Lebanon's Economic Prospects and Challenges[1]
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Lebanon, a small middle-income country that was devastated for many years by internal and regional conflicts, has been trying in more recent times to rebuild itself both politically and economically. Strife among the 18 separate religious sects that comprise Lebanese society (and whose leaders have frequently commanded more loyalty than the national government), violent intervention by neighboring Syria, and Lebanon's entanglement in broader regional conflicts have repeatedly torn apart this country of four million people, causing extensive physical damage and human suffering. Fortunately, Lebanon has been relatively stable during 2010, but it still faces significant risks, as suggested by recent clashes involving internal sects, Hizbullah and Israel.

To rebuild the country after the virtually continuous civil war of 1975-2000, the government borrowed heavily, incurring one of the world's highest public debt-to-GDP ratios. This ratio came to exceed 150%.

The government committed itself to a program of fiscal reform aimed at reducing the debt in exchange for $7.6 billion in foreign aid pledged at the Paris III Conference of January 2007, but delivering on its reform promises has proven to be difficult. The major elements in the reform program were fiscal consolidation, debt reduction, privatization of two mobile phone companies and increases in electricity tariffs to eliminate, or at least ameliorate, costly subsidies. Implementation of the reform program stalemated under the "national unity government" formed in July 2008. The peaceful election of June 2009, which was won by the "March 14" coalition, rekindled hopes for further reform, but reform has remained stuck because the cabinet is divided and the government does not control parliament. Recent moves toward heightened dialogue and potential reconciliation between Israel and the Palestinians offer hope for Lebanon's future. But many complications remain to be surmounted, including ongoing contention over the position in the political system of each of the sects represented in the ruling coalition, Lebanon's relations with Syria, the role of Hizbullah and the danger of conflict over the regional role of Iran.

Despite the slow progress of reform, the economy grew at an estimated rate of 6.9% in 2009, only slightly slower than the record rate of 8% in 2008. Although its financial system, exports, tourism and remittance receipts are all vulnerable to the global recession and Lebanon's economic growth potential is dependent on trends elsewhere in the Middle East, the country has generally weathered the global financial and economic storm quite well. It has maintained financial stability, raised international reserves and achieved some control over public spending. Despite having more linkages to global markets than other banking systems in the region, Lebanon's financial system has not come under stress. Economic growth this year has been driven by the tourism, construction and banking sectors. The average value of real estate sales rose rapidly, which stimulated the construction industry.

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The Economist Intelligence Unit (EIU) expects the Lebanese economy to grow at 7.2% this year and at 5.8% in 2011, with service exports leading the way. Exports of services account for more than one-half of GDP. Growth in domestic consumption and private investment will be dampened down by austerity in public sector spending and the high cost of private borrowing as banks extend most of their credit to the government. Political and security issues will also help to keep investors cautious and deter the shift toward the more balanced economy that Lebanon needs.

Lebanon's already large current-account deficit widened substantially in 2009 and will remain high this year, with some improvement expected in 2011. The government of Lebanon does not publish current account data, but new estimates by the IMF indicate that recent deficits have been even larger than previously thought. The IMF calculates that the current account deficit climbed to 22.9% of GDP in 2009 after running at 13.7% in 2008. The main factor in the rise was a drop in tourism receipts, which seems to have occurred despite a higher number of visitors.

However, capital inflows should continue to be sufficient to cover the deficit. In 2009 capital inflows exceeded the current account deficit in value, creating an overall balance of payments surplus of $8.9 billion. This pattern is expected to hold at least through 2011, barring a major political shock -- and even in that case Lebanon would probably receive additional capital from its external allies.

Fiscal reform is still needed to reduce the large government debt and high debt service obligations. The government's budget deficit is projected to remain large, adding to Lebanon's debt burden and committing one-third or more of the budget to debt service payments. In 2009 the deficit increased moderately (to $3 billion) in absolute terms and fell slightly (to 9%) as a percentage of GDP. Parliament has yet to pass the 2010 budget and this delay has restrained government spending, particularly capital expenditure so far this year. When taken together with a high rate of growth in government revenues, the slower spending will result in considerable shrinkage of the government deficit in 2010, perhaps to 5.1% of GDP. In 2011, however, as delayed spending occurs and revenue growth slows down, the deficit is expected to widen once more (the EIU says to 7.4% of GDP). As in the past, it should be possible to finance the budget deficit through Eurobond sales unless the financial environment worsens.

