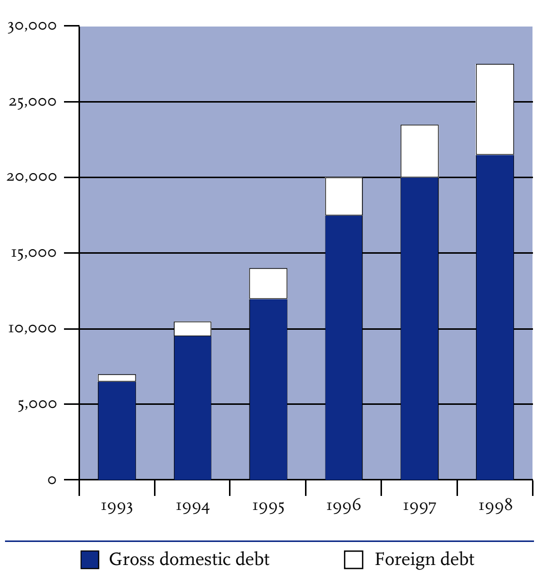
FINANCING DEVELOPMENT: FISCAL REFORM, DEBT MANAGEMENT AND FINANCIAL MARKETS

Contents

EVOLUTION OF PUBLIC DEBT (in Billion LL)



by JIHAD AZOUR
Adviser of the Minister, Ministry of finance

A. The Problems

Despite the post-war reconstruction era, the Lebanese economy witnessed slowdown and structural weaknesses. The symptoms of this economic slowdown are:

1. Fiscal problems:
- High Budget deficits
- Low ratio of public revenues: Ratio Revenues/GDP under 18% in 98
- Increasing debt/GDP ratio: from 52% in 93 to 113% in 98
- Increasing debt service ratio: from 26% in 93 to 42% of expenditure in 98

2. External imbalances:
The balance of payments passed from a surplus of 1,170 Mn $ in 93 to a deficit -488 Mn $ in 98

3. Social issues
- Regional disparities : e.g. household income , illiteracy rate, public transportation
- High level of poverty
- High unemployment rate

4. Declining economic growth
7% in 93
3% in 98

Also the Reconstruction period created continuous fiscal deficits and caused debt accumulation which have urged the development of a program for growth and stability. The milestone of this program is a Fiscal Adjustment plan that will reduce budget deficit and public debt. This program will also try to increase private sector growth and competitiveness, it will tackle the administrative reform and promote regional and social development.

B. The Reforms

For the reasons mentioned above, the government has put in place a Five-year fiscal adjustment program with the following objectives:

The election of a new President and the formation of a new Cabinet bode well for fiscal consolidation. The executive branch has made clear that the country will embark on a five-year fiscal adjustment program to secure a sound fiscal policy conducive to economic growth through wide private sector participation. The general targets of the five-year fiscal program are spelled out below:

Ü Reduce the budget deficit by a massive 11.1% of GDP, to 4.5% of GDP by 2003

Ü Reduce the debt level to 96.3% of GDP by 2003 (the peak is expected to be attained in 2000)

Ü Decrease interest rates on local and foreign debt (the decrease in interest rates on foreign debt will occur through increasing the share of concessional loans)

Ü Reach annual growth rates of 5% by 2003.

The plan seeks to achieve these broad objectives through the following reforms:

Ü **Tax reform and modernization**, mainly through:

One. Income and property tax reforms, already introduced in the context of the 1999 Budget. The main purpose of these reforms is to increase equity and fairness in income distribution and to boost revenues.

Two.Introduction of a VAT in 2001, currently under preparation at the MOF. Amongst the proposed fiscal measures, the introduction of the VAT will yield the sharpest increase in overall tax revenues (by 2.9% of GDP) in 2001.

Three. Introduction of a global income tax, intended to replace the current existing system of schedular income taxes.

Four. Reforming the tax administration through continuous training of existing staff and the recruitment and training of 300 new auditors.

Five. Other tax reforms and modernization, such as the continuous adjustments in gasoline prices in line with international market levels as well as the consideration of the introduction of appropriate various investment-neutral taxes and fees, as may be justified.

These reforms will result in an increase in total budget revenues by 4.5% of GDP by the end of the five-year period.

Ü **Expenditure rationalization** through imposing a ceiling on the level of expenditures in reducing current expenditures in real terms: Expenditure is projected to decline in real terms, from around 35% of GDP in 1999 to 28.6% in 2003. This is to be achieved by curbing non- interest spending (will remain below 20% of GDP in 2000-2003). The key adjustment factor on the expenditure side will be the decline in debt servicing costs, by 5.3% of GDP over the 5-year period. This will be the result of much smaller borrowing needs (due to growing primary surpluses from 2001 onwards and the fiscal impact of privatization), and the projected decline in interest rates on LBP-denominated to 11.0% by 2003 on average, from 14.5% in 1999. As to capital expenditures, it is assumed that a large part of the remaining infrastructure works will be conducted by the private sector and therefore, the private sector will become the main engine of growth in the country.

Ü **Privatization program and increase in private sector's participation in infrastructure development** (USD 4-5 billion privatization proceeds by 2003 to retire debt): the five-year fiscal adjustment program assumes that a new source of budget financing and debt repayment - privatization receipts - will come into the equation in 2000. The privatization program is front-loaded with 2000 target for proceeds of LBP 2,054 billion (about USD 1.4 billion, including re-negotiation of mobile phone licenses), with the level declining gradually to LBP 1,900 billion in 2001 and then to LBP 1,000 billion in 2002-03.

Ü **Improving public debt management and structure** through strengthening the institutional framework of the debt management unit at MOF, the development of new debt instruments, the reform of the local debt market with the objective of increasing depth and liquidity in secondary market trading.

It is worth noting here that the 5-year Fiscal Adjustment Program started in 1999, with Budget 1999 incorporating sizable revenue reforms along with a reduction of expenditures as well as with the preparation of a number of reforms such as VAT and privatization.

