Middle East and North Africa

Working Paper Series
No. 16
April 1999

Reconstruction in Lebanon
Challenges for Macroeconomic Management

by
Daniela Gressani
John Page

The World Bank
Produced by the Social and Economic Development Group (MNSGD)

Summaries in Arabic and French

FILE COPY
Reconstruction in Lebanon:
Challenges for Macroeconomic Management

by
Daniela Gressani and John Page

April 1999
Reconstruction du Liban :
Défis pour la gestion macro-économique

par
Daniela Gressani et John Page

Dans ce document, nous nous attachons à déterminer si les déséquilibres macro-économiques actuels au Liban devraient être considérés comme une menace sérieuse au processus de reconstruction ou comme un phénomène de transition inévitable, et quelle serait la politique macro-économique la plus appropriée pour remédier à ces déséquilibres. Nous concluons que bien que l'émergence de déséquilibres externes importants ne constitue pas un phénomène inhabituel dans les phases précoces du processus de reconstruction et qu'elle ne conduit pas forcément à une instabilité macro-économique, l'ampleur des déséquilibres externes combinés aux déséquilibres budgétaires qui les accompagnent, donne lieu à de graves préoccupations. Les décideurs devraient concentrer leurs efforts à l'ajustement budgétaire non seulement en se basant sur les déséquilibres existants, mais aussi en tenant compte de l'ouverture de l'économie et des modalités actuelles du taux de change qui limitent le recours aux instruments monétaires. Finalement, l'ajustement budgétaire devrait être axé sur l'augmentation de l'épargne publique, étant donné que l'investissement public, bien qu'élevé, n'a pas été excessif.
اعادة الاعمار في لبنان:
التحدي الذي تواجهه ادارة الاقتصاد الكلي

بَلَم
دانييلا غريساني وجون بيج

نشر في هذه الدراسة في تحديد ما إذا كان ينبغي اعتبار اختلالات الاقتصاد الكلي الحالية في لبنان خطرا جديدا يهدد عملية إعادة الاعمار أو أنها ظواهر عابرة من التمثيل تفاديها، وتحديد منطلق سياسات الاقتصاد الكلي الملائم لمعالجة هذه الاختلالات. وتخلص إلى أنه على الرغم من أن ظهور الاختلالات الكبيرة في القطاع الخارجي يعتبر أمرًا عاديا في المراحل الأولى من إعادة الاعمار ولا يؤدي بالضرورة إلى عدم استقرار الاقتصاد الكلي، إلا أن حجم الاختلالات في هذا القطاع جنبا إلى جنب مع حجم الاختلالات المالية المرافقة لها يعتبر سببا للكثير من التقلق. ويجب أن يركز واعضو السياسات جهوده على التكيف (التصحيح) المالي ليس بسبب الاختلالات المالية فحسب، ولكن أيضا لأن افتتاح الاقتصاد وتترابط سعر الصرف (القطع) المالية يحد من استخدام الأدوات النقدية. خاتمًا، يجب أن يركز التكيف المالي على زيادة الادخار العام لأن الاستثمار العام ليس زائدا عن الحد اللازم على الرغم من أنه مرتفع.
Reconstruction in Lebanon:
Challenges for Macroeconomic Management

by
Daniela Gressani and John Page

In this paper we set out to investigate whether the existing macroeconomic imbalances in Lebanon should be considered as a serious threat to the reconstruction process or as inevitable, transitory phenomena, and what is the appropriate macroeconomic stance to deal with these imbalances. We conclude that, while the emergence of large external imbalances is not unusual in the early phases of reconstruction and does not necessarily lead to macroeconomic instability, the size of external imbalances together with the size of accompanying fiscal imbalances is cause for serious concern. Policy makers should concentrate their efforts on fiscal adjustment, not only on the ground of existing imbalances, but also because the openness of the economy and existing exchange rate arrangements restrict the use of monetary instruments. Finally, fiscal adjustment should focus on increasing public savings, as public investment, though high, has not been excessive.
INTRODUCTION

