RECONSTRUCTING THE ECONOMY OF LEBANON

Atif A. Kubursi

THE BASIC THESIS OF THIS ESSAY is that Lebanon's current economic predicaments are rooted in the unmanaged mercurial successes experienced in the 1950s through the mid-1970s, in the traumatic consequences of the civil war and the massive reconstruction effort that followed it, and, in a less obvious way, in the confessional structure of the economy that is still one of its dominant organizing principles.

It is also argued that accounting for past successes and the processes that supported and sustained them is a necessary prelude for understanding the economic causes and consequences of the civil war and the difficulties encountered in reconstructing the post-civil war economy. Such an understanding could also be helpful in restructuring the economy and reconstituting the Lebanese polity and society.

The essay begins with an examination of the sources of past Lebanese economic growth and the economic causes and consequences of the civil war. It ends with a suggested economic framework for reconstruction and rehabilitation of the economy and society, one that is different from the framework used by the Hariri government.

THE LEBANESE ECONOMIC MIRACLE

There is nothing magical or miraculous about the sources of the past economic success and growth in Lebanon. Actually, most of the sources and causes of this growth can be explained in terms of traditional economic factors.

Generating a surplus is a good measure of the ability of an economy to save and to expand its productive capacity. A central feature of the Lebanese economy that goes back to the early 1940s was the high ratio of investment to GDP (gross domestic product). In fact this ratio, on average, had rarely fallen

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Atif A. Kubursi is Professor of Economics, McMaster University, Montreal, Canada. and President, Econometric Research Limited.

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below 20 percent throughout the 1950s until the eve of the 1975 civil war. Starting with a capital-output ratio of about 2.47 (see Saidi, 1986), this investment ratio could have theoretically supported an annual GDP rate of growth of about 8 percent, a rate that was in fact typical of the Lebanese economy for much of the prewar period.

Given that services accounted for more than 60 percent of Lebanon's GDP, the 20 percent investment ratio understated the magnitude of investment per unit of output in the commodity-producing sectors of the economy. A high investment to value added originating in these sectors explains the relatively high capital-labor ratios in the commodity-producing sectors of Lebanon before the war. This, in turn, explains the relatively high labor productivity indices generally then observed in Lebanese manufacturing and agriculture.

Table 1. Sectoral Contribution to GDP, 1970, 1979 (Factor Cost, $US Million, Current Prices)

Year	Total GDP	Agriculture	Mining, quarrying	Manufac-turing*	Construc-tion	Services
1970	1488.5	136.1	---	202.2	66.7	1083.5
1979	2523	215.2	76.1	391	86.3	1754.4
Sectoral contribution to GDP (%)						
1970	100	9.1	---	13.6	4.5	72.8
1979	100	8.5	3.0	15.5	3.5	69.5

Source: Sayigh (1982), Tables 18 and 19. * Includes electricity, gas, and water.

Another central feature of Lebanese development before the war was a young and growing population investing heavily in education and supplying a dynamic, well trained, and highly motivated labor force (Saidi, 1986). Lebanon had the highest adult literacy rate (73.5 percent) in the Arab region and one of the highest among developing countries (Richards and Waterbury, 1990). This domestic skilled manpower was supplemented by a large pool of cheap semi-skilled Palestinian workers trained by UNRWA at little or no cost to Lebanon and a large group of unskilled seasonal immigrant Arab workers from neighboring countries, particularly Syria. Estimates of the foreign labor force in

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the early 1970s put the total number at about one third of the national labor force (Khalaf and Rimlinger, 1982).

The Lebanese economy was and is basically a confessional economy that grew as a natural outcome of an extensive intersection of interests of basically Maronite bureaucrats and Sunni trading families. The former group was primarily interested in developing and securing a stable source of public finance, which in the context of the then prevailing conditions and structures of the Lebanese economy could only be based on custom duties on foreign imports. Much of this activity was controlled primarily by a handful of very powerful Sunni trading families in the coastal cities of Beirut, Tripoli, and Sidon. These traders saw their interests best served by a government restricting itself to building an efficient social infrastructure and maintaining a policy environment favorable to free trade. This intersection of interests manifested itself politically in the National Pact. It also manifested itself, perhaps in a less obvious way but no less strongly or importantly, in an implicit economic and social contract that gave the political accord a strong economic base.

The terms of this implicit contract called for the public sector to invest heavily in building an extensive infrastructure of trade routes, ports, airports, warehouses, and an excellent communication network. It also required the government to restrict its activity in promoting competing commodity producing sectors or regions that could undermine the dominance and the free flow of imports. The terms also called for a pro-free trade, pro-business policy environment with minimal government interference, low or no income or profit taxes, bank secrecy laws, and a free foreign exchange market.

In a less obvious but no less certain way, confessionalism has given rise to Everett Hagan's "blocked minorities" phenomenon (see Hagan, 1962). Disgruntled and disenfranchised Orthodox, Protestants, Shi'ites, Druze, Armenians, and Palestinians sought influence, power, and protection through economic success outside bureaucratic jobs and trading monopolies, thus giving rise to a proverbial class of local entrepreneurs and highly competent professionals.

Lebanese prosperity also had much to do with the fact that Lebanon had a jump start in economic and social development over neighboring countries rich in resources but relatively poor in skills, world contacts, and developmental experience. The advanced educational system in Lebanon and the extensive connections the Lebanese had garnered with the West bestowed on Lebanon some real advantages in its ability to act as the indispensable middleman in much of the contact of the Gulf and other Arab countries with the West.

The Palestinian enclave (sub-) economy also contributed to Lebanon's prosperity. The Palestinian "infrastructure" within Lebanon may have been a negative political factor, but it certainly injected into the Lebanese economy a good amount of operating and capital money in addition to cheap semi-skilled and unskilled workers and some first class bankers and entrepreneurs. At one time, this economy was estimated to have pumped over $4 billion annually in

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social services, wages, and salaries into its "public servants and army" and other goods and services in the domestic economy.

Last but not least, a stable political environment (relative to its neighbors), combined with a banking system designed to attract and protect foreign hot capital, meant that Lebanon was able to capitalize on the growing pains and political instability of other neighboring countries.

The 1975 war undermined most of these favorable factors and processes and, in addition, created some very negative mechanisms and attitudes of its own that are proving to be difficult to reverse or correct.

A brief account of some of these negative processes and a simple analysis of their underlying mechanisms is attempted below by way of sketching the necessary framework to deal with them.

