Strategies for Change in Lebanon & Syria: Finance, Trade, Globalization & the New Economy

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Lebanon and Syria are living in the aftermath of the war on Iraq and its consequences, including the changing geo-strategic balance for the countries of the region. They are living in a world changed by the events of September 11, 2001 and characterized by the increased dominance of security-related issues in international relations. The events of September 11 came as the "irrational exuberance"[1] of world stock markets that characterized the "roaring nineties" ended. The extended economic boom of the nineties, lasting nearly a decade, appeared to defy our understanding of business cycles. Past patterns of several years of growth and expansion, followed by shorter periods of slow-down and contraction appeared to break down. Industrialized countries seemingly lost their name, with the services sector representing an increasingly larger share of income and production. World trade expanded at an even faster pace than economic growth, with an increasing number of countries liberalizing their economies, de-regulating and opening-up. Financial markets boomed driven by the forces of technology in the developed economies and by privatization, economic reform and de-regulation in the emerging markets. Technical progress and innovation was highly visible in the advances made by the ubiquity of media, information and communication technologies, which were viewed as heralding a new age of unparalleled prosperity, encapsulated in the "new economy". The new "information age" would transform our lives and activity into those of 'knowledge-based economies and societies'.

The Arab countries, the countries of the Middle East and North Africa, for the most part, missed out on the new information revolution and the winds of change accompanying the increased integration of economies and markets. The phenomenon of the "roaring

[1] The term comes from Robert Shiller's perceptive analysis in "**Irrational Exuberance**", Princeton University Press, 2000.

nineties" was largely a lost decade for most of our countries. Economic growth barely kept pace with high population growth rates, resulting in stagnation in per capita incomes and levels of well-being, while poverty levels persisted and unemployment rates rose among an increasingly frustrated, disenfranchised young labor force. Unlike other emerging economies, the Arab economies did not become integrated with the world economy. The main link with the rest of the world continued to be energy, oil and gas. Oil and gas remained the main source of national income, of exports and of government revenue. But the volatility of oil prices is a source of risk and vulnerability: it generates volatile economic growth and pro-cyclical fiscal outcomes, tending to accentuate the oil-induced boom-and-bust cycle and potentially turns the fiscal stance into an automatic de-stabilizer. The absence of economic diversification in production and trade and the wide disparities in incomes between the oil producers and the no-oil economies of the region induced labor force migration. In turn, remittances from the migrant labor force became a large component of the income of the labor exporting countries, with a pro-cyclical bias generated by oil revenues. Remittances tended to increase in high oil income years and decline when oil revenue growth was low or falling. Thus, there were several channels for the transmission of oil revenue shocks to the non-oil producing countries of the region. First, exports of goods and services (representing more than 40% of the total exports of the non-oil producers) to the oil producers were pro-cyclical and followed the oil cycle. Two, remittances from the migrant population (originating from salaries & wages or business income and profits) depend on economic activity in the oil producers and vary accordingly. Three, capital inflows, whether in the form of portfolio investment or foreign direct investment- from the oil-producers to the other countries of the region tend to vary pro-cyclically, increasing with higher incomes and wealth. Fourth, the oil producing countries tend to be more generous in the provision of aid and recipient countries more solicitous when times are good than otherwise. Hence these factors and linkages tend to transmit oil shocks to the non-oil countries, making the whole region vulnerable to oil shocks.

For the MENA countries recorded workers' remittances were about US$ 14 billion in 2002, substantially more important as a source of external financing than the US$ 4.3 billion in net private debt and equity flows. Countries like Jordan, Lebanon, Yemen and

Egypt were more exposed than others: income from remittances represented about 23% of GDP in Jordan in 2001, 16.1% in Yemen and about 14% in Lebanon, putting them among the top 10 developing country recipients of workers' remittances (as a percent of GDP). On the other hand Saudi Arabia (second only to the USA), Kuwait, Oman, Bahrain, were among the top twenty country sources of worker remittances.

