Rapport présenté en vue de l'obtention du grade de M.Sc. en Sciences Economiques

The Role of Financial Markets in the Stabilization and Reconstruction of Lebanon

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Le 16 Juillet 1998.

Université de Montréal

1. Introduction

Over a period of 15 years prior to the onset of the civil war in 1975, Lebanon experienced rapid economic growth accompanied by a favorable balance of payments, relative price stability, and a sound national currency. The private sector was the catalyst for this success which, in turn, made Beirut the most important financial center in the Middle East. Indeed, prior to 1975, Lebanon attracted a major portion of foreign capital especially from the Arab world. The two main reasons are: 1) Lebanon was considered a refuge or a shelter for privately held Arab capital escaping the threat of nationalization campaigns that so characterized the Egyptian, Syrian and Iraqi economies which, in turn, generated substantial investments mainly in the real estate sector. 2) Lebanon was considered as a relay for much of the contacts / transactions between Europe and the Middle East. Its position was strengthened by the political and economic freedom which characterized the country. This prosperity had much to do with the fact that Lebanon had a jump start in development over neighboring countries rich in resources but relatively poor in skills. Factors such as traditional investor-friendly economic environment, a strong human resource base, entrepreneurial talent, and a private sector leadership in the productive and services sectors enabled Lebanon to act as the indispensable middleman in much of the contacts of the Gulf and other Arab countries with the West.

At the time the public sector was investing heavily in building an extensive infrastructure of trade routes, ports, airports, warehouses, communication network, however it kept away from interfering in the free flow of imports, exports and the migration of capital. Indeed the government also carried out a pro-free trade pro-business policy environment with minimal government interference, minimal income or profit taxes, bank secrecy laws and a free foreign exchange market. Last but not least, a relatively stable political environment 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.

However, the civil war, which began in earnest in 1975, inflicted heavy damage on the economic sector. It shattered the economic base of the country, causing a severe decline in the level of economic activity, and leading to the destruction of a major part of Beirut and its financial center. The destruction of capital stock, coupled with the migration of talented and skilled professionals led to a huge decrease in output and productivity in both the industrial and service sectors. Indeed the UN has estimated the damage from the civil war at $25billion[1].

By the 1980s, the budget deficit coupled with a balance of payments deficit led to an unprecedented monetary depreciation. Lebanon's economic predicament was compounded due to the drastic decrease in foreign aid and capital inflow. The latter was mainly the result of the relocation of the "Palestinian Economy" from Beirut in the wake of the 1982 Israeli invasion, which had been injecting into the Lebanese economy a substantial amount of money and operating capital in addition to some first class bankers and entrepreneurs, cheap semi skilled and unskilled workers. At one time, this economy was estimated to be pumping over $4 billion annually on social services, wages and salaries to its "public servants and army"[2]. The contraction of capital inflow was exacerbated by the Lebanese government's inability to collect revenues which were *de facto* being levied by the warring militia. At the same time its expenditure remained high: salaries to its employees, subsidies on products like gasoline and wheat, and the running costs of an increasingly unproductive administration. This resulted in a critical budget deficit that increased both its interior

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[1] See Country Overview: Lebanon, the World Bank Group.1995.
[2] See Kubursi (1991).

debt and debt servicing costs. The economy was unable to cushion the shocks and quickly absorb them.

Soon after the signing of the Taiff agreement in 1990, Prime Minister Rafiq Al-Hariri was elected to office. He pursued a tight monetary policy which successfully brought under control inflation from about 100% in 1992 to single digits in 1997[3]. The Hariri government rule was successful in restoring confidence in the dynamics and viability of the Lebanese economy which suffered a heavy blow following 17 years of civil strife. This rebuilding process and the increase in confidence level are evidenced by the return of highly skilled labor accompanied with significant savings resettling in the country aiming at carving up a share of the projected growth in the Lebanese economy. Growth in GDP per capita from less than $1,000 in 1990 to approximately $3,300 in 1997[4]. The world Bank resumed lending to Lebanon in early 1993 and later in 1996 (a total of $225 million) for supporting the government's efforts to rebuild the infra-structure. The government was so successful in stabilizing the economy that it managed to successfully float several international issues of Eurobonds with increasing maturities and narrowing spreads between 1994 and 1997[5].

In 1993 the government launched a $2.3 billion National Emergency Recovery Program (NERP) to rehabilitate key physical and social infrastructure over three and a half years. The program is supported by the World Bank which in December 1996 hosted a donors' conference that elicited enough support that the government has since developed a more ambitious longer-term investment program - Plan Horizon 2000[6]. As

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[3] See Country Overview: Lebanon, the World Bank Group.1995
[4] Idem.
[5] Refer to table p.30.
[6] See Country Overview: Lebanon, the World Bank Group.1995.

part of this program, expenditures of $600 million were planned on improvements in the areas of housing, education and health, together with an additional $500 million on improvements in public transport, roads and the Beirut airport. Whilst part of the cost of these projects was to be financed through foreign aid, a major part had to be financed through commercial loans.

To ensure the current and continued effective mobilization of such resources, Lebanon has to re-develop its capital markets. It comprises debt market, equity market as well as institutional and financial instruments that provide specialized credit. Aware of the need for reliable institutions able to attract and manage a consistent volume of capital, the government has taken a number of actions aimed at developing capital markets to facilitate private sector participation in the Lebanon's reconstruction program. The Investment Development Authority of Lebanon(IDAL) was created in 1994 to support foreign investors and promotion of build-and-transfer(BOT) and similar projects; Midclear was created in 1994 to facilitate domestic and regional equity transactions; and the Beirut Stock Market was officially reopened in 1996 after a 13-year hiatus. Currently Lebanon has 82 commercial banks including the Royal Bank of Canada. This is significantly more than the number of banks in any of the neighboring countries. In recent years investment houses have been established as well. Today it would be highly unrealistic to assume that Lebanon will regain its former role since the political and economic conditions in the entire Arab world have drastically changed since 1975. Lebanon will, however, have to become a more sophisticated capital market to channel resources back into the region, where current and future investment requirements are vast.

In this thesis, I will first tackle the preconditions necessary for the stabilization of the Lebanese economy and the development of capital markets. Next, I will examine the role of financial markets in the reconstruction and normalization phases in Lebanon. Drawing on the Lebanese unique experience, I will look into the different factors to be taken into consideration in the setting of rules and regulations for the Beirut Stock Exchange and how the organization of such an exchange can have significant effect on the economic development of Lebanon.

2. Stabilization

Background

During the entire civil war, and particularly starting in the mid-1980's, the Banque du Liban (BDL) had to accommodate the contradicting goals of satisfying the needs of the state, which sustained an ever growing budget deficit, and defending as much as possible the parity of the Lebanese pound (LBP). An attempt was made to implement these objectives by trying to offset the advances given to the state with a very restrictive monetary policy. Furthermore, the use by the state of foreign exchange profits in the balance sheet of the BDL were unquestionably inflationary. Yet, this solution was the best alternative available at the time in order to safeguard the functioning of the economic machine while waiting for a political solution which would give back to the state its authority, resources, and prerogatives.

By 1988 there was a certain modification of political expectations which left the population believing that a stabilization and a slight improvement in the situation was forthcoming. These expectations partially modified the monetary position of savers and fund holders in favor of the Lebanese pound. This, in turn, promoted an improvement in the exchange rate parity, a certain drop in the rate of dollarization of the economy, and the progressive replenishing of the foreign resources of the BDL. The interest rates on T-bills were twice reduced during that year[7]. However, these tendencies for improvement rapidly faded away and the situation resumed its deteriorating trend as of September 1988 when the Presidential Elections were twice postponed and eventually led to a double headed political regime by General Aoun and President Hrawi.

One must also note that in the absence of the "rule of law", all efforts for regulation

[7] See Quarterly Bulletin, 4th quarter 1988, Banque du Liban.

and adjustment policies given the very intimate links between politics and economics failed. Monetary measures, which would have produced positive results under normal conditions, were only capable of giving mixed results due to the complete lack of coordination between the monetary authorities and the other centers of political decision making. On the whole, the 1980's can be characterized by the following elements:

1) Fundamental economic disequilibrium, in particular, a huge budget deficit giving rise to massive non-productive financial needs that kept on increasing year after year.
2) Monetary policy regulated quantitatively: credit limitations, high legal reserves requirement (LRR), compulsory subscriptions in T-bills for commercial banks.
3) Direct interventions by the BDL on the foreign exchange market to put an end to fluctuations in the parity of the Lebanese pound vis-à-vis foreign currencies. However, these interventions did not have the expected stabilizing effect until the end of the war.
5) A high rate of growth of money supply as the authorities were unable to fix growth objectives.

The dual objective of the monetary authorities of ensuring the financing of the state and hindering the depreciation of the Lebanese pound remained unchanged. The final objectives were to ensure the financing of the state and to reduce sharp fluctuations in the value of the Lebanese pound. The intermediate targets used were stringent limitations on advances and credit and limitations on the rate of growth of money supply. Monetary policy objectives were transmitted to the economy through compulsory subscription in T-bills for commercial banks, legal reserve requirements (LRR) and direct intervention of the central bank on the foreign exchange market.

Clearly a normal development of the economy cannot take place within such a restrictive monetary framework. Monetary policy must use more flexible instruments putting into play the different market mechanisms. For such a system to work a complete rethinking of the actual policy must be contemplated implying that a number of fundamental conditions will have to be met. The most significant factor contributing to the process of inflation and depreciation was undoubtedly the budget deficit and the growing internal public debt, both of which were consequences of the inability of the Lebanese state to exercise its authority.

Prime Minister Hariri came to office in 1990. This followed the signing of the Taiff agreement which addressed most of the disequilibrium in the distribution of political and executive powers amongst the various religious sects in Lebanon. The first 18 months of the Hariri government rule were successful in restoring confidence in the dynamics and viability of the Lebanese economy which suffered heavy blows following 17 years of hostilities. It was thus clear that restoring confidence was the first step to launch a vast reconstruction program and that the implementation of sound monetary stabilization policies and development policies would be a necessary prerequisite for the years to come. Since Hariri took office, the government has taken significant initial actions to encourage private investment and attract significant amounts of necessary external support and financing that would be needed to realize the reconstruction scenario. The Hariri government is well aware that the short-run stability that has been established is tenuous.

Concurrent with this recovery in confidence, however, Lebanon experienced rapid inflation between 1990 and 1992. High levels of government borrowing and nominal interest rates were accompanied by a significant fall in the value of the Lebanese pound against the US dollar. When comparing M2 in December 1988 and December 1993 two features are immediately apparent *(refer to table below).*

Money Supply	Dec-93		Dec-88	
Money in Circulation	715	4.56%	116	5.00%
Deposits in LBP	4,594	9.30%	431	20.00%
Deposits in FC	10,370	66.14%	1,628	75.00%
M2	**15,675**	**100.00%**	**2,175**	**100.00%**
Counterpart to Money	**Dec-93**		**Dec-88**	
Net Foreign Assets	14,931	95.23%	3,700	170.00%
Gold	6,166	39.33%	2,004	92.00%
FC	8,765	55.90%	1,696	78.00%
FX Reevaluation	-6,630	-42.29%	-2,236	-103.00%
Sub Total	**8,301**	**52.94%**	**1,464**	**67.00%**
Net claims on the public sector				
Net Claims on the private sector	5,942	37.90%	740	34.00%
Other Net Assets	-1,661	-10.59%	-251	-12.00%
TOTAL	**15,679**	**100.00%**	**2,175**	**100.00%**

source: *Banque du Liban - website.*

First, the strong depreciation of the Lebanese pound has given rise to a swollen balance sheet. Thus, the account "liabilities to the public sector" has become the most important in the BDL's balance sheet. This is due to the foreign exchange revaluation which occurs when estimating the BDL foreign assets in Lebanese pounds. Hence, the overall sum of this revaluation represented 85% of total liabilities in the 1988 balance sheet against 71% in 1991 and 60.3% in 1993. The second apparent feature is the huge rise in both the "net claims on the private sector" and the "net claims on the public sector" which increased to LBP 5,942 billion and LBP 3,097 billion respectively in December 1993 up from LBP 740 billion and LBP 222 billion respectively in December 1988. While the increase in the "net claims on the private sector" is attributed to foreign exchange revaluation due to the fact that in 1993, 89% of these claims are in foreign currencies compared with 84% in 1988, the increase in the net claims on the public sector is mainly due to deficit financing.

The government responded to this problem by taking measures aimed at reducing its level of annual borrowing by increasing revenues from taxation. As a result, more than half of government expenditures in 1993 were financed by taxation. At the same time, there had been a significant improvement in monetary conditions as perceived by a fall in nominal interest rates, the virtual elimination of inflation in 1993, and the stabilization of the Lebanese pound against the US dollar.