Since the end of the civil war in 1991, Lebanon has been engaged in an unprecedented reconstruction effort. The magnitude of economic disruption caused by the war is in fact enormous. After 15 years of conflict (1975-90), total damage to physical assets was estimated at US$25 billion. Real per capita income in 1991 was less than half of pre-war levels, while more than 200,000 professionals and skilled workers had emigrated.¹

During the last few years, Lebanon has begun to make significant progress in rebuilding its infrastructure, with the economy demonstrating high but declining rates of growth. At the same time, the economy has experienced large imbalances in fiscal and external accounts. Historical experience from industrialized countries in the Post World War II period suggests that large external imbalances tend to accompany reconstruction programs; in Lebanon, reconstruction has also contributed to the rapid growth of domestic debt. This poses some interesting questions for policy-makers.

Are Lebanon's fiscal and external imbalances a serious threat to the reconstruction process, or are they inevitable, transitory phenomena? Is the current macroeconomic policy stance appropriate to prevent such imbalances from leading to macroeconomic instability? How should policy-makers respond to them? In this paper we attempt to address these questions on the basis of the limited information available. As a result, our conclusions will also be limited. One of the lessons we will learn in the process is that policy making in Lebanon is in great need of good statistics.

I. THE NATURE OF THE RECONSTRUCTION CHALLENGE

The magnitude and speed of the reconstruction of the Lebanese economy is one of the most important factors driving public and private investment spending and is significantly affecting macroeconomic balances. The Lebanese government has launched a large-scale public investment program aimed at re-building critical infrastructure sectors, and there has been substantial private sector investment in the housing sector.

Public investment spending has targeted the reconstruction and upgrading of existing infrastructure, in part to catch up with countries at similar levels of development. This program prioritized the rehabilitation and expansion of power and transport, as well as housing reconstruction. According to the original ten-year program, public investment is scheduled to total US$12 billion; implying an average expenditure of 11% of GDP per

¹ See Eken et al., 1995, Economic Dislocation and Recovery in Lebanon, IMF Occasional Paper 120.
year, front-loaded to some 13% of GDP during the earlier years. While the composition of the reconstruction program was generally viewed as appropriate for Lebanon’s needs, its size and phasing were viewed by some -- including the World Bank -- as excessively ambitious and likely to lead to serious macroeconomic imbalances.

Although the public investment program was not implemented as rapidly as originally planned, progress has nevertheless been remarkable. Since the initial launch of the reconstruction program in 1993, public investment has averaged over 7 percent of GDP over the period 1993-98. This figure is basically consistent with estimates considered appropriate by most observers of the Lebanese economy -- again, including the World Bank. Nevertheless, the magnitude and speed of implementation of the reconstruction effort contributed to larger budgetary deficits and faster domestic debt accumulation than originally envisaged. The evolution of current expenditures -- in particular, interest payments on domestic debt -- contributed to this outcome, together with the fact that the program was largely financed on commercial terms, and private participation was limited for the most part to management and provision of infrastructure.

