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LEBANON AND THE FINANCIAL CRISIS OF 2007

by

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AN ABSTRACT OF THE PROJECT OF

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The following paper is a country specific research of the ability of the small open developing economy – Lebanon, to weather the financial crisis that emerged in the global developed capitalized economies towards the end of 2007. After the introduction and a literature review related to peculiar features of the Lebanese economy, the paper presents the global financial crisis that emerged in financial markets and later passed on to the real side of almost all economies. A brief introduction to Arab economies later follows in the same chapter. The major issue of the paper was trying to track the path followed by the Lebanese economy. A thorough examination of almost all sectors of the Lebanese economy shows that Lebanon has been ranked among the few countries that not only have not been affected by the latest crisis, but also have upgraded their performance in almost all sectors of their economies. Some of the reasons underlying this fact are the conservative approach adopted by the Lebanese government and the banking sector trying to protect the Lebanese economy amidst the unstable political atmosphere of the country, together with a sound financial sector, and a supportive investor base. Nonetheless, Lebanon seems to have domestic situations that may be more destructive to its economy from the global crisis. The paper investigates some of the threatening characteristics of the Lebanese economy, namely the surging public debt, the vulnerable geopolitical atmosphere together with a lack of productive factors underlying economic growth. The final section presents some policy implications together with conclusive statements.
CONTENTS

ACKNOWLEDGEMENTS

ABSTRACT

GRAPHS

Chapters

I. INTRODUCTION ................................................................. 6

II. LITERATURE REVIEW ......................................................... 9

III. THE FINANCIAL CRISIS ..................................................... 23

A. Global Overview .............................................................. 23
B. Arab-World Overview ....................................................... 31
   1. General Overview .......................................................... 31
   2. Transmission channels .................................................. 33
      a. Oil Revenue ............................................................. 34
      b. Capital Markets ....................................................... 35
         i. Stock Markets ...................................................... 36
         ii. Sovereign Wealth Funds ........................................ 36
      c. Trade ................................................................. 39
      d. Foreign Direct Investment ......................................... 40
      e. Real Estate ........................................................... 43
      f. Tourism .................................................................. 45
      g. Banking sector ....................................................... 46

IV. LEBANON ........................................................................... 48
A. Historical Macroeconomic Overview............................................... 48
  1. Public Debt................................................................. 49
  2. History of Monetary Policy – Exchange Rate Stability........... 51
  3. Dollarization............................................................... 54
  4. Balance of Payment....................................................... 55
     a. Capital Inflows...................................................... 56
        i. Remittances................................................. 56
        ii. Foreign Aid.............................................. 57
        iii. Foreign Direct Investment........................... 58
  5. Tourism........................................................................... 59
  6. Financial Sector............................................................ 60
     a. Banking Sector....................................................... 60
     b. Stock Market....................................................... 64

B. Lebanon During and After the Global Financial Crisis.......... 65
  1. Banking and Financial Sectors - Monetary and Financial
     Statistics................................................................. 66
     a. Some Chosen Rates.............................................. 67
     b. Deposits............................................................. 68
     c. Foreign Reserves................................................ 70
     d. Money Supply.................................................... 71
     e. Beirut Stock Exchange ........................................ 72
  2. Public Finance and the External Sector............................ 73
     a. Government Budget............................................. 73
     b. External Sector.................................................. 74
     c. Balance of Payment............................................ 75
     d. Foreign Direct Investment................................. 76
  3. Tourism........................................................................... 77
  4. Main Economic Indicators............................................... 79

C. Why Was Lebanon Able to Weather the Crisis? ...................... 81

V. CONCLUSION AND POLICY IMPLICATIONS ......................... 88

Appendix ................................................................................. 95
  I. DATA................................................................................. 95

REFERENCES ............................................................................. 97
GRAPHS

Figures

1. The movements of some chosen rates between 2007Q1 and 2010M2…………………67

2. The increase in different types of deposits between 2007Q1 and 2010M2 ……….. 69

3. The increase in foreign reserves between 2007Q1 and 2010M2 ………………….. 71

4. Fluctuations of different measures of money supply – M1, M2, and M3 between 2007Q1 and 2010M2…………………………………………….. 72

5. Budget deficit, ratio of interest payment to total public sector revenues, and net total public debt between 2007Q1 and 2010M2………………………... 74

6. The trade balance – exports and imports between 2007Q1 and 2010M2……………75

7. Level of access to capital markets for Lebanon, FDI in absolute value and as a percentage of GDP, and remittances……………………………………77

8. Number of tourists to Lebanon (with a display of Arab and European arrivals) in 2006, 2007, 2008, and 2009………………………………………………78

9. The coincident indicator with some other indicators of overall economic activity in Lebanon between 2007Q1 and 2010M2 ……………………79
CHAPTER I

INTRODUCTION

A. Schimmelpfennig and H. Gradner have once expressed in an IMF paper that the Lebanese economy is a unique economy and has interesting lessons for other countries; nonetheless continuing their argument they say that it is unlikely that countries could, or even should try to, replicate the Lebanese experience (2008). It seems to be a sentence full of profound connotation relating to the Lebanese economy. This project will try to study the specific characteristics of the Lebanese economy in the context of the global financial crisis of 2007.

In conveying his viewpoint regarding the global financial crisis that exploded in August 2007, J. Stiglitz has said “in a world of globalization it is not just the good things that move more easily across borders, but the bad things as well. Now, America has exported its downturn to the world.” The crisis was a severe one and could have easily turned into a depression similar to the one in 1930s. Nonetheless, the excessive support from the public sector and international organizations and funds prevented that from happening. In later periods, the crisis took another nature and started to get out of solely financial markets and get through the real side of global economy. It ultimately came to remind that in a risky world regulations can only reduce the risk of financial crises and not eliminate them; according to Dilip Das, the idea that a globalized
A section in the project is devoted to a detailed examination of the nature and the unfolding of the crisis after two years of its outburst. The same section assesses the impact of the crisis on the Arab world. The Arab countries, especially the oil exporters, are highly integrated in world trade activities – mainly in the markets for natural resources. This and other transmission channels like capital markets, sovereign wealth funds, foreign direct investment and others have let the crisis pass through the Arab world and leave its impact on many of its economies.

Ultimately, the main focus of the project is followed; Lebanon – the small open Arab developing economy. Lebanon is a diversified economy, with unique political, geographical, social, and economic features. It has a large and globally dispersed Diaspora, sound banking sector, and dynamic tourism and investment atmospheres. Surprisingly, Lebanon turns out to emerge unbeaten in the context of the global financial crisis of 2007. This, of course, should not be a result of a mere coincidence.

The authors in the opening quote of the introduction were referring to their idea about Lebanon in the context of the limitations of standard models of financial crises and debt sustainability and were referring to country specific financial and institutional frameworks in studying the degree of resilience to shocks – such as the recent global financial/economic crisis. What this project has tried to reveal are the factors that let Lebanon ward off the severe impacts of the financial crisis; not only that, but also what let Lebanon improve the performance of many of its macroeconomic sectors. Other than studying the prospects of the Lebanese bullish economic performance, the
project further delves into trying to identify the factors that might threaten the future of the Lebanese economy.

The remaining of the project is organized as follows: Chapter II presents a literature review of all possibly needed concepts in the project. Some of them are related to the potential transmission channels of the crisis to the Lebanese economy, such as foreign direct investment, capital account liberalization, and remittances. Others are related to characteristic features of the Lebanese economy, like debt sustainability, monetary policy target i.e. exchange rate stabilization, dollarization, and similar concepts. Chapter III follows with two subtopics. The first is a general introduction of the financial crisis; and the second is the specific impact of the crisis on the Arab world. The next chapter, Chapter IV, is entitled Lebanon. The first part of the chapter gives a brief macroeconomic historic overview of the Lebanese economy. Then, there comes the main bulk of the project with a detailed explanation of the evolution in almost all sectors of the Lebanese economy after the onset of the crisis. Finally, Chapter V follows with policy implications and conclusion.
CHAPTER II
LITERATURE REVIEW

A. Capital Inflow

The paper entitled ‘Negative Alchemy? Corruption, Composition of Capital Flows, and Currency Crises’ talks about the relation between these three. It argues that corrupt countries tend to attract less Foreign Direct Investment (FDI) than others. The composition of foreign inflows is such that the percentage of international bank loans would be much higher than FDIs in these countries. Outside the context of foreign investment, this paper further studies corruption and concludes that a corrupt atmosphere will lead to a domestic currency crisis or a financial crisis resulting from the corrupt nature of the financial and banking sector (2001).

According to the trade theory approach, foreign capital flows, whether in the form of direct investment or portfolio capital, will be in the benefit of the host country; this is because these flows will increase tax revenues (especially if they are not attracted because of a low-tax system), and will have direct effects on employment, factor rewards, and capital flows (MacDougall, 1960). Another approach to foreign investment has been the industrial organization approach; this distinguishes between positive and negative effects of foreign investment and its diversified effects on LDCs (Least Developed Countries) and developed countries. According to the latter, emergence of foreign corporations to less developed economies will result in the transfer and diffusion of technology and knowledge, and will have a
positive impact on the structure of the industry and the creation of an atmosphere of competition (Hymer, 1960; Blomstrom, Kokko, 1997).

Furthermore, if privatization in developing countries is conducted with the aid of foreign investors, then according to F. Sader (1995) this will further boost Foreign Direct Investment (FDI) inflows. In his paper ‘Privatizing Public Enterprises and Foreign Investment in Developing Countries, 1988-93’, he has empirically found out the interesting result that every $1 invested in infrastructure privatization will induce additional $2.4 of capital inflows.

Foreign Direct Investment (FDI) dates back to centuries ago, where European colonies invested their wealth in Latin American countries. Later and for a long period of time, there has been a counter-flow to FDI and countries started to go back to inward looking politics. During the past few decades, and going with the flow of globalization, countries have realized the importance of openness to the outside world. FDI inflows have been increasing in the period of 2003-2007 especially to countries with cheap labor and lenient investment laws and tax regulations.

After the crisis, economies are inspecting inwards again to be able to protect what’s left for their economies to survive (Dilip Das, 2010). According to MGI (McKinsey Global Institute) 2009, there was an 82% decrease in cross border deposits and lending, FDI flows, and sale of foreign equities and debt securities worldwide. The decrease was mainly in industrial economies; while foreign investment increased largely in China and India in the period following the crisis since investing there seemed the most rational. However, these inflows might further decrease in case the recovery from recession in industrial countries is slow; this is because the recession
there will result in a decrease in demand for what’s produced in the developing economies and their investment there (Dilip Das, 2010). Nonetheless, despite this decreasing trend of capital flows in world economies lately, there is a general view that this trend is a temporary one and that capital flows will later catch up with the state they were in before the crisis; this is attributed to the accepted view of the immense profitability of capital flows in world economic trade, cooperation and integration.

G. K. Helleiner, in the paper entitled ‘Capital Account Regimes and the Developing Countries’ (1998), has tackled the impact of surging capital inflows on an economy in two different scenarios: one with fixed exchange rate and one with flexible exchange rate regime. Central banks of developing countries that try to maintain stable exchange rates will experience an expansion of their monetary base as a result of private capital inflows. This is because of the increase in foreign currency reserves. In this case of stable exchange rate system, real appreciations of the currency and overheating of the domestic economies can be prevented either by the central bank sterilizing domestic monetary consequences or by tightened fiscal regimes. The latter has been proven to be less practical in the sense that in most instances it has been difficult to use fiscal policies as short-run responses and that it would worsen the problem of unsustainable inflows if confidence in economic policy grows strongly. The paper also adds that most countries that have been experiencing monetary and exchange rate pressures from private capital inflows have later experienced fiscal surpluses or at least balance (like Chile, Republic of Korea, and others); and that fiscal tightening is particularly appropriate for countries with large fiscal deficits. Nonetheless, the more frequently used response to surging capital inflows in fixed
exchange rate regimes is the central bank’s sterilization of domestic monetary consequences through open market operations in issuing or exchanging government or other securities; or through increased reserve requirements, or through the redeployment of government deposits from commercial banks to the central bank. Private capital inflows would lower interest rates in the first place; tightened monetary policy may lead to increased interest rates which may further induce more capital inflows. The increasing spread between the high interest rates on domestic liabilities and relatively lower ones on earnings of foreign currency might lead to quasi-fiscal losses for the central bank. In cases where domestic prices inflate under stable exchange rates or in cases of fragile and weakly supervised financial institutions with no central bank sterilization, real exchange rate will appreciate as a consequence of large capital inflows and will deteriorate the current account of the balance of payment, ultimately reversing the inflow of capitals. The latter is very similar to a surge in capital inflows to flexible exchange rate systems. A last remark can be made concerning weak financial institutions and banking system, whereby huge capital inflows may ultimately develop into a bubble or a crisis.

S. Nsouli and M. Rached have investigated about capital account liberalization in the southern Mediterranean economies (1998). Capital account liberalization is defined to be the access of residents or non-residents to total convertibility permit of the country’s currency to foreign currencies under the prevailing exchange rate; and their use for international transactions. This liberalization process will render allocation of savings more efficient and will increase the country’s attractiveness to foreign investors. Lebanon, among the Mediterranean countries, enjoys one of the highest capital inflows. Nonetheless, the risk of sudden reversals has brought
forth debate on capital mobility especially after the East Asian crisis; it necessitates its achievement in a strong macroeconomic stance, with sound institutions and an orderly sequencing of reforms, to maximize the benefits of capital account liberalization and minimize its risks.

In another IMF paper about interest rate determination in Lebanon issued in 2006, T. Poddar, M. Goswani, J. Sole, and V. Icaza talk about the effect of capital mobility on interest rates. They argue that in an environment where capital is highly mobile, domestic interest rates would be highly affected by international financial conditions and linked to international benchmark rates frequently used in financial contracts (like LIBOR or US T-bill rates). The paper also discusses some effects of liquidity on interest rates; this might not be directly related to capital inflows but may be suitable to mention for purposes related to the flow of this paper. The authors extract from theoretical literature that increases in liquidity for a particular country’s assets, arising from factors like relatively cheap available global credit, or increased risk in other foreign markets, or changes in risk appetites of international investors, would lead to higher asset prices; an example would be - higher demand for Lebanese deposits would lower the rate of return on deposits. Therefore, changes in liquidity conditions, i.e. desired holdings of a country’s assets, would lead to changes in Central Bank interest rate policies. And finally, in another context, they have mentioned the prevailing risks in the Lebanese financial market being the high level of public debt risk and that of a forced exit from the exchange rate peg.
B. Remittances

Remittances are a major characteristic of the Lebanese economy; and therefore the following part will be devoted to a review of their literature.

Emigration of highly skilled workers is a great loss for a country. The loss can partially be offset by the remittances the emigrated compatriots send. And moreover, even if leaving residents are unskilled workers escaping unemployment, the remittances will be a net gain for the developing country. Remittances have a great potential if invested effectively. It is really difficult to track where the remittances go and what purpose are they used for. Remittances have been a major source of income to many societies; there exist economies which rely on them even more than FDI. It has been shown that if restrictive licensing of money transfers and other impediments don’t obstruct their ways, remittances can have great contributions to domestic GDP of the receiving country especially that they are not related to domestic situations and therefore can be more stable than FDI, foreign lending, or capital market flows.