For Lebanon the decade of the nineties opened with the promise of stability, reconstruction and growth. The Taif Agreement brought an end to fifteen years of wars and violent conflict, that destroyed Lebanon's physical infrastructure, tore apart its social and political institutions, generated macroeconomic instability with accompanying inflation and currency depreciation, and lead to internal displacement of population and outward migration of skilled human capital. Ten years on, security has been restored; much of the critical infrastructure (power, transport, and telecommunications) has been restored –though unevenly across different regions of the country- and wage and price inflation stabilized. However, this has come at a high cost in terms of a large build-up of debt, exceeding US$ 30 billion, some US$ 6,820 per head, one of the highest levels of public indebtedness in the world, with debt service consuming most of government revenue. The Paris I and II meetings were intended to gather international support to remedy the unsustainable debt dynamics and public finances by offering a debt restructuring package allowing for extending the lifetime of debt at lower rates in addition to long- term financing for reconstruction projects.[2] Reducing debt service costs is only one strand of a required comprehensive reform package encompassing structural changes, administrative reform, tax and fiscal reform and including other measure aiming at improving the competitiveness of the Lebanese and the ability of its productive sectors to compete in the face increased opening up of the economy through a variety of bilateral and multilateral trade liberalizing agreements.

For Syria the nineties ushered in a transition away from a command economy, where economic development was headed by the public sector for more than two decades. The

[2] *Participating countries subscribe to the issue of a 15-year Eurobond holding a semi-annual coupon of 5 percent and a 3 to 5-year grace period on principal repayment.*

beginning of economic and financial reforms aimed at stimulating private sector activity, reducing the dominance of public sector production and government controls on economic and financial activity. Syria undertook a series of important measures to stimulate private sector activity and liberalize the economy. Measures included: (i) the opening of new areas of economic activities and provision of strong fiscal incentives to private investors (Law No. 10); (ii) exchange system simplification, with a series of moves toward a unification and more depreciated official exchange rates; (iii) price and foreign trade liberalization; and (iv) increases in administered prices (including agricultural procurement prices) intended to elicit increased output. These liberalization measures in Syria coincided with the end of the wars in Lebanon, and which had the effect of reducing perceived security, political and economic risk in the two countries. Syria (and Lebanon) experienced an economic boom in the early nineties, which extended through 1995-96. However, this could not be sustained in the absence of deeper, comprehensive, structural reforms including a review of the role of the public sector and the restructuring of public enterprises, extensive de-regulation, and simplification of the trade, payment and exchange systems. Additional reform measures are being undertaken with impetus from President Dr. Bashar El-Assad, aimed at opening the Syrian economy, wider scope for private sector participation, particularly in the banking and financial sector, and focusing on administrative reform. The medium and longer term growth prospects of the Syrian economy will depend on the outcomes from the reform measures and the sustainability of the liberalization and reform process, enabling Syria to compete internationally.

Despite the expressed official commitment to extensive reform, the design of reform policies and actual implementation of reforms has been slow. This threatens the credibility of the reform process and weakens the pro-reform movement and its proponents. Why is the reform process so slow? First, the political economy of the process of reform is complex. Specifically, countries that have established economic and social policy regimes with strong socialist/collectivist characteristics find extensive difficulty in undertaking reform.

