BOARDS OF GOVERNORS•2000 ANNUAL MEETINGS•PRAGUE, CZECH REPUBLIC

INTERNATIONAL MONETARY FUND
WORLD BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

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Press Release No. 70

September 26–28, 2000

Statement by the Hon. **GEORGES CORM**,
Governor of the Bank for **LEBANON**,
at the Joint Annual Discussion

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Fiscal Reform Dynamics in a Post-conflict Emerging Economy

I would first like to congratulate Mr. Köhler, the new Managing Director of the IMF, for his election and for all the efforts he has already devoted to listening to members countries he has visited. We have heard from him the expression of a strong will to promote ownership of Fund programs and to study new policy options more adapted to the specificity of each country. We are looking forward to a prompt implementation of this new direction which might change some of the negative views or criticism to which the Fund has been exposed to, especially in the aftermath of the East Asian and the Russian crises.

We are also very happy to see Mr. Wolfensohn continuing for a second five-year term as President of the World Bank Group. His refocusing of the Bank Group to the alleviation of poverty is already having a positive impact on the ground. His attention to redefining the role of the World Bank to better serve the needs of middle-income countries is equally welcome.

We also welcome the attention that the World Bank and the international financial community have been placing on helping alleviate the pain of conflict and post-conflict situations in the world. Lebanon was very encouraged by the immediate statements of support from the President of the World Bank and the Secretary General of the United Nations after the withdrawal of the Israeli army on May 24, 2000 from south Lebanon. After 32 years of political and military conflict on our soil, much of which was due to factors beyond Lebanon's control, Lebanon is today in urgent need of the assistance of the international community.

As is well known, Lebanon's economy has dramatically suffered since the end of the sixties from different types of violence and armed conflicts linked to the Arab-Israeli conflict, the Cold War, Middle Eastern geopolitical rivalries and the disfunctioning of its own sectarian socio-political system. Famous for being the Switzerland of the Orient, the financial center and the commercial entrepot of the Middle East, the Lebanese economy was exposed to a succession of destructive blows. The first one took place on December 1968 when an Israeli attack on Beirut International Airport destroyed the Middle East Airlines civilian fleet. The last ones took place successively in June 1999, February and May 2000 with Israeli attacks on Lebanon's electricity infrastructure. These attacks heavily damaged Lebanon's economic potential and its regional role.

The Israeli army occupied parts of south Lebanon in the spring of 1978; Beirut was besieged and bombed during a second Israeli invasion in the summer of 1982 to uproot the PLO presence in Lebanon. When withdrawing from central Lebanon in 1984/ 85, the Israeli army enlarged its occupation of South Lebanon. Between 1975 and 1990 domestic armed militias inflicted continuous economic damages to both private and public sector institutions; attacks on private and public property, ransoming of private sector and depriving the public sector from its sources of revenues have been generalised to all parts of the country.

During the last 32 years, Lebanon has shown an amazing resilience by maintaining the functioning of its political as well as economic system. The political system of Lebanon as a parliamentary democracy has resisted all the years of turmoil assuring political continuity and the survival of the Republic of Lebanon regionally and internationally. In 1989, the Constitution was renovated after the Taef Agreements. The Lebanese free enterprise system has also survived and Lebanese businessmen have shown during all these year a great sense of patriotism and a great management capacity under the most difficult circumstances. This represents one of the most valuable assets for future economic development.

During all these years, the Republic of Lebanon never defaulted on its domestic or international debt, no exchange control was introduced and the economic and financial system remained free of any government restriction. The banking system of the country resisted all the turmoil of the last 30 years and is back to its pre-war dynamism and vitality with a renewed presence of international banks. After a dramatic decline of banking assets between 1984 and 1989 from $12 billion to $4.5 billion, banking assets stand to day at $40 billion. Deposits represent 220% of GDP. The Central Bank of Lebanon continued to operate daily without any interruption during all the period even in the worst days of fighting. Gold reserves were preserved. A law adopted by Parliament in 1985 and which has not been repealed prohibits the government from disposing in any form of the Central Bank gold assets. Central bank reserves of foreign currencies have now reached the historical level of $7 billion (excluding gold holdings), representing more than one year of imports.