A credible stabilization program is necessary in order to ensure that the government's priorities in the reconstruction program can be successfully implemented and that the private sector can be enticed to bring back its capital and, therefore, invest in Lebanon. Indeed, the Council of Development and Reconstruction, a government body responsible for all aspects of infrastructure development in Lebanon, projected in 1993 that achieving an annual growth rate in Lebanon's GDP of approximately 8% over a period of 10 years was necessary in order to provide the government with enough resources and hence allow it to fulfill its role as a central player in the reconstruction process. This forecast assumes that total investments of USD 37 billion will be required during a period of 10 years, of which USD 10 billion are expected to come from the public sector and USD 27 billion from the private sector[8]. Therefore, the magnitude of financing required by the private sector would not be possible without the establishment of financial markets and the development of secondary ones.

The Stabilization Process

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[8] Refer to table p22.

It is surely obvious that the securities market in an underdeveloped country should be viewed and assessed in relation to the country's limited economic and financial development. Consequently, any specific measures aimed at fostering the growth of the securities market should be introduced as part of a general program for economic and financial development. It is important to emphasize the significance of curbing inflation and freeing interest rates if securities markets are to flourish. Inflation, unquestionably, has deleterious effects on the real value and the yield of bonds, debentures, etc., as their capital values are expressed in fixed money amounts with fixed interest rates.

The preconditions involve a balanced budget, a stable balance of payments, an acceptable rate of inflation, and the liberalization of the economy. The achievement of these requirements is made very difficult as they will have to be fulfilled within a short period of time given the urgent need for funds. Hence, serious efforts to implement structural adjustment plans have to be made. A cut in public spending involving a cap on the rise in salaries, a reduction of public investment, the elimination of subsidies to unprofitable public enterprises and drastic cuts in social spending should all be considered. In addition, a restrictive monetary policy should be implemented in order to curb inflation and reduce trade deficit. A loose monetary policy will depreciate the domestic currency and make the imported goods even more expensive without any offsetting benefits on the exports side since Lebanon is not a heavy exporter.

These measures will undoubtedly create social and political unrest. A good policy would be one that achieves the above mentioned goals without exacerbating social and political tensions. The first and most important prerequisite for the prosperity of financial markets is the improvement of the financial position of the public sector in order to relieve inflationary pressures on the money supply and reduce its rate of growth. This condition presupposes a net amelioration of the income tax base and income tax collection. It also presupposes an effort to rationalize public spending and control all superfluous expenditures at all levels. The second condition concerns the reinforcement of the position of the BDL. The extent to which this can be achieved depends on the ability of the BDL to dissuade operators on the foreign exchange market from speculating against the Lebanese pound. In other words, the BDL must be able to stabilize the national currency independently of any political shock that might occur. This would lead to a self-feeding process where political stability would reinforce monetary stability which in turn strengthen the role of the Banque du Liban as a market participant.

In the case of Lebanon's dollarized economy, a third condition that must be fulfilled would be to reduce the rate of dollarization of the economy. This must occur in order to free enterprises from credit restrictions in the national currency. In fact these restrictions push agents who need financing towards loans in foreign currencies (mainly in US dollar). Commercial banks encourage this process since it provides uses for their excess liquidity in foreign currencies. Furthermore, the restrictions set by the monetary authorities cannot but have a partial effect on stabilizing the economy when, at the same time, these restrictions are indirectly encouraging "the dollar circuit" instead of " the LBP circuit " in financial activities. It is clear that any deterioration of the "actual equilibrium" in the foreign exchange market will favor the first circuit at the expense of the second.

The above analysis infers that for domestic and foreign capital to be invested in Lebanon a structural correction in the public sector finance will have to be implemented. This, in turn, will alleviate the pressure off the money supply and stabilize monetary aggregates and the foreign exchange parity of the Lebanese pound. These steps will minimize the risk of depreciation and encourage investors to invest their savings in Lebanon.

Financing the deficit by issuing Treasury bills swelled money supply especially when commercial banks were the subscribers. The process was as follows: increases in deposits led to increased subscription by commercial banks; this meant more resources available to the government which led to unproductive spending by the government. This in turn increased deposits proportionately and led to the creation of money via the multiplier effect. Subscription by private individuals on the other hand were the least inflationary since these individuals had to lower their deposits in order to subscribe and hence only interest accruing on Treasury bills would count as money creation. By 1993, an encouraging sign was evidenced by the evolution of the share of different subscribers in Treasury bills. As indicated in the table below, the share of the BDL dropped to 3% at the end of 1992 after it had reached 21.2% at the end of 1986 and had peaked to 52% in 1987. In fact, at that time, conflicts between the BDL and the commercial banks concerning which restrictive policy to pursue induced the latter to cut on their subscriptions which, in turn, forced the BDL to step in and swell its own portfolio in order to ensure the immediate needs of the government. However, we should note that the share of commercial banks increased in 1992 to reach 77.86%.

Subscriber share of total T-bills outstanding

Subscriber (%)/Year	**1988**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Commercial Banks	76.50%	77.86%	73.66%	79.23%	70.93%	73.76%	70.64%
Banque du Liban	3.88%	3.00%	6.95%	0.29%	0.78%	0%	0.19%
Non-Banks	19.62%	19.14%	19.39%	20.48%	28.29%	26.24%	29.17%

source: *Banque du Liban - website*

This increase compensates the decline in the share of the private sector from 27.85% in 1991 to 17.12%. This drop in the share of the private sector has been attributed to the monetary collapse of 1992. Thus, the relative stability of 1993 seems to have convinced private investors to increase their share at the expense of commercial banks. By August 1997, the BDL exempted commercial banks from mandatory subscription to government's bonds, at an average rate of 40%, and also refused to accept further subscription from individuals and institutions outside Lebanon[9]. However, this exemption is only symbolic since the commercial bank's share of total T-bills outstanding was at 70.64% in 1997, much higher than the newly abolished mandatory subscription rate of 40%.

As we have seen in the previous section three sources for financing the budget deficit existed: the BDL, the commercial banks, and the public. The advances of the BDL are highly inflationary since it involves the functioning of the printing press at full power (monetary creation without any counterpart in real production). Borrowing from commercial banks is certainly less inflationary. Yet, it still involves a money multiplication process. The subscribed amounts are spent by the public sector in order to be re-pumped by new subscriptions. Given the economic and political conditions of the country, this source was the easiest to target (via monetary policy) and less harmful than BDL advances since it permitted, at least in the short-run, to neutralize a part of the liquidity and limit, as much as possible, the speculative behavior against the Lebanese pound. The third and last source for financing was subscriptions in T-bills by the public. This policy was the least inflationary because the liquidity increase arising from this method would be limited to the interest earned on these T-bills. There exists a direct one-to-one relationship between the public sector and the private fund holders and the individual household, for, in order to subscribe, a private investor has to lower its bank deposits.

The BDL has also been very successful in preserving and gradually improving the

[9] See MEED, May 2/1997, p.18.

parity of the Lebanese pound. This action has been undertaken in a favorable environment and has permitted the BDL to reinforce, in a very substantial way, its means of action particularly in terms of foreign currency resources.

To this date, the BDL intervenes in the markets periodically, selling foreign currencies from its reserves to maintain the value of the Lebanese pound in accordance with the government's policy of financial stability. Yet, this process proved to be a very costly one. "The cost of its intervention in 1997 exceeded USD 2 billion, or more than half its total foreign currency reserves", a bank official said[10]. The value of the Lebanese pound has come under pressure on the region's turbulent money markets as a result of the country's economic difficulties, notably a continuing budget deficit and very low growth rate. Recently, in December 1997, Saudi Arabia deposited 600 million dollars with the Banque du Liban to help it overcome the financial crisis and maintain the level of the Lebanese pound. The privately owned Al-Ahli bank deposited the money for three years at a very low interest rate[11]. The Saudi authorities gave their blessing to the move. Prime Minister Rafik Hariri maintains friendly relations with Saudi leaders, particularly King Fahd.

The stabilization of the LBP parity was due to the cessation of hostilities and the prospects for a brighter future rather than to a change in any of the economy's fundamentals. The main problems facing the Lebanese economy are the soaring budget deficit and the high inflation risk which is reflected in a precarious foreign exchange rate parity. A report by the IMF in June 1992 ("Lebanon: The Fiscal Position and its Reconstruction) stated that "given the size of the deficit it will not be possible anymore to finance it by increasing revenues. The budget deficit problem is the consequence of a very substantial increase in spending. Hence, it is as important

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[10] See Monday Morning Website, December 1997.
[11] Idem.

to control these expenditures, curb their growth and channel them into productive outlets as to improve revenue collection". The same report also states that it should be possible for the Lebanese government to improve its revenue collection without hurting the reconstruction process.

The government has since investigated many avenues in order to increase its revenues. An amendment of the income tax law was adopted by the parliament at the end of 1993. Recently, in June 1997, the government voted to increase custom duties sharply on imported cars. The move was welcomed by economists, who believe that the government must increase its revenues in order to cut the budget deficit. The new tariffs on imported cars will range from 20% on those worth up to $9,730 to 100-200 % on those worth $65,000 to $150,000[12]. The new tariffs are intended to help the government reduce the wide budget deficit. The deficit target in the 1997 budget law is $1,600 million around 36% of expenditures. However, the deficit for the fourth quarter of 1997 stood at more than 69% of expenditure[13]. The discrepancy between the target and the actual deficits is due to both the inadequacy of public revenues and excessive public expenditure.

Another attempt by Hariri to finance the $800 million social services development plan by raising gas prices was recently rejected by his cabinet, underscoring the struggle to both fund the reconstruction and ease economic hardship. The decision reflected concerns that the country would sink further into debt, currently at $ 13 billion, $ 2.24 billion owned abroad, in an economy with an estimated GDP of $14 billion[14].

Stabilization and the financial markets

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[12] See MEED, June 20/1997, p.20.
[13] See Quarterly Bulletin, 4th quarter 1997, Banque du Liban.
[14] See Reuters, Feature fears grow for Lebanese Pound, October 20/1997.

The need to develop an efficient monetary policy that would influence the level of economic activity in the short run had become an urgent necessity. Indeed, there was a pressing need to change the transmission channels of monetary policy. The reopening of the Bourse de Beyrouth in 1993 coupled with the introduction of new financial instruments to Lebanon's banking sector has provided the monetary authorities with the means to achieve this goal. The objectives of ensuring the financing of the state and the reconstruction project along with maintaining the stability of the Lebanese pound could now be achieved through the control of the growth of money supply and its effect on interest rates fluctuations. The fluidity between the different markets will ensure that the entire economy is impacted. Beside the effects of interest rate variations, LRR policy and the intervention of the BDL on the foreign exchange market will enhance the conduct of monetary policy.

In order to achieve an economy of "capital markets", the development of the financial markets will need to be accompanied by a "banking disintermediation" process where banks discontinue playing their central role of financing the economy through the process of money creation. In such an economy supply and demand of funds meet on the financial markets where the price of money will be set. In addition, the innovations and modifications of the regulatory framework should make it easier for enterprises, and even banks, to access these markets.

In such an environment, enterprises will have three means to finance themselves. In addition to auto financing and bank loans, these enterprises will have the possibility to issue "treasury notes" or "commercial papers" on the financial markets. These papers and notes will materialize the claims on the enterprise and will be negotiable (tradable). The monetary authorities, through fiscal or other means, could then channel the savings towards placements in securities and regulate their issuance in order to ensure the harmonious development of the financial market.

The above evolution however, will have negative repercussions on banking intermediation and bank deposits will have a tendency to diminish. Financial intermediaries, in turn, will be forced to rely on financial markets to issue CDs (Certificate of Deposits) which represent short and medium term deposits. Contrary to the usual bank deposits, these CDs are negotiable and can be subscribed to by every economic agent. Hence, the monetary market will stop being an inter-bank market. If the necessary precautions are taken, the CDs market will develop without being a destabilizing element. Furthermore, the CDs will provide banks with a more flexible management of their liabilities. The monetary market could be enlarged even further by authorizing the different financial institutions and firms to issue securities similar to CDs and have the same characteristics and fiscal regime. As such, the clear cut frontier between the monetary market and the financial market will progressively wither away allowing for adjustments via interest rates. This will be facilitated as the state and local collectivities indulge into issuing securities in the market. This would be stimulated by the public need for funds which would enable the state and local bodies to develop and execute economic and social projects of national interest. The needs of the state will thus be covered by resident and non-resident lenders. Likewise, the budget deficit will be partly financed by the foreigners.

This type of situation implies a different concept of monetary policy where interest rates play a central role. Their control will regulate the markets as the effects of an interest rate modification will spread unconstrained from a market to the other to ultimately reach the whole economy. The BDL will thus be able to indirectly determine the cost of financing of the banking system, consequently, it would be able to control the variations of the money supply. The focus on interest rates could be complemented and reinforced by a legal reserve requirement policy with a main goal to limit the banking mechanism of credit distribution and money creation. The resumption and development of the commercial paper market will permit the authorities to set up policies of rediscounting and open market if the need arises.