THE WAR ECONOMY

The economic causes and consequences of violence are not well researched or documented in economics. Generally economists have shied away from studying these phenomena, preferring to leave them to other social scientists and disciplines. In a way, Lebanon provides a kind of a social laboratory for analyzing and gauging the economic mechanisms and processes spawned by violence.

Even without the war, the uneven sectoral, regional, and class development was bound to create social tensions, contradictions, and conflicts. Whether it would have exploded into open warfare the way it did in 1975 is debatable. Several mitigating factors could have easily made these tensions and inequities simmer for a long time on the back burner of history. The new explosive opportunities in the Gulf region were just beginning to loom on the horizon. The uninterrupted and continuous growth that began in the early 1950s was just as solid in the 1970s. Furthermore, a new vigorous economic spurt was just about to begin, fueled by the emergence of a vibrant and dynamic small-scale manufacturing activity that was primarily export oriented. The war blunted this growth and sent the economy reeling on a contractionary spiral that lasted over 17 years.

Perhaps the most long-lasting damage was the profuse brain drain triggered by the war. Professionals and skilled workers with international transfer prices (i.e., with skills that are easily transferable in the international market) emigrated, leaving semi-skilled or unskilled workers behind to fend for themselves. Losses in productivity were experienced in most sectors and real incomes of the unskilled plunged sharply, exacerbating an already iniquitous and skewed income distribution system. Conservative estimates of net emigration suggest that a total of 740,000 people left Lebanon between 1975 and 1988 (Labaki, 1989, 1990). Another 240,000 are believed to have emigrated in the first eight months of 1989. The total tally of all those who emigrated during the Aoun-Lebanese Forces conflict was difficult to estimate precisely, but the conflict was believed to have triggered another wave of emigration of no less

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significance than that experienced in 1989. Eighty percent of all Lebanese emigrants to Arab oil producing countries between 1975 and 1982 had some technical qualifications. In the mid-1970s over 50 percent of the emigrants were part of the labor force. In the 1980s this bias was toned down to 25-30 percent as earlier emigrants gathered their families.

This out-migration of talent and skills could have been partially compensated for by fresh crops from the educational system. But the Lebanese educational system suffered, too, as good and experienced teachers left the system and school days were cut short by frequent and incessant fighting. A growing and dynamic population that was heavily investing in its education and training was replaced by a declining population with fewer years of schooling and little or no on-the-job training. More than one third of the Lebanese emigrated between 1975 and 1989; fewer than a third of them returned between 1990 and 1997.

In attempting to identify the consequences of demographic and manpower movements and adjustments caused by the war we have had to rely rather heavily on limited and outdated sources. These included the official manpower survey of 1970, the ECWA (now ESCWA) Statistical Abstract of the Region of the Economic Commission for Western Asia of 1978, and data provided by the United Nations International Labor Office. The most reasonable conclusion one could draw from all these sources is that the level of nonagricultural employment in 1977 was half the aggregate level it would have been without the civil war. Employment levels recovered slightly in the mid-1980s, but slumped again in 1989. The consequences of this major slump in employment have been drastic. They have had, however, a differential impact on the various sectors of the economy. In the early 1970s manufacturing activity grew faster than most other economic activities, but only slightly faster than commerce, hotels, and the restaurant sector. The result was that the earlier dominance of services in the economy was unaltered. The Lebanese economy remained a basically service-oriented economy with services accounting for 50 percent of total employment and about 70 percent of nonagricultural employment shortly before the war (Khalaf and Rimlinger, 1982). The largest drop in employment following the start of the civil war was in the construction industry where employment losses exceeded 72.2 percent (Khalaf and Rimlinger, 1982). The reason the construction sector suffered more than any other sector despite the fact that other sectors were comparably sensitive to political instability had to do with the fact that construction workers in Lebanon were recruited to work in the Gulf region that was then embarking on a massive development program to construct its infrastructure following the explosive increases in oil prices and oil revenues.

Manufacturing and extractive industries lost (57 percent), as did transportation (63.2 percent) and commerce (53.5 percent). All these losses involved above average employment losses between 1974 and 1977 (Khalaf and Rimlinger, 1982). Service related activities appear to have weathered the difficulties with more resilience, losing only 23.6 percent. This was perhaps a

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reflection of the local nature and the predominance of the informal sector in this activity. Public sector employment did not change much as the government obstinately resisted downsizing its operations despite the drastic fall in government revenue.

Human capital losses were matched by massive losses in physical capital that was either destroyed or laid waste. Few repairs were made and new investment virtually ceased during the war years. Actually, net investment turned negative for most of the years between 1976 and 1989. New additions to the capital stock were below the depreciation rate. While it was difficult to conduct extensive and complete surveys of the total damage inflicted on the economy's capital stock during the war, the Council for Development and Reconstruction (CDR) completed some partial surveys shortly after the cessation of hostilities that presented some benchmarks of these damages. The evidence collected by the CDR suggested that the Lebanese capital stock suffered on two important counts. First, there was considerable evidence that the existing capital stock was over-used during the war with little or no maintenance or replacement. The typically high investment to GDP ratio of 20 percent before the war declined to less than 3 percent by 1985 (Saidi, 1986) and to even lower magnitudes in 1989. The Lebanese simply consumed their capital. The ratio of gross investment to real capital exceeded 8.2 percent in 1974, but declined to below 1.2 percent in 1985. There were enough indications that pointed to an even lower ratio in 1990. Second, there was extensive and massive destruction of buildings, bridges, power stations, schools, refineries, and factories that the capital stock stood at less than 45 percent of its 1974 level (see Table 2). Estimating the capital stock losses using the concept of potential capital stock (the level of capital that could have been accumulated had the war not happened and had Lebanon maintained its prewar capital formation levels) would result in a decline in its level to less than 32 percent of the prewar capital stock.

Markets were segmented, and an already small economy was fragmented into yet smaller "enclave" economies with even smaller goods and labor markets. The south, which Israel occupied under the pretext of establishing a "security" zone, became essentially a captive market for its products and a source of cheap labor and non-saline water, and more recently a source of fertile topsoil. The Biqa' valley and the north were tied more strongly to the Syrian economy and less and less to the rest of Lebanon. The "Christian" enclave was severed from the rest of the economy, and the Palestinian enclave was dispersed into smaller sub-enclaves. This fragmentation increased the transactions cost of exchange and production and reduced measurably the productivity of the economy as goods and labor were not allocated efficiently to their best uses and the efficient economic size of producing firms was further compromised. Exports markets were also curtailed as foreign importers diverted their demands to more reliable and secure suppliers.