Munzele and Ratha argue that low-income countries that are risky (i.e. that have high debt to GDP ratio) attract more remittances than others; and that these inflows increase the inequality gap between rural and urban areas because they will mainly be invested in real estate and enterprises in the urban areas.

In the econometric results of the paper ‘Remittances: Development Impact and Future Prospects’ by the above mentioned authors, it has been clear that the marginal propensity to save for income from remittances was higher than that for rental and domestic income. So, in addition to increasing a country’s income, remittances increase investment and savings.
Dilip Ratha argues that emigrants send money home even when they are not in a good financial situation. This is especially true when the amounts sent are a small percentage of their income. But when the migrants leave their work and return home in large numbers (in the context where the author argues about the consequences of the global crisis of 2007), then there may be a risk of a sudden fall in remittances (the *Economist*, February 2009). He has argued that the initial short-term rise in remittances right after the crisis in some countries may be due to the savings of the returning migrants; after which their return home will thoroughly cut these inflows.

R. Adams, A. Cuecuecha, and J. Page, in their paper (2008) about the African region, have mentioned the three views in literature about how remittances are spent and their impact on economic development. The first view states that they are spent like income from any other source; and this implies that the contribution of remittances to development will be the same as that from any other source of income. The second view argues that remittances may affect negatively on development by changing the behavior of households towards their expenditure. Chami, Fullenkamp and Jahjah (2003) categorize these behaviors into status-oriented consumption, i.e. saving of a small proportion of these incomes and spending the rest on non-productive investments like in housing, land, or jewelry. And the third is a more recent positive view of expenditure of remittances oriented towards more productive areas.

C. Monetary Policy

Another useful part to deal with in the literature review would be a general overview of monetary policies and some of the historical views about the targets used for them. The quantity
theory of money that dates back to 1700s remains the leading explanation of how the quantity of money affects other variables in the economy in the long run. This theory says that, if velocity of money is assumed to be fixed, then the amount of money available in an economy which is controlled by the central bank determines the level of nominal value of the output of that economy \((\text{Price (P) } \times \text{Income (Y)})\). The same theory also implies that growth in the money supply by the central bank causes inflation (assuming fixed output).

1. Interest Rates

Interest rates are one of the most important macroeconomic variables; in essence they are the prices that link the present to the future (Mankiw). If people expect higher inflation in the future, then today’s prices will be higher; this is because the increase in expected inflation will lead to a higher nominal interest rate today, which in turn will lead to a lower demand for real money balances and therefore higher prices (assuming money supply is still fixed). It is worthwhile to mention that the relation between monetary policy and nominal interest rates is different in the short-run and the long-run; for example, a tightening monetary policy will lead to higher interest rates in the short-run (where prices are sticky) by the liquidity preference theory-where interest rates are viewed as the price of money; but it will lower nominal interest rates in the long run due to the Fisher effect (because of lowered inflation).

Monetary policy is conducted accordingly: the Central Bank chooses a specific target interest rate. Later the bond traders undergo the necessary open market operations to achieve the specified target. According to Mankiw, the reasons Central Banks target interest rates rather than
money supply are first, the fact that shocks to money market are more frequent than shocks to the real economy; second, interest rates are easier to measure with more accuracy than money supply which has different measures.

2. Exchange Rate Targets

Small open economies have a characteristic that commits monetary policy only to keeping the exchange rate fixed at a specified level; while an expansionary fiscal policy raises aggregate income. In most exceptional cases, such economies can conduct monetary policies by changing the level of the fixed exchange rate: devaluation or revaluation. In cases of recessions or depressions, devaluation will lower the value of the currency, raise money supply, stimulate export and therefore expand production (what happened in most countries after the Great Depression of the 1930s and in Hong Kong lately).

After the Asian crisis (1997-1998) there has been a strong argument in favor of flexible exchange rate regimes because fixed exchange rates turned out to encourage speculative capital inflows, moral hazard, and overinvestment (Fischer 2001). But later, and after the growing role of Euro, exchange rate stability has been proved to be favoring growth (Schnabl, 2007). According to him, the lower transaction costs in fixed exchange rate systems will be in favor of international trade and capital flows together with macroeconomic stability. Also the low volatility of exchange rates will create a favorable environment for further consumption and investment, and ultimately for growth; this can be further emphasized if most of the domestically consumed goods are traded ones (McKinnon 1963). Nonetheless, the conclusion of Schnabel’s
paper remains unclear in regard to whether the relation between exchange rate volatility and growth is a linear one; because it might be that the increase in capital flows will lead to a fall in interest rates and this might lead to asset price bubbles and overinvestment. Then the magnitudes of these effects will decide whether growth is positive or negative.

In 1998, this date seeming to be remarkable in the sense that Lebanon has incorporated the peg of the Lebanese Pound to the US Dollar, G. Sterne of the Bank of England’s Centre for Central Banking Studies, has done an empirical analysis trying to explain the use of explicit targets for monetary policy. He has performed this by gathering practical experiences of 91 economies in the 1990s and has found out interesting information about an evolutionary process being undertaken by choices of targets for monetary policies. One of these results is that in 76% of the countries with exchange rate targets the government had a role in setting the target; others include that during the period of the study the number of countries with explicit exchange rate targets increased from 30 to 47, the increase in explicit money targets had similar results, while those with explicit inflation targets had the most startling result – a seven-fold increase. Another striking result was that many countries used more than one explicit target and that missing a target was acceptable to many of them because of the fact that these targets were sometimes set to reach certain goals and if those goals were achieved then missing the target was not a big deal. With reference to exchange rate targeting the author has stated that exchange rate pegs implied constraints on credit expansion; but targeting exchange rates, even though most of the times have ended in currency crises, have often lowered inflation expectations (Crockett 1999) and have rendered them low and stable for a remarkable period of time especially in developing countries.
Finally, the author has concluded that in the majority of instances, exchange rate pegs have engendered fiscal and monetary disciplines.

In a later period, S. Neaime has studied inflation targeting versus exchange rate targeting in the MENA region (2008). In his paper he also has tapped the concept of generalization of inflation targeting regimes lately in the majority of developing countries. He has further argued that the MENA economies still need to undergo fundamental reforms to target inflation; some of these reforms include allowing exchange rates to float and incorporating more transparent systems to smooth short-run exchange rate fluctuations. Neaime mentioned that the exchange rate targeting regime adopted in most of these countries has led to weather inflationary pressures in the initial period; but fixing exchange rates has rendered monetary policies ineffective and escorted towards persistent real exchange rate appreciations, formation of sizeable debts, limitation of the role of exchange rates in balancing external competitiveness gaps, and ultimately to currency crises in many of the MENA economies. Nonetheless, in cases of huge indebtedness like Lebanon, he suggests that exchange rate targeting proves optimal especially in averting possible currency and debt crises by keeping the debt service under control.

D. Dollarization

Lebanon, being a highly dollarized economy, deserves a background discussion about dollarization in the literature part. A. Papazian (2006) has thoroughly studied the political economy of dollarization in Lebanon. In the theoretical literature review of his paper, Papazian has collected the views of advocates and critics of dollarization – the unrestricted and authorized
use of a foreign currency together with the local currency. Supporters of dollarization see it as a
better alternative to macroeconomic mismanagement and wealth-destroying policies by central
banks. While some of its critiques try to defend the heavy costs accompanied by the loss of
seignorage revenue followed from a loss of local currency effectiveness, loss of independent
monetary policy, central bank’s loss of its role as a lender of last resort, higher chances of
exposure of domestic currency and even domestic economy to shocks experienced by the anchor
currency, and no guarantee of success given that dollarization strategy is a relatively recent
movement with no historical records of successes or failures. The author further assesses the
relation of dollarization with a fixed exchange rate regime, and criticizes that type of regime for a
small open economy like Lebanon.

G. K. Helleiner, in the paper mentioned above, further discusses the impact of
dollarization on capital account liberalization. Included in the reforms of developing countries,
permission of foreign-currency denominated financial transactions (bank deposits and loans) and
authorization for residents to hold foreign currency deposits and for domestic financial
institutions to do local businesses in foreign currencies will create profound implications for
macroeconomic mismanagement. There might be no such problem as long as there is no doubt
about the value of the domestic currency as it is the case with a pegged currency. The author
notes that the need for an external lender of last resort in domestically dollarized systems has
frequently been noted.
E. Debt and Currency Crises

Possible crises Lebanon can be subject to are a debt crisis or a currency or an exchange rate crisis. The last part of the literature review will be dedicated to some overview.

In theory, debt sustainability is often defined by the government’s ability to pursue its fiscal position into the future without threatening solvency. Despite the fact that Reinhart, Rogoff, and Savastano (2003) and Manasse, Roubini, and Schimmelpfennig (2005) have attempted to identify empirical approximate thresholds beyond which countries are prone to suffer debt crises and because of the absence of concrete debt sustainability thresholds, J. Di Giovanni and E. Gardner have informed in their IMF publication entitled ‘A Simple Stochastic Approach to Debt Sustainability Applied to Lebanon’ (2008) that the IMF has decided to look at debt dynamics in order to measure sustainability. Under this approach, debt is considered sustainable as long as debt-to-GDP ratio is held stable or decreasing. Celasun, Debrun, and Ostry (2006) laid down some shortcomings of this method; one of them is the dependence of debt dynamics on macroeconomic conditions beyond the control of the government like GDP growth, interest rate, and exchange rate. Another shortcoming is that, even if the level of debt is declining, the high level of debt and its rollover create a risk that liquidity (or other) shocks may turn into a debt crisis. This same paper says that liquidity shocks faced by Lebanon have been possible to absorb till now by the international reserve buffer.

Paul Krugman (2000) has tried to gather and organize information about currency crises. He says that an informal definition of a currency crisis is what follows the depletion of foreign reserves in a country. Another definition that views currency crises away from reserve-depletion
consequences is brought about by Eichengreen, Rose, Wyplosz; it explains these crises as a result of macroeconomic policy. An example of this could be when an economy has pegged its currency to a foreign one and suddenly realized the cost of holding the peg (like an increase in interest rates) is more than the cost to forgo the peg. And, if suddenly and as a result, the government decides to actually leave the peg and let the currency float, then this will create a loss of confidence of the people in the government’s willingness and ability to preserve the peg; this scenario will ultimately lead to a currency crisis. Nonetheless, Krugman argues that there is no official definition of it. Every time a new currency crisis happened unexpectedly, as in Latin America, East Asia, Europe, and elsewhere, new concepts about its occurrence became revealed.

The literature review section involved a wide variety of economic concepts that might not necessarily directly relate to the ongoing global financial crisis, but given the somehow unique nature of the Lebanese economy seem to be essential in understanding the impact of the crisis on it.
CHAPTER III

THE FINANCIAL CRISIS

A. Global Overview

The financial crisis of 2007 started in the US by the housing bubble of August 2007; and was later intensified by that of UK. It was a result of mismanagement and corruptive steps taken to enlarge economic and financial gains. Callebro described it as the complex interrelations between the global payment imbalances and the demand for and manufacturing of safe (or seemingly safe) financial assets (Pisani-Ferry and Santos, 2009). Before the crisis, there have been many who supported the view of complete dependence on the ability of the market to adjust itself, which later proved to be a wrong assumption to rely on; and led to a journey back to Keynesian economics. Risks were underpriced; this led to mispricing of assets in the financial markets. Dilip Das put it this way: “financial turmoil can occur in any economy, regardless of the fact whether it is small or large, whether it is developing, emerging or developed, whether it is macro-economically well managed and disciplined, or poorly managed” (2010). At the beginning, it was difficult to understand the nature of the crisis; attention was given to supervision and regulation of financial institutions and little importance was given to important global macroeconomic consequences of the crisis.

In studying the relation between financial and economic variables in cases of recessions, Claessens et al (2008) concluded that according to observations between 1960 and 2007, contractions in domestic credit and a decline in asset prices lead to recessions; and that those
resulted from credit crunches and housing price busts are more severe than others. This was exactly what happened in the recent crisis – financial institutions stopped lending for security reasons, credit dried up in the market, and this had its direct adverse effect on the real economy. Another indirect loss, according to Reinhart and Rogoff (2009b), of the current crisis is the explosion of budget deficits and real values of government debts.

The message that the world economy was at the verge of entering into a recession like that of the 1930s was repeatedly heard during the year following the crisis. Ch. Harman (2009) has done a comparative analysis of the slump of the 1930 and the crisis today. According to his views, some of the similarities between the depression then and what is happening now since end-2007 are the following: both had a nature of a world crisis due to the internationalization of finance in the years preceding both crises – US lending to war-torn Europe in the 1920s and East Asian and oil states lending to the US in the early 2000s; in both cases the gap between saving and investment was filled with unproductive investment and speculative spending of different forms. Nonetheless, there were significant differences between 1930s and the present crisis: contrary to the present crisis, that of 1930 did not begin by a credit crunch but later experienced that; the present crisis saw a crisis of many of the biggest banks and the problem of bailing them out was proportionately larger due to the recent scale of their operation globally; and the fact that state expenditures are attracted by such a large importance implies the possible existence of a floor base level below which world economy will not surge – ultimately keeping it away from a slump similar to that of 1930s. Probably the latter is what led Paul Krugman to declare after around two years from the onset of the crisis that: “we are not going to have a second Great
Depression after all” (August 2009). According to Bernanke this was because of the rapid responsive moves of governments and central banks in taking economies out of their frozen states in the aftermath of the global financial and economic crisis; whereby central banks tried to bring market liquidity back by decreasing interest rates. The role played by IMF was also significant; its role has been reactivated by decisions made in G20 meetings. What the G-20 was trying to do in emergency meetings right after the onset of the crisis or in consequent meetings, was to try to preserve the global economy from undermining globalization and entering into far worse recessionary periods. They were especially trying to prevent emerging and developing economies from entering into further recessions arising from drying-up of capital inflows, and were encouraging accumulation of foreign exchange reserves. G-20, focusing on global trade and macroeconomic and international financial institution problems, tried to preserve trade integration, avoid exchange rate policies that adversely affected external trade, and build confidence in multilateral insurance rather than self-insurance. And ultimately they planned to include more representatives of global economies – mainly emerging and developing to the group, rather than relying on a huge number of European and US representation; thus giving the G-20 a more representative nature for current realities (Pisani-Ferry and Santos, 2009; Stiglitz, 2009). After the G-20 meeting in April 2, the Global Insight economist of the Financial Times business daily Jan Radolph said that the weakest point of the G20 communiqué was that it didn’t find a solution to clean banks of toxic assets and restore a healthy banking system (Monday Morning (MM), April 13 2009). The meeting has given the IMF a role more than a lender of last
resort, or a forecaster, or an economic policymaker; the IMF now came forth as a primary liquidity provider amidst the global financial and economic turmoil.

