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(C.P.S.P.S.)

INDUSTRY GROWTH PARTNERSHIPS:

ACHIEVING LEBANON'S TRUE ECONOMIC POTENTIAL

LIGHT INDUSTRY/AGRO-INDUSTRY CLUSTER STRATEGY

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I. INTRODUCTION AND EXECUTIVE SUMMARY

This report presents the findings and recommendations of a two-phased initiative designed to promote accelerated and sustainable economic growth in Lebanon. The initiative is being sponsored by the U.S. Agency for International Development Mission in Lebanon (USAID/Lebanon). The first phase consisted of a diagnostic assessment of Lebanon's economic conditions, constraints and opportunities, aimed primarily at identifying needs to be addressed during the second phase of the initiative. A key emphasis of the inquiry was placed on Lebanon's economic and commercial policies.

The second phase has been the preparation of industry "cluster" development plans for three sets of activities that offer strong growth potential in Lebanon: (1) tourism; (2) regional financial and business services; and (3) light industry and agro-industry. These cluster strategies have been prepared over the past few months by working groups with both private sector and public sector participation. The purposes of this report are to summarize an assessment of Lebanon's overall economic performance and policy framework, and articulate an initiative aimed at stimulating productive economic activities in Lebanon.

The overall project has been carried out by SRI International, in collaboration with Lebanese American University. SRI International, formerly known as Stanford Research Institute, is one of the largest non-profit research and consulting organizations in the United States, and is a leader in the field of economic development and industry cluster growth strategies.

SRI and LAU would like to express our gratitude to the large number of government and private sector leaders who have contributed to this initiative by providing valuable insights and candid viewpoints on Lebanon's economic needs and prospects. We especially thank the industry cluster working group members, who have offered a substantial amount of time and effort to help their country by crafting imaginative programs to catalyze renewed growth in Lebanon.

Over the course of this project, our joint SRI/LAU team has encountered what we believe is an unprecedented level of interest and support for this endeavor. There is a unique consensus among both public and private leaders not only on the diagnosis of Lebanon's economic needs and opportunities, but also on the imperative for a set of concrete, growth-oriented initiatives. No one should underestimate the economic challenges facing Lebanon's economy. Nevertheless, this degree of consensus and good will bodes well for the comprehensive nation building that is now under way in Lebanon.

Domestic Economic Performance

Lebanon's economic performance, prospects and policy strategies can only be understood in the context of the protracted, debilitating war the nation experienced and from which it is now emerging. Accordingly, the nation's recent experience can best be described in terms of three time periods: The pre-war era, the war years, and the post-war period of recovery.

Despite occasional disturbances, the pre-war economy achieved solid economic growth and rising incomes over the period between 1950 and 1975. Economic growth was robust, averaging 6 percent in real terms. In the mid-1970s, Lebanon was considered a middle-income country. Per capita income was estimated in 1974, approaching that of Portugal and about three times the levels prevailing in Egypt or Jordan. Lebanon was the thriving regional finance and trade center, and was a major tourist destination. It was the only significant model for market oriented, private sector-led growth in the region.

The impact of the 15-year war in Lebanon was devastating. Much of the nation's infrastructure was virtually destroyed. Many of the country's residents fled to other nations. Those that remained were forced to concentrate on personal security and economic survival. The ultimate impact was a continuous downward spiral of economic activities.

The recovery years of the 1990s have witnessed great strides in reconstruction, a return to social and economic order, and the re-emergence of productive ventures. A significant share of growth has been directly associated with reconstruction, however, insufficient attention has been placed on "export oriented" activities. As a result, the initial construction-driven boom has reached a plateau, and concerns over macroeconomic stability have given rise to a widespread sense of caution and even pessimism.

International Economic Performance

Lebanon historically has been a service economy, importing more goods than it exports, and covering its trade deficit with surpluses in its services and capital accounts. The country has run overall balance of payments deficits only twice in the past twenty years. But now under the pressure of heavy expenditures for reconstruction and the general rebuilding of the economy, the merchandise trade deficit has grown to tremendous proportions for a small economy like Lebanon.