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Table 2. Gross Investment and Capital Stock, 1974, 1982-85, 1989 (LL millions)

Year	I	K	I/RGDP	I/K	K/RGDP
1974	1644	20133	0.202	0.082	2.47
1982	298	12089	0.05	0.025	2.0
1983	229	11230	0.039	0.02	1.91
1984	173	10393	0.032	0.017	1.9
1985	118	10095	0.024	0.012	2.05
1989*	108	10800	0.02	0.01	2.0

Source: Saidi (1984, 1985). * Author's estimates. I = gross investment at constant 1974 prices; K = capital stock at constant 1974 prices; I/RGDP = investment output ratio; I/K = ratio of gross investment to capital stock; K/RGDP = capital output ratio.

Rampant inflation fueled by currency speculation, declines in domestic production, and unchecked monetary expansions were an early product of the war. The economy was shielded from the full vagaries of this situation in the early years of the war because it was still receiving enormous remittances from Lebanese working abroad and aid from friendly governments. Besides, the government was still in a position to collect some custom revenues and the enclave Palestinian high-spending economy was still thriving and profligate.

As the war proceeded unimpeded, oil remittances started to decline, help dried away, traditional government revenues were usurped by the militias, the Palestinian economy was driven away, and foreign reserves started to dwindle rapidly. The government was forced to lean heavily on borrowing from the commercial banking system and from the Central Bank. Borrowing from the former is constrained by the ability of government to pay back interest and principal; borrowing from the latter was tantamount to printing money. To the extent that interest on the public debt grew larger than the normal revenues of government, the public sector fell into a state of de facto bankruptcy. The government had occasionally resorted to shoring up its finances by using Article 115 of the Lebanese Code of Money and Credit, which credits the government account (treasury) with the foreign exchange revaluation gains (losses) on the Central Bank holdings of gold and foreign exchange reserves. This had the unfortunate consequence of tying the interest of government to depreciating the

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value of the Lebanese pound and drove the Central Bank into pro-cyclical speculation.

Throughout the war period the increase in the velocity of money did not keep pace with the huge increase in money supply; the public preferred instead to shift its holdings of liquid funds into foreign currency deposits. From 1986 to 1987 the money supply, M^2, jumped from LL293 to LL1402 billion, a fivefold increase, whereas the velocity only about doubled, from 3.49 to 6.32. The impact on local inflation, however, is the sum of the increases in the monetary base and velocity. Shifting deposits into foreign currency accounts helped moderate what could have been a worse inflationary bout, but this reduction in the private sector's desire to hold pound-denominated liquid balances exacerbated the pace of depreciation of the Lebanese pound and the linkage coefficient between inflation and depreciation.

To make matters even worse, the bankrupt government purchased a considerable amount of weapons from foreign countries to tighten its grip on the shaky political situation. The government diverted funds away from foreign reserves to finance these purchases. Foreign reserves decreased from $1,883 million to $652 million from 1983 to 1984. As a result of this considerable contraction in foreign reserves, the Central Bank's ability to adopt preemptive policies decreased, and with it its power (or perceived power) to counteract the attempts of speculators to alter the exchange rate in order to reap extraordinary profits.

There is an inextricable link between the inflation rate and government deficits and between the inflation rate and the exchange rate. But these links are so complex and dynamic that it is often impossible to draw the direction of causation or to assess precisely the relative contribution of the various factors.

Deficits were primarily financed by borrowing from the Central Bank; this increased the money supply, raised inflation, depreciated the Lebanese pound, increased the government's cost of operation, and so further raised the deficit. The consequent borrowing from the Central Bank again raised inflation and further depreciated the Lebanese pound. The economy was caught in a vicious circle of deficits, inflation, and depreciation. Adding to the impact of inflation on the exchange rate was another dynamic spiral that worked against the Lebanese economy. Higher inflationary expectations triggered a flight from the Lebanese pound into dollars, thus further depreciating the value of the pound. This in turn raised the domestic prices of imported goods (these account for over 70 percent of total domestic supply), which added new fire to inflation, and the spiral proceeded. The only check on this process was the price elasticity of demand for imports, which acted to constrain the vagaries of this dynamic spiral.

Increases in money supply are not necessarily inflationary. They become so to the extent that the increase in supply is not matched by an increase in demand. Actually, the situation in Lebanon was one of generalized excess supply of money, as demand faltered under pressure from continuous declines in GDP, rampant inflation, and a cumulative tendency toward currency substitution

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and capital flight. Decreases in output provoked commensurate decreases in the demand for money for transaction purposes and inflation enticed economic agents to flee from Lebanese money into safer assets. The rise in world interest rates at the time intensified the currency substitution process and the spread of dollarization of the Lebanese economy. In 1985, domestic currency denominated deposits amounted to $4,013 million and foreign currency denominated deposits to $2,478 million; in 1987 they were $270 million and $3,222 million respectively. The Lebanese pound depreciated sharply from LL2.2 for $1 in the early 1970s to a low of LL2200 in the summer of 1992.

Inflation distorts the pattern of investment away from productive endeavor and into speculative and socially undesirable allocations. It further imposes a tax on the private sector and plays havoc with income distribution, favoring those with market power to protect their real income and disfavoring the weaker classes and those on fixed incomes or who are incapable of adjusting their incomes sufficiently to maintain their purchasing power. It also hurts an economy that needs to export to pay for its mounting imports. Its only advantage, if one can call it that, was its dilution of the public debt that was increasing at the time at very high rates.

Inflation ultimately succeeded in destroying the proverbial Lebanese middle class that shouldered and cemented whatever social stability Lebanon had experienced in the early days of the republic. Inflation also increased the volatility, uncertainty, and risk factors in economic calculations in addition to those directly associated with the war. This contributed further to the deterioration of the operating economic environment and its predictability, and finally compromised the competitive posture of the economy against its trading partners with lower inflation rates. Given that Lebanon, up to the eve of the civil war, had little or no inflation, the hyper-inflation of the 1980s saw the cost of a bundle of goods go from LL10 in 1974 to LL741 in 1987 and as high as LL1500 in 1989. With the demise of the private sector and the erosion of the middle class, the public sector had to shoulder a number of responsibilities which were not within its domain and with which it was ill prepared and equipped to deal.