The financial crisis has challenged the new framework of bank regulations – Basel II; and for Stiglitz it has even failed financial market regulators, at both national and international levels. Recent folding of events raised serious concerns of the ability of banks to manage their own risks. Significantly, the emergence of the crisis as a sub-prime lending problem and its later spread to other securities has shown that there was improper documentation that cut the link of adequate information between sources of risks and their bearers (Demirgüç-Kunt and Servén, 2009).

Governments in developing countries, whose financial markets were the first to get affected, rushed to provide rescue funds to support their economies. Despite the $700 billion bailout of the US congress in October 2008, US economy experienced the worst economic conditions with a record number of unemployment and growth drawbacks since 1945. The same scenario appeared in different developing countries with differing magnitudes. With billions of dollars invested, this is equivalent to roughly state ownership of more than a quarter of the industry’s market value which strongly contrasts with the ideology of western capitalist systems (The Economist, November 22 2008). Countries could have shielded themselves from being severely exposed to the crisis if they had limited exposure to instruments that were the main sources of crisis transmission in the initial period. The transmission channels - especially to developing countries, of the effects of the crisis, amplified by globalization, can be categorized as foreign direct investment and capital flows, remittances, official aid flows, and most importantly
world trade; the latter can be further discussed in the sense that it started by a fall in demand in industrialized countries and was later expressed as a collapse of the exports in developing countries. Through this channel, the crisis was even passed through the global growth motor countries – Asian emerging market economies. The pillars behind globalization – namely, private companies, globally integrated companies, global supply chains, and open markets, were affected by the crisis. First, there was the view that world economies were decoupling – that is the financial credit crunch and similar problems were unique to the US and the European economies. Nonetheless, according to an IMF Finance and Development report in 2009, the sudden drop in capital flows, shocks to foreign exchange reserves, and international trade were channels through which countries that were not directly involved in international capital market integration were affected by the crisis – the remark was mainly for Central and Eastern European and many other Asian countries. Growth in these developing countries averaged 7.8% in 2006-2007. This was reversed afterwards leading to the contraction of their economies.

The result of the reduced growth, freezing credits, and increasing unemployment was increasing uncertainty and large volatility of exchange rates, consumer demands and commodity prices. Uncertainty has proved to be very costly to both consumers and producers in any economy. Recapitalizations and funding guarantees together with decreased interest rates were being held in place as a response to increased uncertainties. Honohan and Klingebiel argue that differing fiscal costs in crises depend on the ways governments handle liquidity crises; the highest costs are for those who provide unlimited liquidity support and blanket deposit guarantees (Demirgüç-Kunt and Servén, 2009). The same paper further argues that an important challenge is to
convince creditors and depositors that authorities of the country have the will and the ability to guarantee support. But the authors move forward to say that not all countries have the ability to provide the needed fiscal support to their economies. And the governments that provide help to their economies seemingly know that they are temporarily participating in reactive process to distorted market conditions and are managing a systemic crisis to re-establish confidence in the short run and contain moral hazard in the long run (Demirgüç-Kunt and Servén, 2009).

The worst phase of the global financial and economic crisis to date has been the period extending between the end of 2008 and the beginning of 2009. The size of the contraction of the world economy and the rate of unemployment had both reached post-WWII record highs. Equity markets were hit and there was a significant decline in equity and real estate prices. Countries that relied on trade as a major income had a hard time; to finance their expenditures they either borrowed or relied on their reserves. This negatively affected domestic consumption.

Most severely affected economies were the US, European economies, Japan; at a lower degree were the EMEs of Latin America and Asia. The latter saw a high pace of recovery being followers of China. A report of Organization for Economic Co-operation and Development (OECD) in 2009 claimed that China led the world recovery process. A large fiscal stimulus package in infrastructure projects, monetary expansion, and an increased domestic demand were the major pillars of the Chinese rapid recovery. In May 2009, ten member countries of the Association of the Southeast Asian Nations (ASEAN), together with China, Japan, and South Korea announced the accord of setting up a $120 billion emergency currency pool to boost liquidity, to help the region overcome the global crisis, and to rebalance growth in Asia from
excessive dependence on the external sector, and to create a greater resilience on both consumption and investment (MM, May 11 2009).

What regards to the United States, Dollar needs to further weaken to reduce current account deficits; for the first time since WWII dominance of the dollar is facing a serious challenge (Dilip Das, 2010). Towards the end of 2009, gold – a major jewelry and investment metal, has been supported by the weakening dollar, inflationary fears, and increasing moves from central banks (particularly Asian ones) to diversify their assets; it has hit record high values. India bought 200 tons of gold from the IMF for $6.7 billion changing the composition of its reserves (MM, December 7 2009). An example of fears of weakening dollar is the setting forth of GCC countries, France, China, Japan, and Russia the question of substituting the dollar by a basket of currencies in conducting oil deals. According to Stiglitz, ‘the dollar-based global reserve system is already fraying – the dollar has proven not to be a good store of value… We need a global reserve system, for a global financial system’.

In Europe, almost all economies were back on the recovery track during the 3rd Quarter of 2009 except Spain and Greece which didn’t do well in normalizing themselves. Euro has appreciated in the period following the crisis; while China’s Wen was trying to maintain its value. This situation has created fears for Europe for its exports to China thus hurting European economic recovery. Stiglitz explains this as an outcome of uncoordinated macroeconomic policies. When European central bank refused to lower interest rates in early 2009, following from the fear of inflation, at a time when American central bank did, a stronger Euro was created and made American GDP look better than the European.
In 2009 OECD warned that world indebtedness would rise to around 100% of GDP by 2010 doubling this percentage from 20 years ago. And if financial markets doubt the abilities of countries to pay their debts then they will deprive them from liquidity by steering clear of official debt instruments. According to Michel Algietta of Ceppi research, this would lead governments to raise interest rates and trigger debt explosion which creates a new wave of recession (MM, December 7 2009).

A United Nations report said that world economy is projected to bounce back to around a 2.4% growth but could enter another recession if state stimulus spending is wound up too early (MM, February 15 2010). This report further warned that world economic recovery is fragile with increasing unemployment rates and weak consumer demand and investment; and it cautioned from the possible still-existent problems in the global financial system as the rebound in equity prices were stronger than expected.

A striking feature in world economy in the dawn of 2010 has been the swelling public debts of Greece, Portugal and Spain – the most serious being that of Greece, getting the euro zone into the most severe crisis in its 11 year life (MM, February 15 2010). The report says that there has been created a vicious financial cycle in Europe, whereby growing debt and deficits are rendering it harder to borrow money to stay afloat. According to the economist Patrick Artus, there exists the risk of ‘free loader’ effect through which other countries are forced to present aid to an ailing euro zone member to prevent default risk of the zone as a whole. In the beginning of 2010, euro zone finance ministers met in Brussels to protect their under-threat currency, support Greece and
prevent contagion throughout the rest of the European member countries (MM, February 22 2010).

B. Arab-World Overview

1. General Overview

The Arab world (sometimes very similar to the Middle East and North Africa (MENA) and/ or the Economic and Social Commission for Western Asia (ESCWA) regions; and thus used interchangeably in the pr) can’t be taken as one integrated homogenous piece of land. Many are the diversities among its member countries: economic, social, political, and dialectical, to mention a few. The two large economic groups in the Arab world are the oil-exporters and the diversified economies. The Arab World entered the first-round effect of the crisis towards the end of 2008 when liquidity constraints were felt in Arab countries that had direct relations to international money and capital markets. Later, in 2009 World Bank described the reaction to the financial crisis in the Arab world as being categorized into four different levels. First, there were the oil-rich Gulf Cooperation Council (GCC) countries which welcomed the crisis with high budgetary surpluses due to the surging oil prices during the few years preceding the crisis. Except Qatar, the others underwent declines in GDP. The harshest was in Dubai where the financial crisis was followed by a housing bubble and a decline in commodity prices. This created uncertainty, distressed the confidence of domestic and foreign investors, increased the cost of input factors; and therefore negatively affected on domestic investment and FDI inflows, and reduced competitiveness in global markets (ESCWA, 2008). Some of these effects on
consumption and domestic demand were mitigated by the normalizing effects of a growing population. The authorities of these countries were among the first who intervened to support their banking sectors and stock markets by easing monetary policy, injecting funds whenever necessary, and by securing liabilities of the banks. The second group was composed of other non-GCC oil countries like Algeria, Iraq, Libya, and Syria, who had lower GDP per capita because of their large population. These had a harder time during oil price declines. Nevertheless they observed a lower magnitude of decline in economic growth. The third group was a group of non-oil exporting Arab countries that were somehow tied to GCC countries in terms of remittances, tourism, or FDI and relied on foreign aid. These were affected to a lesser extent and they mainly felt the echoes of the global turmoil after the world and GCC countries were economically hit by the crisis. Examples of these countries include Jordan and Lebanon. A final group would be formed of those countries in North Africa (Morocco, Egypt, Tunisia) with strong tourism and trade links with Europe and OECD. This group was the first among all Arab countries to get affected from export and tourism sectors. Governments relied on borrowing to mitigate the effect of the struck.

What trade liberalization has achieved during the past two decades has been shaken by the global financial crisis, which later emerged as real economic crisis as it hit the real market after the financial markets. Countries have been directing themselves towards protectionist policies holding back trade and capital flows. The financial crisis started in a period where most of the Arab world was experiencing economic and financial growth, even though the growth levels observed in this part of the world - which could be categorized as a developing region, were
much lower than those observed in other emerging economies in the years preceding the global financial crisis.

The Arab share of world GDP is much lower than the Arab share of world trade, international tourism, or oil and gas production. It is important to further mention that the Arab share of international trade is very highly correlated to developments in the world oil market.

After around a year from the onset of the global financial crisis in August 2007, as had happened in most world economies, Arab countries too directed their intentions inwards, accelerating the return of a portion of Arab capital invested abroad and focusing on Arab regional integration. In one of its reports, Economic and Social Commission for Western Asia (ESCWA) divides regional integration into intraregional trade, intraregional tourism, intraregional investment, and intraregional migrant workers’ remittances. The same report informed that Jordan, Lebanon and Syria occupied the first three places of regional integration respectively. Arab intraregional trade as a share of GDP has doubled between 2000 and 2007; but the growth has been mainly observed in non-oil Arab countries.

2. Transmission Channels

The remaining of this section is going to further delve into the most notable channels through which the global financial crisis has passed to the Arab world – namely oil revenues, trade, FDI and other capital flows, capital market fluctuations, banking sector and tourism. It will
be clear that the mostly affected countries are the ones that were enjoying the largest share of the economic gains right before the crisis.

a. Oil Revenue

For the oil exporting Arab countries, guided by the GCC countries together with Algeria, Libya and Sudan, the fluctuations in oil prices has had a harsh effect on their economies. For the past few decades these have been rentier states relying on the revenues from their natural resources as the chief contributor to their GDPs; and only recently some of these countries have tried to partly diversify their economies to a certain small extent. Starting from around $29/barrel in 2003, oil prices increased significantly to reach a peak of $147/barrel in July 2008. This had allowed the oil-exporting countries to accumulate huge deposits and reserves and made them face the 2007 global crisis in a stronger background. But, of course, this does not mean that these oil exporting Arab countries were not affected by the crisis; it can be said that their economies are the ones affected the most among the Arab countries. The oil price shock following the global financial/economic crisis was not the first of its kind; the average annual oil price change in the period 1970-2005 was 27% (IMF, 2007). Nonetheless, it was unique in the sense that the surge of oil prices that preceded the shock was the longest and the strongest in the 20th century; and therefore the sudden decline following the upsurge harshly affected external trade terms, consumption, investment and employment.

The sharp decline in global oil prices to as low as $35/barrel towards the end of 2008 was a result of the decline in world oil demand, and even though it changed track in 2009 after some
measures have been taken to stabilize the world economy and put it back on a more secure track, this plummet severely reduced a major source of income in the oil-exporting Arab countries. In addition to this, OPEC member countries were forced to limit production to 4.2 million barrels/day. Global Finance House argues that the aforementioned resulted in a significant loss in the region’s export income, trade surplus, current account and fiscal surpluses which already started and will continue to ultimately affect the region’s capital investment and growth.

On the other hand, Arab oil-importing countries benefitted from the decline in oil prices decreasing import bills. The World Economic Situation and Prospects 2010 forecasts that if the price of oil rebounded to around $80/barrel, the trade surpluses of oil-exporting countries will increase conveying optimism, while non-oil-exporting countries will witness higher trade deficits.

b. Capital Markets

According to the World Bank acting chief economist in the MENA region Auguste Tano Kouamé, capital markets that have passed from a stage of bank dominance to stock market emergence in the region as a whole are small in their size and role compared to other developing regions (2008). He adds that MENA, as a whole, was weakly integrated in international financial markets; and stresses that capital markets mainly suffered from domestic economic slowdown in the region. Banking and financial sectors were affected by feedbacks from real economic, trade, tourism, or real estate sectors. In this context, Kouamé mentions the role of the Arab Sovereign Wealth Funds (SWFs) as the global crisis hit the region. He says that despite incurring losses on
their equity investments in international banks, Arab SWFs are likely to play an important role in expanding investment in the MENA region, and boosting the regional economic atmosphere; and further gain an opportunity to strengthen their relative position as international investors.

Sovereign wealth funds in the GCC have had a major role in organizing self-adjustment processes and in emerging as major suppliers of oil and investors of their returns in the world economy (The Economist, July 2009).

i. **Stock Markets**

According to the Arab monetary Fund (2009), Arab stock markets fell by around 50% in 2008 considering it to be one of the worst performances in the world. That year, Arab stock markets recorded their lowest value since 2004. The reasons underlying the bad performance in the Arab stock markets are primarily foreign sell-offs and panic among small investors as a result of the global crisis. Investors tried to shift to higher quality assets like government bonds. Among the Arab stock exchanges, those of GCC were hit hardest despite the measures taken by the authorities to support the local financial sector. Capitalization, share values and volumes, and even the number of listed companies all witnessed declines of different degrees.

![Regional market share of sovereign wealth funds at the end of 2008](image)


ii. **Sovereign Wealth Funds**

At the onset of the global financial crisis and following that period, Arab Sovereign Wealth
Funds (SWF) had played a major role in Arab countries, specifically in the resource rich ones in which they are primarily established. As it is obvious in the adjacent figure, Middle East had 45% of the regional market share of SWFs at the end of 2008. When the crisis was felt in the GCC countries, SWFs directed towards injecting liquidity and supporting their local economies.

