

LCPS

المركز اللبناني للدراسات
The Lebanese Center
for Policy Studies



**Konrad
Adenauer
Stiftung**

Entering a Grey Area: Lebanon's Economic Challenges in the Arab Spring

**August 2011
Roundtable reports series**

The Lebanese Center for Policy Studies (LCPS) is an independent, non-profit think tank that aims to produce independent, high quality research relevant to policy-making and to promote active reform through advocacy and raising public awareness.

The roundtable report series is a synthesis of the discussion and debate that LCPS organizes with key scholars, experts, journalists, and decision makers on pertinent and timely issues affecting Lebanon and the region. The purpose of the meeting is to provide a forum for an open and constructive exchange amongst the panelists in order to gain a better understanding of unfolding events and issues and to also initiate policy ideas and recommendation. To encourage open and frank debate, Chatham House Rule applies.

The report does not necessarily represent the views of the Lebanese Center for Policy Studies or those of the Konrad Adenauer Stiftung.

The report was revised and edited by Sami Atallah based on a draft by Hassan Chakrani and comments by Rania Abi-Habib and Madeleine Lambert.

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Executive Summary

- Although the Lebanese economy has historically benefited from regional and international crises, it has recently failed to attract capital and tourism from Arab countries due to the Syrian uprising that has shaken that country since March.
- In fact, the Arab uprisings, in conjunction with the current financial crisis, have exposed Lebanon's economic vulnerability particularly in regard to the liquidity and creditworthiness of its national debt.
- The changing political landscape in the Arab world could make Lebanon's economic position, once considered unique, irrelevant in the region in the long term unless serious restructuring occurs.
- Despite possessing the human capital and a strong banking sector, the economy is considered to be oligopolistic and highly corrupt.
- Lebanon's economy has many opportunities for development which can be capitalized upon in order to produce sustainable and equitable growth. This growth can only occur, however, if these opportunities are seized alongside the implementation of a new governance structure.

Introduction

Historically, Lebanon has benefited economically from regional unrest. The creation of the State of Israel and the closure of Haifa Port led to the increasing use of the Beirut Port for regional trade and commerce. The unrest and military coups that shook the Arab world in the 1950s and 1960s, particularly in Syria and Egypt, resulted in capital inflow to Lebanon. More recently, after September 11, 2001 and the financial crises in 2008, Lebanon experienced an increase in bank deposits as well as in Arab tourists. With the ongoing Arab uprisings, the effects on Lebanon are not yet clear.

Amidst this background, the Lebanese Center for Policy Studies (LCPS) has organized a roundtable meeting to discuss and debate the impact of the Arab uprisings on the Lebanese economy. The debate addressed the following three questions:

- What are the direct repercussions of the Arab uprisings on the various sectors of the Lebanese economy?
- What are the challenges and dangers resulting from political changes, particularly to Lebanon's regional role? How can the government face these challenges?
- What are the potential economic opportunities offered by the Arab uprisings? How can the Lebanese government build upon political reforms in the region?

The roundtable is supported by the Konrad Adenauer Stiftung - Amman Office in Jordan, represented by Dr. Martin Beck, and moderated by LCPS' Executive Director, Mr. Sami Atallah. Five distinguished panelists were convened: Dr. Jihad Azour, Vice President and Senior Advisor at Booz and Company and former Lebanese Minister of Finance, Mr. Kamal Hamdan, Executive Director of Consultation and Research Institute (CRI),

Dr. Eric Motu, Resident Representative of the IMF in Lebanon, Dr. Fadi Osseiran, General Manager at BLOMINVEST bank, and Dr. Zafiris Tzannatos, Senior Advisor at the ILO Regional Office for the Arab States in Beirut.

The following report summarizes the June 24, 2011 discussion on the effects of the Arab uprisings on the Lebanese economy.

Short term impact: Failing to benefit from the Arab uprisings

The effects of the recent Arab uprisings seem grim for Lebanon. The expected economic growth for the country for 2011 was more than halved after the outbreak of the Tunisian revolution from 5-6% to 2.5%, according to the International Monetary Fund (IMF). Lebanon has failed to attract the capital that flowed out of many of the Arab countries, particularly from Egypt and Syria. Capital outflow has found refuge in Dubai.

The tourism sector is not expected to perform well in Lebanon either. This is because security concerns have emanated from the Syrian uprisings. It is possible that investors fear that violence will spill into Lebanon and hence have opted to direct their assets into safer markets. Furthermore, since many Gulf tourists visit Lebanon and Syria while on the same vacation, the Syrian uprisings have prevented them from traveling to Beirut. The month of Ramadan, which falls in August is likely to deter Arab tourism to Lebanon. In the absence of a government, some

Arab tourists, like Saudi Arabians who tend to be the highest spenders, may reconsider coming to Lebanon for political reasons.