The war saw the public sector increase its relative size from about 15 percent of GDP in 1974 to over 50 percent in 1989. In the prewar years, the government did not participate actively in the economy and did not practice counter-cyclical policies—a feature characteristic of most advanced capitalist countries. Between 1965 and 1975, the government showed no inclination to increase its share in domestic production or to engage in any direct management of the macro-economic affairs of the economy where it would be willing to go into debt to shore the economy in times of slowdowns. In fact, the opposite was true. Governmental activity was on the whole pro-cyclical (see Saidi, 1986).

The war also forced the government into a new stance. Real government expenditures increased throughout the war at an average annual rate of five percent, suggesting that nominal expenditures had increased faster than inflation. With real revenues declining and with the private sector downsizing its operations, the government attempted to absorb part of the slack in the economy

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and to subsidize consumption of some essential goods. It also continued its operations, but primarily with an ambitious rearming scheme of the Lebanese army without linking these schemes to its revenues, foreign exchange reserves, or the wholesale absenteeism and low discipline of the public service. The public debt (a phenomenon unknown before the war) climbed to 150 percent of the GDP. Interest payments on the debt alone grew larger than government revenues from normal sources.

Warlords who had access to resources and revenues without having to shoulder most of the burdens of government entrenched themselves at major access and trading routes and added to the fragmentation of the economy and to its transaction costs. In a way the economy was paying for its demise, fragmentation, and disfiguration and the warlords developed vested interest in sustaining trouble that became their lifeline to influence and power.

Not all the war effects were negative. Some aspects (a small set) were indeed positive. These relate to the reduction in imports, depreciation of the currency to levels that were more supportive of exports, revitalization of local agriculture and manufacturing, and reinvigoration of rural and mountainous regions.

RECONSTRUCTION AND REHABILITATION

From a relatively advanced and prospering economy in the 1970s, Lebanon was on the brink of total collapse in the late 1980s. It is miraculous that it did not implode the way most had expected. To be sure, the Lebanese per capita income in U.S. dollars slipped from a high of $1800 in 1974 to below $500 in 1989, from the ranks of middle income countries to those of the least developed countries, but the economy survived. The question is, Why has it survived and what accounted for this phenomenon?

A great deal of credit goes to the resilient Lebanese people, who capitalized even on their troubles and kept the economy going. When electricity was cut, a number of local entrepreneurs started their own generators, small shops selling all kinds of goods sprang up on every corner, and many families retreated into their villages and produced their own food. Equally important was the fact that many left the country and emigrated to where jobs could be found. They showered Lebanon with remittances and reduced the social costs of unemployment. The massive depreciation of the Lebanese pound acted as a shock absorber that moderated and fueled a countervailing adjustment process. Imports declined, real wages were eroded, debt was depreciated, rents were almost eliminated, barter emerged, and Lebanese exports and assets became cheaper. Meanwhile, the Lebanese government that had shied away from the economy before the war played a significant balancing role during the war, as was discussed earlier.

Unemployment rates increased, but the increase was far below what could have been expected in the circumstances. Evidently, as stated above, other accommodations were taking place. The war precipitated a reverse rural-urban

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migration as people fled the cities to the comfort and security of their villages, where they grew their own food and bartered their services. Militia ranks swelled with fresh recruits as the unemployed were reabsorbed into this informal sector.

While precise figures on the outflow of labor during the civil war do not exist, there is ample evidence to suggest that over 260,000 foreign workers left Lebanon between 1974 and 1978 (Khalaf and Rimlinger, 1982) and a slightly larger number in the early 1990s. Probably more Lebanese left the country during the same period. This out-migration of labor represented a major adjustment mechanism. It reduced measurably the economic costs of employment losses. Otherwise what was a major economic setback could have been a major economic catastrophe.

When the guns fell silent, there were ample reasons for believing that with political stability and the reconstitution of the Lebanese polity the economy could be turned around and growth could again resume its normal course. There were, however, many obstacles to surmount before the economy could reclaim its health and vigor. First, the basic physical infrastructure that was destroyed during the war had to be repaired and rehabilitated quickly and effectively. Second, the inherited rampant inflation had to be arrested and the depreciation of the Lebanese pound stopped. Third, the profuse and continuous loss of Lebanese talent had to cease and the outflow turned to influx. Fourth, the Lebanese middle class that was decimated by war and inflation needed to be rebuilt. Fifth, the Lebanese government coffers were empty and fiscal order had to be restored. Sixth, the social and economic imbalances of the past, whether between regions, classes, sects, or sectors, had to be addressed and redressed.

This was a tall order even for a strong government and a healthy economy. It was doubly so for a fledgling government and a hampered economy. There was no time to spare, and achievements had to be realized quickly and simultaneously. It has now become clear that there are serious pitfalls in repairing a damaged economy and society without a coherent plan and a clear vision of the final outcome of the reconstruction program.

When the Hariri government embarked on its ambitious reconstruction program, the government coffers were almost empty. There was no choice but to borrow. All through the war, Lebanon had almost no foreign debt. This fact proved helpful in allowing the government to borrow on international financial markets without the encumbrance of past debts. This it did. The foreign debt grew rapidly from a low of $150 million in 1992 to over $2.7 billion in 1998. The combined external and internal debt reached $17 billion in 1998 (Table 3, Figure 1). Servicing this debt today requires $2.1 billion annually, over 89 percent of the total government revenues. The combined debt today is larger than the entire GDP (Figure 2). The latter was continuously revised upward but still fell short below estimates of the total debt. Surely this debt level and its servicing are no longer sustainable. It is legitimate to ask why the government has allowed the debt to increase to this high level and why it has accepted these high debt servicing charges. In other words, did the government have any choice regarding the debt level or its level of servicing payments?