The five-year fiscal adjustment program

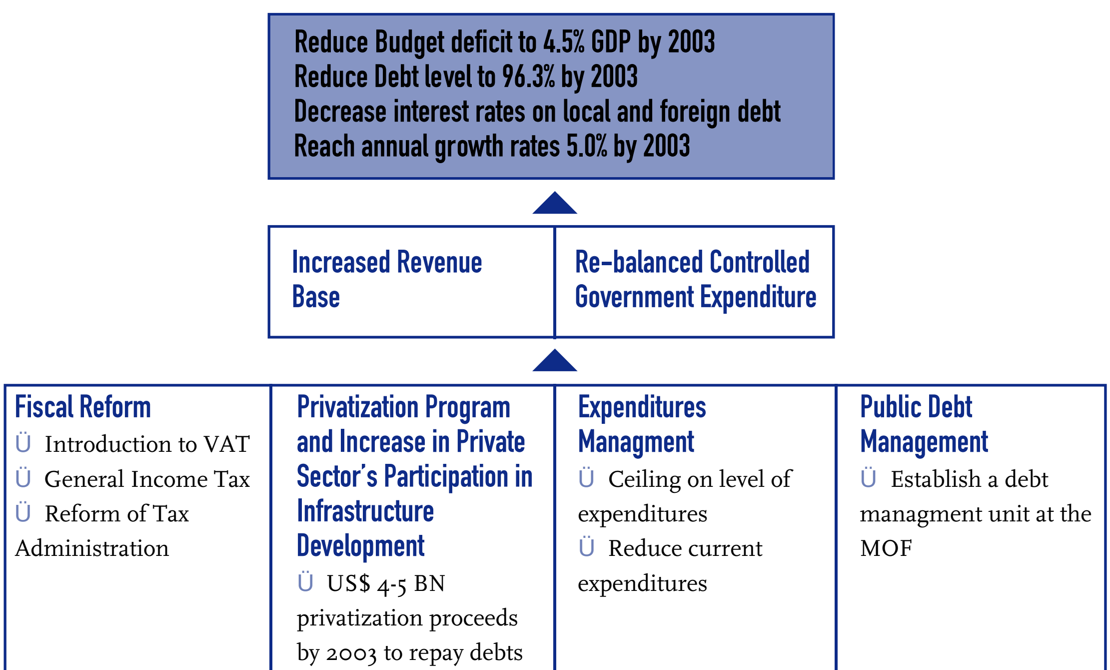
The fiscal adjustment program will be implemented in two main phases:

Phase 1: Establishment Period 1999-2000
This period will be dedicated to:
Ü Recreate sound fiscal environment
Ü Prepare and initiate structural reforms
Ü Implement tax reforms

Phase 2: Consolidation Period 2001-2003
This period will be dedicated to:
Ü Improve fiscal environment
Ü Implement structural reforms : debt management, expenditure, etc.
Ü Complete tax reforms and privatization program

The government expects to reduce public sector role and allow private sector to prosper through the reduction of budget deficit and debt levels, the modernization of tax system, the reduction of public expenditure and the privatization program.

The long term impact of tax reforms will be to increase revenues, introduce more balanced tax system (Direct vs. indirect), increase equity and fairness in income distribution, reduce economic distortions, prepare Lebanon for international challenges, and achieve long term fiscal sustainability.



C. Expenditures Rationalization

In order to achieve long term fiscal sustainability and reposition the government in the economy, an expenditure rationalization strategy is needed. It will be governed by five priorities:

Ü Ceiling of the overall public expenditure
Ü Reduce share of current expenditures
Ü Rationalize investment spending
Ü Focus on social and regional development programs
Ü Improving the administrative efficiency in managing expenditure

Government initiated the reform in Lebanon's fiscal policy in the 1999 budget and plans to continue to pursue its course of reducing the fiscal deficit because as long as the deficit is present to a significant degree, it is not only threatening to spark a revival of inflation but it also affects interest rates, and therefore the volumes of private investment

The government adopted several revenue measures in the 1999 Budget:

Ü Income Tax on Wage and Salaries: New brackets. The maximum rate increased from 10% to 20%
Ü Corporate Tax on Profits: It increases from 10% to 15%
Ü Tax on Dividends: It increases from 5% to 10%
Ü Inheritance Tax: It increases from 10% to 16%
Ü Property Tax: New brackets. The maximum rate increased from 10% to 13%

On the expenditures side, the government adopted a plan to reduce operating public expenditures by over LBP 400 BN in 1999.

The initial results are encouraging. The 1999 budget deficit is at 38% of expenditures and the government has achieved a primary surplus of 888 billion Lebanese pounds.

D. Debt Management

Beside the fiscal issues, the government has to focus on public debt management. A clear government debt strategy and explicitly formulated objective is clearly needed in the case of Lebanon not only because of the size and composition of the debt but also because of the large proportion of debt service in government expenditure.

A debt management framework is presented in the following paragraph:

Objective

To minimize over the long term the cost of meeting the government's financing needs, taking account of risk, while ensuring that debt management policy is consistent with monetary policy

Strategy

Ü Smoothing the Lebanese government debt maturity profile:
Ü Fostering liquidity and efficiency in the market of Lebanese government debt
Ü Creating an integrated risk management system (for both local and foreign debt)
Ü Lowering the cost of government debt service

Requirements

Three criteria are essential in debt management:

Ü Cost,
Ü risk and
Ü consistency with monetary policy

Institutional Framework

Ü Create middle office capacity to manage risks
Ü DMO is essential for an efficient conduct of active debt management

Instruments

Ü Create fungibles and benchmarks
Ü Introduce new products
Ü Active debt management schemes

In reality, government has set forth the Principles and approach of a borrowing strategy that matches the economy's needs:

Foreign Borrowing Strategy

In the context of the debt refinancing strategy of replacing costly and short-term domestic debt with cheaper and longer-dated foreign debt, the MOF accessed the capital markets twice in 1999.

In this regard, the MOF has set a number of objectives, namely:

Ü **Foreign debt limits:** The MOF is cautious about the country's external borrowing limits (including concessional loans), which will not exceed 35% of total outstanding debt.

Ü **Broadening the investor base:** The MOF is working on broadening Lebanon's international investor base and the latest Eurobonds have attracted a much broader international, non-traditional investor base. Diversification of financing sources is a priority and the MOF will continue marketing Lebanon in roadshows throughout the US and Europe.

Ü **Maintaining scarcity of Lebanese Eurobonds:** The MOF is also keen on keeping Lebanon's access to capital markets as limited as possible in order to keep investors thirsty for more Lebanese paper.

Ü **Spread government liabilities into different currencies** in accordance with the Central Bank's foreign exchange reserves and ensure better use of official bilateral and multilateral borrowings.

Local Debt Market Development

Ü Streamlining the issuing strategy and creating benchmarks

Ü Fostering the development of the secondary market

Ü Improving and modernizing the market infrastructure

Ü Developing instruments to enhance liquidity

Ü Adjusting the regulatory framework

E. Privatization
Increasing the role of the private sector

The privatization is a milestone of the five year fiscal program. The main benefits of the privatization would be the reduction of the public debt, the increase in capital inflows, the acquisition of new technology and the broadening of domestic capital markets.