The negative impact that the Syrian uprisings are effected to have on Lebanon is not only confined to export and labor but also to investment and finance as most investors who evaluate the situation in Lebanon take into account the condition in Syria. In addition, the Western imposed sanctions on Syria may lead to sanctions on Lebanon due to the proximity and the close relationship between the leadership in Syria and some Lebanese political parties and groups. The slowdown in tourism and foreign capital are impacting other sectors such as trade and real estate.

In addition to regional instability, the world financial crises and the increase in commodity prices are expected to exacerbate the country's economic situation. Inflation is expected to increase as oil and food prices are set to rise by 5-6%. This will consequently reduce the purchasing power of the average Lebanese person which will in turn decrease their standard of living. Furthermore, according to the latest survey, official unemployment is expected to rise to 11%.

The Arab uprisings and the international crises may not necessarily lead to a recession but will certainly expose Lebanon's economic vulnerability. The immediate consequence will be on public finance, particularly its liquidity and creditworthiness of its national debt. With public deficit at 10% of GDP and debt to GDP ratio at 150%, Lebanon's fiscal situation remains fragile. The recent case of the Lebanese Canadian bank which was forced to be acquired by another local bank exposed the fragility of the banking sector as the result of

international pressure. The recent crisis in Greece is a cause of concern for Lebanon as well. Greek banks were considered to be well managed and were hardly affected by the financial crisis. The Greek financial sector is now in disarray, causing major problems in the country.

The ability of the new government to implement economic reforms is doubtful since the current fragility of the system could lead to collapse. In fact, keeping the status quo in the

economic policies may no longer be feasible in light of the Lebanese Canadian bank debacle. Since US policies toward Lebanon are not yet clear, at least until a government is formed, it will be hard to speculate what the effects will be on the banking sector.

The immediate challenge is how the Central Bank will respond to these concerns and maintain credibility in light of the regional situation. In previous years when the banking sector or the monetary policy lost some of its credibility, regional actors such as Saudi Arabia and Kuwait poured capital into the Lebanese Central Bank in order to salvage the Lebanese pounds. Furthermore, the political situation as well as the Special Tribunal for Lebanon will put pressure on the Lebanese government.

Within the realm of monetary policy, it is becoming too costly to remain independent of fiscal policy. As the consequences of this are many: it is costly, not socially effective, and unsustainable. Hence the complementarity of the fiscal and monetary policies is essential in going forward. As for the macroeconomic situation, it will depend on the ability of the government to service its debt by raising capital from banks. One of the major concerns facing the government is the ability

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to raise revenue. The increase in tax particularly VAT is politically unfeasible due to its social impact on the poorer segment of society especially as unions are demanding salary adjustments by 120% (minimum wage is currently \$333 or LL500,000 whereas the GDP per capita is \$8,800). Alternatively, the government could impose a tax on real estate profit which would generate revenue, targets the rich who are under-taxed, and taxes 60-70% of investment. The government will also come under pressure to provide comprehensive health care as it has been on the agenda of unions by increasing current health care spending by 20 to 30%.

The biggest question in the short term is how to spur growth given regional unrest. The government must find the recipe to generate sustainable or strong growth. This, however, requires a new mode of thinking and a restructuring of the economy. Many have thought that this will require a shock; if so, what type of shock is needed for the country to embark on reform. This is a particularly salient question because since 1996 there has been talk about economic bankruptcy and the collapse of the Lebanese pound.

The current uprisings in the Arab world and the prospects of economic change in Egypt, Syria, and even Iraq could possibly make Lebanon's economic role, which was once unique, irrelevant

Long Term Impact: Losing its "Unique" Economic Role

One of the major features of post-independence Lebanon is its laissez faire economy which rests on free trade, unrestricted capital flow, free exchange rate, and property rights. This served Lebanon particularly well in the 1950s and 1960s by attracting capital from Egypt and Syria which flowed out of those countries due to socialist policies that nationalized property, restricted capital flow, and protected domestic industries.

Furthermore, Lebanon's port which served as a hub between the West and the Gulf benefited its traders. Its education and health systems also attracted many Arabs to Lebanon's universities and hospitals.

The current uprisings in the Arab world and the prospects of economic change in Egypt, Syria, and even Iraq could possibly make Lebanon's economic role, which was once unique, irrelevant. Even Lebanon's bank secrecy law which was the cornerstone of the country's economy and banking sector no longer seems necessary as a prerequisite for growth or a haven for capital. In brief, this compels the government to create a new role for the country's economy in order to keep up with the evolving regional climate.

