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LEBANON'S FUTURE: A REGIONAL CAPITAL MARKET

By Nasser Saidi

We cannot make a realistic assessment of Lebanon's economic future and regional role in development in the absence of a stable background. That is why the implementation of stabilization policies is essential and why we need to invest in our infrastructure. In this context, developing Lebanon's financial markets is an urgent priority.

For countries that are radically changing their economic systems and organization, the development of capital markets usually comes last and normally follows the removal of distortions in other markets. The standard approach is to eliminate existing distortions in the goods, labor, factor and asset markets, as well as remove or reduce tariff and non-tariff barriers to international trade before opening up the capital markets to international market forces. The basic idea is to prevent international capital flows from increasing or adding to existing domestic distortions. As a result, economists and policy-makers normally advocate delaying the opening up of capital markets until other markets have been liberalized.

In Lebanon's case, the reverse should happen. Developing financial markets first is an urgent priority for two reasons: (i) financial markets will attract the resources required for both the private and public sectors to reconstruct; and (ii) financial services are an important contributor to the total national product. On the whole, services - including trade, transport, tourism and financial services - contribute about 60 percent of Lebanon's GNP. Financial services alone contribute more than 40 percent of GNP.

The 1992 estimate of resources required over the next ten years by both the private sector and the public sector will be in excess of US\$25 billion. That is about US\$2 to US\$3 billion per annum. Further, the bulk of public sector investment is concentrated in the initial period of reconstruction, that is, in the first three to four years. It will not be feasible to attract those resources in the absence of organized financial markets, instruments and intermediaries. Overall, four markets need to be developed in Lebanon:

a) The first is the foreign exchange market. Before 1974 the foreign exchange market in Lebanon was not only domestic but dealt on an international basis. Part of that role has been taken over by other markets, such as Bahrain and Cyprus. We believe that Lebanon can regain that role as a regional and international foreign exchange market, dealing in the major currencies including options and futures contracts, as well as developing markets for regional currencies.

b) The second is the money markets. The monetary authorities have recently taken active steps towards developing a "Beirut dollar market." This was done by recognizing the extent of dollarization of the economy and by allowing banks and institutions to hold deposits in foreign currency at the Central Bank and, starting in January 1994, through the clearing of foreign currency payments at the Central Bank. Eventually, the Beirut dollar market can act as an important circuit for funds both from outside the region and within Lebanon and can reorient funds towards productive activities. As the money market develops, we would expect that it will be an important contributor in generating financial resources for the corporate sector.

c) The third market being actively developed is the corporate and government debt market. In terms of the government debt market, the monetary authorities are taking steps

to increase the "breadth, depth and liquidity" of the market. To do so requires an increase in the available maturities and type of government securities, extending the coverage and share of holdings by the non-bank public and the creation of an active secondary market. The first items have been extending the auction system for Treasury Bill subscriptions and the introduction of a swap market, allowing the banks to substitute or swap maturities in the government debt market. It is anticipated that given the attractiveness of doing so, banks will develop that market between each other without the intervention of the Central Bank. Eventually, an active secondary developed government debt market should allow the government to issue new types of financial instruments - such as longer-dated instruments, reconstruction bonds and savings bonds - that can be sold both internally in Lebanon and to the Lebanese Diaspora, as well as to other Arabs and to foreign investors who wish to participate. Clearly, the Lebanese bond market should play a fundamental role in financing infrastructure projects.

With the local Beirut financial market becoming international, we can start issuing debt that can go into private and institutional portfolios on an international basis. In addition, once the government debt market is developed and liquid, it will form the backbone for developing a corporate debt market. This will encourage public utilities - such as the Electricity Company of Lebanon, and potentially the ports, the airport, telecommunications and other public services - to use that corporate debt market to provide themselves with medium and long-term financial resources. In turn, this will remove a burden from the Treasury and will act, on a long-term basis, to restore financial discipline to those corporations and institutions. Simultaneously, it will reduce the debt service that has to be financed from central resources by the Treasury.

d) The fourth and last financial market is the most exciting one: the re-development of the Beirut stock market. In my mind, therein lies the future of Lebanon. In the past, there was a reasonably active stock market, not large by international standards, but with up to forty companies listed on the Beirut Stock Exchange (BSE). Not surprisingly, due to the war and the difficulties of assessing the true profitability and worth of companies, communication problems, and increased political and economic risk, stock market activity declined and now only exists as a grey market. However, monetary authorities are taking active steps to re-develop the stock market. Developing the equity market is critical to Lebanon's reconstruction process: it creates liquidity, provides long-term funding, allows for risk-sharing and risk diversification, and reduces the potential burden arising from a high level of international debt.

What could the potential size of a new Beirut stock market be? A development company - Solidere - which will be redeveloping the destroyed center of Beirut - had a pre-offering capitalization of about US\$1.8 billion based on an assessment of the value of lands and properties in the downtown area. An initial share offering of US\$650 was 42 percent oversubscribed, and the price has risen from US\$100 from the January issue to US\$164 by end-August 1994, providing an extraordinary average monthly return of 9.1 percent to shareholders. The "Solidere" share will form the backbone for a revival of the BSE. In addition, a large number of private sector companies not involved in real estate will also be listed on the BSE. These include some of Lebanon's financial institutions, including banks and insurance companies. The equity market will also attract hotels, wineries and agricultural food processing companies. Estimated total initial capitalization of a new BSE could be well in excess of US\$4 billion. This is not unreasonable for an emerging

capital market and is comparable to "middle range" emerging markets such as Colombia and Jordan. The size of the initial capitalization is potentially at 50 percent of GDP - a respectable number which is likely to increase over time.

At the same time, it will be important for the BSE to allow a cross-listing or parallel listing of company shares from exchanges in the Gulf and Saudi Arabia. These could be listed in US dollars and internationally quoted. So, apart from their own national currency, there would be a cross-listing of these companies in dollars on the BSE.

Finally, the monetary authorities have actively supported the creation and development of a secondary market for securities trading, the Beirut Secondary Market (BSM). BSM started operations in June 1994 with over 30 banks and financial institutions participating as brokers. In due time, new financial and investment companies will emerge as intermediaries, complementing the existing network of brokers. BSM is trading "Solidere" shares and will move to trading Treasury Bills as well as government and corporate debt. The Lebanese Central Bank is also active in reviewing existing laws and regulations with a view to suggesting a modern economic and legal framework for Lebanon's financial markets, applying international norms and standards.

A few final remarks are in order concerning the banking sector. It is essential that Lebanon's private sector commercial banks modernize their facilities and services and increase their capital resources in order to face the challenges of the future. The monetary authorities will provide incentives to encourage this process. Lebanese commercial banks and the banking sector as a whole have already reached international standards in terms of solvency, capital adequacy and risk-asset ratios. The authorities will encourage the increase in capital resources and allow banks to use new instruments - potentially floating rate notes or other instruments - that will allow them to increase this. The authorities are also supporting the drive to mergers within the banking system. Part of the strengthening of the capital base of the Lebanese banking system is through a process of mergers and acquisitions. Finally, they will also introduce an active discount window, again to provide more depth and liquidity to the government debt market. As part of the process of the internationalization of the Beirut financial market, banks and the banking system will be allowed to develop fiduciary deposits and other off-balance sheet items.

Although it is easy to be pessimistic - and anyone who has lived in Lebanon in the past few years will tell you that we do face enormous structural problems and macroeconomic policy concerns - there is an enormous resolution and determination to overcome these obstacles. A whole generation of Lebanese both within and outside the country is committed to the task of reconstruction. I believe that as reconstruction proceeds, more and more people will actively get involved in the process.

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