Unlike newcomers to the market-economy system, Lebanon has launched capital market activities within a minimal gestation period. This is due to three factors:
1) Lebanon already had a stock market prior to 1975, albeit one with a legal and regulatory base that needed to be radically changed before trading resumed. 2) The resumption of market activity did not need to await privatization as there are only a handful of public enterprises that would be candidates for privatization. Moreover, the shareholders of companies that were listed on the pre-1975 stock exchange will benefit from an active secondary market that would provide them with the option *cum* security to liquidate their holdings. These shares and potentially those of hundreds of joint stock companies established over the past two decades may make up a relatively broad equity market. 3) Unlike other developing countries where economic liberalization and deregulation had to precede the opening up of financial sectors to international markets, Lebanon's financial sector has, throughout the war years, maintained its ties with foreign money and capital markets. Through representative offices of major international brokerage firms, Lebanese investors have continued to hold and trade in foreign - mainly US and French- debt and equity instruments, to subscribe to mutual funds and to acquire a working knowledge of trading in the arrays of derivative instruments that are available on the international markets. Therefore the creation of financial intermediaries that would adapt sophisticated instruments and techniques to local market needs would not require a lengthy process of apprenticeship.

Recently the successful flotation of USD 650 million worth of shares to the public by SOLIDERE, a newly established real estate development company entrusted with the task of rebuilding Beirut's central commercial district, was revealing in more aspects than one. The fact that the company was able to exceed its capital raising objective even prior to the establishment of tested issue channels and secondary trading institutions is an indication that investors are well disposed to hold financial assets other than the highly liquid bank deposits.

3. Reconstruction of Lebanon: Role of the public and private sectors.

The reconstruction process in Lebanon required substantial investment in physical capital and infrastructure, human capital, as well as health and social related spending. Investment spending was also required across all sectors of the economy and throughout all Lebanese regions, especially those areas that have been most adversely affected by war and destruction.

A recovery of total output and restoration of economic growth will require a substantial increase in private sector investment that would accompany the increase in public investment. The Conseil du Developpement et de la Reconstruction(CDR), the government body responsible for all aspects of infrastructure development in Lebanon, estimated that Lebanon will require $10 billion for public sector project financing and $27 billion for private sector investment, in 1992 dollars, over a period of 10 years. The CDR figures (*refer to table below*) suggest that, in order to return to the pre-1975 capital to output ratio and to increase the ratio of capital per worker, allowing for increased productivity and higher levels of real income, total private and public investment spending must be substantial. The Table shows investment requirements under two potential scenarios: a "high investment / high growth" and a "low investment / low growth" scenario. In each case the underlying simulations imply a gradual approach (over 25 to 30 years) of real income to the potential level that would have prevailed in the absence of the war. Briefly, the table suggests first that a high annual investment ratio, in excess of 25% of GDP, has to be sustained over the assumed 10-year program. Second, the total public investment program will be constrained by the government's ability to raise revenue and finance during the reconstruction period.

INVESTMENT AND GROWTH, 1993- 2002.		
	High Investment/Growth	**Low Investment/Growth**
Cumulative GDP, $BN	174	145
Cumulative Investment, $BN	37	26
Investment as % of GDP	26%	25%
Public Investment, $BN	**10**	**6**
Total Private Investment, $BN	27	20
Foreign Investment, $BN	22	17
Foreign as % total Investment	60%	65%

source: *Recovery Planning for the Reconstruction and Development of Lebanon, CDR 1991.*

Third, despite the ambitious public investment program, the private sector will have to provide the bulk of total investment, on a 3:1 basis relative to public sector investment. Fourth, external resources, - aid, direct foreign investments, debt and equity inflows - will play a dominant role in financing the investment expenditures required for reconstruction. Resources arising from the flow of annual domestic savings will not be able to contribute more than one third of total investment requirements.

The forecast above assumes a relatively high investment to GDP ratio. This is a central feature that characterized the Lebanese economy since the early 1940s. In fact this ratio, on average, has rarely fallen below 20 percent throughout the 1950s and until the eve of the civil war. Starting with a capital-to-output ratio of about 2.47:1, this investment ratio could theoretically support an annual GDP rate of growth of about 8 percent, a rate that is typical of the Lebanese economy for much of the prewar period. Given that services account for more than sixty percent of Lebanon's GDP, the 20 percent investment ratio understates 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 observed in Lebanese manufacturing and agriculture.

The above highlights: (a) the substantial volume of investment resources required over the reconstruction period and (b) the critical role to be played by the private sector and external resources.

The Public Sector

The Lebanese government is playing a major role in the reconstruction process. In 92/93, the Council for Development and Reconstruction (CDR), proposed a plan extending over a ten year period, including a total public investment package amounting to USD 10 billion. This plan, the "National Emergency Reconstruction Program"(Horizon 2000), was scheduled to take place in two phases, cover all major sectors, and generate an equitable regional distribution of projects and investments. As shown in table below, the public investment spending plan gave priority to rebuilding the country's infrastructure and to providing basic services.

This program relates to public investment, largely constituting infrastructure investment critical to the recovery of output and economic activity. Indeed, it is important to stress that such public investment in infrastructure and in public goods and services is a critical element in the recovery and growth of private sector economic activity. Public utilities, such as electricity, transport, communications, water, and waste management should be considered as productive inputs that are complementary to private sector inputs of capital and labor. An increase in public sector investment is likely to have two types of effects during the reconstruction phase: (a) it would lead to an increase in the efficiency and productivity of private sector capital and labor, and (b) by raising real income prospects and providing public amenities, it would increase the rate of return-migration of the labor force and population located abroad.

PLANNED PUBLIC INVESTMENT SPENDING

1993 - 2002 (Millions of $US)

Sector	Year 1 to 3	%	Year 4 to 10	%	Year 1 to 10	%
Electricity	554	19.4	1246	15.3	1800	16.4
Waste MGT	165	5.8	840	10.3	100S	9.1
Communication	462	16.2	158	1.9	620	5.6
Transportation	503	17.6	2342	28.8	2845	25.9
Water	161	5.6	254	3.1	415	3.8
Health + Education	220	7.7	1515	18.6	1735	15.8
Housing	392	13.7	558	6.8	950	8.6
Productive Sect	220	7.7	1085	13.3	1305	11.9
Govt. + Admin.	179	6.3	141	1.7	320	2.9
TOTAL	**$2,856**	**100**	**$8,139**	**100**	**$10,995**	**100**

source: *Recovery Planning for the Reconstruction and Development of Lebanon, CDR 1991.*

Over the ten year program, transport, electricity, health and education are the sectors of first priority. On the financing side, the initial CDR forecasts predicted that up to 40% of investment spending will be financed from expected budget surpluses by 1995 and increasing over the ten year period. The remaining balance of investment spending will be aid and debt-financed, including foreign debt, supplier credit and the like. In summary, it is expected that external resources will provide up to 60% of the finance of the public investment program. The economic model used for this original reconstruction plan, the first version of Horizon 2000, assumed that the budget deficit, now running at around 59 % of expenditures, would be bridged by 1999. A second version revised the date to 2003. Today, the CDR estimates the deficit will not be closed until 2007. Indeed, this last version also assumes that growth will return to 7% this year and next. The latter compares to an official growth forecast of 6% and an actual growth rate of around 4% for 1997[15]. An important learning is that forecasts of significant future funding from budget must be considered an uncertain element in the estimates. *(refer to Appendix- table 4).* This resulted in a higher need for public debt to enable the government to finance public sector projects.

In an attempt to speed up the reconstruction, the government has sought to move planned public sector projects to the private sector. This is in line with the recommendation of Jannik Lindbaek, Executive vice president of the IFC, the private sector arm of the World Bank who advised the government, last October in a conference held in Beirut, to seek private funds through private markets, both in the domestic and the international markets for its costly reconstruction to ease public debt. This would alleviate the pressure on the public debt and give possibilities for the public sector to devote its attention to areas that cannot be covered by the private sector[16].

Indeed, in addition to the Société Libanaise pour le Développement et la Reconstruction (SOLIDERE), another USD 3.5 billion out of the USD10 billion public investment program is expected to be taken up by the private sector. The BDL has launched a program to subsidize commercial banks' short and medium-term loans to productive projects. The program will enable local industries to borrow more than USD 300 million at 11% interest. The government has allocated $15.5 million for the subsidies in 1997, to cover 5% of interest on loans to industrial, agricultural and tourism projects[17].

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[15] See the Middle East Monitor, July 1997, p.55..
[16] See Reuters, IFC urges Greater Private Financing for Lebanon, October 20/1997.
[17] See MEED, May 2/1997, p.18.

The subsidies will be divided equally between the three sectors. Discussions are under way between the BDL and the Finance Ministry to extend the subsidy for up to seven more years. The loans must be at least worth USD 32,370 and no more than USD 1.9 million, and have terms of five-seven years. Interest on foreign currency loans must not exceed 2% over the 3 months LIBOR. Interest on Lebanese Pound loans must not exceed 2-year Lebanese treasury bill yield. These currently stand at just over 16%, equivalent to the new Lebanese pound prime lending rate agreed upon by members of the Lebanese Bankers Association in mid-March 1997.

As the government attempts to package projects in ways that appeal to private sector investors, there are nagging concerns in Beirut's political and business circles about the scale of the reconstruction. These concerns are intensifying in light of the government's dire finances. Although foreign debt is still only $2.4 billion, or about 14% of estimated gross domestic product, the fact that total debt stands at more than 80% of GDP leads many to suggest that a fundamental rethinking of the reconstruction project is required[18]. The size as well as the scope of the plan should be considered. In a plan that might have been too ambitious, infrastructure construction has been given clear priority over industry and agriculture and over reforming the institutions.

Private Sector

The factors that would determine a return of Lebanese capital funds located abroad, as well as foreign capital inflows will be discussed next. The standard paradigm is that there are substantial funds waiting to flood the gates as soon as a minimum of political entente and security are achieved, attracted by the requirements for reconstruction and profitable investments. However, the following issues should be mentioned in this context.

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[18] See MEED, August 1/1997, p.21.

As for Lebanese capital it is very difficult to assess the amount of capital placed outside which is likely to be returned to the country. This is because, on the one hand, estimates of total expatriated Lebanese capital vary between $6 and $20 billion and, on the other hand, it is unclear as to how much of this capital is liquid and hence easily transferable and how much is in illiquid form such as real estate. Some suggest that a plausible scenario would be to consider that the total of all Lebanese expatriated capital is around $6 billion and only half of it would be returned. However, transfer payments and capital repatriation figures allowed us to be much more optimistic as early as 1993 when the total amount of capital transferred to Lebanon amounted to around $5 billion[19]. These inflows, vital to cover a trade deficit averaging over $ 6 billion in each of the past three years as reconstruction forged ahead, have increased steadily. Gross capital inflows were $6.5 billion in 1994, $6.7 billion in 1995 and $7.3 billion in 1996 in spite of the 17- day Israeli bombardment of Lebanon in April[20]. In 1997, inflows for the first half of the year rose 26% over year ago, to reach $3.9 million, giving a balance of payment surplus of $673 million, compared to a surplus of $786 million for all of 1996 (refer to table below). The second half of the year witnessed the crash of the Asian markets which incurred significant capital outflows from emerging markets. However, traditional seasonal transfers at year end alleviated some of pressure on the balance of payment(BOP). As a result, the BOP registered a net surplus of $403 million for 1997.

[19] See Financial Times Survey, October 27/1997, p.1.
[20] Idem.

Balance of Payment Results (in million of USD)

	Central Bank	Banks	Total
Q1 - 95	(194.5)	(96.4)	(290.9)
Q2 -95	(575.6)	318.1	(257.5)
Q3 - 95	(15.2)	(393.4	378.2
Q4 - 95	1,376.4	(950.2)	426.2
1995	**591.1**	**(335.1)**	**256.0**
Q1 - 96	215.6	(186.2)	29.4
Q2 - 96	30.3	(21.2)	9.1
Q3 - 96	459.7	(175.9)	283.8
Q4 - 96	722.8	(258.7)	464.1
1996	**1,428.4**	**(642)**	**786.4**
Q1 - 97	696.7	(132.2)	564.5
Q2 - 97	653.5	(545.6)	107.9
Q3 - 97	(443.4)	613.1	169.7
Q4 - 97	(845.1)	422.8	(422.3)
1997	**61.7**	**358.1**	**419.8**

source: *Banque du Liban - Website*

As for Lebanese human capital, economic theory suggests that the decision of return migration is complex. However, the fundamental element is the forward-looking aspect: it is the expected prospects of growth and prosperity over the relevant time horizon in Lebanon relative to those abroad which affect the decision. In this context, we can not expect that there will be large inflows of return-migration to Lebanon in the near future. This can be attributed to several reasons; real wages and incomes in Lebanon have fallen substantially over the past fourteen years compared to the high an rising real incomes in the countries of migration (except possibly for the Arabian

Gulf countries over the past three years). The absolute and relative gaps are high. It is only if real incomes in Lebanon can be expected to rise rapidly and eventually overtake the expected real income path abroad (after adjustment for total taxes), that we can anticipate a substantial flow of return migration.