Assets, Constraints, and Opportunities: The way forward

With an exposed economy in the short term and an economic model that could become irrelevant in the long term, Lebanon needs to find a new role given the political transformations in the region. Lebanon must capitalize on its existing endowment, address the constraints in the economy, and take advantage of the opportunities that lie at its door. The country has an economy dominated by the private sector. It has a strong banking sector which has raised significant amount of deposits in the last 20 years. It is well endowed with human capital.

Despite these assets, the country faces severe constraints: Although its economy is dominated by the private sector, it is not market based. The sector is highly oligopolistic since more than 50% of the 300 markets are in the hands of a few companies. This high level of concentration is also found in regard to finance as 2% of companies take more than 50% of the loans. This high level of market share concentration reduces competition and innovation. Furthermore, the sector is not productive as it is dominated by small companies (more than 95% of companies have less than 10 employees).

Another challenge facing the economy is high levels of corruption which not only increases the costs of doing business, it distorts the allocation of resources in the economy. This has negative consequences on attracting foreign investment. Furthermore, the corruption in public agencies increases the costs of public

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service delivery. An example is the Electricity du Liban which has not been audited since 2003 and now has a deficit of \$1.5 billion. One of the major problems facing the public sector is the low skill level. This has reduced the capacity of the state to institutionally respond to crises or to even set policies. Most of the policy making initiatives are done by experts and advisors to politicians leaving the public sector with the task of simply executing policies. Finally, the economy has failed to create enough jobs. Although Lebanese workers are known to be well endowed with human capital, firms do not seem ready to pay for their skills. This has led to high levels of emigration of skills mostly to the Gulf countries.

Regardless of these constraints, Lebanon has the potential to grow in several directions. The Information and Communication Technology seems to be a promising sector for Lebanon since it has the human resource capacity and innovation to become a leader in the region. Despite the increase in the number of universities in the Gulf, Lebanon's education sector has the infrastructure to grow to meet future challenges. And although the lack of attention and concern has been given to the productive sectors, both the agriculture and manufacturing sectors have significant room to export if the right policies were put in place. For one, the industrial sector's exports are more sophisticated than other countries in the region which is a strong indicator for future growth.

Lebanon's financial sector, which has primarily financed government debt since the end of the civil war, needs to finance the productive sector to create jobs. Despite bank subsidies which have amounted to \$200 million, its developmental role has been limited

due to the absence of fundamental reform by the government. Furthermore, there is a need to build a partnership with the private sector particularly for infrastructure projects but this should have strict rules in order to reduce cronyism and corruption which was evident in the last two decades.

More recently, the discovery of gas off the coast of Lebanon could provide a significant boost for development. The government is expected to be granted its first license for extracting gas in the beginning of 2012. However, the management of both the extraction process as well as the accrued revenues will impose a tremendous challenge for the government.

For these opportunities to be realized, economic reforms must go hand in hand with political reform. The old mantra espoused by the World Bank and the IMF that economic reforms should precede political reforms is a non-starter. This is simply because the governing elites went ahead with reforms that they found suitable to their interests, profited from these reforms, and consolidated their power further. Hence there is a need to reform the political system in such a way that will ensure that the pursuit of these opportunities will be beneficial to a large portion of society. This involves serious political changes along electoral reforms and party politics. Furthermore, there is a strong need to complement the political changes with social reforms, which will require that a proper welfare system established to protect vulnerable citizens. It is unforeseen that a more inclusive growth with a welfare system could be introduced without a change in the political system.

For growth to be both sustainable and equitable, political reform is inevitable

Conclusion

The Arab uprisings pose serious questions about the viability of the Lebanese economy. In the short term, Lebanon does not seem likely to benefit from the regional instability as capital and tourism are finding markets and destinations other than Lebanon. This is a stark distinction from the past.

Moreover, the Arab uprisings and the world financial crises are exposing the vulnerability of the economic system. It is expected the growth will slow down and the liquidity and creditworthiness of the government debt will be in question.

The long term economic impact of the Arab uprisings on Lebanon remains uncertain as it will depend on the type of political and economic regime that will emerge in the Arab states. However, one potential scenario is that Lebanon's "unique" role in the region, as an open and laissez faire economy that rests on free trade, unrestricted capital inflow, and private property may be coming to an end.

For Lebanon to remain relevant, it must undergo structural changes in its economy that capitalize on its human and capital assets, address the oligopolistic market structure which has reduced the dynamism of the private sector, and seize the opportunities particularly in the ICT and the gas sector. However, for growth to be both sustainable and equitable, political reform is inevitable.

