Lebanon: a macro-economic framework

This paper is intended to present a synthetic overview of the Lebanese economic situation and to assess the main options of macro-economic policies.

Basic economic trends

The recent economic evolutions remain in line with the trends observed during the previous years. Simple corrections have nevertheless been necessary to the published indicators to make them, at least conceptually, relevant (quantitative exactness needs obviously further work and larger means). The results seem consistent with each other and with the available indirect social and economic indicators.

The main features of the Lebanese economy between 1992 and 2000 have been stable and comprise:

- a **persistent domestic inflation** at the level of the GDP deflator (as opposed to a low level of inflation measured through the CPI),
- a deep and generalized **dollarization** of the economy (that relativizes the importance of the LBP and the impact of its stabilization),
- a persistent **appreciation in the real effective exchange rate** by about 80% (aggravated by the recent appreciation of the USD against other currencies, mainly the euro),
- a persistently **low or negative real rates of growth** (as opposed to alleged high, though declining, rates of growth), the nominal levels of the GDP being themselves questionable in the light of various indicators (namely the late industrial survey),
- a persistent and **rapid increase in all monetary indicators** (usually presented as favorable and reflecting the re-emergence of the regional financial role of Beirut),
- a persistent external **deficit at the level of the current account mainly covered by capital inflows** in the form of short-term deposits(recent major correction to the official balance of payments accounts for the years 95-98, as published by BdL, under the influence of the IMF confirmed the analysis but, after their publication, surprisingly aroused very little interest).

Recent evolutions

In the absence of reliable economic references and indicators, the common speech reports that during the past two years, the Lebanese economy went into recession; this statement implicitly suggests that the previous situation was by far more positive.

The most reliable indicators remain the evolution of prices (as measured by the CPI) and the volume of internal transactions (as measured by the value of cleared checks) beside the customs and financial sector statistics.

Domestic **prices** in LBP (and in USD) have been stable for two years, but this stability hides a significant level of increase due to the pegging of the LBP to the USD that meanwhile appreciated against other currencies. Weighted according to the structure of Lebanese imports, the LBP appreciated by more than 12% over the period. Since imports represent almost 40% of domestic demand, this fact suggests the persistence of a yearly domestic GDP inflation of about 8%. Domestic inflation was previously hidden by the regular appreciation of the LBP against the USD.

The volume of cleared **checks** has stabilized (with a slow increase in 2000) at a lower level than in 1998. Its relation to production is nevertheless indirect: it incorporates, on one hand, transactions on imported goods (the prices of which should be corrected to reflect changes in cost and currency variation according to the country of origin) and its domestic part should, on the other hand, be corrected by the GDP deflator.

The volume of **imports** has decreased in USD terms, but expressed in a weighted currency basket, it has been almost stable. The level of **exports** accounted for in customs statistics is almost constant and remains at insignificant levels. Imports of machinery remain low by any standard.

The **financial** indicators (domestic credit, savings, public debt, etc… both in absolute terms and compared to GDP) went on their rising trends, even though at slower pace.

The other partial and indirect signs are not very significant; the downward trend in the indicators related to **construction** simply reflecting the large oversupply that characterizes the sector.

The overall appreciation of the economic evolution remains therefore mitigated, not only because of the unreliability and the insufficiency of indicators, but mainly because of the disconnection and the confusion between growth and the evolution of the volume of transactions or, in other words, between added value and turnover.

External deficit and public deficit

The key feature of the Lebanese economy is a persistent and huge current account deficit that places Lebanon on top of almost all countries in terms of the ratio of current account deficit to GDP. As opposed to frequent allegations, this has not been always the case. The increases in the import of goods and in the negative flows of services and of factor payments have overrun the almost stable unilateral transfers and remittances since the early nineties.

Calculations based on the available data suggest that the current account deficit is equally due to public and private deficit.

Within this frame, the fiscal deficit plays an important, but not unique role, as many pretend. Independently from the debatable economic validity of several projects and their inadequate scaling, the alleged cost of reconstruction remained a secondary element in public spending. The various plans, including the last 5-years economic development plan, have proven their inadequacy to the financial and administrative ability of the public agencies and to the absorption capacity of the economy. Apart from their structure and its economic effects, public revenues have been regularly rising both in nominal terms and relatively to the GDP. The main (historic and structural) component of public expenditure and therefore the main cause of the cumulative public deficit have been current expenditure and namely current transfers of which interest payments, as support to the monetary policy, have been taking an increasing part. The current fiscal deficit adds to the private economy deficit but also fuels it and complements it.

This external deficit is being financed partly by externally financed investment (that is decreasing) and demand (that remains almost stable) and, for the rest, by short term capital inflows to the banking sector, which are channeled, through credit both to the public and to the private sectors, to finance consumption. This conclusion gives sense to the huge "inflation" of the banking sector and is fully consistent with the observable trends at the level of the various financial indicators. Any explanation through foreign direct investment (essentially in real estate) is clearly contradicted by direct physical indicators.

Factor allocation, rigidity and price distortions

Investment has been persistently low, both in the public and in the private sectors, apart from the excessive boom in construction up to 1996. Factor allocation shows heavy distortions. Capital is diverted towards real estate and financial claims. Labor supply shows heavy excess in university degrees and trade related professions but severe lacks in technical skills. The high cost incurred for education and the high indebtedness supported for asset financing, added to social considerations, make any reallocation look costly and need time and gradualism. Revenues from interest on savings tend to become a major source of income for many middle-income households.