However, there is a price to be paid for all these years of turmoil and destruction. Reconstruction effort that was deployed since 1992 by previous governments were done at a high cost due to inflation that has only been subdued in the last four years and due to the lack of fiscal discipline. It was assumed in 1992 that peace on all fronts of Arab Israeli Conflict was imminent through the Madrid Peace process and that Lebanon would immediately recover its pre-war position in the Middle East through rebuilding and enlarging its traditional physical infrastructure centered in its capital Beirut. The dramatic economic changes that had taken place in the region and in the world economy were not sufficiently taken into account. Continuous conflict and hostilities due to Israeli occupation of South Lebanon contributed also to decreasing growth rate in the economy.

After an outburst of high growth rates (1991-1995) centered on the luxurious segment the of real estate sector, flows of foreign direct investment (FDI) by Lebanese expatriates, and Arab and international corporations and individuals, began to dwindle. At the same time the increasing financial needs of the Government led to higher real interest rates as inflation was decreasing. However, in 1997 and 1998, in spite of difficult conditions on the international markets due to the Asian and the Russian crisis, the Government, was able to mobilize substantial amounts of foreign funding through Euro bound issues. These borrowings were at cheaper cost for the Government than domestic borrowings. Since the election of President Lahoud in October 1998 and the nomination of a new Government in December 1998, several changes of economic policies have taken place to address the main macro-economic imbalances that have negatively affected economic growth in the last decade. These are explained below.

I. The reform of the public finances

a. We have produced a fiscal consolidation plan aiming at bringing down the level of domestic and foreign debt under 100% of GDP and the level of budget deficit from 14% to 5% of GDP. This plan has received the support of international financial institutions, namely that of the World Bank. Support has also been expressed by the European Union which has attributed a grant of 50 million Euro as budget support to the Republic of Lebanon.

b. We have implemented a legal framework through which all arrears due by the State to the private sector are to be recognized and cleared. Law 95 of June 1999 has established such a framework and 80% of such arrears has now been paid through handling three years T-bills to the beneficiaries of the arrears. Most of these T-bills have been discounted by the beneficiaries to the banking system. We have thus relieved the economy from this very burdensome situation for the private sector.

c. We are now preparing another legal framework to clear arrears inside the Public sector between autonomous public entities and between the Central Government and the entities and the municipalities.

d. We have begun to implement a full modernization of our outdated and inefficient tax system. The main elements of this modernization are the introduction of V A T and the creation of a global income tax system. This will allow decreasing dependency on custom duties and a number of cumbersome excise taxes and stamp duties. The V A T law has been prepared and forwarded to the Parliament in the hope to begin implementation in year 2001.

e. In addition, an amnesty on tax penalties was introduced last year to improve relations between the taxpayer and the tax administration. Substantial amounts of tax arrears have thus been recovered. We are also preparing a restoration of the status of limitation in relation to tax controls. This status has been waived during the war and not restored by the previous governments. We believe that this tax policy contributes greatly to improving investment climate in Lebanon.

f. We raised very moderately the various income tax rates that were lowered to minimal levels in 1994 in spite of all the financial needs due to reconstruction. At the same; time we have been granting substantial tax incentives. Some of these incentives are targeted to help overcome the deep sluggishness of the real estate sector; others are designed to induce family owned business to introduce shares on the Beirut Stock Exchange or to open their share capital to foreign companies which shares are quoted on a stock exchange.

II. Privatization plans

Our Government has also committed itself to implement privatization in a clear and transparent legal framework. In fact, Lebanon never had a large Public sector producing goods and services, as has been the case in most Arab countries. Rather, the role of the Public sector in Lebanon was traditionally confined to providing for the main public services as water, electricity and telephone. Airport transport was in the hand of a private company (MEA) till a few years ago when the Central Bank of Lebanon had to recapitalize the company and land transport has been mainly in the hand of the private sector, especially when train and tramways facilities came at a stop before the war. The previous Government introduced the BOT formula to create and develop cellular phone network, the postal distribution and new services at the Beirut International Airport. However, no overall legal framework has been put in place to regulate the development of Private sector financing capabilities and management skills in the supply of public services.

This is why our Government since taking office has prepared a general law for privatization, which was recently approved by Parliament. The law provides for general rules and procedures applying to the transfer of ownership and/or management of public services to the Private sector. It also stipulates that all receipts accruing from privatization should be applied to reducing the public debt. In addition, our Government has prepared three regulatory laws for the sectors of water, electricity and telecommunications so that strategic investors interested in the management and partial ownership of Public entities to be privatized would know how the concerned economic sectors will be opened to private competition and regulated by the State. The law on water has already been approved by Parliament.