Panelists

Sami Atallah

Sami Atallah is the Executive Director of the Lebanese Center for Policy Studies (LCPS). Prior to joining LCPS, he served as a consultant for the World Bank, the European Union and the UNDP in Syria and Saudi Arabia. He also served as an advisor for the Lebanese Ministries of Finance, Industry, and Interior and Municipalities, as well as in the Prime Minister's Office. His policy research work spans the fields of fiscal decentralization and municipal finance, corruption and governance, institutions and development, industrial policy, and competitiveness of firms. Atallah is pursuing a PhD in Politics at New York University. He holds two masters degrees, one in International and Development Economics from Yale University and the other in Quantitative Methods from Columbia University.

Jihad Azour

Jihad Azour is Vice-President and Senior Executive Advisor for Booz and Company. Prior to taking up this position, he was the former Minister of Finance of the Republic of Lebanon from July 2005 till July 2008. He also chaired the G8-BMENA Ministerial Group for 2006-2008, which regroups Ministers of Finance and Governors of Central Banks of the G8 and MENA countries. Dr. Azour also occupied senior positions in the government (senior advisor to the Minister of Finance), international organizations (project director of the UNDP/World Bank at the Ministry of Finance), and the private sector, (including McKinsey and Cie, Booz Allen Hamilton, Compagnie de Saint-Gobain and Caisse des dépôts et consignations), focusing

on economic policymaking, banking and financial sector, corporate governance, and overall economic development. He also consulted for the International Monetary Fund's Fiscal Affairs Department. He published several books and articles on economic and financial issues and has a long teaching experience at the American University of Beirut. Dr. Azour obtained his Ph.D. in International Finance from the Institut d'Etudes Politiques de Paris in France. While completing his Ph.D., he served as post-doctoral fellow at Harvard University's Department of Economics researching the integration of emerging economies in the global economy. Dr. Azour also holds a post-graduate degree (DEA) in International Economic and Finance and a Masters in Applied Economics from Dauphine University, Paris, France.

Martin Beck

Martin Beck who is currently on leave of absence from GIGA Institute of Middle East Studies in Hamburg, Germany, has been the Resident Representative of Konrad Adenauer Stiftung in Amman, Jordan, since 2010. He served as Visiting Professor at Denver University, USA; Birzeit University, Palestine; the University of the Federal Armed Forces in Hamburg, Germany; and the University of Bremen, Germany. He has published extensively both in German and English on Middle Eastern affairs. He obtained his Ph.D. as well as his "Habilitation" in political science from Tübingen University, Germany.

Kamal Hamdan

Kamal Hamdan is currently the Executive Director of the Consultation and Research Institute (CRI). He has supervised and coordinated a wide range of studies and projects covering social and economic issues, for local and international entities in both private and public sectors. He contributed as senior consultant to many research studies conducted by international institutions, including the World Bank, EU institutions, UNDP, ILO, UNICEF, UNESCWA, UNRISD, UNFPA and UNESCO. He also worked with the private sector on many market and financial feasibility studies. Backed with a highly diversified career path, he served as senior consultant to several Lebanese ministerial committees for economic evaluation and reform purposes. His major specific areas of interest are: macroeconomics, labor economics, competitiveness and social development. He has produced many books and tens of publications in well-known Lebanese, Arab and international economic reviews and periodicals. Mr. Hamdan has a Diplome de Specialite in Petroleum Economy.

Eric Mottu

Eric Mottu is the Resident Representative of the International Monetary Fund in Lebanon since September 2009, and is now also the Senior Desk Economist for Egypt. He has been working for close to 14 years at the IMF on numerous emerging and advanced economies in Eastern and Western Europe, the Middle East, and Africa. Before that, he worked at the Swiss Ministry of Finance. Dr. Mottu has a Doctorate in Economics from the University of Geneva.

Fadi Osseiran

Fadi Osseiran is currently the General Manager of BLOMINVEST, one of the largest banks in Lebanon. Prior to that, Dr. Osseiran was a member of the Med Group from 1990 till 1994. He undertook professorial duties in the Institute of Money & Banking at the American University of Beirut (AUB) until 1993. Dr. Osseiran has also held various posts in organisations such as the Association of Lebanese Banks, the Lebanese Management Association, the Lebanese Centre for Policy Studies and the Lebanese Economics Association. Currently, he is President of the Lebanese Brokers Association. Dr. Osseiran has published several articles and books related to the Lebanese Economy and Banking. He holds a Doctorate in Economics from New York University.

Zafiris Tzannatos

Zafiris Tzannatos is the Senior Advisor at the ILO Regional Office for the Arab States in Beirut. He was the Chair and Professor of the Economics Department at the American University of Beirut. He previously served as Advisor to the Managing Director of the World Bank where he was also Manager for Social Protection in the Middle East and North Africa Region, and Leader of the Global Child Labor Program that he initiated. He has held senior academic and research appointments in Europe and advised governments of industrialized and emerging countries as well as international organizations. His publications include 14 books and monographs, and more than 150 reports and papers in the areas of development strategy and social policy.