The pattern of factor allocation creates imbalances and rigidities. Social, sector-related and inter-regional imbalances, both inherited and aggravated by the macro-economic pattern, justified several redistribution and tariff-protection measures that added to distortions by diverting resources and hampering productivity and strengthened political opposition to rationalization and reform.

Both the economic mis-allocation of resources and the political redistribution measures reflect in sharp and persistent rises in costs of assets and factors that impede competitiveness and draw towards:

- over-investment in the production of non-tradables at the expense of tradable goods,
- increase in prices of non-tradables and therefore in the cost of all domestic inputs,
- decrease in relative productivity and search for higher effective protection rates,
- deepening of the external imbalances,
- increase in the need for external financing, both by attracting new flows and maintaining existing stocks.

The Lebanese economy was reshaped during the nineties by the addition and the internalization of an external layer to an original structure that had been previously weakened by fifteen years of war and had adapted to mere survival requirements. This additional layer consisted, on the side of sources, of increasing financial claims, and on the side of uses, of massive consumption. Its large relative size and its long duration have had major effects on the basic structure, in terms of the various economic indicators and behaviors that adapted to levels and patterns consistent with the understandable, but nevertheless erroneous assumption that those incremental sources and uses were internally generated and applied. The reversing of external and domestic spheres put the paradoxical developments of the Lebanese economy in line with economic literature and topics.

Thus the complementary flows have been dealt with as if they were the mere result of domestic economic performance, but what is more important, the market indicators of the domestic economy readjusted consequently in return and made the persistence of those complementary flows essential.

Macro-economic risk and sustainability

The sustainability of the prevailing Lebanese economic pattern ends depending essentially on the ability to continuously attract new financial inflows and to effectively channel them to cover the various components (public and private) of the persistent external account deficit.

In this respect,

- the opacity and/or manipulation of economic indicators,
- the commitment for the same monetary policy,
- the practical collusion between the Central Bank and Lebanese banks

have been effective in gaining time at the expense of aggravating the risks and increasing the costs of correction.

The limits of the exercise have been extended so far because of the initial availability of liquid capital resources held by Lebanese abroad in amounts that were very large as compared to the effective size of the Lebanese economy in the early 90's and because of the technical success in risk shifting at the level of the financial sector (BdL and banks) that succeeded in trading off low present financial risks for higher future economic risk, thus covering the ineffectiveness of fiscal and economic policy.

Different readings and approaches

Because of the nature of the basic economic distortion that is derived from an "internalization" of an externally funded demand, in addition to the prevalence of similar economic patterns in neighboring countries (mainly oil-economies) and to the ability until now to finance the generated external deficit, little interest has arisen in economic analysis and in data gathering. Under those circumstances, it is understandable that the various attitudes towards the economic situation can fit within two broad sets of understandings and of approaches:

- whether the difficulties encountered are of cyclical nature and demand-driven or structural,
- and whether correction should be smooth and slow or heavy and front-loaded.

Between 1992 and 2000, the attitude of the successive governments evolved according to the following sequence:

Period	Understanding	Approach
End 1992-mid 1997	Cyclical problem	Front-loaded action
Mid 1997-end 1998	Cyclical problem	Smooth action
End 1998- mid 1999	Structural problem	Front-loaded action
Mid 1999-end 2000	Structural problem	Smooth action
End 2000	Cyclical problem	Front-loaded action

The new orientation in economic policy, inaugurated by the appointment of the new government would aims, as per official declarations, at a massive increase in external but necessarily also domestic demand through tariff and tax alleviation and open skies deregulation, with low priority given to fiscal adjustment and sector-related restructuring.

There is no clear reason why this renewal of the same policies that marked the first period in 1993-94, would lead to better results, all the more private and public indebtedness have meanwhile gone much higher and comparative disadvantages in terms of costs and productivity have gone deeper.

It becomes therefore urgent to reach a common diagnosis of the economic situation and to assess the various possible impacts of any intended measures.

Axes of correction

In view of the above analysis, action should aim at structural correction while managing transitional risks. In order to restore balance to the domestic economy and to its external relations, correction should ultimately consist in a search for the alignment of internal productivity and prices with the international market. If the whole correction was to take place through a drop in the value of domestic assets and factors, it would no longer be a reform but a major and cruel crisis (since alignment through exchange rate correction is meaningless because of the dollarization). On the other hand a short-term rise in the overall productivity of factors through classical cyclical monetary and fiscal economic policies does not seem to be realistic without restructuring and reallocation. The whole process of reform could therefore be described as an attempt to affect:

- factors pricing and allocation
- assets pricing and allocation,

in such a way to maintain their internal prices for enough time to let the effects of adjustment increase the overall productivity, and therefore their real value, as compared to the international market benchmarks.

Considering the present levels of macro-economic exposure and the rigidity in economic, social and also political variables, the transitional risks must draw the utmost attention, especially in the early stages, in order to:

- avoid and overcome transitory crises that would jeopardize the whole reform process,
- seek a reasonably even distribution of the cost of correction.

The main axes of intervention would therefore be:

- reforming public finance,
- re-engineering the monetary policy,
- re-directing the role of the banking sector from deficit financing to capital mobilization for real economic growth,
- restructuring the basic economic functions (education, health, transport, energy, labor, etc…)

Supportive policies and contingent dispositions for the transition period remain necessary and should be defined beforehand.