Sovereign Wealth Funds are the long term counterparts of foreign reserves that are for short-term liquidity and safety guarantees, and of stabilization funds that are for medium-term macroeconomic objectives (Truman 2007). The Sovereign Wealth Fund Institute defines a SWF as ‘a state-owned investment fund composed of financial assets such as bonds, real estate, or other financial instruments funded by foreign exchange assets’. Their growing importance in international finance implies that wealth is being redistributed from developed to developing countries and from private to public sector (Truman, 2008). In Arab resource rich countries, SWFs are for achieving long-term returns on oil revenues as saving funds for future generations (Behrendt, 2008). Arab SWFs are located mainly in GCC countries and other commodity exporting countries like Algeria and Libya – the larger ones concentrated in GCC. Arab SWFs can be categorized as large and well-established funds functioning mainly as portfolio investors like Abu Dhabi Investment Authority (ADIA) which is the biggest SWF in the world in terms of the size of its foreign portfolio and Kuwait Investment Authority (KIA); and smaller more active ones that are more integrated in forming alliances and partnerships throughout and outside the Arab world in energy, real estate, infrastructure and services sectors like the Qatar Investment Authority (QIA). Saudi Arabian Monetary Agency (SAMA) is also considered to be a large SWF and a central bank at the same time. From the little available data about the composition of the
Arab SWFs, it can be concluded that the currency composition is mainly denominated by the US Dollar; while asset allocations mainly in smaller SWFs are largely in public and sizeable real estate companies. Sester and Ziemba report that SWFs have stated plans to increase their investments in emerging markets in Asia, which promise to have flourishing earning prospects amid the medium term global economic conditions (2007). Similarly, according to Sturm et al. (2008), even though the US market remains the main destination of funds from GCC countries, their interests in Asian markets are increasing; and moreover, many SWFs have recently directed towards diversification of their portfolios towards private equity, real estate and other high yielding products. This diversification processes and the high export revenues in recent years preceding the crisis have mitigated the losses of the subprime crisis on the Arab SWFs in the short term. However, as suggested in an ESCWA report, it is unlikely that SWFs will massively direct their funds towards local commercial bank deposits retrieving from the US market because of the fact that, among other reasons, the majority of the GCC countries have pegged their currencies to the US Dollar and an action like that might affect their own currencies (Sturm et al, 2008). As long term implications following the crisis, there had been arguments that the nature, composition, and the ownership structure of SWFs has led to a destabilization of the financial system due to the argument that political considerations might have outweighed purely economic ones. As governments recently are responding to international calls for regulatory frameworks – like that of ADIA in March 2008, there seems to be an intention towards further diversification plans and direction towards regional investments mainly in the real economy or investments in other developing regions.
c. Trade

The Arab world is a region that highly relies on trade activities. The oil-exporters are, as their name suggests, highly integrated in the world trade of natural resources; in addition to that they are major importers too. And most of the other Arab economies are major importers rather than producers of foreign products - food, heavy equipment, and capital goods. They mainly import from non-Arab countries. Arab intraregional trade has not provided help to the development of regional integration in the Arab world mainly because of the fact that it was directed towards services sector.

North African Arab non-oil-exporting countries, mainly Tunisia, Morocco, and Egypt, are highly integrated in trade with European Union and therefore got affected from the recessions experienced in European markets. These countries were the first in the Arab region to get affected by the crisis. Arab countries other than the North African ones that are more diversified and rely on European imports of machinery and transport equipment and other heavy manufactures were ultimately affected by the European status. As the crisis hit the world and started to weaken the economies of the developed countries, their demand for foreign products declined, reducing energy and commodity prices and consequently, negatively affecting exports from developing countries. Nonetheless, an ESCWA report argues that the Arab world might not be severely affected by what happened in North America due to the fact that between 1997 and 2005 Arab exports to the United States averaged around 7.8% of total Arab exports; even though US exports constitute a major part of Egyptian, Saudi, Algerian, and Jordanian exports. Away
from American and European markets, the Asian markets, some of which experienced growths even during the worst phases of the recession, seem to be an attracting outlet for exports of GCC oil; this somehow has cancelled out the effect of other factors that reduced Arab oil export. Ultimately, the decline in oil prices in 2008 and onwards has had different impacts for oil-exporting and non-oil-exporting Arab economies. Both were affected, but through different channels and by different degrees.

All what has happened affecting Arab terms of trade together with a diversion of Arab exports from Europe and other western developed countries towards Arab countries has been leading to the improvement of the status of Arab Trade Financing Program (ATFP) and the enforcement of implementation in the Greater Arab Free Trade Area (GAFTA) which eventually might lead to intra-regional trade progress.

d. Foreign Direct Investment

| FDI FLOWS TO ARAB COUNTRIES AS A PERCENTAGE OF Flows to developing countries and to the World 2005-2007 |
|-------------------------------------------------|-----------|
| As a percentage of flows to developing countries | 2005: 15.03, 2006: 16.81, 2007: 14.50 |
| As a percentage of flows to world                | 2005: 4.96, 2006: 4.92, 2007: 3.95 |


Many Arab countries have been experiencing growth in attracting foreign investment during the years preceding the crisis. According to an ESCWA report (2008), the share of Arab world in total FDI flows to developing countries has more than doubled between 2003 and 2006. There have been different factors contributing to this increase, among which are improvements in business and investment environments, amplifications in privatization processes, and expansions in economic conditions resulting from
higher oil revenues (UNCTAD 2009). Three major Arab countries have contributed to more than 60% of total FDI flow in the Arab world – Saudi Arabia, United Arab Emirates, and Egypt; and an important percentage of them were directed towards investment in oil and gas sectors and to a lesser extent towards construction, real estate, financial, telecommunication, wholesale and retail trade and banking sectors. The distribution of FDI inflows varies immensely among three different categories: largest recipients, as mentioned above, being Egypt, Saudi Arabia, and UAE; next comes smaller high performing economies - Bahrain, Qatar, Lebanon, Jordan, and Oman; and the lowest recipients – Kuwait, Palestine, Syrian Republic, and Yemen.

After the shrinking of available credit for investment in the US and the Western World, these countries have observed intra regional FDI activities. Even though the Arab share of world FDI flows has increased from 1.2% in 2002 to around 4% in 2007 (as seen in the above table), and despite the good performance of Egypt, Saudi Arabia, and UAE in their participation in world FDI flows, the Arab world had a less than average performance in growth of FDI flows in 2007 with the main bulk going to Mergers and Acquisitions of Transnational Corporations (TNCs) and a very small portion to greenfield investment. The significant progress of Jordan, Lebanon, Bahrain and Egypt in attracting FDI during 2007 has highlighted the fact that even though natural resources are an important factor for attracting foreign investment, it is not a sufficient one per se; the creation of an investment friendly atmosphere together with diversification of the economy are necessary. According to S. Neaime and M. Marktanner, other than the dynamics of trade and political regime developments in the region, the Arab world is lagging behind in world FDI flows because of geo-economic and geo-political factors.
As it has been mentioned earlier, the financial crisis has almost interrupted the growing cycle of international investment flows. And this would have necessarily affected FDI flows to the Arab world – especially investment in oil and gas sectors, in addition to suspension of many construction activities due to tighter credit availability in investor countries and in transnational corporations investing overseas. The huge decline of FDI flows was experienced in the last quarter of 2008. According to United Nations Conference for Trade And Development (UNCTAD), the Arab countries that were mostly affected are the ones that had the largest shares of total FDI flows; while in most Arab countries, similar to what happened in many developing countries, relatively smaller recessions, and mainly unchanged FDI flows were observed. Resource-seeking investments were mostly delayed or postponed especially in the initial period of the crisis right after the decline in oil prices, and therefore resource-rich countries were highly affected. The Dubai real estate turmoil has kept investments in residential and commercial sectors pending. Saudi Arabia and UAE have witnessed contractions in greenfield investments. Lebanon, a more diversified Arab country whose FDI inflows depend largely on flows from GCC countries, observed a minute contraction of flows. It might be possible that some Sovereign Wealth Funds in GCC countries might direct their investment prospects towards comparatively advantaged sectors of different Arab countries like agro-food, business and personal services, textile fiber and clothing, and intermediate food and processed seafood; ultimately contributing to intraregional FDI development and regional growth (ESCWA, 2009). In addition to this, Arab world might further focus on creating and expanding partnerships with emerging countries, which are becoming the main driving force behind FDI flows especially after the crisis.
e. Real Estate

The global credit meltdown has had an impact on the majority of the real estate sectors in the Arab world – especially in the GCC countries. After the Dubai housing bubble, there has been a wide range of housing price correction processes. This is because of the fact that during the years preceding the crisis and accompanied by the sharp increases in oil prices and expatriate influx and therefore high level of liquidity, together with large public investments in real estate aiming at diversifying their economies, and the buoyant economic growth, there has been a sharp, rapid and disorganized increase in the real estate sector especially in the GCC countries. According to the Institute of International Finance (2008), housing prices have been growing in double digit rates during the few years preceding the crisis and the property sector has been a major contributor to the GDP of most of the GCC countries. Global Investment House (GIH, 2009) reported that rents have become the most important component of inflation in these countries. The record level of construction and rent prices has led to a high degree of speculation and imbalance between the supply and demand in the housing market, and consequently has made it vulnerable to the slightest shock received from the global crisis. The decline in oil prices, credit crunch, and the receding economies has led to a decline in the availability of credit on hand to be allocated to the real estate sector; and even though there has been an accompanying decline in international material and commodity prices – mainly cement and steel, the shock left a scar on the real estate sectors of the countries that had been experiencing a boom in this sector. Demand has decreased and exerted a downward pressure on rents and property prices; firms have rescheduled or even reduced their investment projects and laid-off employees. The most severe
shock was faced by UAE, specifically Dubai. Property prices plummeted as the speculators that were buying off-plan properties and selling them off at a profit were leaving the market and rushing out (ESCWA 2009). As a response to the shrinking credit conditions in the market, monetary authorities in many GCC countries cut interest rates and reduced reserve requirements injecting liquidity in their markets. In UAE, authorities were further concerned in deleveraging the speculation activities in the real estate market. Even though property prices might decrease following the measures taken by the authorities of the highly affected countries and directed toward demand side increase in real estate projects rather than speculative increases, the high rate of population growth in the Arab world is worth mentioning in this context. The demographic increase might further stabilize the property prices in the medium term, and re-establish some of the vitality in the real estate sector experienced by these countries before the global financial crisis.

One other aspect that can be mentioned together with the shocks to the real estate sector is the decrease in intraregional workers’ remittances. As huge housing projects in some Arab countries were being frozen and workers were being laid-off from those construction projects, a large concern was being raised due to the fact that many Arab countries like Egypt, Lebanon, Jordan and Yemen highly rely on remittances as a major source of capital inflow. If remittances sharply declined, it would have had a harsh impact on the foreign exchanges of the countries that relied on them and would have led to increased unemployment and poverty rates in the receiving countries. Nonetheless, towards the end of 2009, figures revealed that the decrease was not as severe as expected in most Arab countries.
f. Tourism

According to the United Nations World Tourism Organization (UNWTO), Middle East had the best performance in 2007 among all regions in terms of tourism expansion in an already globally expanding tourism performance; the region attracted 48 million tourist arrivals, with Egypt, Lebanon, Jordan, and Morocco being the most attractive places. The growth in tourism continued for most of the year 2008, nonetheless and naturally, it later experienced a decrease especially in tourists coming from the developed countries. Arab countries that highly relied on European tourists – like Egypt and Oman, observed a sharp decrease in tourists and consequently in foreign currencies. While countries that were attractors of Arab and specifically Muslim tourists – like Saudi Arabia, continued experiencing high levels of tourist arrivals as a consequence of the highly growing Arab population. Dubai, which has been attracting a good enough number of tourists, was slightly affected after the crisis hit its economy towards the end of 2008; nonetheless the situation has been improved since then. Remarkable is the story of Lebanon among the tourism activities in Arab countries. Mainly a destination of Arab tourists, Lebanon has witnessed an increase in tourist arrivals; the reason can be attributed to the fact that many Arab tourists that under normal conditions would have visited European or any other western country, have decided to visit Lebanon under the global conditions created after the crisis.
g. Banking Sector

The banking sector responses were differing between GCC countries and the other Arab countries; as mentioned earlier, the GCC banking sectors faced markets experiencing capital outflows, shortages in credits and liquidity to finance their projects, together with vulnerability of investor confidence and market demand, all these ultimately affecting the growth of their economies. Consequently, the banking authorities in the GCC countries even though the majority being well capitalized, increased foreign liabilities, cut interest rates, and reduced reserve requirements to finance the demand for credits in infrastructure and real estate projects. They further announced developmental projects for the coming years to boost domestic demand. Banks in non-GCC countries were less affected by the crisis. Remarkable are the banks in Lebanon and Jordan with high degree of liquidity and relatively sound financial stability; while the strength of the Egyptian banks’ balance sheets have managed to mitigate the impact of global crisis on the Egyptian economy given its high level of integration in world economy. The Central Bank of Egypt further guaranteed that it will interfere in case the level of deposits decreased.

As a result of global financial turmoil, the oil exporting Arab world experienced declining oil revenues, and almost all of them experienced different degrees of downturns in bank assets, market capitalization and stock market indices, together with losses incurred by the Arab Sovereign Wealth Funds. This led to a fall in demand for housing and real estate properties, which was also one of the surging sectors before the effects of the crisis were felt in the region. Downturns in some of these sectors might exert pressure on the exchange rates of the currencies of some of the non-GCC countries further worsening their economic conditions.
In February 2009, the IMF Middle East and Central Asia Department Director Masood Ahmad said that the continued investment and spending of Middle East oil exporters is helping in softening the impact of the global financial crisis, generating a positive spillover to neighboring countries, supporting global demand and therefore helping in stabilization processes. Nonetheless, he further stated that ‘because of the high public debt ratios…the scope for counter-cyclical policies is limited for most of the emerging market countries’.