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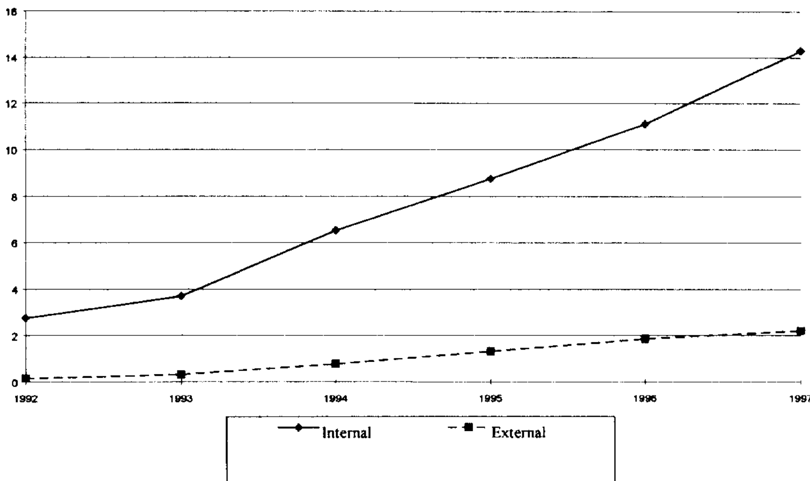
Figure 1
Internal and External Debt ($US billions)



The level of the debt is increased by the yearly deficits on the government budget. These deficits are of two kinds—a primary deficit that reflects the difference between program expenditures and government revenues and a secondary deficit that represents interest and other payments on the debt. The primary deficit in Lebanon was rather low and is expected even to turn into a positive (surplus) value in 1999. The difficulties arise from the debt service payments. These are too large. They increased from $282 million in 1992 to over $2 billion in 1997. Their level is determined by the size of the debt and also by the interest payments made on it. Unfortunately, the high interest paid on both the domestic and foreign components of the debt is responsible for the high deficit that raises the debt. It is hard to break away from this vicious cycle without higher economic growth, higher government revenues, and lower interest payments. Not surprisingly, lower interest rates and higher economic growth are also highly correlated (possibly the former is a cause of the latter).

While borrowing was a necessary option, the terms under which it was done were high (for the foreign component, about 250-350 basis points above comparable rates for the U.S. government) and the maturity period was relatively short. This is true for both the domestic and the foreign components. It is true that Lebanon's creditworthiness was not high after the war, but borrowing at rates that were significantly higher than the prevailing rates on dollar accounts, taking into account a reasonable risk premium, is not defensible. Similarly, with the Lebanese pound exchange value fixed in terms of the U.S. dollar (actually, it even appreciated in value), the double digit rates paid on the Lebanese pound denominated treasury bills and bonds exceeded by far the opportunity returns on comparable dollar accounts. These rates have already become a significant

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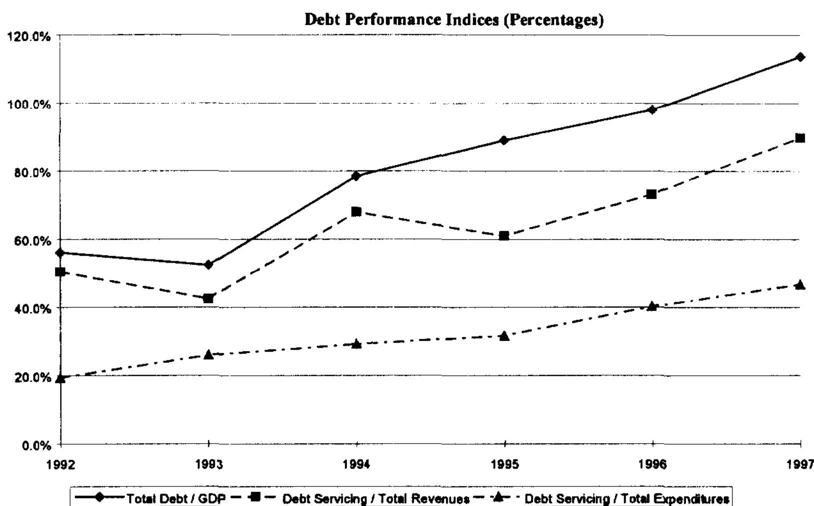
burden on the economy. The higher interest rates that were needed to stabilize the foreign exchange value of the Lebanese pound so as to play the role of a financial anchor for reducing inflation have driven a wedge between fiscal policy and monetary policy, distorted investment, and compromised production. Higher interest rates were required to attract foreign capital, sustain constrained domestic liquidity, finance the government deficits, and stabilize the foreign exchange value of the Lebanese pound. But they also increased the deficits, the borrowing requirements of the government, and the diversion of liquidity toward government bills and bonds and away from trade and investment credits. In the process they constrained investment, domestic production, and exports. Perhaps worse, the brunt of economic adjustment is now borne exclusively by output and employment (quantity adjustments versus what could have been a price-quantity adjustment process). As is clear from Table 3, annual GDP real rates of growth fell from 13.3 percent in 1993 to 3 percent in 1997.

Figure 2

Debt Performance Indices (Percentages)



The population at large will ultimately pay for the cost of borrowing to build this infrastructure. The poor, however, will bear more of the burden than the rich, given the prevailing regressive tax structure in Lebanon, which is disproportionately made of customs duties, consumption taxes (gasoline and tobacco), and flat income tax rates. Unfortunately, the poor in Lebanon are already paying for this program with lower job opportunities (as exports and production are constrained by higher interest rates and an appreciated exchange rate). They have not apparently reaped significant benefits from the construction program either, given the high proportions of foreign labor involved in this

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activity and the high import content of most of its inputs, which have reduced the magnitudes of its associated employment multipliers.

Saudi Arabia is unique among developing economies in its ability to separate infrastructure development from the capacity of the using sectors to pay for it. It was able to do so because of her revenues. In Lebanon there are no such sources of income or wealth to rely upon to help pay for the debt (at least the foreign component). In such circumstances, it is the added productivity that should enable Lebanon to service the debt. Reconstructing the infrastructure in Lebanon in isolation of its contribution to production is dangerous and unacceptable. The size, timing, nature, and costs of this infrastructure should be determined by its contribution to growth and its capacity to raise sufficient revenues to pay for it. If there is any lesson to be learned from Saudi Arabia, it is that the development of infrastructure needs to be managed wisely. Today many Arab Gulf countries are suffering from the high maintenance costs of an exceptionally large and at times basically unproductive and economically unsupportable infrastructure. While the Arab Gulf states can perhaps afford this kind of waste, Lebanon cannot.

It is great to have a large, clean, modern airport, but its capacity should have been tied to traffic volumes that could be realistically expected over the medium horizon. Building a modern and shiny central business district may not be the best alternative use even of private investment funds when no large business has been developed or could be expected to develop soon. Constructing highway rings to ease legendary Lebanese traffic jams may be inferior to developing public transportation alternatives.