We also finalized an agreement with IFC to assist the Government and the Central Bank in divesting their shareholding assets in MEA In addition, the World Bank is appraising a support loan to privatization to assist in the financing of compensation schemes to be paid to redundant personnel in Public entities to be privatized.

We feel that substantial preparatory work has now been conducted for a good implementation of the few privatization operations that will take place in the next years. We hope that the clear legal and regulatory framework that has been prepared will optimize privatization receipts. There were very conservatively estimated at 4.5 billion dollars in our fiscal consolidation plan for years 1999 to 2003. We feel now that the privatization and development of the telecom sector alone could yield 7 to 8 billion dollars in the next few years allowing a substantial reduction in indebtedness.

III. Interest rates and indebtedness

As mentioned earlier, Lebanon suffers from a high level of real interest rate on its domestic debt, presently standing at around $17 billion with an average cost to the Treasury of 13,67%. However, since our Government took office and began to implement its fiscal reform plan, domestic interest rates have been on the decline and the balance of payments turned back positive after a sharp deterioration in 1998. Yields on two years T-bills declined nominally from 16.6% to 14.6%, while on an effective basis they declined from 21.5% to 14.6%.

Today, the domestic debt represents 75% of total indebtedness and foreign indebtedness around 27%, equivalent to $6 billion. Bilateral official debt represents only $456 million and borrowings from International Financial institutions is equivalent to $760 million. In total, long-term concessional loans represent only $1.2 billion, while the rest of the foreign debt consists of international bond issues. For a country that has been torn by war and regional conflict for so many years, efforts to raise grants and concessional funding have not yielded enough tangible results. We believe that the Liberation of Southern Lebanon should now open access to more concessional loans and grants, so as to reduce the burden of servicing each year more private domestic or international debt at high interest rates.

We also anticipate that the use of privatization proceeds to reduce part of the domestic debt will alleviate the burden that this debt is putting on economic growth. Interest rates will decline, thus reducing the high budget deficit which amount is equivalent to the amount of debt service.

Our Government has also made efforts to diversify and lower the cost of our foreign debt issued on international markets. Last year we were the first Arab borrower to tap the euro sector of the bond market and we intend to issue on the Samurai bond market in the next future. Our policy for foreign borrowing is quite conservative. We do not want to increase our foreign indebtedness above our capacity and in fact, last year, we reduced the amounts borrowed through international bond issues from 1.5 billion in 1998 to 1.2 billion. This year we have proceeded with our first international bond issue at the beginning of July for the amount of $500 million and we were able to reopen the 2009 issue of September 1999 for an additional amount of $250 million. Lastly, continuing in diversifying its debt instruments, in September 2000 Lebanon raised a 3-year double tranch dollar bond (half of it floating rate and the other half fixed rate) for an amount of $450 million. Although interest rates on the dollar and the Euro have been on the climb affecting also domestic interest rates on the Lebanese pound and preventing a further decline in rates, we believe that the withdrawal of Israeli troops from Lebanon after 22 years of occupation will definitely have a strong impact on the level of interest rates on the domestic market. The political risk attached to the persistence of conflict, violence and occupation in the South being waved, spreads paid above LIBOR for dollar deposits in Lebanon and the high spreads existing between interest rates on dollar deposits and those paid on Lebanese pound deposits will inevitably have to be reduced. This will require productivity adjustments on the part of the Lebanese banking system that have been accustomed to high interest rate environment to secure substantial level of profits.

Foreign banks are welcome on the domestic banking market to stimulate competition inside the sector. As we are anticipating an upsurge in FDI and in Arab and international aid, we believe that decline in interest rate will continue, thus reducing the high cost of financing for both the State and the Private sector.

It is to be noted that our government has developed a substantial plan to improve liquidity management in the public sector and the management of the domestic public debt which is highly rigid and which is still linked to monetary policy. A gradual shift to the separation between monetary policy and domestic debt policy has begun in coordination with the Central Bank. The Ministry of Finance has signed a structural adjustment loan with the Arab Monetary Fund to assist this shift and develop a secondary market for the domestic debt and a new system for organizing auctions and primary markets. We have also been extensively consulting with both the World Bank and the IMF on these issues. To be successful, any assistance package should recognize the importance of the fiscal consolidation plan that has been implemented very successfully in 1999 but delayed in 2000 due to the elections. In addition, Lebanon needs to keep its access to international markets open as a regular issuer of international bonds.