Legal and institutional framework

Ü Creation of High Committee for privatization led by the Prime Minister

Ü Law to regulate privatized sectors

Ü Introduction of strategic partners into entities to be privatized

According to the 5-year fiscal adjustment plan, privatization proceeds (USD 4-5 billion by 2003) will be used to retire public debt and decrease expenditures through the decline in interest payments and the decrease in the wages and salaries bill. The first phase of the privatization process is near completion due to the following developments:

Status of the privatization law:

Ü The Privatization draft law, prepared with assistance from the World Bank, was approved by the Cabinet last May and forwarded to Parliament immediately thereafter. It is currently being reviewed by Parliamentary committees.

Ü Two of the three Parliamentary committees who have studied the draft law, have approved it with minor amendments.

Sectoral preparations:

Ü A specific sector law for telecommunication is currently under preparation and will soon be submitted to the Council of Ministers. This law is designed to restructure and regulate the telecommunication sector, to allow for licensing new entrants, and permit the corporatization and privatization of the sector.

Ü The Ministry of Hydraulic and Electric Resources will launch a sector law for electricity in 2000. The Ministry is currently drafting requests for proposals for legal advisors to draft the new energy law that would allow for privatization and competition in the sector.

Ü The most important assets to be privatized in 2000 belong to the telecom sector. The first part involves the conversion of the 2 mobile phone concessions into licenses. The second part entails the sale of the fixed line operator. The government believes that it will be able to raise at least half of the USD 4 billion expected through 2003 from the sale proceeds of the telecom sector.

Ü Moreover, privatization of Middle East Airlines will be launched in 2000.

Privatization's relative impact on the progress of the fiscal adjustment could be very important. While the government is determined to implement the program in accordance with the revenue plan, it is equally keen to ensure that privatization is based on sound legal and technical foundations.

In line with its fiscal policy, the government should improve public service performance because much remain to be done in this field. The government has to review the size of the public sector, re-engineer the human development policies especially in the case of pay policy, incentive structure, Job evaluations, standardization of recruitment. There is a need also to Review procedures, improve accountability and retrain civil service staff.

If the reforms that are set forth continue on the right path, the economy will be able to return to the virtuous circle of fiscal reform:

↓Deficit => ↓Borrowing needs => ↓Debt =>↓Debt service => ↑Credit to private sector +↓Interest rates => ↑Economic Growth => ↓Deficit

F. Financing Development: Linking Fiscal Reforms to Financing Development

The fiscal reforms(e.i. Tax reform, Expenditure Rationalization, Debt management, Privatization Program) constitute a crucial issue in financing development. These reforms will lead to a reduction in interest rates, reduction of public sector borrowing needs, increase in the available liquidity to finance the private sector and improvement of Lebanon's credit position.

The Government should channel the liquidity or Lebanese private savings to finance development through different ways:

Banking Sector

Ü Major source of financing
Ü Active in traditional instruments
Ü Developing new means of financing the private sector : project finance, term loan, etc.

Capital Markets

Ü Develop promising sectors of the economy
Ü Finance reconstruction
Ü Restructure existing finance
Ü Channel savings to investment in Lebanese companies

Special schemes

Ü Microcredit programs
Ü Credit guarantee schemes
Ü Subsidized loans to small and medium sized entreprises
Ü Housing loans

G. Renewing Financial Markets

Ü Promote contractual savings
Ü Develop market infrastructure Clearing & settlement, information, technology, etc.
Ü Regulation: New Financial Act to promote development of the financial sector
Ü Reactivate the capital markets: Listing, continuous trading, intermediaries, etc.

Role of the Government

Government policy should be based on the premise that the private sector must be the engine of growth

Ü Assure the provision of the basic social services and infrastructure
Ü Strengthen its regulatory and monitoring roles in the economy
Ü Ensure that the basic needs of poorest groups in the population are met
Ü Acting as catalyst to foster economic development

BEYOND THE NEOLIBERAL–MONETARIST IMPASSE: TOWARD A NEW POLICY OF ECONOMIC RECOVERY

by GHASSAN DIBEH
Professor of Economics, Lebanese American University (LAU)

Introduction

Economic policy makers in Lebanon are finding themselves again in a seemingly intractable impasse. After seven years of "local voodoo economics" the picture is bleaker than ever. The economy is plagued with persistent and unyielding high budget deficits, rising debt-to-GDP ratio, and declining output growth rates that many argue has developed into a classical business cycle with absolute declines in GDP registered in the past two years. The present government is hence faced with the task of lifting an economy out of a recession while at the same time reducing the budget deficit over time, stopping the exponential growth in debt-to-GDP ratio and maintaining economic growth prospects in the future. The Fiscal Reform Plan, adopted by the cabinet, was a step forward in economic policy making in Lebanon. It addressed boldly the issues facing the Lebanese economy and proposed a comprehensive set of policy steps over five years to reduce the budget deficit/GDP, debt/GDP ratios and to increase economic growth to an average of 5% by 2003. My view is that the plan and current economic policies in many ways fall short of expectations. There is a need for a theoretical vision that breaks with the past practices of supply-side economics, monetarism and neo-liberal thought. At present nothing of the sort has happened. Except for a shy reform of income taxes towards a more progressive system, current policies remain within the parameters of conservative thought. That consists of a belief in balanced budgets, contractionary monetary policy, privatization, and increases in indirect taxes (gasoline, tobacco, import tariffs) albeit it carries more dangerous elements: commitment to fiscal austerity at a time of economic recession and an aggressive policy of substitution of foreign debt for domestic debt.[1]

If the task at hand is to think of what can be done in terms of fiscal policy (and monetary policy) to finance development in this decade, a quick look at the effects of the above policies on the Lebanese economy will show the need for a new policy of economic recovery. This new policy has to do away with what we can call 'depression economics' (to borrow from Paul Krugman). The outcomes of 'depression economics' can be summarized as follows. Fiscal austerity will hamper economic growth and will constrain the state's future outlays for public investments in physical and human capital which in turn will generate less national savings in the long run.[2] Contractionary monetary policy that aims solely at

[1] Even the envisioned VAT is said to have a one rate, which of course increases its regressive nature. The Hoss government was seen by many as the government of national salvation. A break with the past was expected. However, to their disappointment, the social and economic policies of the Hoss government were more conservative than its predecessors.

[2] Of course the theoretical basis for the relationship between budget deficits and economic growth goes all the way back to Keynes. For recent analysis that apply to the US case, see Eisner (1994) and Tobin (1993). For an anti-austerity anti-neoliberal argument at the European level, see Lipietz (1992). For a defense of Keynesian polices, see Tobin (1986).

price stability, currency value, maintenance and expansion of existing foreign exchange reserves, and balance of payments equilibrium at the expense of employment and economic growth will form huge constraints on any growth-oriented strategy in this decade.[3] In its turn, privatization is a big gamble if the macroeconomic conditions, regulatory frameworks and hence private investors' risk aversness are not right. My conjecture is that privatization will end up in a fiasco on many grounds: efficiency, distribution of wealth, monopolization, and consumer welfare. More importantly, for our purposes, the fiscal benefits will be doubtful. Last, the external debt issue continues to be considered an 'accounting problem'. The ratioale for the substitution of external debt for internal debt is the interest payments savings resulting from the differential interest rates between dollar bonds and LP bonds. This accountant mentality ignores the other aspects of external debt. The current trend if it continues will form a resource-constraint on development finance in the next decade.