My concern is that the reconstruction program has become too costly, too fast, too large, untied from the absorptive capacity of the economy or to its capacity to pay for it, and disconnected from a clear and coherent development plan to guide, monitor, and harness it. The vision driving it, if there is one, appears to be insensitive to global changes in industry, technology, and the basis of economic success in the new economy. It suffers from a long list of structural biases that compromise its developmental worth: an urban bias (in contrast to a rural-urban balance), a cement bias (in contrast to a balance between human development, technology, and construction), an import bias (in contrast to encouraging exports and domestic production), a services bias (in contrast to a balance between commodity producing sectors and non-commodity producing sectors), and so on.

It may not be too late to suggest that Lebanon can float reconstruction bonds around the world that Lebanese emigrants can buy into à la the Israeli Reconstruction Bonds that attract billions of dollars to Israel annually at favorable terms. A coherent plan for how this money will be used, some credible guarantees of payment of principal and interest (set at very low levels), a transparent program administration, and a co-management framework that can attract the full participation of the contributing expatriates may permit Lebanon to tap into a large pool of available funds without the strings and costs associated with commercial borrowing.

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Table 3. Macro-Economic Indicators, 1992-97 (US$ billions)

	1992	1993	1994	1995	1996	1997
GDP (current prices)	5.17	7.67	9.29	11.3	13.2	14.5
Annual real GDP growth (%)	---	13	9	7	4	3
Implicit inflation rate (%)	120	35.1	12.1	14.6	12.8	6.8
Actual government revenues	0.56	1.08	1.36	1.9	2.28	2.37
Actual government expenditures	1.45	1.76	3.17	3.66	4.15	4.56
Budgeted revenues	0.52	0.99	1.36	1.9	2.28	2.37
Budgeted expenditures	0.9	1.98	2.49	3.52	4.16	4.2
Actual deficit	-0.89	-0.68	-1.81	-1.76	-1.87	-2.19
Budgeted deficit	-0.38	-0.99	-1.13	-1.55	-1.57	-1.52
Internal debt	2.75	3.7	6.53	8.75	11.1	14.3
External debt	0.15	0.32	0.77	1.31	1.85	2.2
Total debt	2.9	4.02	7.3	10.06	12.95	16.5
Debt servicing	0.282	0.458	0.926	1.16	1.67	2.13
Current expenditures	0.65	1.07	1.48	1.74	1.9	2.12
Development expenditures	0.52	0.23	0.76	0.76	0.58	0.31
Total exp. excl. debt servicing	1.17	1.3	2.24	2.5	2.48	2.43
Total exp. incl. debt servicing	1.45	1.76	3.17	3.66	4.15	4.56
Foreign currency deposits (%)	69.4	69.9	61.5	62.3	59.6	61.0
Bond maturity period	13.18	16.35	18.73	15.42	16.97	18.03
Primary deficit	-0.61	-0.22	-0.88	-0.6	-0.2	-0.06
Total deficit - primary deficit	-0.28	-0.46	-0.93	-1.16	-1.67	-2.13

Source: Ministry of Finance (1992-95, 1996-97).

The macro-economic stabilization program of the government has produced some major successes and some critical problems. The inflation rate declined from 120 percent per year in 1992 to less than 7 percent in 1997. The

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Lebanese pound reversed its downward slide and real growth in GDP in 1992-95 was solid and significant. This success came at a high price. The country is facing a liquidity crunch as banks and people prefer the high yields on government IOUs to real investment returns. The investment GDP ratio has declined from 33 percent in 1995 to 27 percent in 1997 despite the massive reconstruction effort (Koniski, 1998). Unemployment is still high. The official estimates of 8.5 percent grossly underestimate the real magnitudes of this problem, believed to exceed 30 percent. A large number of apartments in Beirut and surrounding areas are empty and unsold with potential adverse effects on the entire banking system. Growth has slowed measurably. Real GDP growth rates have slumped from 13.3 percent in 1992 to below 3 percent in 1998 (Table 3). Exports are less than 10 percent of imports (Koniski, 1998). The surplus on the balance of payments is dwindling fast. Foreign investment is declining (from $478 million in 1995 to $154 million in 1996 "excluding real estate and portfolio investment"). The deficit continues to rise, debt servicing absorbs almost all government revenues, and the foreign component of this debt requires a servicing charge that is larger than total exports. Debt has already surpassed the red line of 100 percent of GDP (see Table 4). Government revenue elasticity is below one (the percentage change in government revenues divided by the percentage change in GDP between 1996 and 1997 was 0.4, suggesting that government revenues grow less than the GDP). Over 61 percent of all deposits in the Lebanese banking system and over 88 percent of its loans are in U.S. dollars (Sarkis, 1998).

Last but not least, the Ministry of Social Affairs and the United Nations Development Programme (UNDP) has just completed a major study on living standards in Lebanon and its regions. Their findings indicate that 35 percent of all families are unable to meet their basic needs and that over 7.09 percent of all families are severely deprived. They also found wide variations in the standard of living of families across the five *Mouhafazat*, with the North (Akkar), East (Hirmel and Baalebek), and South having far higher proportions of their families that are severely deprived than Jebel and Beirut (*Al-Safir*, 14 November 1998).

A number of Lebanese experts, probably inspired by the IMF, feel that the exchange rate should be allowed to depreciate and to fetch its market value. I am not convinced that this is the best way to deal with the problems at hand. Surely, it does not make much sense either to continue to appreciate the Lebanese pound against the U.S. dollar. If anything, a downward crawling peg may be more helpful. Under the prevailing global conditions of speculative bubbles and almost perfect free capital mobility that succeeded in wrecking the once solid economies of East Asia, the Central Bank will be ill-advised to loosen its grip on the exchange rate. Lebanon is still dependent on imports to meet a large proportion of its domestic demand (over 60 percent), and it will shortly have to pay its foreign debts. Raising the price of imports (as a consequence of depreciation) will undermine the fight against inflation and can trigger new vicious circles of escalating costs as labor and other social groups hurt by inflation will fight to protect the purchasing power of their incomes. Besides, it

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is difficult to argue that Lebanon should pay its foreign debts with large resource transfers.