**THE NATURE OF THE MACROECONOMIC CHALLENGE**

The enormity of Lebanon’s reconstruction needs is reflected in recent trends of key macroeconomic variables, which show a rapid recovery of income and public investment (Figures 1 and 2), combined with sizable current account deficits and fiscal imbalances (Figures 3 and 4). Though somewhat lower during the last two years, both fiscal and external imbalances remain extremely worrisome: the fiscal deficit at about 15% of GDP, and the current account deficit in excess of 20% of GDP.
A number of policy constraints and structural characteristics limits macroeconomic policy options. First, Lebanon has a very limited scope for independent monetary policy, since it maintains a tightly managed exchange rate peg and has an overwhelmingly dollarized financial system. Second, economic activity relies heavily on services rather than industrial activities as the main source of export earnings. Lebanon also has access to a very elastic supply of unskilled labor from neighboring countries (especially from Syria); and has a large expatriate -- relative to resident -- population that represents a source of transfers and capital inflows, as well as skills. Finally, Lebanon has a very open foreign trade and capital regime—even though trade taxes remain high— and maintains good access to private capital markets, both for the government and selected private banks. As a result, fiscal and external deficits have been accompanied by the growth of domestic public debt and private capital inflows.
Given these factors, reconstruction poses special challenges for macroeconomic management beyond the initial recovery. A rapid increase in output, as experienced in Lebanon in the early stages of reconstruction, is easily achieved as spare capacity is utilized to meet rising demand. However, initial spare capacity is generally exhausted before the fiscal revenue base can be expanded. The main macroeconomic challenge then consists of managing the pressures on the budget and external balances resulting from large public and private investment expenditures at the same time as households seek to recover previous consumption levels. Managing these pressures is critical for ensuring that growth is sustained beyond the short-term recovery and that a solid basis is laid for restoring pre-war levels of income as well as the pre-war growth path.

**MACROECONOMIC SUSTAINABILITY OF THE RECONSTRUCTION EFFORT**

The recovery of the Lebanese economy -- after a high inflation-rapid devaluation episode in 1992 -- has been accompanied by low inflation, a stable exchange rate and growing foreign exchange reserves. However, these favorable macroeconomic outcomes were achieved at the cost of rapidly accumulating domestic debt, which keeps interest rates very high and absorbs an ever increasing share of public revenues (Table 1 and Figure 5). There is no doubt that the sheer size of fiscal imbalances in Lebanon endangers the reconstruction effort itself by raising the prospect of macroeconomic instability and thus undermining the prospects for robust growth beyond the first reconstruction phase. The questions posed by these developments are how and how rapidly should Lebanon address these imbalances.
Table 1: Composition of Public Expenditure
(current prices; percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Expenditures</td>
<td>21.8</td>
<td>20.0</td>
<td>25.8</td>
<td>25.7</td>
<td>29.4</td>
<td>31.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Interest on external debt</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.7</td>
<td>1.1</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Interest on domestic debt</td>
<td>5.0</td>
<td>5.7</td>
<td>9.4</td>
<td>9.7</td>
<td>11.9</td>
<td>13.9</td>
<td>13.0</td>
</tr>
<tr>
<td>Consumption</td>
<td>14.8</td>
<td>14.0</td>
<td>14.5</td>
<td>14.1</td>
<td>15.4</td>
<td>15.7</td>
<td>15.0</td>
</tr>
<tr>
<td>Subsidies</td>
<td>1.5</td>
<td>1.6</td>
<td>1.2</td>
<td>1.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>6.9</td>
<td>9.9</td>
<td>11.2</td>
<td>10.4</td>
<td>11.1</td>
<td>10.7</td>
<td></td>
</tr>
<tr>
<td>Capital Expenditures</td>
<td>1.5</td>
<td>3.4</td>
<td>9.3</td>
<td>9.4</td>
<td>8.5</td>
<td>5.5</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Figure 5: Total Government Debt
(current prices; percent of GDP)

Reconstruction in a Historical Context

Post-war experience in West Germany and Japan\(^2\) -- the two most war-ravaged and most successful economies after World War II -- indicates that rapid recovery is not difficult to achieve after severe disruptions in economic activity. Historical experience also suggests that during the early stages of reconstruction large external imbalances

---

are likely to emerge, as a byproduct of restoring production capacity, infrastructure, and household consumption levels. Both West Germany and Japan experienced large trade deficits for brief periods, at the early stages of the post-war reconstruction effort. West Germany also had to borrow for balance-of-payments support.

The experience of reconstruction in industrialized countries also suggests that an early recovery is no guarantee for sustained growth. Macroeconomic stability and a strong private sector recovery were achieved in post-war West Germany and Japan by pursuing tight fiscal policies and ensuring wage restraint. While fiscal restraint contributed to limiting and eventually eliminating external imbalances, wage restraint enhanced firm profitability and retained earnings -- an important source of investment finance in a weak financial market.