Public Debt Management

Post-war Lebanon embarked on an ambitious reconstruction project that aimed at putting the Lebanese economy well into the upper-middle income group of nations by the year 2007. This economic growth plan has been accompanied by other economic, fiscal, and financial measures aimed at monetary and fiscal stabilization. In order to fight inflation and achieve external balance, the Hariri government and the central bank used the nominal exchange rate as an anchor in the post-1992 stabilization program. This restrictive monetary policy depended on high reserve requirements and the abandonment of infla-

Table 1 Budget Deficits 1993-1998 (in bn LP)

Year	1993	1994	1995	1996	1997	1998
Revenues	1,855	2,241	3,033	3,536	3,753	4,441
Expenditures	3,017	5,204	5,856	7,244	9,161	7,906
Deficit	1,162	2,963	2,823	3,708	5,408	3,465
Deficit/GDP	9.0	19.3	15.6	18.2	23.6	14.1

Source: For 1996-1998, BdL Quarterly Reports 1999:1. and 1998:4. For 1993-1995, Ministry of Finance. GDP for 1993-1995 from BdL reports. GDP for 1996-1997, IMF Occasional Paper 176. For 1998, Fiscal Reform Plan.

Table 2 Public Debt of Lebanon (1993-1998)

Year	Net Public Debt (in billions of LP)	External Debt ($ million)	GDP	Debt/GDP(%)
1993	4,433.6	327	12,892	34.4
1994	6,681.9	772	15,347	43.5
1995	9,259.9	1,343	18,061	51.3
1996	16,318	1,898	20,417	79.9
1997	22,098	2,434	22,878	96.6
1998	25,826	4,199.80	24,509	105.4

Source: For external debt 1993-1998, BdL. For Net Public Debt 1993-1995, Ministry of Finance. For NPD 1996-1997, IMF Occasional Paper 176. For 1998 NPD, BdL Quarterly Report 1999Q1 and GDP, Fiscal Reform Plan.

[3] For a discussion on the relationship between the objective function of central banks and economic growth and employment, see Epstein (1992).

tionary finance that characterized government financing in the 1980's. This policy was successful in bringing down inflation that averaged in 1986-1992 at around 110% annually (BdL, 1993) to its current single digit levels. In contrast, fiscal policy has been expansionary in that the fiscal adjustment was minimal if not non-existent.[4] This expansionary fiscal policy coupled with the supply-side tax reforms of 1993 that reduced taxes on profits, salaries, capital incomes and others led to the growth of public debt in Lebanon to unprecedented levels. Tables one and two summarize budget deficits and the debt evolution in the post war period.

Tables one and two show that government deficit growth was one of the main developments in public finances during this period. The persistent government deficits, led public debt both internal and external to grow tremendously. The stage was set for a fiscal crisis of the state represented by the exponential growth in debt to GDP ratio and growing deficit to GDP ratio that reached record levels in 1997 of 23.6%. This fiscal crisis was the result of the Hariri government ambitious plan of reconstruction, increase in public wages and social expenditures and the tax reforms of 1993 that reduced direct taxes on wages and profits to record levels. This combination of large expenditures and low taxes led to the continuos widening of the budget deficit and hence to the accumulation of debt.[5] These deficits were financed by the issuance of local T-bills denominated in Lebanese pounds. However, starting in 1998, as the fiscal crisis intensified and local savings were deemed insufficient for the financing of the state, the government started looking for external markets for finance. This was reflected in the discrete jump in external debt figures for 1998. This policy is continued today at an accelerating speed. The pure accounting ratioale given by the government for such a move is unconvincing to many. The political economy of such a shift to external debt reflects the unwillingness of local agents mainly commercial banks to continue to rollover debt in LP-denomination. Whatever, the reason is for this substitution drive, the economic implications of borrowing in foreign markets and in foreign currencies have to be investigated.[6]

The Risks of External Debt

The debate over the proper mix of internal and external debt has centered on the pure accounting idea of interest rate differential between debt instruments denominated in foreign currencies and debt instruments denominated in Lebanese pounds. The differential currently stands at around 5-6%. Although the reduction in debt servicing payments can be substantial if the debt mix included higher ratios of external debt, the picture is not complete without including in the analysis the economic implications of substituting external debt for local debt. Such analysis has been missing from the ratioale of such policy advanced by both the previous and current governments. It seems that the expediency of solving or better said postponing the fiscal crisis of the state is overriding all other consideratio. But what are these other consideratios?

The major difference between external debt and internal debt is that the first entails a resource transfer from the country to the outside world while the second involves internal reallocation of resources between holders of debt instruments and eventually taxpayers.[7] To understand this important difference which at times is ignored in public policy discourse, a look at a debt crisis situation in two extreme cases will help. Case A, in a country that holds only inter-

[4] This policy was similar to the Reagan administration's disinflationary policy of the early 1980's. Restrictive monetary policy led to disinflation while expansionary fiscal policy led to the mitigating of the adverse effects of monetary policy on output at the expense of higher local and foreign debt. For details of fiscal adjustment during the Hariri period see my paper Dibeh (1997).

[5] The Hariri government fatal error was not in its ambitious plan of government expenditures as many would argue but in its failure to create a modern revenue system through progressive taxation and taxation on interest bearing instruments. If such a system was implemented, Lebanon would have had acceptable levels of deficits and debt to GDP ratios. Lawrence Summers in evaluating the impact of Reagan's policies said with great relevance to the subject at hand "The choice is not between tax increases and deficits, but between tax increases and deficits followed by tax increases" (Summers, 1984, p.190).

[6] A classic example of stop-go relationship between government debt roll-over and markets is the French Franc crisis in the 1920's (Krugman, 1991).