Table 4. Macro-Economic Indicators, 1992-97 (percentages)

	1992	1993	1994	1995	1996	1997
Actual deficit/actual expend.	61.4	38.6	57.1	48.1	45.1	48.0
Total debt/GDP	56.1	52.4	78.6	89.0	98.1	113.8
Primary deficit/GDP	11.8	2.9	9.5	5.3	1.5	0.4
Total deficit/GDP	17.3	8.9	19.5	15.6	14.2	15.1
Debt servicing/total debt	9.7	11.4	12.7	11.5	12.9	12.9
Debt servicing/GDP	5.5	6.0	10.0	10.3	12.7	14.7
Debt servicing/total revenues	50.4	42.4	68.1	61.1	73.2	89.9
Current expenditures/total revenues	116.1	99.1	108.8	91.6	83.3	89.5
Debt servicing/total expend.	19.4	26.0	29.2	31.7	40.2	46.7
Current/total expenditures	116.1	99.1	108.8	91.6	83.3	89.5
Development/total expend.	35.8	13.1	24.0	20.8	14.0	6.8
Actual/budgeted deficit	234.7	68.7	160.2	113.5	119.1	144.1
Actual/budgeted revenues	107.7	109.1	100.0	96.4	88.0	88.4
Actual/budgeted expend.	161.3	88.9	127.3	104.0	99.8	108.6

Source: Ministry of Finance (1992)

I believe that we need to look at this problem from another angle. What is needed is a lower interest rate for investment purposes and more funds made available for productive investment and for export promotion. These can be achieved directly through subsidies linked to production and export performance in lieu of depreciation. The optimal tariff literature is a very useful reference here. Subsidies and taxes can be assigned directly to specific targets. South Korea, which pays high interest rates on domestic savings, provides large soft

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loans to producers and exporters, the terms proportional to their success in meeting specific negotiable export and employment targets.

The availability of productive and performance loans can be negotiated with the banking system and recourse can be made to available bank reserves and capital. Broadening the tax revenue base is inescapable (see Figures 3 and 4). Very low flat income and profit tax rates are regressive and untenable given the fiscal difficulties encountered by the economy. If the question is one of noncompliance and tax evasion, then this problem should be dealt with directly through tightening the collection apparatus, the laws governing them, and administrative reform. Government revenues are shamelessly regressive and their income elasticities are very low. Increasing these revenues must be achieved by ensuring an equitable distribution of their burdens. This can be achieved through progressive taxation on incomes, profits, and even an expenditure (value added) tax but with large offsets (or counter-transfer payments) for poor families and higher rates on luxury goods the rich Lebanese are fond of.

Now that inflation has been snuffed, it is perhaps advisable to lower the nominal interest rates to levels consistent with the old real rates before the decline in the inflation rates. This will encourage investment and reduce the debt service charges (every 1 percent reduction in interest rates reduces debt servicing payments by over $140 million per year). The latter may restore coherence to the policy mix (fiscal and monetary policy coordination). The two policies are currently inconsistent—high interest rates raise the deficit, increase the debt, and in turn raise the interest rate. There is a definite need for realignment and synchronization between the two planks of public policy. There is a definite and unjustified bias toward monetarism. The interest rate adjustment, if used judiciously, can also bring down the exchange rate in an orderly manner to a level that is more consistent with export promotion without causing a major collapse of the foreign exchange market.

The stabilization program of the government suffers too from some unnecessary biases. It demonstrably has a monetarism bias, a technocratic short-term solutions bias, a debt bias, and a bias in favor of regressive taxation and therefore in favor of the rich and against the poor. The credibility of the government has suffered from consistent forecasting errors. Budgeted revenues and expenditures deviate widely from predicted magnitudes. The debt has reached unsupportable levels and the deficits are 15 percent of the GDP (see Table 4). Debt service charges are unreasonably high regardless of the measure used (percent of government revenues, of GDP, of total deficit, etc.). On the positive side, the government succeeded in controlling inflation, in building a financial anchor through the exchange rate, in creating an environment that projected a credible image that Lebanon is open for business, and in fostering valuable cooperative arrangements with several Arab monetary authorities that came to help when needed.

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Figure 3
Government Revenues and Expenditures
Actual and Budgeted ($US Billions)

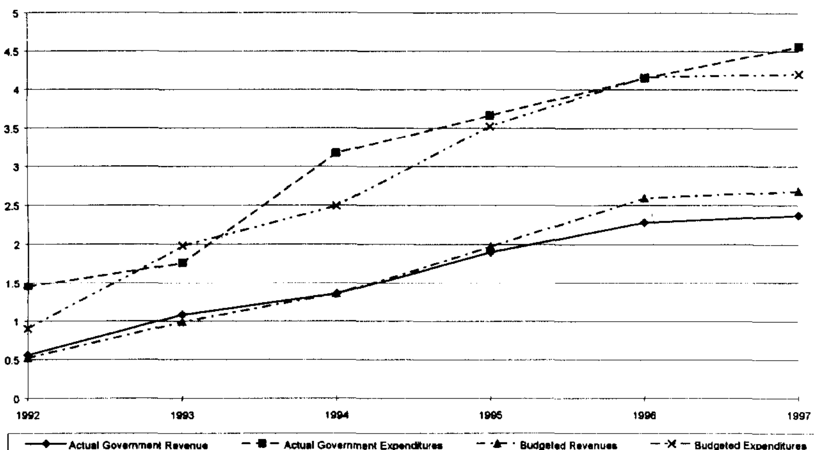
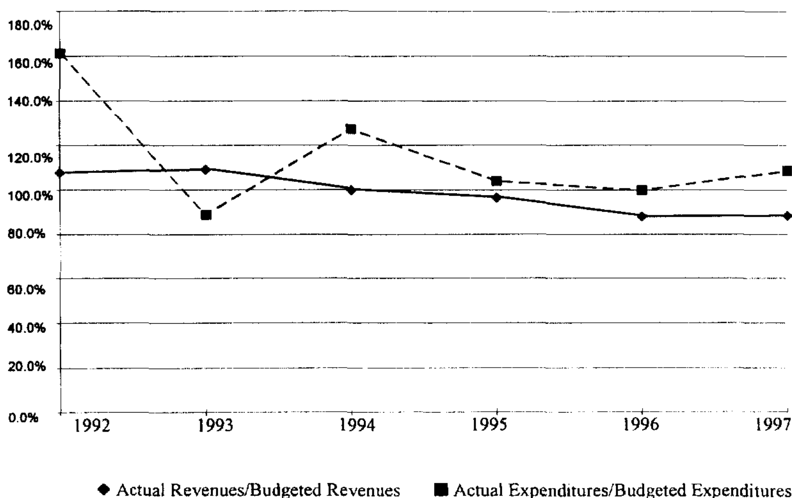


Figure 4
Budget Forecasting
Errors (Percentages)



The reconstitution of the Lebanese middle class and the gathering of Lebanese talents abroad are difficult tasks but practical and noble goals. There is no better mechanism to achieve them than good employment opportunities, law

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favored few will not do it. This is a far more serious issue than treating senior government officials and technical and professional bureaucrats as if they were employees of a private company and showering them with lucrative and unsustainable fringe benefits. Not enough is done to attract migrant talents. What is needed is a systematic inventory database that tracks these people's abilities, addresses, and needs. As well, a clearly defined strategy and well-formulated procedures should transform the existing informal, personal, and opaque process into a well-established, effective, transparent, and formal process of repatriation.