IV. Investment climate: the One Stop Shop

Although legislation is very liberal in Lebanon and do not differentiate between domestic and foreign investor (except in relation to land holding), investors suffer from the weight of bureaucracy and of outdated regulations in many areas that have not been yet modernized. Conscious of this fact and pending legal and administrative reforms to modernize outdated administrative procedures, the Government has established the " One stop shop" system for domestic and foreign investors. IDAL, the Government agency in charge of investment promotion has been entrusted with the sole function of assisting investors in getting through the various administrative procedures required to complete an investment. It has already been successful accelerating quite a few investment operations that were encountering administrative difficulties.

The Government is also preparing special legislation to encourage investment in media, electronics and computers activities. In addition to the tax incentives and policies described previously, tax holiday are available for investment in rural areas or investments for the production of new products. An economic conference of expatriated Lebanese businessmen was also held on the 5th of June in Beirut that has attracted many prominent Lebanese form the four continents.

V. International aid packages adapted to prolonged conflict and post-conflict situation

As a country that has been victim of an intractable regional conflict for 32 years, we feel that we have not received our fair share of international assistance, especially in the form of grants. We are faced today with two types of needs: the first relates to the immediate post-conflict needs of liberated south Lebanon. The population of the south is in need of assistance to help alleviate poverty, provide basic infrastructure, rehabilitate its health and education sectors, and revive economic activity. A preparatory conference for donor countries was held in Beirut on July 27, 2000 at which the Government presented a plan for both emergency needs (approximately $250 million) and for a full five year development period (approximately $1.4 billion). A tripartite Committee consisting of the World Bank, UNDP, and the Arab Fund for Social and Economic Development, was formed to assist the Government and its High Level Committee to raise and monitor funds.

The second need relates to larger macro-economic assistance to help complete and properly implement the fiscal consolidation plan that our government has put in place. The implementation of this plan, unfortunately, has met resistance. The population, trade unions and political opposition were expecting an expansionary policy which would stop the decline of the growth rate, create more employment and allow for an overall increase of salaries. As in any democracy, our government has had to deal with these tensions. Although we did increase civil service salaries, that has been blocked for the past seven years, we did not encourage increases in the salaries of the private sector which was already suffering from high production costs and lack of competitive capacity.

The relatively tight-fisted stance of our government has resulted however in a return of old-guard political figures through the recent parliamentary elections which took place August/September 2000. The years of the old-guard brought about widening budget and current account deficits. We believe that this could have been avoided if Lebanon had received, within the framework of its fiscal consolidation plan, a substantial package of grants and financial support at reasonable costs to reduce the very heavy burden of its domestic debt. However, we do hope that such package of assistance would be forthcoming in the near future, with no political conditions attached, and with a well-designed macro-economic framework that will <u>fully</u> take into consideration the 32 years of prolonged conflict that Lebanon has suffered. No package should inflict additional austerity measures on the poorest strata of the population. In addition, any aid package should be realistic about the time frame Lebanon would need to restore fiscal balance, given the numerous constraints of the domestic economy, and the present additional pressure on the fiscal position coming from the increase in oil prices and the payment of arrears left by the previous government to the private and public sectors. The recent temporary degradation of our credit rating has also been due to the delay in implementation of the fiscal consolidation plan and the fear that a new government would return to the practice of widening budget deficits. We believe that this warning is sufficient and that any new package of aid (with or without the constitution of a Consultative Group) should adequately take into consideration progress already achieved and should not depart from the sound foundation of the present fiscal consolidation plan.

As for south Lebanon again, the Government and people of Lebanon have been very disappointed that the initiatives of the World Bank and the United Nations to help the people of the south have not yielded to date any tangible results. Help has been extended outside the mechanism of a donor's conference only by the Islamic Development Bank and various other Arab development funds. Some good intentions have been expressed by larger donor countries but it has also been implied that the donor's conference should now wait until an undefined period of time. We hope that assistance to Lebanon does not once again become hostage to wider regional uncertainties or be linked to any delays in the peace process.