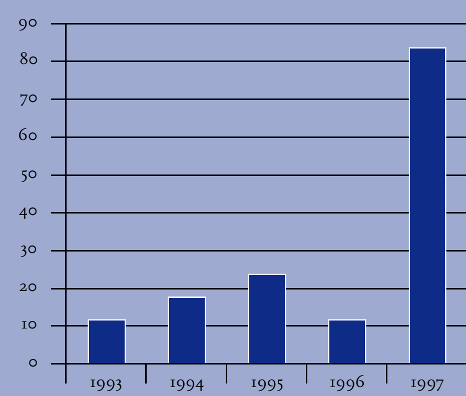
[7] The distributional implications of internal debt are enormous especially in Lebanon where the T-bill holdings are concentrated in the hands of commercial banks.

nal debt and case B, a country that holds only external debt. A debt crisis is generated when the country is no longer able to make debt repayments and hence additional debt sources dry up. In case A, the country can reduce the debt burden by inflationary finance through printing money or can resort to foreign debt on a one-time basis. All these measures do not involve any resource transfer to the outside world and hence consumption, investment and other components of aggregate demand are not affected. In case B, the adjustment process involves currency depreciation and production shift from non-tradables to tradables. This adjustment leads to reduction in consumption, imports, economic recession and a dramatic increase in debt-to-GDP ratio.[8] The Latin American countries that went through the world debt crisis in the 1980's faced this dynamic. The same happened in Mexico after its currency crisis in 1994 which was generated also by the presence of short-term debt denominated in foreign currencies.[9] Hence, a higher default probability and vulnerability to currency crisis are important factors in deciding to substitute foreign debt for internal debt as the consequences of a debt or currency crisis in the presence of external debt can be economically devastating. Many indicators are important in assessing both currency crisis vulnerability and the probability of default in indebted LDCs.[10] Following are the indicators and their time evolution in Lebanon in the past years.

1) The debt service ratio (DSR). DSR is the ratio of external debt service to exports of goods and services. The debt service includes interest and principal payments. The higher the ratio is the more likely the country is going to face difficulties of debt repayment. The following figure shows the DSR for Lebanon. {Figure 1}

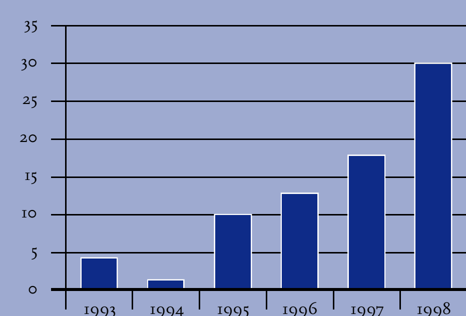
2) Ratio of interest on the country's external debt to exports of goods and services. This indicator although closely related to the DSR it differs in its emphasis on the short-term of external debt. {Figure 2}

Figure 1 Service Payments on External Debt relative to Exports: 1993-1997



Source: For exports www.bdl.gov.lb- For Debt Service Payments IMF Occasional Paper 176.

Figure 2 Interest Payments on External Debt relative to Exports: 1993-1998



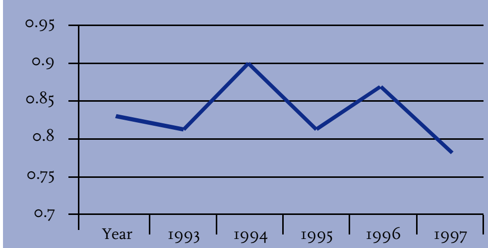
Source: For exports www.bdl.gov.lb- For Debt Service Payments: BdL QREP-1-1999 and IMF Occasional Paper 176.

3) Rate of International Reserves to Imports. This indicator measures the flexibility of the Foreign exchange reserves of the central bank in accommodating foreign debt. {Figure 3}

4) The ratio of external debt to reserves. This indicator measures the degree of absorption of foreign exchange reserves by external debt. The higher is this ratio the more probability of rescheduling is increased. {Figure 4}

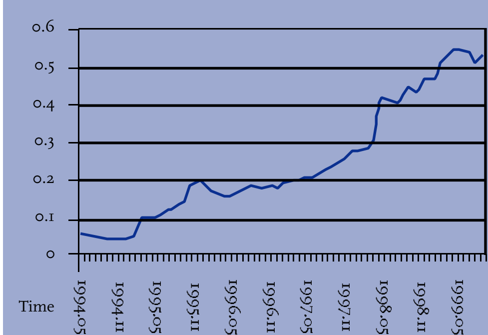
8 For details on the adjustment process under external debt and the experience of Latin American countries, see Sachs and Larrain (1993).
9 For a description of the Mexican currency crisis, see Edwards and Naim (1998).
10 For details see Woller and Phillips (1996) and Charbaji, Ali and Mrrash (1993).

Figure 3 Ratio of Imports to Gross Foreign Exchange Reserves: 1993-1998



Source: BdL Data Base

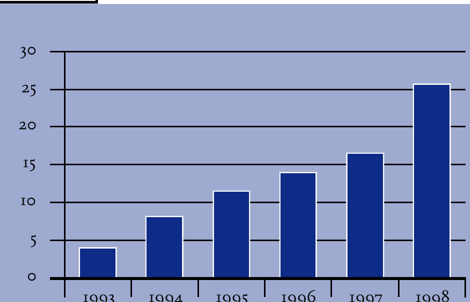
Figure 4 Ratio of External Debt to Gross Foreign Exchange Reserves: 1993-October 1999 (monthly)



Source: BdL Data Base

5) The ratio of external debt to GDP. {Figure 5}

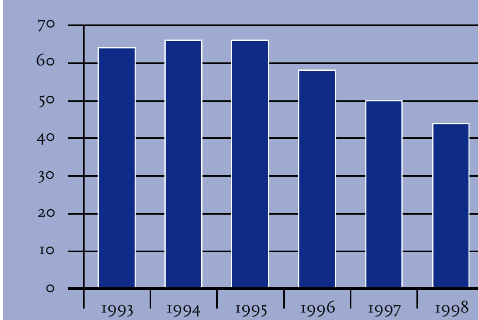
Figure 5 The ratio of External Debt to GDP.



Sources: External Debt, BdL data base. GDP: various sources.

6) The degree of openness of the economy. This is measured by the ratio of imports to GDP. This indicator measures two things. First, the extent of the adjustment of the economy in case of a debt crisis. Second, it measures the extent of foreign exchange available for debt servicing. {Figure 6}

Figure 6 Ratio of Imports to GDP in Lebanon (1993-1998).



Sources: For imports, BdL data base. For GDP: various sources.

All the above indicators except for imports to GDP show an increasing trend over the past six years. With the current policy of external debt substitution for domestic debt, the forecast is for these trends to continue at even a faster rate. Threshold levels after which a debt rescheduling occurs are difficult to determine nor optimal levels are readily available. However, it is clear that in the case of Lebanon, there is an increase in the degree of vulnerability of the Lebanese economy to the ravages of a debt crisis. The resource transfer to the external world is increasing and given the public debt dynamics that the economy witnessed in the past six years and shows no signs of abating, the road of debt substitution taken by the government is a risky one and its negative effects may well go beyond the immediate and short term effects of interest differential savings.[11]

According to Krugman (1991), the debt crisis in Latin America was preceded by a convential currency crisis and only then it developed into a debt crisis.