All Arab countries like almost all developing countries in the world took expansionary steps to boost their domestic economies and reduce the impact of the imported effects of the crisis. Governments have expressed their promptness in guaranteeing certain levels of bank deposits to maintain confidence in their financial sectors and to protect their national banking sector from credit risks. A large majority of the funds that have been invested by Arab countries in foreign markets abroad are projected to direct towards domestic investments and in real economies rather than paper assets (ESCWA, 2009).
CHAPTER IV
LEBANON

A. Lebanon: Historical Macroeconomic Overview

Lebanon is a Middle Eastern Mediterranean country that has experienced a high degree of aggressions and violent attacks during the past four decades - be those civil wars and internal violence among different parties, or regional clashes with neighboring countries. The 25-year civil war from 1975 to 1990 has been a period enough to paralyze the country economically. From 1990 and on, Lebanon has been striving to reconstruct the country and its infrastructure, restructure the economy on sound bases, and regain its reputation as a safe haven attracting capital inflow and reestablishing the confidence of investors in the economic and financial atmospheres of Lebanon. A country not healed from the scars of the civil war yet has been involved in clashes within the country or with neighboring countries; of which the most recent ones are the consecutive bomb reports starting from 2005, the July-August 2006 Israel-Hezbollah attacks, and the May to September 2007 Nahr-el Bared clashes between the Lebanese army and the Palestinian refugees. The summer 2006 war was comparatively more aggravating to the already unbalanced nature of the economy by blockading air and naval connections with the external world, harshly damaging the country’s infrastructure, to mention a few.
1. Public Debt

On its way to the reconstruction of the country, the public sector, only just out of the civil war, and after making the most possible out of its modest reserves, didn’t find itself capable of doing anything else than resorting to borrowing to finance its needs. When the volume of total public debt together with its structure are studied, it will be clear that the size of the debt has been growing over time since 1993 and that the percentage of foreign debt out of total public debt is likewise increasing. This could be explained by the inability of the government to sustain in borrowing domestically and therefore has resorted to external financing. Nonetheless, the accumulated debt, despite helping the economy, also posed a critical risk to it – the country has been incapable of servicing it and therefore the bulk of the debt is continuously rising. To further explain the severity of the problem, it is important to start by saying that accumulating debt is not as harsh a problem when the debtor is aware of its ability to service it back. Most of the world leading developed economies have debts. For example, the United States (US) had an annual public debt exceeding $4 billion until it entered the crisis in 2007. Almost all member countries in the European Union (EU) have accumulated public debt. But what is dangerous in the Lebanese case is that it constitutes around 160% of GDP; whereas the public debt to GDP ratio has been around 37% in the US and bounded by a margin of plus or minus 60% in EU by which all EU members should abide. A public debt to GDP ratio of well above 100% reflects the fact that public debt has been increasing at a much faster rate than the rate of growth of Gross Domestic Product (GDP); and this might be worrisome. According to Roubini (2001), public debt can be viewed as sustainable as long as the public debt to GDP ratio is non-increasing.
Servicing the debt burden has become cumbersome to the Lebanese economy; the debt service to GDP ratio has been uncontrollably increasing for the past 2 decades. Some stabilization in debt ratio has been observed in the past few years and together with a better GDP growth trend; but none of them is significant and they are subject to any future shock.

An interesting point to mention here is the no-default history of the Lebanese economy. Despite these unusual figures of debt, Lebanon has always been able to endure without defaulting even in the worst periods of political conflicts and wars and even during the late global financial and economic crisis of 2007. To have a glimpse of why is this so, further examination of the country’s macroeconomic fiscal, monetary, and financial profiles are needed.

Lebanon is a small open developing economy; it primarily relies on the services sector including financing, insurance, real estate, construction, trade, commerce, tourism, hotel and restaurants, among others. The services sector has contributed to more than two thirds of the Lebanese GDP throughout the past few decades. Two major distinguishing subsectors of the services sector in the Lebanese economy are the banking system and tourism. While the latter, even though being significantly contributing to the economy either directly or indirectly, still needs some reform; the banking sector in Lebanon is appreciably sound. The banking sector had a key role in reestablishing the confidence it has regained after the civil war and throughout the other conflicts in the period of reconstruction. Free capital mobility, Banking Secrecy law, and other remarkable characteristics make the Lebanese banking sector, guided by the Central Bank, one of the best in the region.
2. History of Monetary Policy – Exchange Rate Stabilization

Right after the civil war the Central Bank of Lebanon gained an appreciable independence following the exchange rate crisis in 1991. Starting from 1993, before which its roles were confined to printing money and somehow trying to finance the newly accumulating public debt, the Central Bank emerged with new laws and regulations that granted it the gear of conducting monetary policy in Lebanon. At the initial period, in an environment of around 100% inflation, the monetary policy was to target inflation. The demand for a depreciating Lebanese Pound (LBP) was low and the confidence of people in a banking sector just out of war and with low reserves was little. Central Bank found itself in front of no other choice than resorting to raising interest rates. They were aiming at stabilizing the currency and helping the government finance its deficit without resorting to seigniorage revenue.

Within a period of five years, this instrument was able to achieve its goal and to lower inflation to one-digit values. This was mainly possible because Lebanon was an open economy in which about 90% of domestic consumption is imported; and therefore domestic prices are related to exchange rates. Stabilizing exchange rates and controlling money growth led to the desired goal. It was also capable of attracting capital inflows, increasing reserves, and succeeding in gradual reestablishment of confidence from investors and depositors whereby the conversion rate from foreign currency deposits (mainly USD) to deposits in LBP was increasing and investors were willing to invest in TBs excessively issued by the Central Bank. The latter also helped in decreasing the spread of the rates between USD and LBP. The increase in interest rates had its
drawbacks too, whereby the Lebanese currency appreciated; and this led to falling exports from 23% of GDP in 1989 to around 4% of GDP in 2000.

In 1998, and to further restore stability and gain the confidence of the government, the Central Bank pegged the Lebanese Pound to the US Dollar, considering it a less depreciating currency. Since then, the exchange rate has been fixed to 1507.5 with a certain fluctuation margin. By time, this initiation, of course, led to a great loss of independence of the monetary policy making the exchange rate the nominal anchor for the monetary policy that takes precedence over the inflation target. Amidst the political upheavals and the atmosphere of confusion that the country has been subject to, fiscal and monetary authorities have seen it suitable to maintain a fixed exchange rate as a first step immunity against a possible exchange rate crisis resulting from vulnerabilities of the prevailing economic system. To keep the exchange rate peg with the USD, the monetary policies conducted by the authorities of the country become almost obsolete; whereby the monetary policy will be conserved for keeping the peg and therefore be incapable of targeting any other goal related to the real side of the economy. In the course of targeting its goals of exchange rate and price stability together with financing the government budget deficit, the Central Bank uses interest rates on TBs as a primary control instrument for conducting the policy and achieving monetary stability. In addition to the aforementioned, Central Bank also makes use of interest rate on commercial banks’ deposits in Central Bank, required reserve ratios, swap operations, open market operations together with buying or selling foreign currency reserves to control excess liquidity in banks, to prevent speculative attacks on LBP on foreign exchange markets, and to a lesser extent to encourage
competitiveness in the Lebanese banking sector through merger and acquisition activities. Of course, preserving currency stability is not of no cost; for example, during the 2006 war, whereby the economy has been struck severely, Central Bank lost an equivalent of $1 billion (around one-twelfth) of foreign exchange reserves to conserve its peg to the USD.

One of the critiques that this system has been subject to is that, in a world of political stability, a super fixed exchange rate sounds contradictory to the Lebanese market-oriented economic philosophy (Papazian 2006). Indeed, a freely floating rate fits more naturally to Lebanon’s free market economy than the fixed exchange rate which seems to be the result of a fear of float (Reinhart et al., 2003). The fact that stabilizing exchange rate diverted attention from GDP growth in the country should not be ignored as well; whereby, and especially in the initial period, the country was subject to consecutive recessions. Nevertheless, even the critiques above admit that, the fixed exchange rate system is viewed to be one of the least harmful in a highly indebted economy like Lebanon and that true political and institutional reform must precede any other reform.

The Central Bank succeeded in keeping inflation below 1% during the period 1999 and 2006; this rate has increased after 2006 as a consequence of international factors like overall increase in prices globally as a result of rapid growth, increase in oil prices, and depreciation of the USD to which the LBP is pegged. Lebanon, being a major importer and having almost 35% of its imports coming from the European Union countries which have been experiencing high inflation rates before the crisis, has been affected from this increase in prices and experienced a rise in inflation rates albeit not exceeding 6%.
3. Dollarization

The high dollarization rate, another remarkable characteristic of Lebanon, stands still to remind that even if confidence in the Lebanese banking sector has been mostly re-established, the vulnerability rate in the country is so high that hardly anyone can bring forth the issue of complete de-dollarization. Lebanon is, if not the most, one of the most highly dollarized countries in the developing world. A. Papazian (2006) views this as a lack of trust and freedom from a political economic point of view. The lack of trust can be explained by a simple word, corruption, which is a characteristic of the Lebanese institutional framework. A straightforward numerical example that will justify why people don’t fully trust in the well functioning of the system is that of the electricity sector – Electricite Du Liban (EDL). According to 2007 estimates, 9.03 billion Kwh of electricity was produced of which 8.42 billion Kwh was only consumed. EDL is granted a subsidy of around $1 billion annually from the reserves of Central Bank. According to Papazian, the high dollarization rate damages the local wealth creation potential of the Lebanese State. This rate had scored one of its historical peaks in 1992 (deposit dollarization rate of more than 70%) due to the high inflation rates and the devalued LBP; but what is interesting about the dollarization rate and the evolution of time, is that another peak similar to that of 1992 reached in 2005. Even though this rate has decreased throughout the course of the period between 1992 and 2005, it shows that nothing much has been changed since the end of the war, and that the LBP is still facing high risks. And from that date on, despite its large fluctuations due to efforts from responsible authorities to lower it, the rate increased any time the country faced political turbulences. Liability dollarization, despite being a high source of
instability and a source of bankruptcy in case of possible devaluations, will probably still remain there as long as exchange rate stability target is adopted together with a higher domestic interest rates relative to the anchor currency. The latter together with fixed exchange rate should encourage savings in LBP; nonetheless, this is not what is observed in Lebanon, due to the fact that USD lending rates are much lower than those of LBP.

4. Balance of Payment

Lebanon has had an ever increasing gap between the current account and capital account balances. This increase can be explained by two factors. First, an increasing current account deficit is fed by the budget deficit. According to the results of Neaime’s ‘Twin Deficit in Lebanon: A Time Series Analysis’ (2008) Lebanese already existing trade deficit resulting from a gap between relatively higher exports than imports has been further accentuated by the ever increasing budget deficit. The view states that Lebanon follows the Keynesian school of thought whereby increases in budget deficit in a small open economy like Lebanon will increase interest rates and attract capital inflows, appreciating the real exchange rate and increasing current account deficit by increasing trade deficit. The second reason is the increasing capital account surpluses, whereby Lebanon has been able, starting from mid-1990s, to attract capital due to many reasons. This is why the balance of payment has been more or less balanced in the last two decades where the capital account surpluses have been roughly canceling out the effect of the existing current account deficits.
a. **Capital Inflows**

Another major aspect of the Lebanese economy that highly affects the material studied in this project is capital inflows. So, it is worthwhile to further delve into the emergence of an increasing capital account balances after the war and its status in the past two decades. Capital inflows comprises primarily of foreign direct investment (FDI), foreign portfolio investment (FPI), foreign aid, and long- and short-term investment flows including public and private borrowing. Another major form of capital transfer in which Lebanon stands distinctive regionally is remittances. There are no restrictions on foreign exchange or capital movement to Lebanon and there is an ease of access to foreign investors with close links to the region. As data reveal, capital inflows usually increase during and after domestic political turmoil. For example, according to Banque Du Liban figures, capital transfers in balance of payments accounts have been calculated to be 50.8 and 27.4 millions of USD during 2004 and 2005 respectively, while this number has mounted to 1,940.4 million USD in 2006 – the year that corresponds to the summer calamities with Israel. The following part will further investigate the most essentials among the capital inflows to the Lebanese economy.

i. **Remittances**

Lebanon is a country that has record high emigrants who have left the country either as families, escaping from warfare and hostilities seeking more peaceful and decent lives; or youth in search for better job opportunities. If, according to different sources, a rough estimate of the Lebanese population during the past decade or two is 3.5 million residents, than the Lebanese
Diaspora could account to more than three- to four-folds of this number spread all around the world. Despite the loss of human capital and labor force the country has and still is experiencing, the most conspicuous benefit it gains from its expatriates are the remittances they send to Lebanon. These inflows significantly increase during times of political upheavals and wars that result to destructions and temporary unemployment – a feature very peculiar to Lebanon; while during normal circumstances, remittances account to around one fifth of the Gross Domestic Product.

ii. Foreign Aid

On the way towards further investigation of why hasn’t the Lebanese economy ever defaulted in an environment of volatile stability conditions, it is important to mention the role of foreign aid. Lebanon has time and again been on the verge of defaulting on its massive debt burden; nonetheless a report from Credit Suisse Investment Bank mentions that the guarantee from donors and investors in and outside Lebanon, and from international financial institutions has been a major shield from currency, financial, or any other form of crisis. Under the surveillance of the government economic reform plan, international institutions and countries have recurrently granted long-term loans at reduced rates. Most notable among these are the Paris I, II, and III conferences and frequent Arab soft loans. After the wars Lebanon has gone through, the aids from Arab countries in billions of Dollars have poured into the Lebanese economy significantly for the purpose of reconstruction of the economy and the damaged infrastructure, and in support of the social impairment. Those coming from the international community are
aimed for, in addition to the above mentioned purposes, further reforms of the Lebanese economy and fight for corruption towards more stabilized and co-integrated infrastructure in the middle of turbulent political atmospheres.

Around $2 billion from Paris II Donors Conference in 2002 just came to soften an increasingly heightened sovereign risk. It came to decrease the spreads and increase deposits in banks. Another $7.5 billion have been pledged to Lebanon in 2007 by Paris III Donors Conference. The latter has been for budget support and development – mainly focusing on fiscal reforms and privatization plans.

iii. **Foreign Direct Investment**

Foreign direct investment is another type of capital inflow to Lebanon. Investors need peaceful and economically sound environments to invest in, a place where they know that the byproduct of their investment is going to be profitable and marketable. Starting from late-90s, data have revealed that the level of foreigners seeking investment in Lebanon has been increasing and that the real estate and construction sectors have been the major attractors of FDI inflows. According to a research performed by Inter-Arab Investment Guarantee Corporation, Lebanon is one of the largest net Arab direct investment (ADI) recipients among Arab countries and that its ADI-to-GDP ratio has been increasing at a very fast rate since 2001.

Lebanon, even though its government does not restrict foreign investment, suffers from corruption, arbitrary licensing decisions, high taxes, tariffs and fees, among others. In general, foreign investors are attracted to Lebanese papers driven by diversification incentives and that
they keep their eyes open to the political situation, soft lending and gross international reserves there because the price of Lebanese papers highly depends on these local idiosyncratic events in the short-run (A. Schimmelpfennig, H. Gradner, 2008). The same authors argue that a liquidity shock not only depends on high debt levels but also on the nature of investor base; and that Lebanon has tamed these shocks lately given its relatively stable nature of its investors. Another plausible result that keeps the market for investment welcoming to international investors is the very low probability of default of the Lebanese debt, which is largely held by domestic banks and which, in case of a default, leads to high costs to the domestic agents. And therefore, this low correlation between the Lebanese debt and the market attracts portfolio investors for diversification purposes.