CONCLUSION

It is easy to be critical of government policies and to pronounce on their efficacy. It is hard to appreciate the contexts within which these policies are chosen and the constraints under which they operate. Economists write on the skin of paper and politicians write on the skin of people. Difficulties and challenges are posed by large deficits, huge debts, declining growth, an over-valued Lebanese pound, high unemployment, widespread poverty, and regional and sectoral imbalances. A massive run on the dollar can undermine all the achievements of the government and can sink the country into a serious crisis. It is a miracle that things are not worse than they are, given the underlying economic weaknesses and structural imbalances the country faces. It does not help to be alarmist, and economists should recognize that their statements, even when well meaning, could trigger unintended results. But complacency is just as dangerous. It is time to challenge the government to take another look at its programs and policies. The time is now, and there is still good time to do so.

Governments are no longer expected or believed able to do much about their domestic economies in the globalized world we live in today. At a minimum they are expected to create a favorable economic environment for business and growth, provide sufficient inputs that raise the productivity of the economy and meet the basic needs of citizens, moderate and temper extreme distributional outcomes of the market, and provide an affordable social safety net. Few if any would doubt the success of the Hariri government in providing a positive economic environment for business and projecting a positive image about Lebanon's business potential to the world community. All would certainly agree that it has also rebuilt the basic infrastructure without which the economy could not function. It failed, however, to articulate a coherent development program and provided little or no arbitration to moderate the negative market outcomes on income and wealth distribution among people, regions and sectors. The standard of living study mentioned above points out to high incidence of poverty and deprivation among families, particularly in the North, Northeast, and South, particularly in the areas of education and health. These are crucial components of human capital and reflect the untenable bias in government investment toward cement, large construction projects, and emphasis on Beirut to the detriment of other regions.

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There are a number of measures that can be taken to change and improve the economic and social situation in the country. It is difficult to list them all; the short list here is presented without regard to the priority or sequential logic of these measures.

First, a serious macro-economic stabilization effort should target reducing the deficit at once. This can be best achieved by reducing the interest rate by at least 200-300 basis points, renegotiating the maturity terms of the debt, and raising more revenue from progressive taxes on income and wealth and from expenditure taxes that involve high offsets or credits to lower income earners. Equally important is to explore the possibility of borrowing, at favorable terms, from the Lebanese expatriates abroad. Other supporting strategies should involve reducing waste in government expenditure, improving the income earning capacity of the Central Bank reserves, scaling down construction projects, and judiciously privatizing part of the infrastructure development.

Raising more revenues without fostering growth is unsustainable. Growth can be fostered through granting of optimal subsidies (tying the subsidy or the soft term of the loan to production and export performance indices), credit expansion toward productive uses, and a more export-oriented value of the exchange rate. Allowing the pound to fetch a more export-friendly value should be done in a managed, moderate and orderly manner and coordinated with the interest rate policy and other friendly Arab Central Banks. This will bring about the desired synchronization between fiscal and monetary policies.

Dealing with unemployment seems to have an unjustifiably low priority for the government. Growth with emphasis on employment creation can be achieved through a well-designed employment creation program that can be worked out with the private sector. This policy should be tied to the strategy of fostering growth; the two cannot be separated.

Second, a new development perspective should be formulated with the full participation of the people and their representatives after a lengthy and serious civic debate. Such a framework should address the current imbalances between regions, sectors, and classes and should be part of the de-confessionalization goal. Heavy emphasis should be placed on human development, education, training, and fostering the new economy. Resurrecting old Beirut as the financial capital laundering center of the world is not a worthy or realistic option. Reinventing Beirut as a center for advanced knowledge, software development, and design engineering is more realistic.

The Lebanese comparative advantage has always been its people, great geographical beauty (whatever is left of it), relative water abundance, and ingenuity. Building on strength requires developing agribusiness that utilizes wisely and efficiently Lebanon's relative water advantage in the region, integrating the deprived southern and eastern regions into the development program, and opening again our traditional export markets. It also requires a more realistic tourism policy that attracts large volumes of visitors yearly to sample Lebanese flavors. Greece, which is only an hour's flight away from Beirut, is capable of attracting 12 million visitors a year. I am sure Lebanon can

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attract multiples of its low volumes of visitors with proper coordination among tourism operators, the government, and private business. Israel has already started planning on attracting visitors at Lebanon's expense. Their designs include transforming visitations to a one-day safari like visits Jordan is experiencing today, while diverting the lion's share of this flow.

Developing tourism without preserving Lebanon's natural beauty will not work. The environment is part of the natural endowment and capital of Lebanon and deserves its attention and concern. Not enough attention has been paid to the environment. This neglect is costly and should not continue. An environmental assessment review should precede any project. Tourism is ultimately the financial payoff on the effort to preserve the environment; Lebanon's survival in the end is at stake here.

Foreign aid was expected to complement public funds, but these funds have trickled in at far lower rates than was expected. Many Lebanese have amassed substantial wealth abroad; some estimates put this wealth at over $30 billion. The return to normalcy and the preservation of the free enterprise stance was believed sufficient to entice this group to return and to reinvest in Lebanon. A good number of entrepreneurs returned, but many preferred to keep their money abroad. The expected flood turned out to be a minor trickle. A serious effort should be made to attract a larger share of this capital abroad.

The profuse out-migration of skills and talents during the war can be reversed. The return to Lebanon of this pool of experienced talents with new skills learnt abroad could reestablish Lebanon's comparative advantage in services and knowledge. Not enough has been done to tally this group and to research what it takes to recruit them. The present informal and haphazard way should be replaced with a more systematic and formal program. The advantage of maintaining a lead over neighbors on the learning and technological curve cannot be exaggerated. Lebanon has lost ground in this area. An intensive effort is needed to rebuild and reposition the schools and the educational infrastructure to generate the quality professionals and researchers that accounted for Lebanon's success in the past and will ensure that it can be engendered again.

Lebanon does not have much time to waste. The costs can be catastrophic but the returns on a coherent and well-studied plan are great and real.

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