[11] Although a significant amount of debt is held by local banks, a debt crisis will still induce an adjustment process described above even if the resource transfer problem is mitigated. The reason is that a debt default crisis will be accompanied by a currency and balance of payments crisis and the necessity of closing the external gap generated by the persistant current account deficits.

The crisis started as a crisis of anticipated devaluation of the Latin American currencies. When creditors realized that the difficulties of the economies were going to affect not only the exchange rate but debt servicing, a cutoff of lending occurred. Sachs, Tronell and Velasco (1996) construct a theoretical model of currency crisis. According to their model, countries that are most vulnerable to a reversal of capital inflows are those with a weak banking system, an overvalued exchange rate and low reserves relative to their liquid liabilities. The indicators are then: real depreciation, bank credit to the private sector relative to GDP and M2/R. Following are the data for Lebanon, Mexico, Argentina and the Philippines which experienced currency crises in 1994 and 1995.

Table 3 Comparison between currency crisis indicators for Lebanon and three countries that experienced currency crisis

Country	Real Depreciation	Lending Boom	(M2/R)
Lebanon	-21.3	66.6	3.46
Mexico	-28.5	116.2	9.1
Argentina	-48.0	57.1	3.6
Philippines	-6.7	50.0	4.1

Source: For Mexico, Argentina and Philippines, Sachs et al (1996). For Lebanon, computations by author from several data sources. For real depreciation, it measures the average currency appreciation during 1995-1997 relative to the average of the years 1992-1994. Raw data from IMF Occasional Paper 176. Lending Boom is growth in Private credit-to-GDP ratio for the years 1993-1998. Source: For credit, BdL Database. For GDP, various sources. Reserve Adequacy Ratio is for November 1999, M2=currency in circulation +demand and savings deposits in LP + T-bills held by public in LP. R=net reserves. Source: Association of Banks of Lebanon database.

Privatization

Although the question to privatize or not to privatize may be an ideological one, the issue at stake at the current juncture in Lebanon is whether privatization will be effective in reducing the budget deficits and the public debt. The goal of privatization as stated clearly in the Fiscal Reform Plan is to reduce both current budget deficit in the year of the sale and the use of part of the proceeds for the retirement of public debt. The plan stipulates the following temporal allocation of privatization proceeds

Table 4 Fiscal Revenues from Privatization

Year	Proceeds (in Billions of LP)
2000	2054
2001	1900
2002	1000
2003	1000

Source: Fiscal Reform Plan.

Although empirical evidence shows that privatization is more effective in reducing the debt burden than in reducing the budget deficit in a current year (Pinheiro and Shneider, 1995), the fiscal benefits from privatization are not self evident. The primary objective of privatization according to many experts including the World Bank and the IMF is efficiency and productivity enhancement in the delivery of basic services such as utilities more than it is an instrument for budget deficit and debt reduction. According to Pinhiero and Schneider (1995) the proceeds form privatization are usually “too little and too late to help in resolving a fiscal crisis.” Moreover, according to Mackenzie (1998), proceeds from privatization should not be used to finance recurrent expenditures nor privatization itself should be a substitute for willingness to increase taxes. A large emphasis on fiscal revenues, as the case is presented in Lebanon, may lead to adverse conditions such as highly leveraged purchases and increased monopolization which in the end lead to less than the desired efficiency and productivity increases. If such a situation develops privatization becomes the substitution of an asset for a future stream of cash flows whose net effect on the intertemporal government budget is zero. In general there are conditions under which privatization may reduce the present value of public sector borrowing requirements such as: the company has to be worth more to the private sector than for the state, the state enterprise has to become more profitable after sale and the state enterprise has to grow faster in private hands. Hence, the macroeconomic conditions under which the sale occurs are very important. Adverse macro conditions and the absence of regulatory framework can increase the risk aversness of investors leading them to reduce the value of the company and hence greatly reduce the fiscal impact. If the value differential is such the case that the government receives less for its assets than they are worth then the intertemporal effect is negative which has the opposite effect of fiscal tightening (Mackenzie, 1998). Moreover, if private investment in the privatized firms reduces investment elsewhere then the fiscal benefits are greatly reduced. Moreover, when the government's purpose is financial gain, it will restrict competition (to guarantee profits for investors) and hence lead to the deterioratio of allocative efficiency. This dynamic was evident in the Argentinean privatization (Gallani and Petrecolla, 1996). The regulatory environment was intentionally not established so as to allow quasi-rents to exist where financial losses did.

According to Mackenzie (1998), there are other macroeconomic effects of privatization. If the value of the firm for the private sector is larger than for the public sector, then its transfer may entail a reduction in investment equal to the value of the assets of the company. Moreover, even if investment does not fall, the aggregate supply will increase as a result of increased productivity and that will widen the gap between AD and AS necessitating a more expansionary fiscal and monetary policies. Financial markets are also important in privatization. In underdeveloped markets, the privatization process may have a large effect on the money supply and that would lead for shares to be traded at lower prices than the privatizable enterprise net worth.

In Lebanon, the current privatization fever offering it to the public as a panacea for all the country's economic problems carries many dangers. First, macroeconomic conditions are not favorable for the valuation of the companies by private investors. Second, the regulatory framework is virtually non-existent. Third, it is not clear especially in the case of major utilities (telephone and electricity) that the efficiency gains will lead to future revenue stream for the government through taxation higher than the current revenues. Fourth, the signaling value of privatization has high risks in Lebanon since the government and other proponents has put it at the top of the agenda for fiscal balance. The positive signal can turn into a negative one very easily when projected proceeds start dropping and the projected fiscal deficit increases as result.

Toward a New Economic Policy

At the start of 1999, the Governor of the Banque du Liban stated that one of the main macroeconomic policy targets of the Central Bank is to curb inflation. The ultimate objective is to lower interest rates on the Lebanese pound and foster economic growth while trying to preserve the purchasing power of the national currency.[12] This policy bias lies at the basis of economic policy in Lebanon in the post war period. This orthodox monetarism combined with supply side economics of the Hariri governments had generated the fiscal crisis of the state and subsequently the economic recession of today. The present government has substituted fiscal conservatism and neoliberal thought for supply side economics but kept orthodox monetarism. The results could be worse especially that the initial conditions are of fiscal crisis plus economic recession. The government's plan for fiscal reform is too austere. A quick look at the projected revenue, expenditures and debt evolution in the next five years tells to this fact.

