See Picard (1996).
- (4) See Denoeux and Springborg (1998).
- (5) See Collier (1999) for more on the stylized facts. By 1991, the cost of damage to the physical capital stock had reached close to \$25 billion, in addition to the emigration of 200,000 skilled persons and flight of financial capital of more than \$10 billion; see Eken et. al (1995).
- (6) On the travails of Lebanon's laissez faire model, see the excellent analysis by Gaspard (2004).
- (7) On a scale from -2.5 (most corrupt) to 2.5 (least corrupt), The World Bank estimates that between 1996-2004, Lebanon's index averaged -0.4; see Kaufmann et. al (2005). Also, on a score from 0 (most corrupt) to 10 (least corrupt), Transparency International gave Lebanon a score of 3.1 in 2005; see Transparency International (2005).
- (8) See Picard (1996) and Salem (1991).
- (9) The cost was later increased to \$17.7 billion; see Republic of Lebanon (1992).
- (10) See International Bechtel (1992) and Kisirwani (1998).
- (11) See Rodrik and Subramanian (2003) and Rodrik (2000) for the primacy and workings of institutions.
- (12) Harriri himself was a major contractor; and the program was criticized early on that it centered on "building stones, not people" (binaa alhajar ma albashar).
- (13) The most salient expenditures were on a new airport, an extension of the fixed telephone system and a network of new roads especially to the South.
- (14) See Bolbol (1999) and the more cautious conclusion in Bhattacharya (2003).
- (15) See Houghton (1998) for more on the pace and sequencing of these policy measures. One essential feature of these measures is that they require patience, which calls for caution not to inflate expectations in the immediate post-war period.
- (16) See Economist Intelligence Unit (2004).
- (17) The losses at EDL are a product of low tariffs relative to operating costs, theft and non collection, and bad governance. It is also estimated that a \$10 increase in the international price of oil would worsen the fiscal deficit by 1.1% of GDP – roughly one half would come from higher transfers to EDL while the other half from lower excise tax revenue due to the cap on gasoline prices; see IMF (2004a).
- (18) Not counting Middle East Airlines, Intra Bank, and Casino du Liban, which are all actually owned by the Central Bank (Banque du Liban).
- (19) For more on these aspects, see The World Bank (2005) where a Survey on Doing Business ranked Lebanon 95th among 155 countries.
- (20) Collier (1998) refers to this as "war overhang".
- (21) In 1991, real per-capita income in 1974 prices was \$560.

- (22) Tabbarah (2002) argues that unemployment increased by more than 5%.
- (23) There are two other adjustments: (a) the structural deficit, and (b) the full-employment deficit. The first measures deficits independent of the business cycle because of the swings in welfare and unemployment payments that these cycles generate. The second measures deficit at the long-run potential level of output. Both adjustments do not yet apply to Lebanon because of the absence of a welfare system in the country and the difficulty in ascertaining long-run GDP in the limited post-war period.
- (24) The second notable source of revenue is income from the two mobile telephone operators, which bring in close to 20% of government income at more than \$900 million a year. See Ministry of Finance (Various Issues).
- (25) The sufficient condition for stability is: $d(d(B/Y)) / d(B/Y) = r-g < 0 = r < g$. The solvency condition – the ex-ante requirement that future primary surpluses be equal in present – value terms to the outstanding stock of net debt – is only a necessary condition for stability since it can be met ex-post through debt restructuring, monetization, or repudiation.
- (26) Currently, T-bills with maturities of one year and more constitute 75% of all T-bills issues. See IMF (2004a).
- (27) On the threshold conditions for episodes of illiquidity and insolvency, see Manasse and Roubini.
- (28) Real interest rates on foreign debt is calculated as nominal interest rates plus exchange rate depreciations minus domestic inflation rates. The reason real interest rates on foreign debt are less than those on domestic debt is because the interest parity condition does not hold, an outcome of three possible asymmetries. The first asymmetry arises when domestic investors expect or fear a larger devaluation on domestic currency debt than that forecast by the government – and the government may decide it is to its advantage to take on the foreign exchange risk itself. The second asymmetry arises when domestic investors, whose portfolios consist mainly of domestic claims, demand a higher return on holding more government debt than foreign investors. The third asymmetry may occur when the government is viewed as less likely to default on a foreign bond issue than on a domestic one; see Gray and Woo (2000).
- (29) See Hakim and Andari (1997) and Gaspard (2004), where the latter estimates that a reasonable market interest rate is about 8-9%. In addition, how could one otherwise explain the huge drop in interest rates (by 4%) from Paris II as a result of debt transactions involving 11% only of total debt! In fairness, though, interest rates seem also to have been set so as to allow banks a margin to attract capital from the region and enable them to rebuild their reserves and capital base.
- (30) The spread is the average difference between interest on two-year Lebanese Eurobonds and US T-bills of the same maturity.
- (31) The difference between resource gaps and the lower current account deficits reported in Table 2 is private unrequited transfers, mainly emigrants' income.
- (32) This compares to an MPK of 20% for developing countries. See IMF (2005).
- (33) See Kubrusi (2001).

- ⁽³⁴⁾ Competitiveness, of course, was not helped by high average tariffs which up to 2002 constituted 35% of tax revenues.
- ⁽³⁵⁾ This is equal to the difference between, on one hand, the difference between 14.9% paid on government bonds because of sterilization and 4.2% in London inter-Bank Offer Rate (LIBOR) earned on foreign reserves and, on the other hand, the difference of 7% in interest saved from contracting foreign instead of domestic debt.
- ⁽³⁶⁾ This paper does not go into a discussion of which system of adjustable flexibility is best, but suffice it to say that it is recommended that flexibility targets a level of real exchange rates that helps maintain external/internal balance and be tied to a currency (or a basket of currencies) that reflect trading potential and foreign debt composition. See IMF (2003).
- ⁽³⁷⁾ In other words, the government incurs a short foreign exchange position by assuming foreign currency debt, and a depreciation will increase its servicing cost due to declining foreign currency value of its revenues.
- ⁽³⁸⁾ For more on this concerned view, see IMF (2004b).
- ⁽³⁹⁾ See Central Bank of Lebanon (Various Issues). In 2004, the composition of banks' assets was as follows (in LL trillion): 29.8 reserves; 20.4 foreign assets; 24.1 credit to the government (14 in foreign currency sovereigns); and 24 credit to the private sector. As to the composition of deposits: 1.4 demand deposits; 66.9 time and foreign currency deposits; 18.3 foreign liabilities; and 1.5 government deposits.
- ⁽⁴⁰⁾ It is true that confessionalism is not the germ of all ills in Lebanon, but unfortunately, it is the one that is hardest to eradicate.
- ⁽⁴¹⁾ At a corruption or waste rate of 20%; see Gaspard (2004).
- ⁽⁴²⁾ It is interesting that a relatively large public sector still implies a weak state, and this in a country that has always prided itself of its *laissez faire*. See Kisirwani (1998).
- ⁽⁴³⁾ A market-based financial system is yet to develop. The stock exchange has only 16 listings with a market capitalization to GDP ratio of about 10%, and the active bond markets are those of T-bills.
- ⁽⁴⁴⁾ For more on these issues, see Gaspard (2004).

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