Lebanon depends heavily in inflows of capital and remittances. In recent years, capital inflows have been directed to investments in real estate and in portfolio instruments. The latter have been encouraged by high real interest rates created by the government's tight monetary policy. The growing concern is whether capital can continue to be attracted in view of the rapidly rising indebtedness of the government, which has financed chronic and growing fiscal deficits with the issuance of government securities.

The Macroeconomic Policy Framework

Lebanon's senior economic management team is sophisticated by both regional and international standards, and strongly supports appropriate policy principles.

Policy makers embrace the desirability of private sector-led growth, and voice a common view against government intervention in the economy. These leaders are supported by a widespread national consensus in favor of market forces and private enterprise. Notwithstanding disagreements in other areas, the degree of unanimity on long-term economic policy is unique, and represents a strength upon which Lebanon can build an effective, unifying strategy.

The nation's fundamental dilemma regarding macroeconomic policy stems from the need to rebuild the economy and at the same time maintain socio-political stability, which implies high government expenditures, despite the fact that Lebanon's productive sectors are not yet ready to finance the fiscal burden through tax revenues. This in turn gives rise to concerns over the pace of reconstruction and the levels of government-provided employment and services. Once again it was the war that has created this dilemma.

There is a growing consensus in Lebanon that continued large government deficits are unsustainable. The danger is that if uncorrected, Lebanon's ability to attract increasing amounts of foreign capital inflows may prove inadequate to cover the deficit, leading to a crisis of confidence, capital flight, and a difficult "hard landing" for the economy. Proposed solutions focus on both increasing revenues and reducing expenditures.

The Commercial Policy Framework

The project team began this assessment by examining Lebanon according to the Commercial Policy Model developed by SRI International. This model provides for the "scoring" of commercial policies in nine categories: Import, Export, and Tax Policies, Investment Incentives, Foreign Investment Restrictions, Business Start-Up Procedures, Pricing and Interest Policies, the Foreign Exchange System, and Labor Policies. Once scored with values ranging between 0 and 100, countries can then be compared to regional competitors and international best practices.

Lebanon scores high on its commercial policies, achieving a score of 81 (the highest global score is 92 held by Singapore). Lebanon offers the best commercial policy environment among the regional countries used as benchmarks (Bahrain, Cyprus, Egypt, Jordan, Morocco, and Tunisia). Jordan was the closest competitor with a score of 77. Lebanon performs well in tax, export, import, foreign exchange and labor policies in relation to its regional competitors. The major general policy problem to be addressed is the need to improve business start-up procedures. However, particular policy-induced constraints were identified in each of the industry clusters included in this initiative.

Unique Factors Affecting Lebanon's Economic Strategy

Any strategy designed to stimulate a nation's productive economic activities should be based on the country's actual conditions, opportunities and constraints. Many patterns of environmental factors and performance can be held in common by a number of countries, and individual conditions can be similar to those experienced in other countries. Nevertheless, each nation is unique and faces a singular blend of economic, social and political factors that collectively determine its economic prospects. Accordingly, each requires its own tailored approach to fit its particular circumstances.

Lebanon is unique, and displays a number of special factors or "drivers" that need to be taken into consideration in the design and implementation of an effective economic strategy. These include both constraints that need to be addressed and opportunities upon which a plan should capitalize.

Constraint Drivers

Externally-imposed political risk

The cost of physical reconstruction

The need to modernize "soft" infrastructure

The small size of the market

Lack of consensus on Lebanon's economic future

The high cost of capital driven by high deficits

Opportunity Drivers

The stable macroeconomic situation in Lebanon

The pro-market orientation of the government and people

The heritage of entrepreneurship

The Lebanese "Diaspora" (overseas Lebanese community)

Economic Growth Balance Sheet

While economic and commercial policies form the critically important environment for productive activities, a nation's economic performance is affected strongly by its various endowments of resource inputs, which collectively determine its comparative advantage. Equally important is the ability of economic actors to enhance their country's resource strengths and overcome resource constraints -- essentially transforming comparative advantage into competitive advantage. One way to gauge an economy's overall strengths and weaknesses is to prepare a "balance sheet assessment." Simply stated, this technique identifies both "assets" and "liabilities" in key input areas, such as natural resources, labor, capital, infrastructure, and so forth.