[12] The exact figure for inflation in 1999 has been the subject of controversy. However, some economists and policy makers are claiming that we have acheived a zero inflation level. The problem lies not in the figure but in the interpretation. This is hailed as a triumph for monetary policy. Of course, any able-minded economist knows that zero inflation means that a drastic disinflation has occured with great costs in unemployment and lost output. If the figure is true, we need to congratulate the monetary authorities for presiding over one of the severest deflationary episodes in the capitalist world since the Great Depression in 1929. This is one of the reasons why monetary policy in Lebanon should not remain outside the realm of democratic accountability.

Table 5 Government Plan for reduction of deficits and debt (1999-2003)

Year	Tax. Rev.	Expenditures	Inflation	Debt/GDP	Deficit	Debt
1998	3,543	9992	4.50%	118.8	5562	29117
1999	4369	8958	4.00%	127.6	3453	33167
2000	4745	9416	3.50%	126.7	3437	35116
2001	5760	9733	5.00%	115	2524	34813
2002	6253	9633	3.50%	105.4	1824	34509
2003	6830	10081	3.00%	96.3	1583	34106

Source: Fiscal Reform Plan.

At first sight, the plan seems to achieve most of what most economists have been calling for since a long time. However, a proper measure of the future budget deficits by looking at real budget deficits to see their impact on aggregate demand gives s different picture.

Table 6 Real Deficits in the government plan

Year	Real Deficit (a)	Real Deficit (b)
1999	3320.192	2774.346
2000	3320.773	761.5024
2001	2403.81	-1960.76
2002	1762.319	-1470.97
2003	1536.893	-1396.38

a) Real Deficits calculated from the nominal deficits projected in the Fiscal Reform Plan using inflation levels predicted by the plan itself.
b) Real Deficits calculated from the projected debt evolution in the Fiscal Reform Plan.

The real deficits from table 6 can be seen to be drastically reduced during 1999-2003. This may seem necessary to reduce the burden of the public debt on the economy. However, once we account for inflation and debt retirement using privatization proceeds, nominal deficits starting in 2001 become real surpluses. This means that debt reduction can occur at a slower pace than envisioned in the plan and hence incurring a less contractionary impact on the Lebanese economy.[13] Given the current recession, the planned increase in taxes (see table 5), the planned privatization that may decrease aggregate demand, and the contractionary monetary policy of the BdL, the prognosis is that we will linger in economic recession all the way until the year 2003.

What is the alternative? The outline of a policy of recovery follows. It is based on four premises. First, Fiscal policy cannot turn contractionary at the time of economic recession and given the current economic structure has to lead the economy into an expansion. Second, monetary policy, although cannot lead the expansion because of the current fears of exchange rate stability, has to accommodate the fiscal expansion and abandon its anti-inflationary policy. Third, given market nervousness about the fiscal deficits and debt, a credible policy of deficit and debt reduction has to be enacted. The key for its success is a radical reform of the taxation system and the abandonment of quick fix solutions such as external debt issuance and fire sale privatization. Fourth, privatization, although may beneficial in reducing the debt burden, it has to be postponed until economic recovery takes hold and macroeconomic and profitability conditions are better. Detail of the plan are:

[13] It is important to note here that the reform plan, as austere as it is, does not bring Lebanon out of the levels of unsustainable debt. Using the rough formula of Olivier Blanchard for maximum sustainable debt (MSN = LFPS/r) where MSN = Maximum Sustainable Debt, LFPS = Largest Feasible Primary Surplus and r = real interest rate on debt, we get MSN in 2003 equal to LP 25100 bn compared to actual projected debt of LP 34106 bn. Values for Lebanon used r = 0.06 which is the weighted average of real rates on foreign and local debt projected by the plan for 2003 and LFPS = 1506 which the plan predicts to be the primary surplus in 2003. Given the current political opposition to the government plan and the 1999 and 2000 budgets, it is safe to assume that 1506 bn is the maximum politically feasible primary surplus.

1. A plan to increase taxes starting in 2002. Once recovery takes hold, measures to reduce the budget deficit and debt-to-GDP ratio can start. The direct tax system should be reformed radically. The initial thrust of tax reforms has come to a grind. The issue at stake was, of course, not the minor changes in the income taxes that were enacted (which is a significant improvement over the tax law 282/93) but the need for a comprehensive tax reform that would bring the Lebanese revenue system in line, in terms of its modernity, with the current expenditures system of the post-war period. High marginal tax rates should increase for incomes above LP 120 million, which in the current system become essentially flat. There is plenty of room there for many brackets and higher tax rates. Taxes should be levied on incomes with low propensity to consume such as returns on T-bills and savings deposits above a certain threshold. The decision to reform the tax system should not be postponed indefinitely in preference to quick fix solutions with no long run viability such as borrowing or privatization.[14]

2. The second element in the recovery program is fiscal expansion for the next two years through public investment programs. Given the current level of real interest rates, investors' expectations, high indebtedness of consumers, the collapse of the real estate market, real appreciation of the Lebanese pound and export slowdown, the only engine of aggregate demand is government expenditures. Supply-side policies such as incentives and tax breaks will not do it at this stage. Public investment will provide the fiscal stimulus needed for the economy to move out of the current recession. The by-product of increase in the debt-to-GDP ratio of few percentage points should make no difference compared to the drastic rise in the past seven years.

3. For the fiscal stimulus to succeed, monetary policy should be coordinated with fiscal policy. The current obsession with inflation should be abandoned or the central bank will frustrate the fiscal policy through even a more severe contractionary measures. The role of the monetary policy has to be changed to monetary accommodation of the fiscal stimulus.

4. Reformulate the whole policy on privatization. The large scale fire sales currently planned will be detrimental to consumer welfare, regulatory functions, and above all to the fiscal benefits from privatization. Privatization should be put off until the economy is in full recovery and all alternatives for the public enterprises have been thoroughly investigated.

Conclusion

The policies of the Hariri governments in the post-war period have pushed the economy towards its current state of fragile stability. The present government policies of monetary and fiscal contraction combined with exchange rate stability cannot be maintained indefinitely in the face of high debt growth and economic recession. The consequences can be tragic in terms of a sudden collapse of the currency engendering a generalized economic crisis. The policy reforms advanced in this paper, that unshackle the Lebanese economy out of its neo-liberal-monetarist straightjackets, should remove the specters of total collapse that currently haunt Lebanon.

[14] For a tax reform plan along the above lines see Dah, Dibeh and Shahin (1999). The current "take from the poor and give the rich" fiscal system through regressive taxation and high interest rates on T-bills held by commercial banks and the rich class has to come an end. The working and the middle class who paid the highest price on the barricades of the civil war should not also pay the reconstruction cost.

Bibliography

Ü **BdL (1993)** Annual Report of the BdL.

Ü **Charbaji, A., H. F. Ali and M. Mrrash (1993)**
"Predicting the Government's Decision to Seek a Rescheduling of External Debt," *Applied Economics*, 25, pp. 751-757.