5. Tourism

Ultimately, another key contributor to the Lebanese economy is the tourism sector. Data from Euromonitor International of World Tourism Organization show that right after two years from the barricade of the Lebanese airport in summer 2006, tourist receipts have exceeded that of the pre-war period. Other than being a touristic Mediterranean country, Lebanon welcomes its scores of emigrants who visit their homeland frequently. Most of the tourists to Lebanon are from the Arab world followed by Europeans.
6. Financial Sector

According to data from World Development Indicators (WDI), the liquid-liabilities-to-GDP ratio in Lebanon has been increasing starting mid-90s till recently to exceed the 200% level in 2007. The ratio measures the extent of financial intermediation in the Lebanese economy and thus, the level to which the financial sector – primarily the banking sector in Lebanon - is contributing to economic development of the country. The high percentage recorded is owed to the sound banking sector despite its limited independence. An efficient financial sector is a pivotal element in capital account convertibility, which is a major need of the Lebanese economy to prudently invest capital inflows and weather shocks amidst a highly turbulent environment (Nsouli, Rached; 1998).

a. Banking Sector

As mentioned earlier, right before the global financial and economic crisis of 2007, Lebanon had experienced two severe exogenous shocks – the country’s political turbulences starting from 2005 and the summer 2006 war. As it is obvious, the two are very close to each other, and are even very near to the onset of the global crisis. The political destructions of course would not have taken long to get an economic stance: decreasing reserves – a threat to the peg, diminishing bank deposits and increasing dollarization rate, increasing Eurobond spreads, slowing down of growth and highlighting budget and balance of payment deficits. In all these instances, the Central Bank, in coordination with the government, was able to recoup the paralyses and boost the economy, just to see another shock in face. As mentioned earlier, the
capital inflows right after each shock in the form of international aid and particularly Arab inflows had a major part in helping the economy out – to the extent that in some instances, the loans from Arab countries more than reshaped the lost reserves and deposits. Nonetheless, it is a given fact that the price paid for these shocks in terms of forgone growth, higher domestic interest rates and a weakened financial position was high.

Together with these calamities, there were the already high and increasing oil prices creating fiscal problems in the country, and periods of increasing interest bills as a result of maturing Paris II zero-interest credits. So Lebanon, with its government and Central Bank, was time and again able to contain pressures that could have easily transformed into destructive financial storms. In most of these instances the government debt was the bearer of the losses.

An IMF working paper titled ‘Interest Rate Determination in Lebanon’ by T. Poddar, M. Goswani, J. Sole, and V. Icalaz (2006) discusses the importance of this market-oriented monetary instrument which plays a great role in conducting monetary operations. The paper also concludes that global benchmark interest rates have great influence in the determination of domestic interest rates. In 1995, the Lebanese government has been issuing dollar-denominated papers called Eurobonds to finance part of its needs. The IMF paper focuses on three main interest rates in Lebanon: Eurobond rates, rates on foreign currency (FC) deposits that stand at a premium over LIBOR, and those of local currency. To reach its main monetary policy objective which is to preserve the currency peg to the USD, the Central Bank follows two operational targets: first, the spread between FC deposit rates and the rates on international markets (such as LIBOR) - this can be used to measure banking sector risk; and second, the spread between LBP interest rates
and USD interest rate in Lebanon and which measures currency or exchange rate risk. The former attracts capital to the country to finance current account and budget deficits, while the latter promotes deposits in LBP. Other major risks faced by a highly indebted economy and a banking sector like those of Lebanon, are solvency risks resulting from liquidity problems, and large rollover risks due to the fact that debt is mostly backed by short-term deposits. In addition to the above mentioned, the fact that local banks are highly exposed to the sovereign by holding most of the government debt in the form of government papers (whether TBs or Eurobonds) makes a sovereign debt crisis very easy to be transformed into a banking sector crisis. A global financial researcher and analyst group Moody’s 2007 views Lebanon’s high exposure to the sovereign due to political instability as the most serious risk of the banking sector. S. Nsouli and M. Rached have argued that the debt sustainability problem is contributed by three risky factors: the high exposure of the banking sector to the government and the Central Bank, the reliance on short term capital flows on financing, and on the high dollarization rate.

Before talking about the methods the Lebanese banking sector follows and the tools it uses to manage these risks, it is worthwhile to mention about the role of the banking sector in financing the public sector needs. The government issues Treasury Bills (TB) in Lebanese Pounds and Eurobonds; these are mostly bought by domestic commercial banking sector. During the past few years, the Central Bank has been obliging commercial banks in Lebanon to buy government TBs instead of investing in foreign international financial markets. Thus, debt is mostly held domestically – a feature unique to Lebanon among its peers. A. Schimmelpfennig and H. Gradner (2008) present an advantage and a disadvantage of this fact. The advantage is
that the chances of default are very low given that the cost of default to the banks is very high. On the other hand, the fact that government papers have maturities of at least one year while they are mainly financed by banks through deposits having average maturities much shorter than one year, exposes the banking sector to rollover risk and to systemic risk, whereby no bank will exit the government paper market without bearing the consequences itself. In addition to these risks, creditors will bear credit risks which might pass to them in case of an exchange rate risk created as a result of the high degree of dollarization and borne by both public and private debtors.

Deposits, liquidity, and international reserves come forth as saviors in this scenario of high risk exposures.

Deposits are mostly attracted from Lebanese residents and the large Diaspora, together with the ones from the Arab investors of the region. Historically, the reason why large amounts of deposits are drawn towards Lebanese banks are banking secrecy and high degree of proficiency whereby investors have hardly ever lost money due to bank failures. Lately, the full capital account convertibility especially looked for during times of political upheavals, the system’s high dollar liquidity, the exchange rate peg and its good ratings in reference to world financial sector indicators have added value to the already existing sources of attraction. With the emergence of regional competing financial markets like those in GCC countries, Lebanese banking sector has lost its uniqueness in this context; nonetheless it hasn’t lost attractiveness to investors and depositors. A. Schimmelpfennig and H. Gradner add a further guarantee that deposits to Lebanon will not easily change trend, and their argument is the presence of a large Diaspora which hold deposit in Lebanon supported by family, real estate and investment ties to
the country and an eventual return. While deposits from non-Lebanese, mainly for investment in real estate, is backed by the liberal cultural and natural attractiveness of this country to the Arab non-Lebanese population. At the beginning of 2000s, deposit inflows decreased and turned negative and international reserves fell to an extent that government was finding it difficult to finance its needs. Paris II Donors Conference in 2002 narrowed the spread for the Eurobonds decreasing sovereign risk, increased liquidity, and reserves.

Reserves are assurances that the economy and the banking sector will be able to sustain any possible liquidity crisis and prevent it from turning into a solvency crisis. The IMF working paper on interest rates determination in Lebanon (2006) has found out that international reserves and interest rates are negatively related. According to the authors, the key issue for Lebanese policymakers is to know the methods to lower Lebanese interest rates in order to reduce its massive interest bills; they further argue that stronger fundamentals are required to achieve this.

Lebanon’s short-term interest rate has low volatility – and this is surprising given the major shocks Lebanon witnesses, but it reflects the central bank’s ability to manage the interest rate in the face of volatile capital flows. Just before the global financial crisis, Central Bank has almost fixed the 3-months TB rate at around 5.15% since 2004 and the interest rate on deposits around 7%.

b. **Stock Markets**

The stock market in Lebanon, Beirut Stock Exchange (BSE) has been re-launched in 1996 after the civil war period. Throughout its period of growth, it has seen certain
improvements in terms of volume, value traded and market capitalization. Turnover ratio, which represents how often shares change hands in the stock market and which is measured as the value traded relative to market capitalization, has also been increasing in BSE. All these figures have been increased dramatically after 2005. Officially, the BSE is state-owned, which might make decision making processes relatively slow; but it is open to foreign investors. The latter fact, nonetheless, is not benefitted from optimally due to the institutional framework of the BSE that still needs some improvement in order to further attract investors.

B. Lebanon During and After the Global Financial Crisis

The following section will investigate what has happened in Lebanon after the onset of the global financial crisis towards the end of 2007 and what track has the evolution taken after the crisis hit the real sector globally and turned into a financial-economic crisis. Most of the data are collected for the period extending from the first quarter of 2007 till the second month of 2010. The reason for choosing the start date as mentioned underlies the assumption that if Lebanon, being a weakly integrated market internationally, was going to get affected by the crisis then it would be starting from the beginning of 2008; and therefore, the availability of data from the start of 2007 might be beneficial for year-on-year comparison. While the end date is merely a coincidence – February 2010 was the last available data for most of the indicators at the time the study was being performed.

The study will start by the banking and financial systems even though there was a belief that Lebanon has endured the crisis from the banking and financial point of view but might
probably get hit from the real sector because of the openness of its economy. This section will include an examination of monetary and financial statistics, together with policies of the banking sector headed by the central bank, movements of some chosen rates, and performance of the Beirut stock market. Next, a brief study will be conducted on public finance statistics. Then balance of payments accounts will follow. In this context, current account balances will be examined the main focus being on exports and imports; then capital inflows will follow focusing on FDI and remittances. Lastly, the real sector will be assessed. In this last part, in addition to certain indicators of the performance of the real side of the economy, special attention will be given to the behavior of the GDP and prices.

1. Banking and Financial Sectors – Monetary and Financial Statistics

Due to the political instability, Lebanese banks had already adopted a conservative approach before the onset of the crisis. After almost a year from the summer 2006 war, and during a period where prospects of a peaceful growing economy were in sight, there were the echoes of the crisis being heard. The echoes seemed to be far because of the fact that Lebanon was not integrated in the markets from which the problems arose. Nonetheless, the banking sector in Lebanon had to shield itself from the possible inconveniences the crisis could cause to an already ‘risk bounded’ economy. And therefore, the Central Bank of Lebanon and the responsible authorities followed further conservative approaches to keep the economy functioning on the sound track it has been placed after the 2006 war, to maintain the stability of the currency and the financial system, to control liquidity and contain any possible inflationary
pressures. In fact, the course of events internationally and domestically were in favor of the Lebanese economy and in particular they were in favor of its banking and financial sectors. One of the remarkable characteristics of the sector during this period was its ability to maintain respectable stability for certain rates. This, in turn, boosted confidence in the banking sector.

a. Some Chosen Rates

The following graph compares the deposit and lending rates on LBP and USD in Lebanese banks, and the 3-months domestic TB rate and the LIBOR 3-months rate.

![Graph](image)

Figure 1: The movements of some chosen rates between 2007Q1 and 2010M2

It is obvious from the above graph that towards the end of 2007 and onwards, all of the mentioned rates have been on a decline in differing paces. The fastest negatively growing pace has been the foreign LIBOR rate, the most harshly affected by the crisis; this rate has experienced two severe plummets, one towards the end of 2007 and once towards the end of
2008, and has continued declining since then reaching levels very close to 0%. What concerns the Lebanese rates, they have been decreasing in a milder manner. The most noticeable evolution has been the significant gradual decline of the lending rates on LBP starting from 10.1% at 2009Q1 and reaching 8.83% at the beginning of 2010. This has been accompanied by a relatively stable USD lending rate which led to the decrease in the spread between them. According to the Byblos Research Department, Lebanese banks were offering as much as 3% on dollar accounts compared to European Central Bank’s benchmark rate of 1% and to that of US close to 0%. All in all, the relatively stable domestic rates and the differential between Lebanese interest rates and global rates had boosted confidence in the Lebanese banking authorities and led to an increase in its reserves and deposits, to an immense capital flows to the banks, and even later to an enhancement in their role in investment and productive activities in different fields leading to economic expansion. The flow of funds to Lebanon has led to a fall in yields on Treasury Bills as those of 3-months TBs are observed in the graph. The banking sector was able to achieve stability of interest rates and was therefore able to control liquidity primarily by issuing domestic papers – mainly TBs. Another consequence of the above mentioned was declining spread between Lebanese Eurobonds and US TB rates.

b. Deposits

By looking at the next graph which compares the deposits of residents and non-residents in LBP and in foreign currencies it will be possible to trace the increase in the degree of confidence in the Lebanese banking sector. Together with an increase in deposits in Lebanese
Pounds, the degree of conversion from foreign currencies to LBP has observed a likewise increase. All this led to a decrease in dollarization ratio from high above 70% in 2007 to lower than 70% lately.

The graph on the next page clearly displays that there has been an increase in the total amount of deposits from around 92,077 billion LBP in 2007 Q1 to 101,435 billion LBP in 2007 Q4, the major driving force being the commercial bank resident deposits in foreign currency. While the remarkable increase was observed between 2007 Q4 and the beginning of 2010 - the most recent recorded number being 146,325 billion LBP in February 2010. This increase has been significant by the fact that it has observed an increase in all types of deposits and especially a rise in commercial bank non-resident deposits in LBP which hasn’t observed such a remarkable increase for more than a decade or more now.

![Graph showing increase in different types of deposits](image)

Figure 2: Increase in different types of deposits in commercial banks between 2007Q1 and 2010M2
Lebanese commercial banks were able to maintain the level of liquidity and solvency requirements in BASEL II. They were encouraged to limit dividend distribution and reduce leverage. The satisfactory results of the policies taken till mid-2008 have led responsible authorities to respond to the request from the Association of Banks in Lebanon to stimulate lending in Lebanese pounds. As a result, Central Bank reduced reserve requirements on loans in LBP to education, health care, environmental projects, investment, start-up businesses, construction, and to any other project in productive activities for 2009-2010. In addition to boosting the economy, this might probably lead to a decrease in USD liquidity against LBP in the market, and might restore LBP’s role as a lending and accounting currency after being a savings currency for a long period of time.

Lending to real estate and private consumption were excluded from this list to prevent any possible housing price bubble. As the Intermediate Circular 177 issued by the Central Bank limited bank loans to 60% of the value of a property or of a real estate project’s cost.

c. Foreign Reserves

Other than increase in deposits in LBP, there has been a remarkable increase in foreign currency reserves and in gold reserves since the onset of the crisis. This reflects the trend in the flow of funds to Lebanon. The relative stability of the interest rates and exchange rates in Lebanon, together with a support of the banks to encourage lending in productive sectors has resulted in a rise in capital inflows to Lebanon and to their dynamic investment. The following graph depicts the remarkable characteristic of the Lebanese economy during the period following
the crisis – the immense increase in foreign currency reserves. These have more than doubled from about 9,800 million USD in 2007 Q4 to around 26,800 million USD in February 2010, increasing together with gold reserves the foreign assets to a record of around 36 billion USD, and recording a remarkable rise during this period in the world economies.

![Figure 3: The increase in foreign reserves between 2007Q1 and 2010M2](image)

d. **Money Supply**

What concerns the money supply; it has recorded a noticeable increase during the last two years. One convincing reason for this would be the amplified inflow of capital to the Lebanese economy and which are mostly in foreign currencies. As a result, the Central Bank finds itself obliged to buy those currencies in return for supplying LBP and ultimately maintaining the peg with the USD.
M1, measuring currency in circulation plus LBP demand deposits, increased from around 2.3 billion USD at the beginning of 2008 to around 3.2 billion USD at the beginning of 2010. While in addition to M1, if further the M2 and M3 measures of money supply are studied, the increase would be highlighted more profoundly. The M2 measure of money measures, in addition to M1, the quasi-money in LBP – that is savings deposits; while M3 incorporates M2 plus foreign exchange deposits – or time deposits.

e.  **Beirut Stock Exchange (BSE)**

   It might be true that Lebanon didn’t experience in BSE severe calamities similar to the ones in other economies with stronger and more diversified stock markets. Nonetheless, the reason could be attributed to the relatively weak nature of the BSE compared to other more active stock markets in the region.

