

Lebanon's Economic Reform and Prospects

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1. Good morning. I am delighted to be here among such a distinguished audience to talk about economic reform in Lebanon. It is indeed fitting to talk about such a topic here in this renowned institution that has hosted among its faculty and students some of the brightest economists and political scientists. I will keep my presentation short as I look forward to an interesting and lively discussion as you have promised in your kind invitation.

2. As you well know, the past year has been traumatic for Lebanon. The tragic assassination of prime minister Hariri—a philanthropist, a great and visionary leader, and for me my life long dear friend—and minister Fuleihan, a bright young economist who had a full and productive life ahead of him, and the killing of other prominent political Lebanese leaders sparked very strong reactions. Millions took to the streets in open defiance, and the domestic and international outcries led to the withdrawal of the Syrian forces a bit more than a year ago.

3. We are now at a cross road. Either we pick up the pieces and press forward, or we slip into economic and social chaos. I am pleased to tell that we the Lebanese have chosen to press forward, taking advantage of favorable international and regional circumstances.

Ladies and gentlemen

4. Before I turn to the specific topic of reform, I will, by way of background, give you a brief summary of some important events that have led to where we are today. Lebanon has suffered from a devastating 15-year civil war, an Israeli occupation for about 25 years and still, and a Syrian presence for 30 years. For the sake of truth, one has to admit that the Syrians played initially a constructive role in preserving the unity of Lebanon, and aborting attempts to partition the country. They also played a significant role in bringing about the withdrawal of the Israeli army from the south in the year 2000, though the Israelis do still occupy a part of Lebanon in the Shebaa Farms area. However, and with the passage of time, the Syrian presence became an increasingly heavy burden on Lebanon's political and social life restricting civil liberties and other forms of expression.

5. With the end of the 15-year civil war in the early 1990s, whereby one third of the population were displaced, a good part of

the country was destroyed, and where the country and its population suffered great losses and other forms of lost opportunities. For instance, the GDP per capita in Lebanon in 1975 was somehow equivalent to that of Portugal and very near to that of Ireland. Now it is one fifth of that of Portugal and one tenth of that of Ireland. After all of those sufferings Lebanon emerged and embarked on a major reconstruction effort. In addition to rebuilding human and physical infrastructure, the government took on the task of investing in social peace. But regional security conditions remained unsettled throughout the 1990s, requiring increased spending on security as well as on repairing damages caused by continuous Israeli and invasions and attacks especially before the liberation of most of the south of Lebanon in 2000. The cost of reconstruction and social integration has been very high.

6. By the year 2000, Lebanon had made important strides in its reconstruction efforts and in restoring basic services. However, the overall fiscal deficit had deteriorated sharply (to reach 24 percent of GDP) and interest payments on public debt increased substantially (to 17 percent of GDP in the year 2000), and Lebanon's public debt continued to increase whereby it snowballed to 175 percent of GDP by end-2005.

7. A strong fiscal adjustment has been taken shape since the early 1990s. For example, tax revenues rose considerably from about 9 percent of GDP in 1993 to more than 15 percent of GDP in 2005, an impressive effort in such a short time. In addition, the financial support that Lebanon received at the Paris II meeting of November 2002 led to a sharp decline in domestic interest rates, and interest payments fell to 10 percent of GDP in 2005 (from 17 percent in 2000). As a result, the macroeconomic balances improved significantly.

8. By the year 2004, the real growth rate shot up to about 6 percent, the overall budget deficit declined to less than 8 percent of GDP (from 24 percent in 2000), and the primary budget surplus improved to 3.4 percent of GDP.

9. Unfortunately, this good performance was cut short by political tensions at the end of 2004 (related to the controversial extension of the president's term in office) and the dramatic events of 2005. My government which took office in July 2005 made strong efforts to compensate for the setbacks in the first half of the year and to keep the budget under tight control. What made our task of fiscal restraint much more difficult was the surge in oil prices and the additional cost that this implied on the electricity bill and the loss of excise taxes on

petrol, which have been cut by more than half (due to the cap on the price of gasoline).