In broad terms, Lebanon's most important economic asset is its labor force, which is highly educated and motivated. Offsetting this strength, however, is the relatively high cost of labor at all levels, at least in relation to regional competitors. Lebanon has little in the way of natural resources except its moderate agricultural capacity and water supplies, and its regional location.

Lebanon is by regional standards strong in capital resources (both availability of capital and sophistication of the financial markets), but investment is stymied by high interest rates. The nation's technology base is generally an asset, but many industries require significant investments in new technologies in order to enhance their competitiveness. Finally, the infrastructure base remains weak due to war damage, but is recovering rapidly. Overall, Lebanon's economic balance sheet suggests that the nation should concentrate on the production and sale of high value, "niche" goods and services.

Proposed Economic Growth Strategy and Initiative

During the course of the investigation, it became increasingly clear that the substantive scope of phase two of this initiative should focus on efforts to stimulate productive activities and investments in industries with major growth potential. This conclusion is based on the following considerations:

1. Lebanon's **macroeconomic strategy** is clearly known, and the level of sophistication of the country's economic management team is high. While there is a strong need to address the growing macroeconomic imbalances, as noted above, a major USAID-sponsored activity to deal with macroeconomic policy is not necessary. The appropriate approach would be to provide technical expertise to the government to explore the merits, costs and benefits of alternative options for achieving macroeconomic balance.

2. The majority of Lebanon's **commercial policies** - those forming the environment in which private sector firms operate - are essentially sound. In fact, they are among the most "market friendly" in the region. To be sure, a number of important commercial policy impediments remain in place, and some have been identified in this report. Nevertheless, any initiative directly solely toward improving commercial policies would not be productive. In view of Lebanon's unique circumstances, it would be more useful to address the issue of commercial policy constraints within the context of constraints facing productive enterprise in growth-oriented industries.

3. A key constraint to new investments in productive activities can be summarized as **lack of confidence and direction**. This can be attributed in part to factors (e.g., regional political uncertainty, growing deficits and indebtedness) which are beyond the control of businesses, but also to a lack of consensus on a vision for the economy and hence insufficient investment in modernization in many industries.

Based on these considerations, it was decided to organize the second phase activities around the concept of "industry cluster" strategies. Industry cluster initiatives provide a powerful framework for economic development strategies. They capture economic relationships within specific industry sub-sectors, and provide a set of tools to design and implement effective development strategies.

Industry clusters are attracted to or grow within specific regions or nations. They rely on an active set of relationships among themselves to ensure individual and collective efficiency and competitiveness. They are linked and held together by buyer-supplier relationships (forward and backward linkages), competitor relationships, common customers, flows of factors (labor, technology, capital) between firms, and other factors such as the increasingly important role of service providers.

Phase two thus consisted of the preparation of three industry cluster strategies, one each for **light industry and agro-industry**, **regional business services**, and **tourism**. Each of these clusters fits Lebanon's economic assets and is important to the future of the economy. Small working groups were established for each industry cluster. The working groups included participants from the private sector, government and academia. Participants were selected as individuals who have a strong knowledge and understanding of their respective industry cluster and the conditions it faces, demonstrate a commitment to overall Lebanese economic growth (beyond that of their agency, association or firm), and display a willingness to collaborate with their fellow participants on an objective basis.

The next chapter of this report summarizes the results of the overall diagnostic assessment of Lebanon's economic performance and needs. This is followed by a brief description of the power and process of industry cluster strategies. The remainder of the report (Chapter IV) is devoted to presenting the findings and proposed action plans of one of the industry clusters. The first section of this chapter examines the current status of the cluster. The next section analyzes the cluster's strengths, weaknesses, opportunities and threats. The final section presents the cluster growth initiatives identified by the working group.