Second, there are two important characteristics of the Lebanese migrant population that diminish the probability of return migration: (a) a large fraction consists of the highly-skilled and professional class whose real income differentials are substantially higher than the average, and (b) the majority falls in the age group of 25-45 years, which is the child-bearing and child-rearing age group, which have substantially higher total costs of mobility, and are entering their peak years of earning abroad. These characteristics imply that a large fraction of Lebanon's human capital located abroad will not return in the immediate future unless income prospects in Lebanon are expected to improve substantially and on a permanent basis.

Given the above, the conditions that would tend to raise the probability of a return-flow of human capital include low tax rates and social charges, a rapid implementation of a program to rebuild the country's infrastructure for social amenities, mainly education and health.

Foreign Funding

Lebanon is trying to secure greater foreign investment in its attempt to regain its status as a regional financial and banking center. In a further attempt to assist public spending, Prime Minister Hariri proposed, in August 97, Lebanon borrows $1,000 million from the international markets to finance emergency social spending. This would increase Lebanon's foreign debt to 20% of GDP from the present level of 14%. However, further external borrowing will only have a beneficial effect on growth if it helps reduce the government's domestic borrowing at high interest rates. Lebanon was expected to achieve GDP growth of 6% last year according to official estimates[21]. This compares with an estimated growth rate of only 4% in 1997[22]. However, some analysts are warning against attaching too much importance to the debt figures. Indeed, more than 80% of the debt is domestic. Moreover, the warm reception given to the government's first Deutschmark bond issue in May 1997 suggests that the international capital markets are confident of Lebanon's ability to honor its obligations. Indeed, the government can probably continue on its present course for some time. As long as internal debt is less than 100% of GDP, Lebanon can survive another 3 to 5 years without a collapse. By then , the reconstruction efforts should start to payoff.

The government of Prime Minister Rafik al-Hariri has also had strong backing from international donors and the World Bank. The Friends of Lebanon Donor Conference held in the US at the end of 1996 - a device to drum up external support to speed reconstruction after Israel had vandalized new infrastructure that same year in April, won pledges of soft loans and grants worth $ 3.2 billion. Of $ 3.8 billion of contracts awarded between 1992 and June 1997, nearly $ 1.6 billion was from foreign sources. Another $ 2.0 billion of foreign financing is now available. Indeed both the public and the private sectors have had little difficulty tapping international markets, even though four rating agencies this year marked Lebanon at below investment grade, placing it below Egypt and Tunisia and on par with Jordan and Brazil. The Japanese rating agency, NIS, was the only rating agency to grant Lebanon an investment grade credit rating. These ratings are particularly important insofar as they affect the country's cost of debt. (*refer to Appendix- tables 6 & 7*)

The government in particular has been able to achieve falling spreads and longer

[21] See MEED, August 1/1997, p 21.
[22] See Banque du Liban - Website.

maturities *(refer to table below)*. After 3 Eurobond issues in 1994-96 totaling $800 million, the government successfully sold DM 250 million in D-Mark bearer last June. These were all with maturities of three to five years.

Eurobond Issues: Yields & Maturities

TYPE	EUROBOND I (3 YEARS)		EUROBOND II (5 YEARS)		EUROBOND III (5 YEARS)	
	Yield to Maturity	Spread with US T-Bills	Yield to Maturity	Spread with US T-Bills	Yield to Maturity	Spread with German GUFA
10/1994	9.86	2.66				
09/1995	9.69	3.71	9.24	3.93		
09/1996	7.19	1.72	8.55	1.99		
09/1997	6.19	0.67	7.65	1.59	7.58	2.43

source: *Banque du Liban - Website.*

Last July a new benchmark was set with a $ 100 million, 10 - year Eurobond issue for Electricité du Liban. Indeed, the Lebanese pound held steady, the spread on the country's existent and subsequent eurobonds actually narrowed, as capital repatriation by the Lebanese Diaspora continued to flow in. While the IFC, the private sector arm of the World Bank, authorized $441.8 million in financing 29 investments in Lebanon since 1971, the IFC approved $45 million in loans for its own account and $30 million in syndicated loans to four commercial banks in its 1997 approved projects in Lebanon. "The World Bank and the International Finance Corporation (IFC) have allocated a total $420 million to Lebanon this year", World Bank president James Wolfensohn said June 8, 1997 at a press conference in Beirut. There are no conditions to be met. It is simply a question of making effective use of the money. The Bank pledged a further $1,000 million at the December 1996 "Friends of Lebanon" meeting of donors in Washington. Aid to Lebanon from the Bank and the IFC will total $2,200 million over the 1996-2000 period. Most of the finance provided by the World Bank and the IFC has already been earmarked for specific sectors and projects[23].

In February 1997, the board of the World Bank approved a single currency loan of ¥6,000 million ($48.5 million) to finance a number of drinking water and wastewater projects aimed at reducing pollution on the coast. The loan is the first made to the government in yen, and reflects the government's will to borrow at lower rates. The loan is repayable over 17 years, including a five year grace period. It carries a concessionaire interest rate linked to the London Interbank offered rate (LIBOR)[24]. The approval of the loan came shortly before Japan's credit rating agency NIS gave Lebanon an investment-grade rating, which would help the government borrow at lower rates from the international markets. The loan brings USD 604 million the total amount lent by the World Bank to Lebanon since March 1993[25]. The European Investment Bank (EIB) has agreed to lend the government a total of ECU 150 million (USD 172.4 million) to help finance the schemes, which include wastewater treatment projects in Tyre, Sidon and Kesrouan. Japan has lent a further ¥ 13,200 million ($109.4 million). Bids for the work were submitted in February1997.

International funding will continue to be available if an acceptable level of transparency and disclosure are maintained. Accounts prepared to an international standard are required. The availability and cost of funding will depend on an assessment of credit risk. This is assessed on a mix of political and economic factors. Reducing the public sector debt and improving the future fiscal position via privatization receipts would be useful in obtaining a higher quality credit rating. The lower funding costs that results from a better credit rating will in turn improve the viability of projects. Purchasers of debt may get comfort from owning debt to which the earnings stream of a specific entity

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[23] See MEED, June 20/1997, p.27.
[24] See MEED, March 14/1997, p.28.
[25] Idem.

is attached in addition to a government guarantee. This logic implies that a large volume of heterogeneous debt can be raised at a better price than a large volume of homogenous government debt. Other techniques to bring in non-debt finance such as BOT (build, own, transfer), supplier finance and aid finance also need to be sought in order to lower the over all cost of funding via diversification.

It is important to distinguish between three potential sources of capital funds: portfolio investment funds, long-term capital funds and official sources of funds (aid and grants, loans from governments and supranational institutions etc.). Portfolio or short-term funds will tend to be attracted by the prospect of high expected real interest rates and the possibility of capital gains arising from an expected appreciation of the Lebanese Pound. The extent of flows will also depend on the perceived riskiness of the Lebanese banking and financial system, the credit-worthiness of local borrowers including financial intermediaries, and the availability of marketable financial instruments. A relevant issue here is the inherent riskiness of the Lebanese banking system after fourteen years of war: the adequacy of capital ratios, insufficient provisions against bad and doubtful loans and the impairment of assets securing loans. Credit worthiness would be improved through a number of measures: a program of mergers to increase the size of bulks, an increase in capital adequacy ratios to take into account both balance sheet and off-balance sheet items. The flow of longer-term investment funds will be limited by the availability, expected rate of return and riskiness of projects in Lebanon. Given that investment in Lebanon will remain relatively risky compared to other countries with available investment opportunities, we can expect that only a fraction of Lebanese capital funds and foreign capital will flow into the country. Here, the critical issues will be the credibility of the political settlement achieved and nature of the remaining political risk and the supporting program of infrastructure investments -- in particular, transport, communications, and power. Finally, the availability and magnitude of official funding will to a large extent hinge on the feasibility and credibility of the government's proposed reconstruction package, and the ability to service outstanding debt, as well confidence that funds would not be diverted into alternative uses.

The magnitude of capital flows is a function of the set of economic policies implemented by the government during the period of reconstruction. Though Lebanon has an adequate level of international reserves available as possible collateral for an international loan package, the critical issue here will be the government's fiscal policy and its ability to raise revenue in order to service debt and contain the budget deficit as overall expenditures increase.

Further, the challenge is not only to locate the funds but also to devise schemes to channel these funds into the investable projects. It should be clear that the ability to correctly finance this reconstruction project will be the key to its success. For this, it is indispensable to recognize the financial needs of the reconstruction effort and the importance of the role played by capital markets. The financial resources used will consist of the domestic savings, the Lebanese expatriated capital, and the foreign and private funds. The most effective way to channel financing is to institutionalize financial markets and devise rules and procedures in order for the Beirut Stock Exchange (BSE), which reopened in 1993, and the Beirut Secondary Market to operate efficiently. These have, indeed, paved the way for some Lebanese companies to access the international markets.

4. NEED FOR CAPITAL MARKETS

Considerable debate exists about the relationship between the financial system and economic growth. However, theoretical discussions traditionally focused on the bank's role in economic growth. Joseph Schumpeter underlined, as early as 1911, the critical importance of the banking system in the context of economic growth. Indeed, he argued that banks actively encourage future growth by identifying and funding productive investments. Besides the historical concentration on banking, there is an increasing academic and political interest in the relationship between stock markets and the rest of the financial system and the links between stock markets and long-run economic growth. Yet, the academic debate about the importance of stock markets, *per say*, is by no means settled. Some may regard equity markets as inconsequential and consider credit issuing institutions as close substitute for equity markets[26]. However, it is frequently impossible for firms to issue debt without having equity financing first. Therefore, based on the principles of corporate finance, equity and debt finance are complements. Indeed, Boyd and Smith show that stock markets and banks act as complements rather than substitute sources of capital financing[27]. In their model, agents minimize the expected costs of verification. Yet, although lower costs of verifications are associated with debt issuance, some equity financing reduces the cost of debt. Therefore, optimal financing will consist of a mix of both debt and equity. As a result, they establish that stock markets and banks are independently important in firm financing decisions and hence long-run economic growth.

Risk diversification is another means through which stock markets can affect growth. The larger the breadth of the stock markets the greater risk diversification opportunity they offer thereby inducing a shift towards 'riskier', higher-return investments thus

[26] See Rojas-Suarez and Weisbrod (1994).
[27] See to Boyd and Smith (1996).

promoting and accelerating long-run growth[28]. As a result, better functioning, more internationally integrated stock markets boost economic growth by shifting society's savings into higher return investment. More arguments supporting the importance of the role played by stock markets, emanate from the realm of corporate governance. Indeed, efficient and well-functioning stock markets that accurately value firms allow tying managerial compensation to stock performance. Therefore, by aligning the interest of owners and managers, stock markets spur efficient resource allocation and consequently economic growth.

Other discussions focus on the effect of greater liquidity, created by the existence of stock markets, on economic activity and long-run growth. Arguments about potentially negative implications maintain that by increasing the returns to investments and reducing the associated degree of uncertainty, greater stock market liquidity may reduce savings rates via income and substitution effects[29]. However, when studying empirical relationships between measures of stock market development and long-run growth rates, using data for 49 countries from 1976 to 1993, Levine and Zervos found no support for contentions that stock market liquidity reduces private savings rates. In contrast, they found that stock market liquidity as measured by stock trading relative to the size of the market and the economy, after controlling for economic and political factors, is significantly positively correlated with the rates of economic growth, both current and future, capital accumulation and productivity[30]. Indeed, since many profitable investments require a long-term commitment of capital, investors could be reluctant to yield control of their savings for long periods. Liquid equity markets make investment less risky, and more attractive, because they allow savers to acquire an asset and sell it quickly and cheaply if they need to access their investments or alter the composition of their portfolios. Therefore, by facilitating longer-term, more profitable

[28] See to Obstfeld (1994)
[29] See to Bencivenga and Smith (1991)
[30] See to Levine and Zervos (1996).

investments, liquid markets improve the allocation of capital and enhance physical capital formation and prospects for longer-term economic growth. Further, one can argue that by making investments less risky, or more profitable, stock market liquidity can also lead to more savings and investments and hence support economic growth.