Ü **Dah, A., G. Dibeh and W. Shahin (1999)**
The Distributional Impact of Taxes in Lebanon: Analysis and Policy Implications. Lebanese Economic Tribune Series, 6.

Ü **Dibeh, G. (1997)**
"The Social Impact of Government Expenditures in Lebanon: 1992-1996," *Abaad: Journal of Lebanese and Arab Studies*, 5, pp. 64-71.

Ü **Edwards, S. and M. Naim, eds. (1998)**
Mexico 1994: Anatomy of an Emerging-Market Crash. Carnegie Endowment for International Peace.

Ü **Eisner, R. (1994)**
"Deficits, Savings and Economic Growth," *The American Economist* 38(2), pp. 3-11.

Ü **Eken, S. and T. Hebling, eds.(1999)**
Back to the Future: Postwar Reconstruction and Stabilization in Lebanon. International Monetary Fund, Occasional Paper 176, Washington, D.C.

Ü **Epstein, G. (1992)**
"Political Economy and Competitive Central Banking," *Review of Radical Political Economics*, 24(1), pp. 1-30.

Ü **Galbraith, J. K. and W. Darity (1995)**
"A Guide to the Deficit," *Challenge, July/August*, pp. 5-12.

Ü **Galiani, S. and D. Petrecolla (1996)**
"The Changing Role of the Public Sector: An Ex-Post View of the Privatization Process in Argentina," *The Quarterly Review of Economics and Finance* 36 (2), pp. 131-152.

Ü **Krugman, P. (1991)**
" Financial Crisis in the International Economy," in M. Feldstein (ed.) *The Risk Of Economic Crisis*, pp.85-109. Chicago: The University of Chicago Press.

Ü **Lipietz, A. (1992)**
Towards a New Economic Order: Postfordism, Ecology, and Democracy. New York: Oxford University Press.

Ü **Mackenzie, G. A. (1998)**
"The Macroeconomic Impact of Privatization," *IMF Staff Papers* 45 (2), pp. 363-373.

Ü **Pinheiro, A. C. and B. N. Schneider (1995)**
"The Fiscal Impact of Privatization in Latin America," *Journal of Development Studies* 31 (5), pp. 751-776.

Ü **Sachs, J.D and F. Larrain (1993)**
Macroeconomics in the Global Economy. New Jersey: Prentice Hall.

Ü **Sachs, J. D., A. Tornell and A. Velasco (1996)**
"Financial Crisis in Emerging Markets: The Lessons from 1995," *Brookings Papers on Economic Activity* 1:1996, pp. 146-215.

Ü **Summers, L. H. (1984)**
"The Long-Term Effects of Current Macroeconomic Policies," in C. R. Hulten and I. V. Sawhill (eds.) *The Legacy of Reaganomics*, pp. 179-198. Washington, D.C: The Urban Institute Press.

Ü **Tobin, J. (1986)**
"Keynesian Economics and its Renaissance," in D. A. Reese (ed.) *The Legacy of Keynes*, pp. 94-129, San Francisco: Harper & Row.

Ü **Tobin, J. (1993)**
"Thinking Straight about Fiscal Stimulus and Deficit Reduction," *Challenge* 36(2), pp. 15-18.

Ü **Woller, G. M. and K. Phillips (1995)**
"Commercial Banks and LDC Debt Reduction," *Contemporary Economic Policy* 14, pp. 107-123.

SUMMARY

BEYOND THE NEOLIBERAL-MONETARIST IMPASSE: TOWARD A NEW POLICY OF ECONOMIC RECOVERY

by GHASSAN DIBEH
Professor of Economics, Lebanese American University (LAU)

This paper presents an outline of a new economic policy for Lebanon that breaks with the past neoliberal-monetarist paradigm that has dominated economic policy making in Lebanon in the post-war period. The paper argues that the policies of the Hoss government of commitment to fiscal austerity at a time of economic recession, contractionary monetary policy, privatization, and increases in indirect taxes and the aggressive drive of substitution of foreign debt for domestic debt carry with them high risks to the Lebanese economy. The paper delineates the dangers of debt substitution by looking at debt default ratios and currency crisis indicators. It finds that Lebanon's default ratios such as the ratio of external debt service to exports of goods and services, the ratio of external debt to reserves and others are rising as the result of debt substitution. Moreover, currency crisis indicators such as real appreciation of the currency, lending and the ratio of M2 to Reserves are comparable to those ratios in countries that experienced such a crisis such as Mexico, The Philippines and Argentina.

The paper projects the failure of the privatization program. First, macroeconomic conditions are not favorable for the valuation of the companies by private investors. Second, the regulatory framework is virtually non-existent. Third, it is not clear especially in the case of major utilities (telephone and electricity) that the efficiency gains will lead to future revenue stream for the government through taxation higher than the current revenues. Fourth, the signaling value of privatization has high risks in Lebanon since the government and other proponents has put it at the top of the agenda for fiscal balance. The positive signal can turn into a negative one very easily when projected proceeds start dropping and the projected fiscal deficit increases as result.

The paper outlines a new policy for economic recovery. The first element in the plan is tax increases starting in 2002. Once recovery takes hold, measures to reduce the budget deficit and debt-to-GDP ratio can start. The direct tax system should be reformed radically. High marginal tax rates should increase for incomes above LP 120 million which in the current system become essentially flat. There is plenty of room there for many brackets and higher tax rates. Taxes should be levied on incomes with low propensity to consume such as returns on T-bills and savings deposits above a certain threshold. The decision to reform the tax system should not be postponed indefinitely in preference to quick fix solutions with no long run viability such as borrowing or privatization.

The second element in the recovery program is fiscal expansion for the next two years through public investment programs. Given the current level of real interest rates, investors' expectations, high indebtedness of consumers, the collapse of the real estate market, real appreciation of the Lebanese pound and export slowdown, the only engine of aggregate demand is government expenditures. Supply-side policies such as incentives and tax breaks will not do it at this stage. Public investment will provide the fiscal stimulus needed for the economy to move out of the current recession.

The third element concerns monetary-fiscal policy coordination. For the fiscal stimulus to succeed, monetary policy should be coordinated with fiscal policy. The current obsession with inflation should be abandoned or the central bank will frustrate the fiscal policy through even a more severe contractionary measures. The role of the monetary policy has to be changed to monetary accommodation of the fiscal stimulus.

The last element is privatization policy reformulation. The large scale fire sales currently planned will be detrimental to consumer welfare, regulatory functions, and above all to the fiscal benefits from privatization. Privatization should be put off until the economy is in full recovery and all alternatives for the public enterprises have been thoroughly investigated.