It is clear that with the demise of the Soviet Union in 1989, the support for socialist, collectivist forms of organization has disappeared. At this beginning of the third millennium, no emerging market or developing country would advocate or espouse a socialist paradigm or policies as a viable road to development. Indeed, the bulk of the empirical evidence shows that socialism or collectivism has not delivered sustainable growth and development or ensured rising levels of economic well-being. However, anti-socialism has not meant anti-big –government. As Milton Friedman reminds us: "Size of government is determined much more by how much they can raise in taxes than by any ideological theory". Big government, public enterprises and established bureaucracies with entrenched civil servants are motivated by their self interest and are major factor acting against reform and acceleration of the reform process. We need to adopt a public choice approach to gain an understanding of the forces at work. This requires a departure from the view that government is benevolent, that government's role is to correct alleged market failures and that it seeks to acts as an impartial arbiter of socio-economic relationships. Similarly, as economists, we should be wary of the statements of politicians and public officials seeking to justify policies and actions as being in the 'public interest'. More often than not, the actions and policies are self-serving, motivated by the self-interest of the politicians, administrators and civil servants.

This implies an application of a rational choice model to political phenomena & public law and reform. The basic premise is that politicians, public enterprise employees and bureaucrats will act to maximize their private self-interest and personal benefit. From this perspective, actors in political roles act to maximize objective of direct interest: politicians maximize their chances of re-election, public enterprises seek to increase their monopoly powers and benefits to employees and management, bureaucrats maximize the size and power of their bureaux, voters/political clients the benefits from government programmes, interest groups, the programmes giving benefits to their members. Voters/political clients inform themselves and act on issues of direct benefit to them and not general issues. From this perspective, bureaucrats and their political masters do not gain from downsizing government and/or from deregulation. Downsizing implies lower government expenditure, fewer public sector jobs, fewer programmes and less power for bureaucrats. Similarly, smaller government and deregulation implies fewer possibilities of gaining from rent-seeking opportunities and sharing the benefits with the beneficiaries. Generally, the gainers from reform are the general public, consumer, society at large, whose voice is not well represented or loud. In addition, the gain is generally diffused, spread among a large number of people, and the gainers cannot mobilize resources to voice the desire for reform and act accordingly. The losers, by contrast, are well identified, well represented, and vocal and can mobilize resources to fight against and counteract the reform process. A standard example is commercial policy reform leading to tariff reductions. The gain in lower prices and higher quality goods is spread among the general public and consumers. Local producers stand to lose from increased foreign competition resulting in lower prices, output and profits. It is in the interests of the producers to lobby and spend resources to prevent the tariff reduction and pressure the politicians and regulators to avoid the change in policy. Consumers, on the other hand, will find it difficult to counter-lobby or collect resources to support the change in policy. Second, politicians and decision-makers are reluctant to undertake reforms because the reform process is perceived as being riskier than the status quo, the existing state of policies and outcomes. Why risk confrontation and failure? The experience of the Asian and Latin American countries suggests that in the absence of major crises or shocks the decision and approach to reform will be reluctant and gradualist. Similarly, the absence of major crises or shocks has implied that the process of reform has not been considered urgent or critical in Syria, Lebanon and the majority of Arab countries. The problem with this attitude of benign neglect and complacency is that the underlying imbalances, both macroeconomic and structural, are growing and becoming more complex. The required adjustment policies and costs have become larger. Buying time and skirting the issues is not a policy.

In the aftermath of the war on Iraq and geo-political uncertainty in the Middle East, Lebanon and Syria stand at a crossroads. Wars and violent conflicts in the Middle East, Israeli policies and occupation, have generated insecurity and resulted in debilitating, negative consequences for the region. First, it has led to a high level of military expenditures in the Middle East, scarce resources that could have gone to foster socio-economic development. Much, if not all, the military hardware and assets have been imported with little local “value-added”, unlike in the exporting countries where military spending is associated with extensive research & development spending and technical innovation that spreads to other sectors of the economy. Two, violent conflicts have led to political instability and uncertainty and have been a major factor in retarding institutional change and reform. There has been no or very limited investment in institution building, an essential factor in medium and long-term economic growth. Three, wars and conflicts have been a major factor retarding the regional and global integration economies of the region. Trade and investment liberalization and opening-up typically require extensive economic, commercial and financial policy reform and institutional change, which are difficult to undertake and sustain in unstable conditions. As a result, the intra-regional economic integration of the countries of the Middle East – measured by the extent of trade, investment or capital flows- is one of the lowest in the world, similar to that of Sub-Saharan Africa. Similarly, apart from energy exports and related investment, the countries of the Middle East have not benefited from the potential of expansion resulting from greater economic and financial integration. Four, the region has been perceived as high risk as a result of wars and violent conflicts, resulting in limited access to international capital markets, low inflows of portfolio investment and foreign direct investment, and high cost of finance, with investors requiring high ex ante returns to compensate for the perceived investment risks. Indeed, the region has attracted less than 3% of international debt and equity flows to developing countries, and the scarce inflows have been directed at oil and gas exploitation and infrastructure, and to a limited extent to benefit from privatization opportunities. Five, donors and aid providers have been reluctant to give aid and technical assistance into countries living unstable conditions or conflicts, resulting in low levels of assistance to the poor countries of the region. Six, wars and conflict have resulted in low levels of economic growth, volatility in economic activity and growth, as well as macroeconomic instability.