Moreover, Levine and Zervos also found that banking development as measured by bank loans to private enterprises divided by GDP, predicts future economic growth rates and capital accumulation. Even though stock markets may grow in importance in a country's financial structure and the share banks control of the financial system may decrease, the percentage of bank assets to GDP increases, thereby supporting the theory that bank credit and equity financing are different and complementary financial instruments. These results are important to the extent they shed the fear, banks have in many countries, that the development of stock markets will reduce the volume of their business.

Theory and empirical evidence supporting views that stock markets promote sustained long-run economic development emphasize the role these markets can play in both the reconstruction and long-run development of Lebanon. The transformation and optimal use for different activities of this potential input would enhance the growth process. A securities market will provide a hierarchy of rates of return between equities, corporate bonds, and government stock. Therefore, firms and government wishing to raise new capital have to pay a rate of return which reflects both the rate of return on alternative investments and the risk associated with the undertaking. As a result, the allocation of capital is improved, ex-ante, at least. This is important in a capital market which is otherwise repressed and where the cost of borrowing is not related to the demand for capital nor to the riskiness of the investment it will be used for. Stock markets can also provide a vehicle for government corporations to go public. In no way can one ignore the considerable impact of this issue for the development trend of the country. The development of healthy capital markets is therefore a crucial element for insuring successful stabilization and promoting economic growth.

More importantly, the substantial volume of investment required over the period of transition from stabilization to normal growth renders the role to be played by securities markets even more critical. In fact, a large part - USD 20 billion - of the estimated 10 year financing requirements falls on the private sector, both domestic and foreign. To ensure an effective mobilization of such resources and to channel these resources to their most efficient uses, Lebanon must re-develop its capital markets. The latter comprise the debt market, the equity market as well as institutional and financial instruments that provide specialized credit. An active securities markets will serve as an "engine" of general financial development. Indeed, there are few Lebanese based companies large enough to access international capital markets. This suggests that the bulk of this funding will have to be intermediated through domestic channels. To achieve this it is necessary to package channels of intermediation. It is important to recognize, at this point, that the attractiveness of financial assets depends on their convenience and accessibility as a means of payment, their yield as compared to that of other assets, and the risk associated with holding them. As well, the need for reliable institutions able to attract a consistent volume of capital becomes critical. As such, it is very important to have an overview of the various sources of financing potentially available and the means to make them interested in Lebanon.

In every country, domestic savings provide the necessary capital for the growth of the economy's real sector. As long as the general investment environment, namely the factors affecting the safety of capital and return on investment, reasonably compares to other internationally available investment opportunities with a similar risk profile, private households would be willing to invest in the productive sector of the domestic economy. In Lebanon, the creation of a financial market will conceivably encourage investment in stocks. Indeed, the domestic savings currently take, mostly, the form of non-liquid bank deposits. This is indicated by the share of term deposits to total deposits which was maintained at above 80% for the period from 1993 to 1997 for deposits in Lebanese pounds. This share was also maintained at a high level, on average 70%, for deposits in foreign currencies (refer to table below). Since these savings are currently held as a long-term investment, it is reasonable to expect some of them to be directed towards stock market investments.

Deposits Volumes of Residents by type

DEPOSITS(billions of lbp)	1993		1994		1995		1996		1997	
Checking & Current accounts	422	9%	493	6%	508	6%	569	4%	685	5%
Sight Savings account	428	9%	505	7%	508	6%	664	5%	674	5%
Term Savings account	3,712	81%	6,625	87%	7,540	88%	11,547	91%	11,876	89%
Miscellaneous	26	1%	20	0%	45	0%	36	0%	42	1%
Deposits in Lebanese Pounds	**4,588**	**100**	**7,643**	**100**	**8,601**	**100**	**12,816**	**100**	**13,277**	**100**
Checking & Current accounts	1,748	18%	1,806	16%	1,930	15%	2,030	14%	2,376	12%
Sight Savings account	1,424	14%	1,301	12%	1,210	9%	1,116	8%	1,147	6%
Term Savings account	6,554	67%	7,856	71%	9,984	76%	11,460	78%	16,358	82%
Miscellaneous	95	1%	81	1%	81	0%	83	0%	149	0%
Deposits in Foreign Currency	**9,821**	**100**	**11,044**	**100**	**13,205**	**100**	**14,689**	**100**	**20,030**	**100**

source: *Banque du Liban - Website.*

Although the deposits level is still insufficient to finance all reconstruction needs, these funds will play a major role in the reconstruction process if the right structures to channel them are set. A stock market provides savers and financial institutions with a further outlet for their funds. Investors have different risk-taking capacities, and like to be offered a range of risks and a corresponding range of expected returns. A stock market enables investors to select the portfolio which gives the risk-return combination which best suits their liking. Moreover it enables them to diversify their investments and reduce their risk. A stock market, by offering various returns, may be particularly important to investors whose only alternative is to place deposits and receive low, repressed rates of interest. It can therefore encourage saving and the mobilization of funds. If a secondary market is reasonably active, investors have a market which may be much more liquid than some alternatives, such as gold and real estate. Also, in as much as securities markets enlarge the financial sector -promoting additional and more sophisticated financial instruments - they increase the opportunities for specialization, division of labor, and reduction of costs in financial activities.

In this regard, the existence and development of highly liquid capital markets would give rise to a deep structural transformation in the allocation of savings, as has been the case in industrialized countries. Coupled with an evolution in the nature of institutional players in the financial arena, these capital markets will provide for a better and more efficient matching process between the sources and uses of funds. Shares and bonds will directly displace savings and deposits from bank accounts into portfolios of assets for unit trusts, pension funds and similar institutional investors which raise savings from the traditional sector. There are a number of media in which to maintain savings, ranging in liquidity from cash balances to pension funds. Retirement funds would be a principal form of individual savings provided by state and local governments. Mutual funds represent another outlet for savings. By buying into a mutual fund, the saver is indirectly buying into a portfolio of corporate stocks. Mutual funds offer returns tied to the performance of the stock market plus built-in, risk-reducing diversification for individuals who lack the financial resources for do-it-yourself diversification. A substantial increase in the share of stocks, securities and other kind of contractual savings (funds, life insurance,...) would lead to an important drop in demand and savings deposits.

The evolution towards an alternative to bank deposits has already been noted in the trend of the general public's holdings of total T-Bills outstanding. (*refer to table below*). This share peaked ion 1995 to reach a high of 24% of total t-bills outstanding, and has generally stabilized at around 20%..

Distribution of Treasury Bills by Subscriber *(LBP billion)*

	1993		1994		1995		1996		1997	
Commercial Banks	4,437	74%	7,272	79%	9,045	71%	12,578	74%	13,193	68%
Bank of Lebanon	418	7%	29	0%	-	0%	-	0%	287	1%
Financial Institutions	9	0%	20	0%	29	0%	326	2%	292	2%
Public Administration	190	3%	456	5%	653	5%	830	5%	1,875	10%
Public	970	16%	1,464	16%	3,088	24%	3,319	19%	3,732	19%
Total	**6,024.4**		**9,241.3**		**12,814**		**17,053**		**19,380**	

Source: *BDL, Department of Statistics and Economic Research, BDL Web Site*

A stock market can also bring foreign capital into a country from foreign portfolio investors wishing to diversify internationally. The volume of financing envisaged at this stage renders it important to have the potential to tap as many sources of financing as possible, as efficiently as possible, in order to obtain funds at the best rate. Based on the Conseil du Developpement et de la Reconstruction estimates, foreign investments will play a major role in financing the reconstruction projects in Lebanon. Indeed, 81% of the estimated $27 billion of required private sector financing is expected to originate from foreign sources[31].

As direct foreign investment has drawn a certain amount of opprobrium in a number of developing countries, it is worth considering whether portfolio investment in developing countries' securities markets would be a better method of attracting foreign equity capital. Securities markets may be viewed as a means of attracting foreign equity capital from non-bank investors rather than debt from commercial banks. Certain equity is currently more rewarding than debt for many developing countries and inflows

[31] Refer to table p.22.

of foreign portfolio investment may enable local firms to increase their capital and reduce their debt equity ratios. From the point of view of the investors, these markets offer further possibilities of diversification if they are not well-correlated with industrial markets and they may offer higher returns *(refer to Appendix- table 12)*. Furthermore, the share of emerging market investment in North American and European institutional investors' portfolios is still very low. International portfolio theory states that given the low correlation emerging markets exhibit with developed markets, a higher level of holdings of emerging market equities would lead to increased portfolio returns without increasing total risk. However, although portfolio investment would avoid the objectionable aspects of direct foreign investment, it would be far easier to withdraw, making it a much more volatile source of capital. One possible way around this problem is to insert a minimum period of foreign investment, as is the case in Argentina and Chile where both countries have a minimum period of 3 years for foreign investment. Such a rule, however, may deter some investors. This setting, however, is not without its drawbacks and it is essential in Lebanon to recognize these drawbacks in order to avoid them. In fact, institutional investors, as stated before, tend to diversify their portfolio by investing in domestic stocks and real estate. Since a growing share of savings is being channeled through these investors, the market is going to witness a high turnover of property rights for these existing assets which, in turn, will tend to boost their prices without creating much productive investment since these assets already exist. This short-term speculation will tend to raise interest rate on banks credit and the marginal productivity of capital which would reduce longer term investments.

Commercial banks will be constrained both by this increase in speculative interest rate and by a depleted share of savings which would reduce their deposits. In order to increase (or at least maintain) their market share, they will lend to riskier investors (riskier means higher average return especially in the short term) without adequate collateral. This speculative bubble will ultimately burst, leading to very restrictive credit conditions, very high interest rates, and the crash of stocks and real estate prices. In Lebanon, given the pronounced taste for risk and speculation of Lebanese investors in the past, and present experience of speculation in the real estate sector and the foreign exchange market, strict legal regulations must be imposed to avoid this kind of market failure.

A further spur towards creating a more comprehensive capital market in Lebanon has come from changes in the regulatory environment. Key measures in 1997 allowed banks to float up to 30% of their shares and to manage fiduciary accounts on behalf of their clients. However, the Lebanese government still has to complete its regulatory overhaul. While it has a low personal and corporate tax, full currency convertibility, no capital controls and a wealth of support services and professions, it still lacks up-to-date laws governing mutual funds, brokerage dealing, and urgently needs a local securities and exchange commission.

Yet, the important step that remains to be achieved is the creation of secondary capital markets where the issued securities can be traded. These secondary markets are of supreme importance in ensuring the liquidity and the mobility of savings. Small investors would be reluctant to invest in long term projects if they know that they cannot liquidate them easily when an unforeseen need for liquidity arises. The current secondary market has acceptable standards in terms of transparency of pricing and safety of transfer of title. It is only a temporary arrangement however. For both equity and bond markets legislated transparency is required (e.g. disclosure, minority protection). A legal body with powers to investigate breaches of the law and enforce the law is also required. Transparency and enforcement are required to attract international funds as a matter of course and are also required to provide local Lebanese investors with sufficient protection to invest.

As this falls into place, the expectation is that anything between 40 and 60 companies will list on the Bourse de Beyrouth, with construction, tourism, media, food and beverage companies following the banks. That alone, even with Lebanon's own reconstruction needs of around $60 billion, will not launch Beirut as a regional market. In order for Beirut to regain its role as the financial center of the Middle East, it will have to offer a more sophisticated capital market channeling resources back into the region, where current and future investment requirements are vast. Indeed, Syria will initially require Beirut's help to develop a market economy. Syria has only one bank serving approximately 15% of households. Eventually both Palestine and Iraq will have high capital needs to reconstruct. Lebanese entrepreneurs have already established strong links with oil rich central Asia and Iran, with their substantial capital requirements. More generally a trend towards privatization in the region will also pull in substantial capital. Lower oil prices in the Gulf should create a government debt market the Lebanese can tap into. And the region's infrastructure needs are huge. ABB, the electrical engineering multinational with over $5 billion turnover in the region, projects the Middle East will have to spend about $60 billion on power generation and $100 billion on oil and gas development in the next decade. By most estimates, at least one third of this will have to be privately financed. Hence, a regional capital market in Beirut will depend on its ability to provide sound financial advice, financial engineering and lead management for other countries[32].

This requires a change if culture among Lebanese bankers who in their majority are commercial bankers used to make healthy profits financing the government and making short term loans to finance longer term private projects. About one third of total consolidated commercial bank loans are revolving short-term credits to finance long-term business. However, the arrival of outside competitors offering longer term

[32] See Financial Times Survey, October 27/1997, p.1.

instruments and the development of the bond market have been powerful incentives for banks to reassess their activities. The outsiders range from Flemmings to the Middle East Capital Group, backed by the International Finance Corporation and BZW, the investment banking arm of Barclays Bank, while bond operations have been dominated by Lebanese financiers working for international firms such as Merrill Lynch. This Diaspora of Lebanese scattered throughout the top-flight investment houses of the world is both a great advantage and a healthy source of competition.