The following table gives a description of the performance of the BSE during the crisis.
Lebanese Stock Market: Basic Figures 2006  2007  2008

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market capitalization (US$ million)</td>
<td>9,182</td>
<td>11,977</td>
<td>9,323</td>
</tr>
<tr>
<td>Market capitalization/GDP</td>
<td>40.4%</td>
<td>49.9%</td>
<td>38.9%</td>
</tr>
<tr>
<td>Traded volume (US$ million)</td>
<td>1,927</td>
<td>925</td>
<td>1,659</td>
</tr>
<tr>
<td>Traded volume to market capitalization</td>
<td>21.0%</td>
<td>7.7%</td>
<td>17.8%</td>
</tr>
<tr>
<td>Number of listed companies</td>
<td>16</td>
<td>15</td>
<td>13</td>
</tr>
<tr>
<td>Number of listed shares (thousands)</td>
<td>962,790</td>
<td>771,179</td>
<td>801,042</td>
</tr>
</tbody>
</table>

SOURCE: Bank Audi Research Department

2. Public Finance and the External Sector

a. Government Budget

Even though the public finance statistics related to government budget balances still remain in the unacceptable region, they have recorded some improvements after the onset of the 2007 crisis. According to Central Bank statistics, the budget deficit, gradually increasing from low negative values, has finally hit the positive zone after the second quarter of 2009. The budget deficit is defined to be budgetary revenues less budgetary expenditures. The government budget revenues have the tax revenues with its different forms (VAT, excise taxes, and others) as its main source; while public expenditures include, other than general expenditures, interest and foreign debt principal payments as a major part. The aforementioned feature, depicted in the following graph, is considered to be an appreciable improvement for the Lebanese economy. Another upgrading is displayed in the middle graph, whereby the ratio of interest payments to
total public sector revenues seem to be decreasing starting from the end of 2007. Nonetheless, this feature could be disguising; the ratio has most probably been decreasing due to the gradual increase in total public revenues rather than a decrease in debt service accounting. The third graph further establishes this fact by demonstrating the amount of the ever increasing net total public debt by about 6.7 billion USD in almost a two-year period.

Figure 5: Budget deficit, ratio of interest payment to total public sector revenues, and net total public debt between 2007Q1 and 2010M2

It will be interesting to mention that according to the Ministry of Finance, there was an estimated 84% rise in transfers to Electricite Du Liban (EDL) in 2009 representing 11.4% of public expenditures. Electricity generation has increased from around 10,500 million KWh in 2007 to more than 11,000 million KWh in 2009.

b. **External Sector**

What concerns the external sector; both exports and imports have recorded overall increases despite the bad economic conditions of most of the world countries. There has been a 42% increase in exports and 30% increase in imports between 2007 Q4 and February 2010. The
trade balance still remains in the low negative zone implying the imbalance between exports and imports in the Lebanese economy.

Figure 6: The trade balance – exports and imports between January 2007 and January 2010

c. Balance of Payment

The balance of payment (BOP) account surpluses had also increased in value. The current account deficit has not changed significantly, even though the initial decrease in international oil prices has led to a decline in import bills offsetting a possible decline in remittances, tourism, or FDI. Nonetheless, later data show that these three had either remained stable or recorded considerable increases. Capital inflows have recorded a remarkable increase. Gross capital inflows have recorded a boost of around 100% between 2007 and 2010. These inflows were in the form of FDI and remittances, and to a lesser extent portfolio investment in equities and bonds, and were mainly visible in the change in net foreign assets of Lebanese banking sector. The immense increase in the foreign reserves has been discussed above in the banking and
financial sub-topic; these together with other capital inflows have stabilized the current account deficit forming a record high BOP surplus of $8 billion in 2009 up from $3.4 billion in 2008.

d. FDI

According to United Nations Conference of Trade and Development (UNCTAD), FDI year-to-year growth rate in 2008 in Lebanon was significantly higher than the global FDI growth decline of 14.2% and even higher than its 17.3% increase in developing countries. While FDI inflows as a percentage of GDP in 2008 was the highest in the region (12.5%); and FDI as a percentage of gross fixed capital formation had a significantly high amount regionally and internationally – this number was 85.2% compared to 12.8% in developing economies and 12.3% globally for the same year.

Remittances increasing to about $7 billion accounted for around 27% of capital account receipts in Lebanon in 2009. According to a report by Standard & Poor this was the highest such share in the MENA region, and therefore posed the risk of being mostly affected in case of remittances declined.
3. Tourism

Another noteworthy feature in the economy has been the evolution in the tourism sector. At the beginning of the crisis the forecasts were such that many Lebanese expatriates working in the Diaspora were probably going to leave their jobs and return to Lebanon. Were this to happen, the number of tourists would have increased in the first period after the crisis and would have declined later; the same would probably have happened with remittances. Nonetheless, this has
not been the case until the present day – beginning of 2010. The trend might still change; but there is a slight chance that it will curb the current reality. The difficulty in assessing results more accurately in this field is the absence of official inquiry.

As the following graph shows, the number of tourists has been increased from a total of less than one million tourists in 2007, when the country was supposed to be in a flourishing state after the Doha Accord, to more than 1.8 million in 2009; and this number has still been recording growth in the first quarter of 2010. In 2007, there was a 4.3% decline in total number of tourists. In 2008, this trend has been shifted to a 31% growth followed by a 38.9% in 2009. The number of Arab tourists alone has seen a considerable increase especially in 2008 and 2009. While European tourists, despite the fact that their number has increased and they still have remained the second highest ranking number, their ratio to the total number of tourists has seen a slight drawback. The World Travel & Tourism Council (WTTC) estimated that travel and tourism have contributed to 9.3% of GDP in 2009 ($2.59 billion); this figure does not include the indirect effects of the tourism sector on other sectors of the economy, which renders the contribution level even higher (around 28.1% of GDP).

Figure 8: Number of tourists to Lebanon (with a display of Arab and European arrivals) in 2006, 2007, 2008, and 2009
Tourism plays an important role in supporting infrastructure process, create jobs and increase foreign currency flows in an economy.

4. Main Economic Indicators

The coincident indicator, which is an index for overall activity in the Lebanese economy, has recorded a remarkable increase since the third quarter of 2007; it is graphed in the above left diagram. While other indicators for specific activities in the economy are graphed in the other diagram; the shown line graphs include year-on-year growth rates of electricity production, cement deliveries, and construction permits. The significant feature in the latter graph is the above 180% growth peak of construction permits towards the end of 2008. A relatively lower but also significant rise has been observed in cement deliveries between 2008 and 2009. During those two years, growth in imports of machinery has been calculated to be 15.2% and 17.1% respectively; those in imports of petroleum products 14% and 16%. These should be enough
evidence of the growth in investment in construction and real estate sectors to the extent that banks have been prevented from lending extensively to these sectors (as mentioned above) to prevent any possible housing price bubbles. Other key indicators are credits to private sector which has observed a 10.5% growth in 2008 and 13.5% in 2009; and government consumption growing 13% in 2009 up from a negative figure in the previous year. These two indicators measure private consumption and public consumption respectively.

Other than growths in private and public consumption, and foreign and domestic investment, the Lebanese economy experienced strong domestic demand, booming tourism, and successful financial and banking sectors. All these, and despite the previous expectations of an economic slowdown, had led to GDP growths of 8.2% and 7% in 2008 and 2009 respectively. According to a World Bank report, the steady growth rate of around 7% should continue in 2010 given the economic and financial factors in the country. Central Bank has played its role in further enhancing growth, reducing speculation in the domestic market, and lowering risks for the banking sector by encouraging lending in LBP. This would have guided remittances to investment projects and creation of new job opportunities.

Facing the growth observed in the past two years, the Central Bank has been trying to maintain price stability. At the beginning of the crisis the oil price increases together with a weakening of the USD has resulted in an increase in domestic prices. But later, the crisis has led to a global decrease in food and oil prices, and thus prices of imported goods to Lebanon; so there was no fear that inflation might hit high levels. Nevertheless, the growing economy in Lebanon with strong demand especially in real estate sectors has led to an increase in the level of
prices. The Central Bank has been striving since mid-2008 to contain further possible inflation growths. Inflation rate has been decreased to around 3% in 2009 after a sharp increase to 11% in 2008.

C. Why Was Lebanon Able to Weather the Crisis?

As it has been obvious from the analysis in the previous section, Lebanon was able to ‘weather the storms’ (Schimmelpfennig and Gardner; 2008) of the global financial–economic crisis that started in 2007; for, consumption and investment activities increased thus boosting domestic demand, capital inflows increased raising bank reserves and recording an outstandingly high balance of payment surpluses, fiscal balances - despite still having undesirable levels, marked minute advancements, and ultimately the GDP growth level witnessed more than expected heights. These could be remarkably mentioned given the recessionary mood economies were experiencing globally right after and during the years following the crisis. Nonetheless, in this section it will be plausible to change the argument and try to investigate ‘why did Lebanon belong to the minority group who were able to weather the storms?’ or, put it another way, ‘what factors or circumstances helped Lebanon to be able to stand still in the aftermath of the crisis, and what are the chances that it might get affected sometime in the long run?’

It could be an interesting argument to set forth that the political instability in Lebanon in the period right before the global financial-economic crisis presented a cushion for the Lebanese economy. This is because the unstable atmosphere had led to a conservative approach of the Lebanese authorities and banking system which saved the country from a stronger shock to the
Lebanese economy. Lebanon has benefited from the diversification of its savings away from large international banks, a trend that accelerated sharply after the collapse of the Lehman Brothers Holding Inc. in September 2008 (Credit Suisse Investment Bank). The Lebanese Central Bank has forbidden the acquisition of subprime mortgage debt, which was considered to be one of the igniting factors of the crisis. It actually has taken this step to regulate structured products and derivatives and thus protect the Lebanese economy amidst politically unstable atmosphere.

The Economic Intelligence Unit reported that the Lebanese banking sector will continue to function resiliently away from immediate risks given its lack of exposure to the global credit crunch. The Central Bank has even tackled the problem of non-performing loans and encouraged bank mergers, thus mitigating weaknesses that could cause bankruptcies or losses to depositors. According to a Working Paper by IMF, the three main pillars behind the resilience of the Lebanese economy to the shock were the sound banking system that holds the majority of government papers, Lebanon’s no-default reputation despite the high indebtedness (Lebanon hasn’t defaulted even during its more than a decade civil war), in addition to a most crucial support – the implicit guarantee from donors and international financial institutions that Lebanon will never fall into a financial crisis.

In the following paragraphs, there will be an attempt to see whether any of these pillars have an unsteady nature in the long term.
The Lebanese banks, the commercial ones or the Central Bank, hold more than 75% of the papers issued by the government. A simple example of 3-months Treasury Bills is shown in the above graph. Therefore, the Central Bank should maintain a strong position in the economy and hold back a large amount of reserves.

The no-default history despite the large amount of accumulated debt and political instability is indeed an astonishing feature of the Lebanese economy. Nonetheless, the last pillar mentioned above seems to be the underlying reason for this staying power. The implicit guarantee from donors and investors not to let Lebanon default or fall into a crisis has been unambiguous throughout the history of the past few decades.

If one may ask, would the taste of these investors change one day and their preferences divert from Lebanon what would happen to the Lebanese economy without the capital inflows it now enjoys and without their guaranteed support?

An answer to this question could be what A. Schimmelpfennig and E. H. Gardner said in their IMF paper (2008); that investors keep interested in investing in Lebanon, first because of the very null chances of default or liquidation of Lebanese banks due to their supportive nature to the government and the fact that their default would be a self-defeating act, and second because of the large reserve and deposit inflows from a dedicated client base which guarantees the required short-term liquidity to face shocks to the banking sector. Another reason why investors will continue to invest in Lebanon is the fact that Lebanese expatriates form a large part of the investor base. The Lebanese Diaspora is older and better established than many of its counterparts in the region. Other than having played a major role in boosting domestic deposits in
the banking sector and purchasing Lebanese securities, these investors have been a major cause of the booming real estate investment. Being a small open economy with a huge entrepreneurial Diaspora and being able to remain protected from the harsh effects of the financial crisis, Lebanon was able to attract investors following their desires to have a second home in Lebanon and seeking investment in land and real estate considering the Lebanese ones a safe haven. Lebanon has always been striving to protect this investor base despite its unstable nature; an example of this attempt is the pursue of the Lebanese government and the Ministry of Economy and Trade for the creation of a more favorable and developed business investment climate after the Paris III International Conference for Support for Lebanon (ESCWA). It might here be noteworthy to mention that FDI in Lebanon is concentrated in the financial and real estate sectors. Lebanese expatriates and Gulf countries contribute to around 90% of the inflows of FDI (ESCWA).

Another guaranteed inflow is the remittances coming from Lebanese expatriates working abroad. In this case too, there is a slight chance that these inflows change trend and decrease considerably. The best chance for them to have decreased had been the latest global financial-economic crisis of 2007 which worsened the living and working conditions of the majority of the emigrants to countries that had been highly affected by the crisis; the deterioration of conditions was to the extent that many have lost their yearly bonuses, others have been laid off from their jobs, and many others weren’t able to repay for properties they had bought, to mention a few. This could have been considered the worst scenario remittances would be affected from because it was a case where not the Lebanese residents were in a problem now- and which used to be the
case in almost all instances, but the senders of remittances themselves. And therefore, if this situation didn’t worsen the flow of remittances to Lebanon, then it will hardly be a threat to its economy at least in the short-term. Lebanese expatriates kept sending remittances to their homeland despite the harsh economic conditions in their countries of residence. Many of the expatriates returned to Lebanon because of the surge in unemployment following the crisis; but this number does not seem to be as large as capable of making remittances change trend in the long run.

A footnote to the above mentioned would be the tourism sector in Lebanon; according to the World Travel and Tourism Council Lebanon was ranked 11th among 181 countries in 2008 in terms of contribution to GDP. Lebanon historically has been considered a touristic country, and still is – mainly for the Arab population. The ministry of tourism is always in strife to render it a more developed and seasonally adjusted sector and to establish a better image for Lebanon away from the political havoc. The role of the emigrants should not be underestimated when talking about the tourism sector in Lebanon; they keep visiting their country in frequent trips.

This been said, it appears that the three main pillars seem to be safe as long as there is political stability in the country; and sometimes even without the stability - as it has been the case for so long. But could it be true that the Lebanese economy, in the situation it is now, is not facing any risks of disintegration or at least not prone to any other form of crises?

Three of the major factors threatening the Lebanese economic well-being at the present are the internationally acknowledged soaring level of public debt, the geo-political factors subjecting the country to intermittent shocks which perturbs the stability of the economy, and the
absence of growth-promoting factors in the economy. As long as the pillars mentioned in the previous part are steady, then these three threats are partially or totally offset. There have been talks in the year following the crisis that the Lebanese economy might probably get hit from the crisis in the long run despite the fact that it was not affected in the short run. These arguments were mostly backed by the fact that a major part of the Lebanese economy depends on the performance of the Arab world – mainly on tourism, capital inflows, and imports. But this idea seems to be far-fetched now as the Arab world, especially GCC countries have started balancing their economies after being severely affected by the crisis.