Opportunities and Dangers for Lebanon

In summary, the post-war experience of West Germany and Japan indicates that: (a) large external deficits are difficult to avoid in the early stages of reconstruction and do not necessarily lead to macroeconomic instability; (b) the fiscal policy stance is important for ensuring that external deficits are kept under control and eventually eliminated; and (c) labor market developments are critical for achieving public sector-led reconstruction that is accompanied by a strong private sector recovery. These conclusions corroborate the centrality of fiscal adjustment to the success of reconstruction in Lebanon.

There are clearly lessons to be learned from the similarities between reconstruction after World War II and the challenge faced by Lebanon, but are there lessons to be learned from their differences as well? The single most important difference is that Lebanon is a much more open economy, operating in a more integrated global economy with regard to trade and capital flows, than most countries in the 1940s and 1950s. In addition, Lebanon has access to significant pools of capital because of its large expatriate population.

The most important implication of international openness and the supply of expatriate savings is that economies such as Lebanon can externally finance a much larger portion of aggregate spending than would have been possible for West Germany or Japan.\(^3\) Higher foreign savings in turn allow a faster recovery of investment as well as consumption. In recent years private capital inflows and transfers have allowed Lebanon to finance a resource balance deficit in excess of US$6 billion, equivalent to some 40% of GDP.

\[^3\] Despite the foreign aid these two countries received immediately after World War II, West Germany received less than 2% of GNP in support from the Marshall Plan, and Japan's total external transfers never exceeded 6% of GNP. See Giersch, Paque and Schmieling, 1993, cit., and Hamada and Kasuya, 1993, cit.
However, increased availability of foreign resources to finance reconstruction also has a flip side. Excessive dependence on foreign resources imposes new constraints, makes a country more exposed to adverse external events, and lessens the urgency to establish an appropriate framework for public resource mobilization and expenditure management as well as for private savings mobilization.

For the Lebanese economy, capital account openness in general, and in particular dependence on large private foreign capital and transfers, have some important consequences for macroeconomic management. Capital inflows are notoriously sensitive to interest rate developments at home and abroad, as well as to exchange rate expectations. Small changes in investors' perception about future prospects — such as interest rates in the G3, or exchange rates in Lebanon — may lead to large movements of funds. The recent turmoil in East Asian currency markets is a vivid example of how rapidly a shift in market sentiment can lead to large reversals in private capital flows. Private transfers also respond rapidly to interest and exchange rate developments. Egypt, for example, experienced a significant increase in capital inflows and private transfers following the introduction of measures to improve macroeconomic balances and reduce external debt in 1991-2, including a sizable devaluation of the exchange rate.

Capital account openness and the sensitivity of private transfers to interest and exchange rate developments also restricts the scope of monetary policy. For example, attempts to reduce domestic interest rates can be frustrated by shifts out of domestic assets — outflows or reduced inflows of capital and private transfers; these would create pressures for exchange rate devaluation, and thus would require interventions in the foreign exchange market to maintain the exchange rate level; and these interventions would ultimately lead to higher interest rates. Given the limited scope of monetary policy, fiscal policy becomes even more important, as the primary independent policy instrument available to macroeconomic managers.

Capital account openness can also restrict the scope of fiscal policy. During the early stages of reconstruction, when the sheer size of macroeconomic imbalances creates uncertainty, the premium demanded by investors to hold assets denominated in local currency is very large. Maintenance of a tight exchange rate peg further contributes to this premium, by increasing the risk of large and discrete devaluations. High real interest rates then put tighter limits on the size of the sustainable fiscal deficit — i.e., a deficit that will not lead to an explosion of public debt — given the country's growth targets.

4 This is true for foreign as well as domestic investors, since the latter also have access to investment opportunities in foreign assets.
These difficulties are generally associated with reliance on foreign capital inflows but in the case of Lebanon are compounded by rapid domestic debt accumulation in excess of public investment budget financing needs. As a result of abundant foreign financing, public savings have been consistently negative in Lebanon since the end of the civil war and, with the exception of 1995, have been larger than the public investment budget. Borrowing to finance consumption puts in question the ability of the borrower to repay.