Evidence that stock markets promote sustained economic development in the long-run should provide a push towards the establishment and development of such markets as an integral part of any stabilization/economic development plan and induce policy makers to remove any impediment to the development of such markets. If one considers the experience of emerging markets in other regions, there are two broad types of conditions which are important . First, the macroeconomic environment has to be conducive. We discussed in the earlier sections of this paper the many important factors and aspects in this regard. Second, the structure of equity markets must be strengthened through appropriate policies in the areas of information, accounting mechanisms, market regulation and supervision, property rights, pricing efficiency and taxation regimes.

5. "La Bourse de Beyrouth"

A Historical Perspective

The Beirut Stock Exchange - more commonly known as la Bourse - was created by decree No. 1509 of July 3, 1920. In the beginning, the Bourse was concerned with operations in gold and foreign currencies, until the appearance of share holding companies in the mid 1930s. It was not until the mid-1950s that its activities increased, when the total volume of shares traded exceeded a million and a half Lebanese pounds annually.

As a price index was non-existent at the Beirut Stock Exchange (BSE), it would be useful to examine the value of the transactions conducted annually there. The 1954 to 1983 period, when the BSE was officially operative, was occasioned by sharp fluctuations in the value of transactions. After a period of smooth increase, the transactions on the BSE fell suddenly in 1958 due to some early civil unrest; this was followed by a period of stability which eventually translated into an upswing lasting until 1964. In 1965, the trend became bearish. A downward trend that lasted until 1969 began with the failure of two banks that were heavily involved in real estate. As a result, the total volume of trading in 1969 reached LBP 2 million, only 3 percent of the 1964 volume. By the end of 1969, the companies listed on the exchange numbered 42, of which five were banks, ten real estate firms, two insurance companies, six electric power, 19 industrial firms, a concrete company, and two Treasury bills issues. Around one half of these companies did not have a market price and few were actively trading[33].

The stagnation of the BSE was attributed to an important factor; the increasing number of American and European brokerage firms. Although these firms succeeded in attracting a large volume of business, by the end of 1968 this ceased due to the

[33] See La Bourse de Beyrouth, Comité de la Bourse de Beyrouth, 1972.

continuing decline of the international stock markets during 1969 and early 1970. As such, many speculators and investors experienced huge capital loss, and in turn re-channeled their funds into other forms of investment. As a result, a large number of these brokerage firms had to close. Attempts by the government to bring life to the BSE were not successful. So, the BSE's activities remained limited and restricted to the speculation of wealthy individuals. It failed to stimulate greater interest and confidence and to act as a medium through which savings could be channeled to long-term productive investments.

The beginning of 1971 saw a period of good activity on the stock exchange, and a regaining of confidence in stock investment due to the abundance of liquidity and the low money interest rates associated with the good rates of return on stocks. This feeling of prosperity resulted in an increase in the number of transactions between 1970 and 1973. The monetary value of the volume of stocks negotiated increased by LBP 10.4 million in 1970, LBP 14.2 million in 1971, LBP 42.4 million in 1972, LBP 30.1 million in 1973. The market was bullish between 1970 and 1973 reaching a peak never witnessed before in 1972. The 1973 Middle East war started an opposite trend and the level of transactions slumped with the outbreak of the civil war in 1975[34]. From this date onward, the Bourse only worked during cease-fires. In March 1976, it stopped its activities until the cessation of hostilities in November of the same year. The Bourse opened again periodically up to the Israeli invasion of Lebanon in the summer of 1982, then finally closed in October 1983. After a suspension that lasted 12 years, the BSE officially reopened in September 1995, while trading only resumed in 1996.

Learnings from the Beirut Stock Exchange Experience

Over the years, the BSE remained a narrow corner of the Lebanese financial market. Indeed, the turnover of securities is typically low in underdeveloped countries.

[34] Idem.

Basically, new issues are bought for holding rather than trading. These narrow and fragmented markets, such as the Lebanese one, are very susceptible to discontinuities in supply and demand - and also to manipulations - which cause wide price fluctuations. These conditions make equity securities, in such markets, unattractive to investors. On the other hand, any sustained increase of equity supply and demand is unlikely to occur unless the general yield of equities relative to other assets increases.

Moreover, in Lebanon's case, the concentration of private sector's capital in a small number of companies was one of the leading causes hampering the development of the BSE. Supply of equity securities was limited due to smaller company size and family ownership structures which are averse to dilution of ownership and disclosure. Family, or clan companies are common in underdeveloped countries and it has often been observed that such firms are reluctant to admit outside capital, and risk dilution of control. Indeed where outside equity is admitted unsavory policies detrimental to the interests of the minority (outsiders) share holding groups with respect to dividend policy, stock manipulation, corporate disclosure, excessive compensation to executives who are family members are not uncommon. Such activities will discourage demand for equities issued by family-controlled firms. Some such firms have attained what they regard as optimum size and do not wish to expand their operations. Fundamentally, joint-stock companies in Lebanon were created mainly for reasons that were irrelevant to public ownership. Of these marginal reasons we can cite avoidance of inheritance tax in case of death, fiscal advantages given to this kind of firms and finally benefits of limited liability. Furthermore, the taxation system under which companies are subject to a progressive income tax causes large size corporations to be at a fiscal disadvantage further hindering the development of such large-size corporations. Indeed, the most important factor hampering the development of large-size corporations is perhaps the taxation system in application, under which all corporations are subject to a progressive income tax. This system inflicts a heavy penalty on size. It thus tends to negate economies of scale and, in the process hamper industrial development in the country.

In addition, what should be emphasized at this point is that the Lebanese economy since the independence (and especially in the 70's and early 1980's) enjoyed huge amounts of capital resources in the banking sector while at the same time, uses and investment opportunities within the country were scarce. The existence of a substantial capital surplus with the Lebanese commercial banks enabled them to finance the investment needs of Lebanese companies. These companies in turn, because of their closed ownership structure, preferred to rely on short-term bank loans and revolving credits to ensure their capital requirements. Bank overdrafts, nominally short term, were used on a continuous basis as to be long-term in effect. Good banking connections permitted this system of finance to be perpetuated and led to a dependence on bank finance. This pattern probably owes much to artificially low bank interest rates. Hence, there was no need for an exchange or a developed financial market which consequently kept a very marginal role in the economy.

As well, when the present situation gives bank saving deposits, as far as taxation is concerned, the edge over stock market securities, there must be some modifications in the fiscal policy. This policy must be changed in a way that would encourage investments in the securities market. The taxation system should not be biased in favor of one financial instrument over the other. Special tax incentives could be used to stimulate investors interest in securities. These incentives could take the form of the exclusion of dividends from taxable income, the elimination of capital gains taxes and allowing to offset capital losses on shares and bonds against gross income for tax purposes.

The lack of a specialized code of commerce which recognizes the importance of the different financial instruments resulted in a legal framework which was not conducive for the development of the Beirut exchange and the Lebanese financial market. Another manifestation of an inadequate legislation was that banks in Lebanon were not allowed to deal directly in the market. A solution to this problem may lie in the creation of brokerage houses in which banks could be shareholders. With one stock market located in Beirut, investors from other regions would be able to make dealings through these banks. The stock market activity would be more efficient with the creation of financial institutions specialized in the underwriting of securities and in market operations. Such institutions as Lebanon Invest and the investment banking arm of major banks (Banque Audi and Banque de la Mediterranee) exist today and constitute a real competitive presence in Lebanon's financial markets. New regulations should also give incentives for the creation of specialized financial institutions like mutual and pension funds, savings and investments banks. Equity and bond issues require a broker or investment bank to package and distribute them, whereas mutual and pension funds can effectively channel savings into these new instruments. The prospect of a reasonable volume of issues can be expected to attract foreign firms to Beirut and so enhance the prospect of Beirut's becoming the regional financial center.

Establishing a market

To create viable markets, potential sources of demand and supply should be explored in order to establish how activity might be stimulated. It is necessary first to distinguish between government and corporate securities. In most countries enough government securities seem to be available to provide the basis for a market in such paper. As the government bond market gains more depth, it will greatly facilitate the development of domestic futures and options markets. Corporations and banks should also be encouraged to issue their own debt instruments now that a benchmark on pricing on these issues has been established. The abundance of government bonds will help to acclimatize investors to the idea of buying fixed rate issues.

However, to encourage the development of a private bond market, corporations need to be credit rated. Otherwise, private and institutional investors will be reluctant to invest in unrated paper of other institutions. Credible rating agencies should be established to carry out periodic credit analysis of locally incorporated companies and to provide investors with reliable and up to date information on them. A joint venture between a local institution and an experienced international rating institution, would go a long way towards satisfying these requirements.

But both the supply of, and the demand for, corporate securities is, by nature, very limited in most underdeveloped economies. Since its creation, the BSE has always experienced a relatively low transaction/trade volumes. The reason for this was the very small numbers of stocks listed for transactions. In fact the stocks of only 45 companies were listed on the Beirut exchange out of which only those of 10 companies were actually traded. Indeed, the development of the BSE will be directly related to the increase in volume of transactions without jeopardizing the "quality" of the listed securities. In other words, it will be necessary for the success of the exchange, to ensure the maximum possible number of acceptable stocks for trade. These stocks and firms should have the suitable size and credentials to be able to win the trust and confidence of investors. Thus putting very stringent conditions for the admission of firms will allow only a very small number of firms to enter the exchange. This will reduce the volume of transactions and deter investors from locking in their money in an illiquid market. On the other hand, if leniency is adopted when admitting firms to the market, this could lead to severe shocks and consequently adversely affecting the BSE's reputation.

The increase in supply of market equity securities could follow a reform of the economic and legal business environment such as noted above. Family-owned will not necessarily remain the predominant form of business organization. As a matter of fact, a number of factors will generate pressure for change in business organization. Local companies will inevitably be prodded to stand up to the stronger competition from corporations based in neighboring countries where thriving capital markets have put vast financial resources at the disposal of concerns in all sectors of business. This will prompt local businesses to shed individual or family-based ownership and management in order to become regionally competitive, and will rely on corporate financing channels and options to raise the capital necessary to make investments in advanced technology and achieve larger capacity. Long-term bank financing, in the traditional way of merchant banks which provide equity capital to firms, could be considered an appropriate alternative in this case. In this case, financial institutions, -either public or private- could sell their own bonds, to domestic and international investors, and employ the proceeds to extend long-term loans to domestic enterprises. Therefore, markets for public debt instruments need developing in order to facilitate the access of foreign capital to local debt markets.

Foreign firms can also be considered as an additional source of supply of public equity securities issues. The Lebanese laws allow foreign companies to be listed in the Beirut Exchange subject to the fulfillment of some predetermined requirements. To that effect, one major development for the BSE is the signing, in September 1996, of a regional cross-listing agreement with the Egyptian and Kuwaiti Stock Exchanges. This agreement took effect in January 1997, however this opportunity was never used due to the narrowness of the BSE. However, on the longer term, the Beirut market could very well interest some regional investors given the increased economic and financial openness of the nearby countries. Furthermore, the Lebanese investors having businesses in other countries will ultimately rely on the Beirut market to finance their operations. This orientation of internationalization of financial markets is increasingly gaining pace and geographical or countries' frontiers are no longer obstacles for the expansion of these markets. Yet, the exchange authorities should closely monitor the development of this external window preventing it from becoming a tool for avoiding the local regulations and frameworks. This, for example, occurred in the Kuwaiti "Manach" market when the Kuwaiti exchange committee adopted a hard line approach in giving registrations permissions for local firms. This encouraged investors to create their firms and companies in other Gulf States and list them in the Kuwaiti market.

The revival of the Beirut stock market would also get a boost by a government decision to privatize (completely or partially) some public enterprises like the telephone, electricity, port and airport, and petrol refineries. The existence of the Beirut Exchange will undoubtedly remove the objections that some people will raise concerning the privatization outside the market. In this case many will feel that privatization means squandering public sector's money and creating unfair opportunities for few rich Lebanese investors. This logic doesn't hold in a market setting. Examples on this point are numerous in industrialized countries. In Britain, the conservative government of Margaret Thatcher resorted to financial markets when privatizing automobile and oil industries and this of course in order to ensure a maximum number of subscribers of all size, thus preventing a small number of investors from monopolizing the ownership of the privatized institutions.