10. But the calamitous events of 2005 proved once again the economy's astonishing resilience. True, there were outflows of capital and pressures on the Lebanese pound and international reserves after the assassinations. But by July (and perhaps because of the confidence factor triggered by the formation of a new government with wide domestic and international support), capital inflows had resumed and were sustained throughout the remainder of the year, restoring international reserves to more comfortable levels. The balance of payments registered a USD 400 million surplus by the end of 2005 and growth indicators for 2006 lead us to think that it may be above 4% on annual basis after a meager growth of barely 1% in the year 2005.

Ladies and gentlemen,

11. This is where we are today. We are keenly aware that huge vulnerabilities exist and formidable challenges lie ahead if we aim to realize the economy's great potential and meet the needs and aspirations of the people. We are also aware of the complex political situation that may have an impact on our reform efforts. But, given Lebanon's significant human resources, well-educated workforce,

large and rich Lebanese Diaspora, well developed banking sector, as well as attractive climate and location, much higher growth rates that would benefit the everyday lives of the Lebanese are within our reach.

12. We truly believe that inaction is not even an option. Otherwise, all the painstaking reforms that we have achieved so far will be lost in vein. If we do not act, macroeconomic stability will be threatened with devastating effects on the population and especially on the most vulnerable groups who cannot protect themselves.

LEBANON'S REFORM PROGRAM

13. That is why the government decided to act and act now. A high-level economic team has prepared a comprehensive medium-term reform program. The overriding objective of this program is to lay the groundwork for growth to pick up to at least 5-6 percent, create much needed jobs for our qualified and skilled youth, while protecting the most vulnerable from the possible adverse impact of reform.

14. But as you all know, this requires above all putting Lebanon's large public debt on a downward trajectory toward sustainability and creating a stable macroeconomic situation and a friendly business environment where the private sector—which has

always been the backbone of the economy and the engine of growth in Lebanon—can flourish and lead the way toward growth and prosperity.

15. The government's reform program is articulated around six domestic pillars and the financial support of Lebanon's friends. These pillars are: (1) A strong fiscal adjustment; (2) prudent monetary policy focused on price stability; (3) privatization and the dynamic role of the private sector; (4) social reform; (5) growth-enhancing reforms; and (6) international support in the context of the international conference for the support of Lebanon.

16. Ladies and gentlemen, let me now briefly talk about each of these pillars.

I. Fiscal Policy

17. The program's overriding objective is to increase the primary surplus, which will be the anchor for guiding fiscal policy and restoring confidence. The government will undertake strong and sustained fiscal adjustment efforts to increase the budget primary surplus gradually from 2 percent of GDP in 2005 to 8 percent of GDP in 2010 so as to reverse the debt dynamics and place the debt-to-GDP and debt service ratios on a downward path.

18. The government naturally prefers to streamline expenditures and cut waste in key sectors such as electricity and social security before raising taxes. But as you well know these measures will take time to show results. And time is of essence. Thus raising taxes moderately may have to be considered.

19. Expenditure measures will focus on reducing primary current expenditures while raising capital spending with greater emphasis on the partnership with the private sector. Key measures include cutting waste including in the energy sector (the electricity company) and containing the wage bill with total savings of 3-4 percent of GDP over the next five years. On the other hand, we may need to increase some taxes very moderately such as the VAT and the tax on interest income, and gradually restoring the excise tax on gasoline to its 2004 level when cap on gasoline prices was imposed, with additional revenue of some 2-3 percent by 2010.

20. In addition, several measures related to improving public expenditure management will be implemented. These include: setting fiscal policy in a medium-term expenditure framework (which is important for continued sound budget policy), strengthening commitment control, implementing performance budgeting, improving tax collection and broadening the tax base and introducing

the concept of the global income tax on the income generated in Lebanon.

21. In a complex political environment, we are looking into the possibility of adopting a fiscal accountability law that would set targets on some important macroeconomic variables, such as budget deficits, or the level of debt. The objective is to force future governments and the parliament to adhere to the set targets, thus reducing the risks of fiscal slippages in the future.