An issue Lebanon has to think about in the near future is to get prepared to face inflationary pressures. In an atmosphere of political stability, Lebanon might be able to face the skyrocketing prices because of the fact that it was kept away from the calamities of the crisis. But in case of any upcoming political turmoil and with an exchange rate rather than an inflation targeting monetary policy which renders authorities incapable of controlling inflationary pressures, inflation would become much more difficult to handle.

According to The Banker magazine’s World Financial Health Index (WFHI), a country’s ability to weather financial crises depends on: economic stability, overall indebtedness, financial sector stability, and government finances. The banking sector, if it can be considered a major part of the financial sector is more or less stable and has become more stable after the global crisis as mentioned before. Lebanese economic stability is highly related to the country’s political stability. Overall indebtedness is, needless to say, very risky worsening the status of government finances.
According to A. Papazian (2006), Lebanon has one of the highest dollarization rates internationally. He argues that the credibility issues which gave birth to the process of dollarization are far from being solved yet. He is one of the critiques of dollarization in Lebanon and sees it as an impediment to wealth creation in the country. Even though the author stresses that dollarization could be seen as the least bad alternative to macroeconomic mismanagement in the short-term, and that it couldn’t be laid aside in an environment of high indebtedness, nonetheless he stresses the importance of freeing the economy from the complete dependence on a foreign currency. Papazian argues that, even though the world is heading towards economies with fewer currencies, dollarization without economic and institutional arrangements to share power, benefits, responsibilities, and decision making cannot possibly lead to societal welfare. While S. Neaime (2008) has also criticized exchange rate targeting monetary policies especially after a significant period from its adoption; even though it will help weather inflationary pressures in the initial period, fixing exchange rates will render monetary policies ineffective, will generate persistent exchange rate appreciations, create sizeable debt, and will limit the usefulness of exchange rates in the external competitiveness of the country. In some cases it will even lead to currency crises. Nevertheless, Neaime also has argued that in a situation of huge accumulated public debt, exchange rate targeting still proves to be optimal because it will keep debt service under control and direct any possible currency or debt crisis. And ultimately, despite the fact that the unavailability of reliable data might hinder a thorough study of the subject, it would be worthwhile to mention another economic problem that Lebanon is being forced to face – namely unemployment.
A general overview of the global financial crisis, that burst in 2007 and later turned into an economic crisis affecting the real economies of the world, showed that it has been harsh mainly to the developed globalized economies. Developing and emerging economies were later affected as the credit crunch reduced the demand by the industrialized economies for imported products. Governments were following conservative policies, trying to protect their domestic economies; a remarkable feature was the decelerated capital flows internationally after a decade of tremendous trade liberalization. Naturally, Arab countries were getting affected from the global crisis – starting from the oil exporters and spreading towards others. The transmission channels of the diffusion of the impacts of the crisis among Arab countries were trade – remarkably oil trade, foreign direct investment, remittances, tourism, banks and financial markets, and sovereign wealth funds.

All what preceded in the above paragraph was a background needed to answer the major question of the project – was Lebanon, being a small open developing Arab economy, affected by the crisis? If so, which sectors were affected and in what degrees were they affected? If not, then what were the reasons underlying that fact; and was there a chance of further concern?

After a brief macroeconomic background of the Lebanese economy, a thorough study of different sectors of the economy has surprisingly shown that Lebanon was from the few global
economies that did not bear the severe impacts of the crisis. It was one of the few countries that were able to keep the interest rates as stable as possible and at a relatively higher rates than other international market rates. Spreads have shrunk and increased confidence in the banking sector. During the past two years, deposits, remarkably in Lebanese pounds, increased tremendously. Foreign reserves have recorded an outstanding rise, further increasing confidence in the Lebanese financial sector and decreasing dollarization rates. Despite the somehow frozen capital mobility in the global markets, Lebanon experienced an increased capital inflow, either foreign direct investment, remittances, or other forms of capital inflow. Number of tourists has been surging. Dynamic domestic consumption and investment atmospheres have increased imported goods; and despite the decline in global commodity, food, and oil prices in the years following the crisis, trade deficit has widened. Nonetheless, the surging capital inflows has more than offset the amount of current account deficit, leading to noticeable balance of payment surpluses. Real estate and construction activities have increased and have been leading to somehow unmanageable price increases.

August Tano Kouame, an expert in MENA economics at the World Bank, said that the impact of the crisis will be apparent in the real sector first because of the reliance of the Lebanese economy on tourism, remittances, and imports. A decline in remittances, tourism and capital inflows resulting from political instabilities or malfunctioning fiscal policies will have their negative impacts on consumption and investment.

Seemingly, till the beginning of 2010, Lebanon not only has not been affected negatively from the global crisis, but also has gained advantageous positions in almost all sectors of its
economy. Nonetheless, the literature review at the beginning of the project tries to give explanations and background information about definitions and conducted studies related to diverse macroeconomic concepts – dollarization, exchange rate targeting, debt sustainability, debt and currency crises. The combining characteristic of these concepts is the fact that they are remarkable features of the Lebanese economy. And even though Lebanon was not affected from the global crisis, critiques argue that many of the aforementioned characteristics form a threat to its vulnerable economy. Merril Lynch, expressing concern about the impact of continuous political uncertainties on public finances over the long term said: ‘We believe that the story is not about Lebanon’s ability to weather the storms, but rather about how destructive these storms have become.’ Lebanon has a much serious problem then being integrated in the international markets and getting severely affected by the financial crisis: its huge public debt and the risks associated with it. Lebanon might further get affected from the crisis, depending on how the global events unfold. The movement of macroeconomic variables in the country will depend on the rate of growth of the global economy together with the domestic political stability.

Lebanon is a service based economy and it is not as safe as it might be had it been an industry or agriculture based. Foreign aid, tourism, remittances, services, and FDI constitute a large part of the income of the economy; these are volatile and risky factors to rely on. Despite the guarantees from different types of donors – be it expatriates, investors, or Arab countries, it might be a good idea for Lebanon to further expand its economy based on more reliable bases.

Creating an atmosphere that attracts capital inflows to the Lebanese banking sector is very crucial for the economy as bank deposits finance the Lebanese government by holding a
large part of the public debt. According to an IMF Working Paper, the country’s financial stability can be maintained as long as deposits (resident and non-resident) are kept at an acceptable level or are improving. After the global crisis, this sector has been flourishing; but political instability is still at hand and might easily shift the balance. Fiscal and monetary authorities have a large responsibility in changing the course of the high dependency of the economy on capital inflows. This could be done by decreasing fiscal deficits and debt-to-GDP ratio and maintaining a level of interest rate differential to the USD that can support deposit growth at comfortable rates.

There seems to be an imbalance between a sound banking sector and an immature capital markets in Lebanon. Authorities can consider further reforms in the financial sector, from improvement policies of the Beirut Stock Exchange and its reinforcement regionally to development of private investment. As part of the reform program, privatization of some public institutions is continuously set forth. It is argued that this should be a priority to achieve a more dynamic and competitive private sector. A major attraction of FDI in Lebanon could be the privatization plans of the past few successive governments. These plans have been delayed because of the strong opposition against them. Chief sectors in need of privatization in Lebanon include telecommunication, electricity, and transportation. Even though many talk about the importance of privatization, it is important to keep in mind that privatization could be a sustainable solution only if accompanied by other institutional reforms. According to Citigroup (2008), privatization of the mobile licenses only can decrease debt by half. Even if these plans don’t take place, it sees fiscal adjustments necessary to
keep attracting foreign capital and boosting market confidence, and thus to be able to repay the sustainable debt and its service.

The IMF has released an article of Consultation Discussions for Lebanon in 2005. The article discusses adjustment plans for the Lebanese economy, which still hold even in the aftermath of the resonances of the financial-economic crisis. Before giving advices which could be applied after public budgetary problems can be solved or in a peaceful atmosphere, the article suggests that in an atmosphere of limited margin of achievements for the fiscal authorities and an extensively dollarized economy where exchange rate becomes an instrument ineffective of adjusting competitiveness, productivity growth becomes the key instrument to stimulate the investment, create jobs and raise standards of living.

The same article focuses on the importance of fiscal adjustment and reform programs as the primary spotlight of the reform agenda. The adjustment should be on both the expenditures and revenues sides. Non-productive public spending should be reduced and unnecessary pensions erased. In addition to the aforementioned, weak transparency and accountability in the government, together with poor expenditure targeting should be obliterated. What concerns the revenue side of the story, reforms there should accompany those of the expenditure side if debt dynamics were to be reversed. As taxes remain the main source of government revenues, tax reforms mainly focusing on a broader, more effective and more progressive income tax system, and on a more harmonized taxation of investment income are suggested; together with a pass-on of part of the energy cost to consumers following the example of other oil-importing countries. The latter would nonetheless be subject to a large opposition as most of the population is not
enjoying an appreciable level of welfare; and therefore it should be taken into a more careful consideration.

Independence and effectiveness of monetary policy, ability of a flexible exchange rate to adjust to competitiveness gaps and to further render the current account balances more acceptable, and many other similar features depend on the adjustment of public finance imbalances, the strengthening of the Central Bank balance sheet, and the diminishing of its vulnerability to government volatilities due to the support it provides to the government. According to an IMF report, this could be done by a shift in the liquidity absorption plan of the Central Bank from issuing long-term CDs to selling parts of its large TB portfolio. This would somehow reduce the quasi-fiscal costs of the Central Bank.

The decreased dollarization, increased deposit growth and international reserve base, and record surpluses in BOP are opening up room for a reduction in interest rates. This would help in the process of encouraging local currency bank lending through reduced reserve requirements of the Central Bank and exchanging maturing Eurobonds rather than tapping international markets and issuing new external debt.

In a world of high dollarization rate and continued uncertainty, pegged exchange rate regime remains the most appropriate monetary anchor. Nevertheless, sustainable growth in the long run requires a solution of the current fiscal problems and a focus towards more liberated, expanded, and competitive economy. It also requires the unwinding some of the costly operations from the banking sector activities.
Lastly, the starting point of the smooth application of the above mentioned reform plans is the formation of a reliable statistics database. Even though during the last few decades there had been some efforts to create different databases of different economic and financial indicators, it still needs a lot of effort to further improve and strengthen them and render them more inclusive and more reliable. This will smooth research and policy making processes and will make them more dependable and sustainable.
# APPENDIX

## I. DATA

<table>
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<td>constant indicator (index)</td>
<td>179.1</td>
<td>175.3</td>
<td>186.4</td>
<td>155</td>
<td>195</td>
<td>157.3</td>
<td>206.5</td>
<td>212.5</td>
<td>231</td>
<td>211</td>
<td>194.6</td>
<td></td>
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<td>cleared cheques in LBP (year-on-year changes)</td>
<td>7.18%</td>
<td>4.27%</td>
<td>10.97%</td>
<td>10.19%</td>
<td>11.33%</td>
<td>10.96%</td>
<td>9.34%</td>
<td>10.19%</td>
<td>10.53%</td>
<td></td>
<td></td>
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<tr>
<td>cleared cheques in foreign currencies (year-on-year changes)</td>
<td>-0.89%</td>
<td>40.63%</td>
<td>40.16%</td>
<td>37.96%</td>
<td>52.76%</td>
<td>64.56%</td>
<td>24.59%</td>
<td>5.39%</td>
<td>4.08%</td>
<td></td>
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<td>construction permits (year-on-year changes)</td>
<td>-25.15</td>
<td>83.23</td>
<td>34.52</td>
<td>34.53</td>
<td>19.13</td>
<td>36.53</td>
<td>189.93</td>
<td>4.8</td>
<td>37.12</td>
<td></td>
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<td>credit delivered (year-on-year changes)</td>
<td>-2.21</td>
<td>4.88</td>
<td>11.5</td>
<td>7.67</td>
<td>7.79</td>
<td>0.65</td>
<td>12.55</td>
<td>0.16</td>
<td>18.34</td>
<td></td>
<td></td>
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<tr>
<td>total imports (millions LBP)</td>
<td>4,372,364</td>
<td>4,378,243</td>
<td>4,359,488</td>
<td>5,374,663</td>
<td>5,755,649</td>
<td>6,830,992</td>
<td>6,473,048</td>
<td>4,886,354</td>
<td>6,522,151</td>
<td></td>
<td></td>
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<tr>
<td>total exports (millions LBP)</td>
<td>1,980,571</td>
<td>1,973,434</td>
<td>1,914,721</td>
<td>1,314,151</td>
<td>1,352,763</td>
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<td>18.38</td>
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<td>6.14</td>
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<td>commercial banks reserves (millions LBP)</td>
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<td>9,317,344</td>
<td>10,674,183</td>
<td>10,449,856</td>
<td>9,111,444</td>
<td>10,053,607</td>
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<td>commercial bank non-resident deposits in LBP (billions)</td>
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<td>701,679</td>
<td>725,829</td>
<td>740,092</td>
<td>811,947</td>
<td>813,478</td>
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<td>commercial bank-resident deposits in foreign currency (bn LBP)</td>
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<td>54,104.71</td>
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<td>64,468.01</td>
<td>68,481.90</td>
<td>70,797.16</td>
<td>80,874.74</td>
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<td>cement production (millions LBP)</td>
<td>12,377.45</td>
<td>12,372.94</td>
<td>12,546.11</td>
<td>12,368.00</td>
<td>12,592.49</td>
<td>12,667.03</td>
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<td>1,267,684</td>
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<td>1,331,173</td>
<td>1,243,295</td>
<td>1,477,544</td>
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<td>M1 (millions LBP)</td>
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<td>3,021,454</td>
<td>3,480,403</td>
<td>3,578,113</td>
<td>3,650,640</td>
<td>3,700,173</td>
<td>3,892,284</td>
<td>4,268,284</td>
<td>4,188,989</td>
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<td>24,575,480</td>
<td>26,430,664</td>
<td>25,678,110</td>
<td>29,059,531</td>
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<td>70,926,484</td>
<td>69,407,542</td>
<td>66,367,987</td>
<td>62,367,607</td>
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<td>8,917,762</td>
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<td>8,843,180</td>
<td>9,688,498</td>
<td>10,084,373</td>
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<td>80,814,482</td>
<td>92,268,810</td>
<td>97,777,623</td>
<td>103,143,310</td>
<td>103,221,808</td>
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<td>LPR deposit rates (%)</td>
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<td>4.94</td>
<td>4.84</td>
<td>4.75</td>
<td>4.67</td>
<td>4.61</td>
<td>4.53</td>
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<td>4.84</td>
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<td>4.77</td>
<td>4.71</td>
<td>4.67</td>
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<td>SOE deposit rates (%)</td>
<td>4.98</td>
<td>4.84</td>
<td>4.72</td>
<td>4.65</td>
<td>4.61</td>
<td>4.56</td>
<td>4.51</td>
<td>4.47</td>
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<td>budget deficit (billions LBP)</td>
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<td>44.8</td>
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<td>% of TBL subscribed to banks</td>
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