Potential sources of demand for marketable securities

The difficulty of identifying the specific domestic sources of demand lies in the fact that they represent individuals, institutions, and business firms throughout the country. However, the magnitude of the demand for funds that can be drawn upon depends on the size of the country's national income, the distribution of income, and the degree of savings that exist. The means of raising a country's national income is beyond the scope of this section but is assumed to grow in the reconstruction phase. Assuming that there is a base of sufficient size to provide the beginning of a functional capital market, the problem which arises is that of inducing savers who have been accustomed to putting their funds in other sources such as savings institutions or real estate to place them in securities. For this transition to take place, two conditions appear necessary. The first is an effective sales force (both persuasive and honest), the second is the adoption of measures which, at the outset, reduce the risk of loss to the investor via the development and use of hedged debt or equity instruments which protect the investor from a possible loss of capital. Furthermore, a secondary securities market can enhance the liquidity of debt and equity instruments and increase investor demand. Investment banking activities should be developed, either from within the existing commercial banking system or through the establishment of new institutions to provide brokerage services, trading and underwriting of securities.

Another readily identifiable source of demand is foreign capital. However, foreign capital should be considered as a volatile source of funds. At this level, the experience in Latin American countries is relevant since they too suffered a lack of funding in their economic stabilization process. Numerous studies that were conducted suggested that the government should convince a small number of investors to place their funds in the country and that would sparkle a reaction chain. This is attributed to the belief that investors always wait for others to take the first step to compensate for the risk involved in the process.

But the government should not confine itself to this role. Whereas it is very important to attract foreign capital by offering medium and long term investment opportunities, it is also very important to set up the proper financial structure and instruments. Hence, in addition to rehabilitating the communications and telecommunications infrastructure, without which no financial market can survive, the government must enact new legislation and create new institutions and financial instruments for the purpose of promoting liquidity, safety, and trade transparency. Indeed, the demand for securities could be largely influenced by government policies. It may be promoted by tax concessions in favor of shareholders. Other incentives might include provisions for shareholders to deduct substantial proportions of the purchase cost of shares from taxable income, provisions for personal income tax exemption of dividends, and provisions for individuals and corporations to discharge a proportion of their tax liabilities by subscribing to special mutual funds whereby withdrawals from these funds could not commence for at least two years. Those funds, in turn, will be required to invest in company securities, particularly new issues. Indeed, different promotional policies can encourage investors. However the government must strike a balance between too little subsidy which, will not be effective, and too much of it, which will deepen the budget deficit and enhance strong inflationary expectations.

Indexation of the principal and income of nominal value securities, as previously discussed, will enhance the demand for such securities. The demand for securities may be greatly augmented by the imposition of portfolio rules upon banks and other financial institutions. Furthermore, the demand for securities will be stronger the greater is their liquidity. The commercial banks will enhance the liquidity of securities if, within reasonable margins, they will accept them as collateral against overdrafts.

Proposed organization of the Beirut Stock Exchange

This question can be asked at two levels. The first one is the conception of the financial market that is intended for Beirut. Is it considered as a means for efficient allocation of resources or will it be considered as a "financial industry" and specialized activity at the international level? The second level concerns the degree of centralization of the market. Trading on the BSE is now computerized, based on a fixing system with a limit up/down of 5%.

For the case of Lebanon however, it seems important to adopt a time evolution according to priorities. Undoubtedly, the first preoccupation of the authorities in Lebanon is to attract foreign capitals and vitalize domestic savings by channeling them towards emergency sectors. Also, the financing of the budget deficit must take place without money creation. Hence the initial approach can not be but that of a market intended for efficient resource allocation. In the future as time goes by, and regional funds start to become interested in the Beirut marketplace by including Lebanese securities in well diversified portfolios and vice-versa (Lebanese capital interested in foreign market place), an evolution towards the second approach would be necessary.

This positive evolution will reinforce the position of Beirut amongst the other existing regional markets. The financial activity will become a specialized one and will permit to exploit a "know-how" at the regional level and why not at an even broader one. Beirut which was before 1975 the most important banking center in the Middle-East might well become in the future the financial market place of the region.

A national market can not be transformed into a regional market unless a sufficient potential of market mechanisms, reflexes and behavior ensuring an efficient functioning of the national financial system are already well embedded in it. Among the necessary elements of the realization of this condition we must once more emphasize the importance of transparency made possible by adequate information to investors and intermediaries, and the strict respect for clear rules of professional conduct which ensure market equity and the stabilizing character of speculation. This new *"savoir-faire"* will hence be exported and thus will give the country a comparative advantage vis-à-vis the whole Middle-East. This will be an important element in making Lebanon regain its place in the region.

As such, the BSE like any other stock exchange will have to show characteristics of security, transparency, equity and liquidity. Furthermore, it must answer the requirements of rapidity and low transactions costs. As we have seen an evolutionary approach can be contemplated whereby at the beginning the market will be set up to answer, in the best conditions of efficiency, the national economy's need for capitals. Later if conditions are there, a more expansionary approach can be adopted.

It is very important to start with an information campaign at all levels in order to instruct the public about the advantages and risks of dealing with stock markets. Furthermore, there is a need for specialized persons in the business of dealing with securities and stock markets. Traditionally in Lebanon, the stock market was the responsibility of the Ministry of Finance. The trend internationally is to have an independent institution for administering, controlling and supervising the market. This institution would have the right to check the accounts of companies, auditors, brokers, and other market participants. It would work in cooperation with the Exchange's Committee, and have the final decision on matters such as the listing of companies at the stock market and the licensing of brokers. It should constitute a major factor in increasing investors confidence in the stock market.

Many considerations should be kept in mind in order to develop the Beirut Stock Exchange. The establishment of a proper supervision of joint-stock companies is an essential task which must be accomplished by the responsible authorities. In fact, the regulations and statutory texts of the BSE never specified the creation of any control commission. The control and surveillance role were given to the exchange committee and the judiciary system. Yet, all foreign exchanges did not contend themselves with such arrangements. Rather, all of them, created control commissions as is the case in the Lebanese banking sector. In this sector and in addition to the governate of the central bank, there exists a bank control commission whose mission is to check the transactions and ensure the exactness of the financial statements issued by the firms registered in the exchange. In industrial countries, these commissions are very important in securing and protecting investor's money and enhancing the trust and confidence of these investors. Therefore, a Security and Exchange Commission representing the Lebanese government should be established in order to supervise the stock market to insure honest and fair dealings, supervise the activities of members of the stock exchange both in the trading hall and in their dealings with clients and with each other, establish appropriate qualifications for admission to membership and organize regular training programs for members and staff.

In determining eligibility for listing on the BSE, particular attention should be given to the earning power, value of net tangible assets, and the aggregate market value of the publicly held shares. There must be no absolute right of continued listing. To be listed on the stock exchange, a joint-stock company should be expected to meet certain qualifications (listing requirements) and to be willing to keep the investing public informed of the progress of its affairs. Those responsible for the management of the stock exchange should be in a position to delist a particular security when they believe that the continuous trading in this security is no more advisable. As far as the listing of stocks is concerned it is important to have two markets: one for blue chips and another one for securities of a lower class. The factors that determine the listing of those securities in one market or the other may be the following: the authorized capital of the company, the number of shareholders, the degree of concentration of ownership, the market activity of the stock, and the degree of transparency of those companies. Currently, 8 companies are listed on the BSE. These companies are: Ciment Libanais, Ciment Blanc, Eternit, Uniceramic, Solidere, Bank Audi, Bank of Beirut and Banque Libanaise pour le commerce.

To date, confidence in the published financial statements of corporations is still lacking. The auditing profession as well as disclosure standards are not regulated. Equity and bond flotations require disclosure based on standardized audited accounts. Lebanon has acceptable accounting standards based on French standards and a small number of quality auditors. Companies have not been interested in proper auditing standards in the recent past as they have generally not had to deal with third parties requiring quality data, except the tax authorities who do not appear to have strict enforcement. To ensure that information disclosed to the market is of an acceptable standard entry standards for auditors need to be raised and the government needs to require and enforce higher standards for tax purposes (which will raise the general standard of accounts).

Psychological effects remain a very important factor in financial markets by shaping the expectations of investors thus affecting prices upward or downward. To that effect, the BSE started compiling a price index in 1996 to document a history investors and others could readily refer to *(refer to Appendix - table 9)*. The overall economic and financial information usually decides the general orientation of the market and the financial statements, balance sheets and other publication of the firms determine their stock prices. In this regard, all financial markets give a first priority importance for the correctness and exactness of the published information. Registered firms are obliged to publish periodically any information relevant in helping people reach their investment decisions. The Exchange control commission is given the right to check and control the correctness of any published information. The control commission should also forbid the management of firms from revealing any secret information which could give an advantage to some investors at the expense of others. In fact, the principle of "equity before information" is considered as one of the most important building blocks for the success of financial markets. In case any distortion occurs at this level the control commission should launch an inquiry and severely punish all parties who infringe regulations. In this regard, the lack of maturity of Lebanese investors will be apparent especially as disclosure of privileged information is not considered illegal. This could well be an obstacle preventing the widening of the volume of the transactions in the Beirut Exchange. It is unfortunate to notice that often when a broker takes advantage of secret information to make profits, other operators consider this a winning coup rather than inside trading. What should be emphasized is that these profits are made at the expense of other investors. This obviously must be prohibited to win the trust of investors.

Lebanon faces the challenge to create a financial market and this requires a high degree of expertise among investors, borrowers and supervisory agencies. Underwriters, advisors, stockbrokers and fund managers need to be established. Credit rating agencies are needed to analyze domestic companies and to provide investors with reliable business information. More stringent reporting practices should also be implemented and an adequate legal system that recognizes in full the rights of creditors and protects those of savers and investors needs to be put in place. This will eventually offer greater scope to investors in Lebanon, who are already active internationally and are familiar with the intricacies of financial instruments to participate in the capital markets of the country. Expatriates should also be allowed to invest locally, if not directly, possibly through investment funds managed by Lebanese banks.

Recommendations

The new challenges facing the Lebanese economy in general and the banking sector in particular will engender structural changes in the current financial framework especially after so many years of chaos, destruction and complete economic stagnation.

Nowadays, we see that the loses caused by the Lebanese war has wiped out (directly or indirectly) the basis on which this economy was laid. Hence, Lebanon will have to adapt to its present situation of scarce financial and human resources. These resources hence must be used optimally to avoid any waste and squandering. This is the primary function of financial markets, hence our contention for the revival of the Beirut exchange while bearing in mind the difficulties this exchange will have to face in order to improve the non-existing confidence of a market which originally was ineffective.

These developments show the necessity for new financial services. Yet, these services in turn will be hard to achieve without the creation of a strong exchange. Furthermore, it is very important to bear in mind that the results will not appear in the short-run. All International markets and exchanges took a long time to develop. Acknowledging these realities, the development of a conducive economic, fiscal and regulatory environment should be considered as a foremost priority.

A reformed code of commerce could give more benefits to public joint-stock companies making this form of business organization more attractive than the personal or family owned entities. The laws governing the stock market should be amended to better fit the new developments and to protect investors' and depositors' rights. A control commission with a mandate to guard, protect and control the safety and regularity of operations would increase investor confidence. This commission would control and check the financial statements and balance sheets published by the companies registered in the exchange and oblige them to issue these publications on a quarterly basis. An enlarged exchange committee, including professionals with financial and economic expertise, would nominate new brokers. Such a committee would adopt competence as the main criterion for the choice of the new brokers in order to ensure the safety of operations.

CONCLUSION

Lebanon has made an impressive initial recovery following 17 years of civil strife and hostilities. The destruction of many industrial plants, the deterioration of basic infrastructures services, and the migration of its human capital inflicted a heavy blow to Lebanon's economy. Indeed, the UN has estimated war damage at around $25 billion[35].

Since Prime Minister Hariri took office in 1990, the government's exchange-based stabilization policy has brought inflation down from about 100% in 1992, to around 6% in 1997. Indeed, halting the Lebanese pound precipitous slide that begun in the 1975-90 civil war, and actually reversing its course in the past six years, is one of the most notable achievements in the government's drive to restore the country's economic health. The new stability has helped to rebuild confidence as well as provide generous returns for residents and foreigners investing in Lebanese treasury bills with double digit rates of interest. These profits were further enhanced by an appreciating exchange rate.

Naturally, when moving from a high inflation period to a low inflation period, a country inherits high interest rates. With respect to Treasury bills, during the past decade or so they have played a very important role both in building the Lebanese government budget deficit and in serving as the main tool in the hand of the monetary authorities to curb the money supply expansion and inflation. However, today, net public debt is at around $20 billion, with $2.37 billion owed abroad. The cost of servicing this mounting debt has proven to weigh heavily on the budget. Fiscal austerity is imperative in order to contain budget deficits and control public debt. While few believe that the Lebanese currency is doomed, economists argue that the government cannot delay action on the

[35] See Country Overview: Lebanon, the World Bank Group.1995

deficit much longer. If this period is prolonged much further, it will be translated into a risk premium in the market. This will induce a further collapse of the Lebanese pound which will result slashing the value of the national debt, largely in Lebanese pounds, at a stroke. But it would also mean hardship for those Lebanese with incomes in pounds instead of dollars. It would also deeply affect the reconstruction strategy, attracting investment through projecting a stable Lebanon rising steadily from war. Presently, the government faces the dual challenge of maintaining economic stability while undertaking its extensive reconstruction plans. It should be very evident at this point that the most important precondition to any stabilization or successful reconstruction and development initiative lies in controlling the fiscal position of the country. Indeed, the availability and magnitude of the much needed foreign official funding will, to a large extent, hinge on the feasibility and credibility of the government's proposed reconstruction package, and the ability to service outstanding debt, as well confidence that funds would not be diverted into alternative uses.