Given the current context and challenges, what can we do? What strategies and policies could be pursued by Lebanon and Syria to address these challenges and reduce their vulnerability? The agenda for policy reform is similar in its broad outlines to that facing other Arab countries. The main message is that partial or gradualist reform policies have not borne fruit, have not yielded the expected results. The Arab countries, Lebanon and Syria, in particular, should leapfrog, should be ambitious in seeking new solutions, adopting new technologies that would allow a qualitative and quantitative jump in economic efficiency and governance. It is in this sense that Chapter [xxx] advocates the implementation of e-Government to undertake administrative and civil service reform as a tool for good governance. Similarly, strategies should be put in place to invest in modern information and communication technologies (ICT) as a tool in economic and social development. It includes: the implementation of political, economic & financial reforms aiming at creating dynamic, democratic societies and economies. Public sector administrative reform to improve governance and reduce waste, corruption and inefficiencies. Both countries continue to live under the inefficient, retarding yoke of a public administration and bureaucracy that are legacies, inherited from past occupation and colonialism: the Ottoman Empire and the French Mandate. Little has been done over the past fifty years –apart from timid efforts at administrative reform- to render government and the public sector an efficient provider of goods and services, to achieve good governance in the public sector. Recent surveys undertaken by the World Bank suggest that the countries of the MENA region, the Arab countries, should undertake major reforms to improve governance.

While efficiency and effectiveness are the quantitative aspects of good governance, there also are qualitative ones. The adoption of good governance, defined as the traditions and institutions by which authority is exercised, policy conducted and government managed, is crucial, especially for the MENA region. A recent study by D. Kaufman, et. al [2], has constructed six indicators of "Good Governance". From their database for 175 countries, the authors construct quantitative measures for six dimensions of governance in 1998 and 2001: (i) Voice and Accountability;(ii) Political Stability; (iii) Government Effectiveness; (iv) Regulatory Quality; (v) Rule of Law; and (vi) Control of Corruption.

The indicators and estimates for the MENA region are presented in comparison to other income groupings in Annex Chart 1 and summarized in Table 1 above. There is, of course, substantial cross-country, variance in the indicators, as well as variance in the responses to each of the indicators for individual countries. The range, as indicated by the maximum and minimum for each indicator is particularly large for the MENA countries confirming and reflecting the large cross-country variance.

Nevertheless, the indicators represent summary measures of the dimensions of governance.

Voice and accountability being the process by which governments are selected, monitored and replaced clearly is the weakest point in good governance for the region. Political participation is limited and citizens' ability to participate in the selection of government is restricted. Regulatory quality and the control of corruption are also areas of weakness for the MENA countries. The 'good governance' indicators and other empirical evidence [3], suggests that the establishment of a democratic culture and, in parallel, the institutional framework required to live democracy on a day-to-day basis, should be high on MENA governments' policy reform agendas. In this context, the concept of "good governance" plays an increasingly prominent role. The best possible management and orchestration of the interaction of institutions – both public and private – is a policy goal in its own right. Good governance can be seen as the exercise of economic, political and administrative authority to better manage affairs of a country at all levels, national and local. The objective is to make collective decision-making efficient, democratic and transparent, to achieve – among other – better socio-economic outcomes and economic development and growth prospects.