Significant portions of public consumption do increase future growth and thus repayment capacity. In particular, expenditures on health and education have been shown to have a potential positive impact on economic growth in the medium term; similarly, adequate operations and maintenance expenditures can increase the return on public investment. It is questionable whether this is the case for the majority of current expenditures in Lebanon. Interest payments on public debt represent the largest component of current expenditures; the next largest component is the wage bill of the government. It should be noted that interest payments and the wage bill each exceeds the public investment budget as well as all other current expenditures (Table 1).

PRIORITIES FOR MACROECONOMIC STABILITY

The unsustainability of current fiscal trends and the lack of independent monetary instruments require that top priority be given to fiscal adjustment in order to ensure that the current imbalances do not lead to macroeconomic instability and thus jeopardize the prospects for a long-term recovery. In addition, it is clear that trends in public savings -- not public investment -- need to be stemmed.

How then should fiscal adjustment be accomplished? How rapidly? Is there a role for other policy instruments to contribute to fiscal adjustment?

Priorities for Lebanon

In Lebanon, these questions should be addressed in the context of high levels of public debt (Figure 5) and real interest rates (ex-post real rates on Treasury bills are currently around 8% per annum). Without a sizable reduction in the fiscal deficit and real interest rates, macroeconomic stability will be endangered by rising public debt. This does not mean that Lebanon cannot count on continuing large capital inflows from abroad, but rather that reconstruction could be accelerated if these resources could be allocated to growth-oriented expenditures instead of Treasury Bills. The sustainability of the reconstruction effort depends on expanding the range of profitable private investment opportunities, in addition to keeping domestic interest rates near international levels.
In order to manage fiscal and external balances while keeping the economy on a steady growth path, policy makers in Lebanon should consider the following:

- The largest portion of the fiscal adjustment will need to come from improving public savings. Public savings have been negative and growing, exceeding the investment budget in recent years.
- Increasing public savings will require a higher tax effort. Overall public revenues remain below 20% of GDP, which is still low relative to countries with similar income levels and also in regional terms, and which can be raised while sustaining a reasonable tax burden.\(^5\)
- Measures to increase the tax effort should at the same time reduce excessive dependence on international trade taxes and expand the base for indirect taxes and direct taxes.
- Current expenditures could and should be reduced. Non-interest current expenditures -- mostly wages -- amount to 15% of GDP. The dynamics of public sector employment will be a critical aspect of current expenditure retrenchment.
- Reducing capital expenditures without slowing the reconstruction effort will require financing a larger portion of infrastructure investment from private sources. Lebanon is in a good position to attract significant private investment -- both domestic and foreign -- in infrastructure sectors most important for supporting the recovery of its service-based economy, e.g., telecommunications.

The size of required fiscal adjustment will depend critically on how quickly domestic interest rates respond to the adjustment itself. As long as real interest rates exceed GDP growth, Lebanon will need to run a surplus in its non-interest fiscal balance in order to avoid further increases in the ratio of domestic debt to GDP.

The extent to which interest rates decline as a result of fiscal adjustment will depend in the first place on the size and sustainability of the fiscal adjustment itself. In addition, it will also depend on expectations about future exchange rates. Investors demand a premium in excess of international interest rates to hold assets denominated in Lebanese pounds -- to compensate them for the risk of a devaluation causing losses in the dollar value of their investments. To the extent that fiscal adjustment improves expectations about future exchange rates, this premium will also be reduced.