Positive economic growth since 1993, even though at a decreasing rate, resulted in a gradual decline in interest rates throughout the yield curve. At the end of 1997, the yield on T-bills ranged from 13.09% for the 3-months maturity to 16.73% for the 2-year notes. While economic growth averaged 7.2% annually from 1993 to 1995, it slowed down considerably in 1996, following Israel's invasion to Lebanon, and stabilized at around 4% thereafter[36]. The atmosphere of uncertainty created by a stalled Middle East peace process has dissuaded the private sector from committing to significant projects. Moreover, attractive yield on T-bills further "crowded out" private investment.

Efficient and liquid stock markets could spur additional investment in the domestic economy by easing excess caution compounded by the illiquid nature of direct investment. Yet, the important step that remains to be achieved is the creation of an

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[36] See Banque du Liban - Website.

active secondary capital market where the issued securities can be traded. These secondary markets are of supreme importance in ensuring the liquidity and the mobility of savings. Small investors would be reluctant to invest in long term projects if they know that they cannot liquidate them easily when an unforeseen need for liquidity arises.

The Beirut Stock Exchange (BSE) has historically played a very narrow role in the economic prosperity of Lebanon. This ineffectiveness resulting from the marginalisation of the exchange did not have deleterious effects on the economy in previous years because of the abundance of the deposits in the banking system due to the unique situation of financial and monetary freedom the country was enjoying. Indeed, short term, revolving bank credit was the main source of project financing in an environment where the scale of business ventures was significantly smaller. Presently, the situation is completely different. Almost all obstacles on regional financial markets have been lifted, domestic resources are depleted, a big chunk of domestic savings is placed abroad. Moreover, the needs for financing in both the private and public sector have risen enormously in the context of the reconstruction of Lebanon. These conditions emphasize the importance of developing both debt and equity markets that will attract foreign investment in the Lebanese economy by offering a more liquid and hence more attractive alternative to traditional, illiquid direct investment. Efficient debt and equity markets channel funds efficiently into productive investments hence optimizing the use of scarce funds. According to CDR estimates, a total of USD 37 billion will be required over a period of 10 years, sourced from the Lebanese private and foreign private investment, public financing from budget surpluses and foreign aid from official sources. If Lebanon is to rebuild itself, given its limited natural resources, Lebanon must become a regional financial center, operating on an international basis. At present there is a need for diversified financial services and for intermediaries that can channel the savings of the private sector towards productive financial assets. The ability of Lebanon to adapt to the new economic conditions and of Lebanese financial institutions to live up to the challenge of new patterns of finance will determine the future shape of the Lebanon capital markets.

In order to alleviate the pressure on public financing which would translate into an increasing public debt, the government plans to rely more heavily on private sector participation and on longer term external investments to finance the reconstruction program aiming at rehabilitating Lebanon's infrastructure. It is actively seeking business partnerships with both regional and international players to ensure the successful completion of its ambitious reconstruction plans. A recent manifestation is the recommendation of the Arab Economic Forum, which took place in Beirut in October 1997, to set up a bank, with an initial capital of $500 million, with a mandate to promote investment and trade between Arab nations. Furthermore, the government is in the process of forging a pact with the European Union (EU) to provide funding for several projects to be carried out through the Council for Development and Reconstruction (CDR). However a progressive reduction of Lebanon's custom tariffs, which is the main reform required, would create an unbearable financial burden on Lebanon during a period of large scale reconstruction. Lebanon derives over 60% of its revenues from custom duties on imports, and the proposed alignment of tariffs, to be implemented over 12 years, would slash the country's income by a total amount of 5% of its GDP at the end of the process[37].

While Lebanon must still overcome some economic and political vulnerability, its open economy, its traditional investor-friendly environment coupled with a government policy committed to non-interference with the private sector, Lebanon has strong prospects for a sustained recovery and continued economic growth.

[37] See The Middle East Reporter, July 26/1997, p.15-16.

APPENDIX

Table 1: Country Statistics

Lebanon	
Head of State	President Hrawi
Area	10,452 Km
Population Forecast (millions)	4.0 (200), 4.5 (2010)
Density	271.5 inhabitants per Km
Capital	Beirut
Main Cities	Beirut (1,500,00), Tripoli (275,000) Jounieh (136,000), Zahle (68,000)
Life expectancy (years)	67.0 (65.1 male, 69.0 female)
Adult Literacy	76.5% (80% male, 73% female)
Languages	Official ; Arabic Commercial : French - English
Public holidays	1 January, 9 February, 1 May 6 May, 15 August, 1 November, 22 November, 25 December, 31 December
Currency	1 Lebanese Pound (1 pound) = 100 Piastres

source : *The Middle East* in 1997, *MEED*

Table 2: Economic Statistics

Lebanese Economy ($ millions)	**1995**	**1996**	**1997**
Population (millions)	3.03	3.1	3.2
GDP	11,400	11,800	12,300
GDP Growth (%)	7	4	4
Inflation (%)	10	9	9
Exports	824	950	1,100
Imports	7,303	7,400	7,800
Trade Balance	-6,209	-6,450	-6,700
current Account	2.250	2,450	2,550
External debt	1,312	1,800	2,460
Exchange rate 1$ = LBP	1,600	1,565	1,550

source : *The Middle East* in 1997, *MEED*

Table 3: **Lebanon's GDP & Debt 92-97**

Lebanon Nominal GDP, 1992-1997
(Leb £'000 millions)

	1992	**1993**	**1994**	**1995**	**1996**	**1997**
Nominal GDP	9,499	13,122	15,305	18,028	20,522	23,840
Budget deficit	1,081	1,162	2,963	2,823	3,692	2,300
Deficit as % of GDP	11.38	8.86	19.36	15.66	17.96	9.65
Net public debt as of GDP	46.14	37.84	52.16	63.01	78.15	82.22

Exchange Rate : $1 = LBP 1,552 (Dec 1996); LBP1,595.8 (Dec 1995); LBP1647.1 (Dec 1994); LBP1,713.2 (Dec 1993); LBP1,850.6 (Dec1992).

source : *Ministry of Finance*

Table 4 : **Budgets vs. Actuals 95-97**

Lebanon Budgets: 1995 - 1997
(LBP '000 millions)

	1995 budget	**1995 actual**	**1996 budget**	**1996 actual**	**1997 budget**	**1997 actual**
Expenditures	5,630	5,856	6,450	7,245	6,433	9,226
Revenues	3,150	3,033	4,022	3,536	4,100	3,753
Deficits	2,840	2,823	2,428	3,709	2,333	5,473
Deficits as % of expenditure	44.04	48.21	37.60	51.19	36.27	59.33

Exchange Rate $1 = LBP 1,552 (Dec 1996), LBP1,595.8 (Dec 1995),

source : *Ministry of Finance*

Table 5 : **Domestic & External Debt 94-96**

Lebanon Debt 1994 - 1996

	Dec '94	**Dec'95**	**Dec'96**
Net domestic debt (Leb Pound '000 million)	6,712	9,286	13,315
External debt	772	1,291	1,769
Net total debt ($millions)	4,847	7,110	10,348
Exchange Rates 1$ = LBP	£1,647.1	£1,595.8	£1552

source : *Ministry of Finance*

Table 6: **Lebanon's Credit Ratings**

Agency	Long Term Credit Rating	Comments
Moody's Investor Services	B1	High Risk Obligations
Standard & Poor's	BB -	Likely to fulfill obligations
IBCA	BB	Likely to fulfill obligations
NIS	BBB -	Strong Payment Capacity

source: *Credit Rating Agencies*

Table 7: **Sovereign Rating of selected Developing Countries**

Investment Grade	Moody's	Standard & Poor's
Egypt	BBB-	Ba2
Oman	BBB-	Baa2
Tunisia	NR	Baa3
Non-Investment Grade		
Jordan	BB-	ba3
Lebanon	BB-	B1
Brazil	BB-	B1

source: *Emerging Markets Debt Monthly, Merrill Lynch, April 9, 1997*

Table 8: **Selected Macro-economic Indicators (1996)**

	Brazil	Jordan	Lebanon
Real GDP Growth (%)	2.9	6.5	4.0
Nominal GDP (US$ Bn)	740.0	7.2	13.0
GDP per Capita (US$)	3,703	1,713	3,187
Inflation Rate (%)	10.0	4.5	8.9
Trade Balance (US$ Bn)	-5.5	-2.2	-6.5
Fiscal Balance (%of GDP)	6.2	-17.0	-18.1
Reserves (months of import)	10.7	2.0	9.3
External Debt/GDP (%)	24.1	104.4	13.8
5 year Eurobond Spread	176	N/A	193

source: *Emerging Markets Debt Monthly, Merrill Lynch, April 9, 1997*

Table 9 : Market Value Weighted Index

End of Period (January 1996 = 100)	INDEX VALUE
1996.01	100.00
1996.02	97.85
1996.03	96.45
1996.04	92.69
1996.05	91.59
1996.06	90.30
1996.07	78.50
1996.08	76.88
1996.09	91.65
1996.10	91.08
1996.11	89.91
1996.12	92.09
1997.01	84.81
1997.02	80.10
1997.03	81.30
1997.04	83.07
1997.05	83.24
1997.06	91.82
1997.07	128.28
1997.08	148.66
1997.09	137.22
1997.10	149.60
1997.11	130.98
1997.12	123.72

source: *Banque du Liban, Department of Statistics and Economic Research, Website.*

Table 10: **Distribution of Treasury Bills by Subscriber (LBP billion)**

	1993		1994		1995		1996		1997	
Commercial Banks	4,437	74%	7,272	79%	9,045	71%	12,578	74%	13,193	68%
Bank of Lebanon	418	7%	29	0%	-	0%	-	0%	287	1%
Financial Institutions	9	0%	20	0%	29	0%	326	2%	292	2%
Public Administration	190	3%	456	5%	653	5%	830	5%	1,875	10%
Public	970	16%	1,464	16%	3,088	24%	3,319	19%	3,732	19%
Total	**6,024.4**		**9,241.3**		**12,814**		**17,053**		**19,380**	

source: *Banque du Liban, Department of Statistics and Economic Research, Website*

Table 11: **Comparison of Market Returns and Risks, Five Years Ended 06/30/1993.**

Market	**Annual Return**	**Annual Risk**
Argentina	47.6	117.6
Mexico	42.9	26.7
Chile	42.2	25.9
Venezuela	26.0	50.6
Brazil	19.6	76.8
Greece	19.0	48.4
Turkey	13.3	71.8
Philippines	12.9	32.0
Jordan	12.1	19.4
Korea	0.6	30.1
Taiwan	-2.2	52.6
Indonesia	-16.9	31.4

source: *IFC Emerging Markets Database.*

Table 12: <u>Market Correlations, Five Years Ended June 30, 1993</u>

	IFC	EAFE	U.S.	LAT	ASIA
IFC	1.00				
EAFE	0.23	1.00			
U.S.	0.19	0.44	1.00		
LAT	0.44	0.16	0.24	1.00	
ASIA	0.96	0.19	0.13	0.20	1.00

IFC Latin America regional composite

	ARG	BRA	CHI	COL	MEX	VEN
ARG	1.00					
BRA	-0.18	1.00				
CHI	-0.02	0.21	1.00			
COL	-0.08	0.15	-0.13	1.00		
MEX	0.33	0.07	0.07	-0.06	1.00	
VEN	0.06	-0.17	-0.20	0.20	-0.11	1.00

IFC Asia regional composite

	IND	IDN	KOR	MAL	PAK	TAI	THA
IND	1.00						
IDN	0.04	1.00					
KOR	-0.16	-0.01	1.00				
MAL	-0.02	0.44	0.28	1.00			
PAK	-0.07	0.07	-0.01	-0.03	1.00		
TAI	-0.15	0.31	0.10	0.22	-0.07	1.00	
THA	0.20	0.35	0.07	0.56	0.07	0.13	1.00

source: *Quarterly Review of Emerging Stock Markets, Second Quarter IFC, 1993*

<u>Key:</u>

ARG	Argentina	KOR	South Korea
ASIA	IFC Asia regional composite	LAT	IFC Latin America regional composite
BRA	Brazil	MAL	Malaysia
CHI	Chile	MEX	Mexico
COL	Colombia	PAK	Pakistan
IND	India	TAI	Taiwan
IDN	Indonesia	VEN	Venezuela

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