The core of the argument in Chapter xx is that government needs to be become more efficient and that part of the key is the implementation of e-Government.

Private sector development and job creation Achieve Arab regional economic integration and increased integration with the EU Invest in Human Capital: education & skills to face the challenges of international competition & integration Prepare & Implement Strategy to enter information age: e-Economy and e-society address the 'Gender divide': increase labor force participation & fight against discrimination of women.

The essays and talks collected in this book are policy oriented. They focus on a number of areas that are building blocks for a strategic partnership between Lebanon and Syria to face common challenges. The position adopted here is that economic and financial integration should be the basis of a long-term strategic relationship. The benefits to the two countries of closer economic and financial ties should underlie and support political and external relations. But is there a basis for greater economic and financial integration and why has this not happened despite the treaties, protocols and agreements that have been signed or initialed between the two countries? The two countries have fundamentally complementary economies. Syria's natural and economic endowments provide it with a comparative advantage in industry and agriculture, whereas Lebanon's endowments generate a comparative advantage in services. Over the past half-century the two countries chose different paths for economic development and economic policy. Syria adopted an economic development paradigm and model based on a pre-dominant role of the state in economic and social development, state production in nearly all economic sectors (with the notable exception of agriculture) and extensive regulation and intervention in economic activity. The strategy was based on state-centered import-substituting industrialization.

Lebanon maintained a non-interventionist policy stance, characterized by limited state intervention in economic and social activity. Effectively, state production was limited to public utilities (electricity, PTT, transport, water and other basic services). The period of reconstruction since 1991 did not lead to change in economic strategies. Successive governments took on the responsibility of rebuilding basic infrastructure and providing public utility services. However, despite the challenges and constraints of reconstruction, the fundamental private sector orientation and dominance of economic activity remained unchanged. Indeed, the period of reconstruction is significantly characterized by private sector finance of reconstruction through the banking sector in Lebanon and via the international capital markets through the issue of Eurobonds and other securities.

With greater economic integration between the two countries, achieved by reducing and removing trade and investment barriers and networking their physical infrastructure (roads, transportation, power, water and telecommunications), would allow increased efficiency in production resulting from specialization according to their respective comparative advantage. The countries benefit from geographical proximity and common borders leading to lower transport and communication costs. In addition, they have a common historical heritage, share a common language, Arabic, and foreign languages (French, English).

Because services are a major input into the production process as well as activities such as distribution and sales, liberalization of services could generate significant gains from lower costs of production for the manufacturing and agricultural sectors. Reductions in those costs should facilitate trade liberalization by enhancing the competitiveness of industry and agriculture. In addition, service sector reforms would increase investment in the liberalized industries, which would generate employment opportunities for skilled and unskilled workers employed by government or import-competing industries or for those who are unemployed.

The most viable option is to capitalize on the lessons of alternative, more ambitious path to integration in the future, one that has clear economic payoffs. If a more ambitious approach to AEI is chosen, the next step is to develop a common vision about the ultimate form of integration, at least initially among a small core group of countries. Given that labor is somewhat mobile in the Arab region and that service markets are relatively inefficient, an alternative path could emphasize parallel agreements on trade liberalization (as in GAFTA), labor mobility, and liberalization of services, which would have a noticeable impact on firm competitiveness. That is not to say that all actions on those three fronts have to be undertaken up front, but that simultaneous progress on all is desirable to enhance their impact. The merits of such an approach are twofold: it should generate significant economic gains and help mobilize support for further trade reform among workers, industrialists, and agriculturists.

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