II. Prudent Monetary and Exchange rate policies

22. The Lebanese Central Bank enjoys a large measure of independence. It will focus on price stability using short-term monetary instruments and the government will in turn endeavor to maintain the operational independence of the central bank including through improving the fiscal situation and refraining from borrowing from the central bank (or avoiding what is known in the economist's jargon as fiscal dominance).

23. On exchange rate policy and in light of the set of fiscal and administrative reforms being envisaged at the present, there is a convergence in views between us and the international financial institutions that a stable exchange rate is serving Lebanon well and is critical to maintaining price stability and confidence. Enhancing

competitiveness (which is not a major concern at this time) does not need to rely on changes in nominal exchange rate. Competitiveness gains can be secured by structural reforms that would foster an attractive and competitive business environment. However, to broaden the range of its policy instruments, the central bank will develop the necessary tools to deal with a more flexible exchange rate regime in the future.

III. Privatization Program

24. The public sector in Lebanon has few privatizable assets. To us, privatization is not an objective in itself; rather, it is a means to stimulate growth, increase efficiency in the delivery of services, reduce the cost of doing business, improve competitiveness, and allow wide public ownership in privatized companies.

25. We are moving forward with the privatization of the telecommunications sector, not so much because of its financial impact on debt reduction and debt service, which is significant, but also because it will lead to a larger subscribers' base (higher penetration ratios), better competition and consequently lower cost, with an overall positive impact on employment and growth. Other privatization plans include the power sector, once all the preparatory steps have been taken, and as well as the national carrier, Middle East

Airlines. The privatizations are expected to result in very significant and substantial growth of Lebanese capital markets.

IV. Social Sector Reforms

26. Given the probable impact of fiscal adjustment on the poor and the less privileged and the need to deal with weak social indicators, improving social outcomes, mainly in health and education, and strengthening the social safety net system are critical for the success of the reform program. To this end, the government will establish soon an inter-ministerial committee to prepare a comprehensive medium-term social strategy before the end of the year. We have also started working on the reform of the pension system, given its significant fiscal cost and its negative social and economic impact if left with no reform.

V. Growth-Enhancing Structural Reforms

27. We are cognizant of the fact that enhancing growth is the corner stone of a successful reform program. But economic growth is multifaceted and there is no single measure or a set of measures that would boost growth overnight. In addition to requiring a stable macroeconomic environment, it requires several structural reform measures, such as improving governance and the business environment, developing capital markets, initiate a reform

administrative program and increase productivity and efficiency and liberalizing trade, among others. I will deal briefly with some of these issues.

28. Improving governance is crucial for a pro-business environment. To this end, we have decided to hire international firms to audit public finances and public enterprises over the last fifteen years (1990-2005) to identify the sources of misuse of public fund in the past, if any. This would avoid domestic political exploitation of this issue and help understand better what should be done to avoid corruption in the future. In addition, the government intends to improve procurement procedures, enhance the role of monitoring agencies, and empower state watchdog institutions to take punitive actions and enforce conflict-of-interest regulations against senior public officials.

VI. Capital markets

29. We recognize how vital strong capital markets are for stimulating the efficient use of savings, both domestic and foreign, and therefore supporting higher productivity and faster growth. Several measures have already been taken to enhance the functioning of Beirut Stock Exchange and an array of reforms and draft laws are now in parliament to improve the legal and regulatory framework.

We expect the privatization program to significantly increase the size of and the public's participation in the Lebanese capital markets.

VII. Reducing the cost of doing business

30. The government is considering several measures to reduce the cost of starting a business and by making labor laws more flexible as well as by enforcing the rule of the law. We have signed an agreement with the IFC to review procedures and measures with the objective of eliminating all legal and bureaucratic impediments to start business.

31. In addition reducing the cost of production will improve competitiveness. Eliminating existing public and private monopolies (as well as exclusive agencies), which represent a key obstacle to business development, reduce the high cost of telecommunications (which already started and should be increased with privatization), and streamlining administrative procedures will be crucial.