Would a devaluation of the Lebanese pound help to reduce external and fiscal imbalances? We believe that in the presence of large fiscal imbalances and an overwhelmingly dollarized economy a devaluation would not work. First, the

\(^5\) For example, tax revenues amount to over 30% of GDP in Jordan, and about 25% in Egypt.
dollarization of the economy limits the ability of a devaluation to increase the relative price of tradables and thus encourage a shift of productive resources toward the tradable sector. A better understanding of the composition of import and export flows is necessary to reach more definite conclusions, but these data are not available. Second, again, in the presence of large fiscal imbalances and a dollarized economy, a devaluation would not by itself lead to a decline in real interest rates and thus bring about a sustainable improvement in fiscal balances, because it would not necessarily reduce the likelihood of future devaluations. However, the fact that a devaluation would not in and of itself help to reduce macroeconomic imbalances does not mean that a devaluation would be unlikely. Without adequate fiscal adjustment, a devaluation would in fact be inevitable; and even with adequate fiscal adjustment, a devaluation may be necessary to complement the needed reduction in aggregate demand.

A related issue that policy makers should consider is the appropriate composition of public sector borrowing from domestic and foreign sources. Currently, interest rate differentials would recommend external financing of a larger share of public borrowing requirements. A shift in this direction could in fact directly contribute to fiscal adjustment by reducing interest expenditures. However, the soundness of this move over the medium term would critically depend on future developments of the real exchange rate and thus on progress toward fiscal adjustment. In the extreme -- and very unlikely -- case that the premium over foreign interest rates is solely determined by exchange rate expectations and that these expectations are correct, it would be irrelevant whether the government borrowed domestically or abroad.

A final issue is the de-dollarization of the economy. De-dollarization would have a number of positive implications for fiscal adjustment — including an increase in seignorage revenues and reducing the substitutability of foreign assets in domestic investors' portfolios. While de-dollarization will in the end depend on the success of fiscal adjustment in strengthening investor confidence in the Lebanese pound, policy makers should review existing financial system regulations to ensure that there are no biases in favor of foreign currency operations. However, de-dollarization could also increase the danger of financial sector crises. Currently, regulations requiring that banks balance their foreign exchange assets and liabilities are reasonably effective at reducing banks' exposure to foreign exchange risk because domestic borrowers are to a large extent operating in a dollarized environment. If dollarization is reduced, indirect foreign exposure of banks would increase even in presence of balanced foreign currency assets and liabilities.

CONCLUSIONS

The extraordinary magnitude of Lebanon's reconstruction effort poses a great challenge for policy makers and in particular for macroeconomic managers. Reconstruction involves large public and private investment expenditures at the same
time that the production base is severely limited, fiscal revenues are constrained, and households seek to recover previous consumption levels. As a result, serious fiscal and external imbalances have emerged. The core of the macroeconomic challenge is management of these imbalances to prevent macroeconomic instability, while ensuring that growth is sustained beyond the short-term recovery and that the basis is laid for restoring not just the pre-conflict level of income but also the pre-conflict growth path.

The historical context provided by post-war reconstruction in West Germany and Japan after World War II suggests that large external imbalances are not unusual in the early phases of reconstruction, and do not necessarily lead to macroeconomic instability. West Germany and Japan were successful in maintaining macroeconomic stability despite large external imbalances by means of tight fiscal policies and wage restraint. The experience of these countries suggests that fiscal adjustment is also critical to macroeconomic stability in Lebanon, particularly in light of the size of recent fiscal imbalances. A top priority for macroeconomic management in the post-war Lebanese economy is clearly fiscal adjustment.

The importance of fiscal adjustment is also reinforced by a fundamental difference between the reconstruction experience after World War II and the challenge faced by Lebanon today. Capital account openness in the Lebanese economy -- together with exchange rate arrangements -- greatly limit the ability of macroeconomic managers to rely on instruments other than fiscal policy to implement reconstruction and thus increase the importance of careful fiscal management.

Finally, fiscal adjustment should focus on increasing public savings. Infrastructure needs to support the recovery of private sector investment are large; at the same time, public investment has not been excessively high. Lebanon is in a good position to attract significant private investment in infrastructure, which would then allow reduction of public capital expenditures without slowing the reconstruction effort.
REFERENCES


MENA WORKING PAPER SERIES


Copies of MENA Working Papers may be obtained from Ms. Gena Gorospe, MNAVP, Ph: 202-473-2623.