Most of the government debt is owned by local banks and helps to keep them strong. The government's debt service payments are in effect a form of support for the banking system. The EIU says that this arrangement will save Lebanon from the kind of crisis experienced by Greece recently, despite having even larger deficits and a higher debt/GDP ratio.

Continued government borrowing and a lack of competition among banks ensure that commercial banks' prime rates will remain high. The average rate on local currency loans was 9.6% in 2009 and little or no decline is expected. This makes credit prohibitively expensive for many small firms. The central bank has reduced reserve requirements for some types of local currency loans in an attempt to stimulate lending.

The Lebanese pound will remain pegged to the U.S. dollar for the immediate future. The central bank is strongly committed to maintaining the peg and has sufficient foreign exchange reserves to do so for some time to come. If the substantial imbalances in the public sector and external accounts were to persist for a long time, however, the peg might come under attack.

Political interests have blocked privatization plans. Subsidies to Electricite du Liban (EdL), the inefficient state-owned electricity monopoly, weigh heavily on the government budget and were equivalent to 5.2% of GDP in 2008. Possible privatization of EdL, two mobile phone companies and other telecommunications operations has been discussed for some time now. Privatization would bring in immediate government revenue and a liberalized telecommunications sector could generate significant additional fiscal resources in the future. Other possibilities for privatization include the Bank du Liban's non-financial assets, including shares in the national airline and a holding company that owns Casino du Liban. The failure to move on any of these privatization projects shows how controversial such moves are in Lebanon. One important impediment is said to be the interests of important politicians in keeping the companies in the public sector. The EIU thinks it unlikely that these long-discussed privatizations will occur until after 2011.

Unemployment is high and may be pushed higher by returning overseas workers. The unemployment rate was estimated at 9.2% in 2007. Many educated and skilled young people have emigrated in the past to find employment, particularly to the Persian Gulf. Lebanon's growing youth population is both a potential asset and a threat to its economic development and political stability. A lack of job opportunities and limited facilities for job-related education and training could cause the young to turn to extremism.

Reforms are needed to improve the enabling environment for private business. Lebanon ranked 108th among 183 countries on the ease of doing business scale of the World Bank's *Doing Business in 2010.* Its ranking in this international survey has slipped in recent years as other countries have reformed their regulatory systems faster than Lebanon. Corruption and patronage are said to be important barriers to private sector development. One bright spot of Lebanon's business environment is that corporate and personal taxes are low by international standards. (The corporate tax rate is 27% and the top personal income tax rate is only 20%, although some tax is levied even on low wage earners; Lebanon also has a value added tax, but at 10% the rate is lower than in most neighboring countries.) Lebanon ranks relatively high in tax collections (34th in the world) but much lower on other aspects of the business environment, especially enforcing contracts (121st), closing a business (124th) and dealing with construction permits (125th). Obtaining a construction permit was found by the World Bank to require 20 separate procedures, take 211 days on average, and cost nearly twice per capita income. Enforcing a contract involves 37 procedures, takes about two years and costs 31% of the claim. Closing a business takes four years and results in a recovery of 19 cents on the dollar.

Lebanon has received, and continues to receive, strong support from the World Bank, the IMF, the U.S. Government and other donors. Disbursement of foreign aid pledged at the Paris III conference of January 2007 was slowed in 2007 and 2008 by political and security concerns, lack of progress on promised economic reforms and, in 2008-2009, global liquidity constraints. USAID has operated in Lebanon since 1951. Its strategy has emphasized reconstruction and humanitarian assistance following the Syrian occupation and destruction during the 2006 war with Israel. Objectives of that strategy included strengthening civil society and governing institutions and promoting dialogue among the various social groupings. A new USAID strategy for 2009-2013 continues that work and also emphasizes job creation and income generation, improvements in basic and higher education, improved water management and infrastructure construction. The World Bank, meanwhile, has just announced a new Partnership Strategy that will enable the government to borrow up to $550 million over the next four years to finance economic and social development. The Bank's strategy has four emphases: stimulating economic growth and fiscal stability; creating a competitive business environment; improving the economic infrastructure; and providing equitable social protection for the entire population. The IMF closely tracks developments in Lebanon, provides short-term financial assistance credits as needed and advises on fiscal and monetary policy as well as other matters.

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