32. To monitor competitiveness indicators on a continuous basis, the government will establish a Competitiveness Council by end-2006. This council would be composed of major public/private institutions to report on, and deal with, business activities and bottlenecks. This will create new job opportunities and increase international competitiveness.

VIII. Openness and trade liberalization

33. Time and again, we have seen how dismantling barriers to competition and trade can foster growth and higher living standards. (Growth in the dynamic economies of China and India has come in the sectors most open to foreign investment and competition.) We are now moving to join the WTO hopefully by year-end, which will improve international competitiveness and provide further assurances to foreign investors against unfair competition.

34. Furthermore, we are discussing an action plan on the EU neighborhood policy and we held successful discussions in Brussels recently (on April 6-7). We should conclude these discussions soon in Beirut. Also, exploratory talks for signing a Trade and Investment Framework Agreement (TIFA) between Lebanon and the USA started last month in Washington.

Ladies and gentlemen,

35. After this brief summary of the main elements of the proposed program, let me turn now to the overall impact of the reform measures on macroeconomic balances over the next five years.

36. Under reasonable assumptions, the primary budget surplus is expected to increase to 8 percent of GDP in 2010 and the debt-to-GDP ratio to decline to 137 percent of GDP (from 175 percent in 2005).

37. But would a debt-to-GDP ratio of 137 percent be sustainable? Our answer is not really. This is too high a ratio to be sustained over the long term. From a policymaker point of view, I consider that a sustainable level of debt is the level at which the government can satisfy its budget constraint without having to resort to drastic measures or experience difficulties in servicing debt.

38. While the adjustment in the primary surplus planned for 2006-2010 is substantial (6 percent of GDP), over the longer term Lebanon cannot realistically sustain an average primary surplus that would keep reducing the debt ratio. Because compressing expenditures further and raising additional taxes would certainly stifle economic activities and provoke social and political unrest, which would negate fully the benefits of reform.

39. That is why we think that international support is crucial for Lebanon. Without international support, the debt-to-GDP ratio will likely revert back to an unsustainable path. Such a support will not only reduce the debt burden but it will also enhance confidence

and contribute significantly to reducing interest rates and increasing growth with a greater impact on debt. It will also have a major impact on the political and social conditions in the country.

40. While political consensus is important for the success of the reform program, I believe that the fruit of economic reform could in itself contribute to improving the political environment and bridging the social divide. Failure to undertake the necessary reforms could threaten social and political stability, radicalize views and positions, and jeopardize the democratic process that Lebanon had enjoyed, and now is trying to revive, with negative spill over in this turbulent region.

41. In our part of the world, Lebanon represents a unique phenomenon of diversity, multi-confessionalism, democracy, tolerance, freedom of expression, and liberty and model for achieving change through peaceful means. We will strive to preserve and keep these ideals alive, but our friends' help is critical to maintain political stability and solve our economic problems. I strongly believe that what happens in Lebanon will have repercussions that far exceed Lebanon's size. Our success in achieving a smooth and peaceful transition towards strengthening our democracy and building a strong economy is in the interest of all and will provide a powerful example for a region that is in dire need of one.

Concluding Remarks

42. In closing, allow me to say that Lebanon has a good opportunity to bring down the vulnerabilities associated with high public debt, provide a stable macroeconomic environment, and put the economy on a fast growth path for the decade to come. We believe that the international and certainly the regional environment—with high oil prices—are conducive to undertake bold and comprehensive reforms.

43. Where do we go from here? We are fully aware that the reform program I just outlined will require a broad national consensus to put in place. Building social and political consensus is essential to advance reform especially in a complex political environment such as ours. I expect that the various segments of Lebanese society and the main political parties will come to the conclusion that the only way forward is through cooperation and dialogue to reach practical solutions to our current economic problems.

44. Our aim is to transform the government's proposed reform program into a national program with a high degree of buy in. Once the reform program is approved by the cabinet, we will then call on our friends to meet in Beirut to support our efforts and to show the world that successful reforms are possible in Lebanon.

Thank you.